



**PRODUCTIVITY COMMISSION INQUIRY
INTO
TASMANIAN FREIGHT
ASSISTANCE ARRANGEMENTS**

**Initial Rejoinder Submission
11 October 2006**

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M-Strad Reference 0604TFESAP

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EXECUTIVE SUMMARY

Through this Initial Rejoinder Submission, Australian Paper is adding to its previous tabled confidential submission to the Productivity Commission's inquiry into Tasmanian Freight Assistance Arrangements. These supplementary comments reflect concerns with the Commission's draft report of 8 September 2006.

Rationale for TFES

While the Productivity Commission recognises that a disadvantage exists in the absence of a rationale there is uncertainty regarding the Tasmanian Freight Equalisation Scheme's efficacy and suggests the Scheme should be phased out. While acknowledging the benefits of having a clearly defined rationale, Australian Paper regards the guidance provided by the Department of Transport and Regional Services web site as providing clear direction.

*"The Scheme assists in alleviating the comparative interstate freight cost disadvantage incurred by shippers of eligible non-bulk goods carried between Tasmania and the mainland. Its objective is to provide Tasmanian industries with equal opportunities to compete in mainland markets, recognising that, unlike their mainland counterparts, Tasmanian shippers do not have the option of transporting goods interstate by road or rail."*¹

TFES is based on principles founded in social and state equity and the scheme remains as pertinent and current today as when the scheme was established. TFES reflects continuing inequities in market access resulting from Government policies and investment in transport infrastructure on the Australian mainland. A key strength of TFES is that it targets a discrete and continuing disadvantage associated with this inequity.

The absence of a clearly enunciated rationale does not provide a legitimate reason for recommending the phasing out of current arrangements.

Benefit Assessment

The Productivity Commission appears to have largely based its assessment of the benefit of TFES on modelling undertaken by Monash University on behalf of the Tasmanian Government. However, the model's results are inconsistent with evidence provided by a range of industries and the Productivity Commission has itself challenged elements of the findings.

Australian Paper's concerns with the assessment of benefit are:

- The appropriateness of running the base model in a 'closed' form assuming that long run reductions in Tasmanian economic activity will be balanced by commensurate increase in economic activity elsewhere in Australia;
- The suggestion that elasticities of substitution used in the model are generous while many major assistance recipients

¹ Department of Transport and Regional Services, <http://www.dotars.gov.au/transport/programs/maritime/tasmanian/index.aspx>, 9 June 2006

produce products that are largely generic in nature and highly sensitive to price competition, especially from international suppliers;

- The observation that the lack of a competitive Bass Strait shipping market and the interstate/foreign ownership will reduce the estimated benefits flowing to Tasmania without commensurate recognition and quantification of the benefits flowing to the mainland;
- The claim that mainland producers lose out to Tasmanian competitors because of directional imbalance in assistance payments. There is no evidentiary support for this position and compelling evidence, previously supplied, which demonstrates that production from Australian Paper's Tasmanian facilities is not transferable to the mainland and importantly, that the demand flowing from reduced production would be met through international imports;
- The suggested TFES related employment impacts, both sectoral and in aggregate, are underestimated.

The veracity and robustness of the estimated impacts, especially as they relate to employment, import substitution and consequent aggregate economic impact need to be tested with the industries that are most directly affected.

Quantification of Sea Freight Cost Disadvantage

There are varying perceptions regarding the relative movement of sea and land freight rates in recent times, and Australian Paper has previously provided confidential evidence in this regard. However, the underlying issue is not the direction of movement but calculation of actual disadvantage. In this regard the Productivity Commission has received evidence suggesting that even after receiving assistance "...there is still a disadvantage, varying generally from 3 to 20 per cent although some goods face higher disadvantages."²

Quantification of the sea freight cost disadvantage is vital to assessing the effectiveness of the current and any proposed alternative mechanisms.

Assistance Mechanisms

While there may be conjecture regarding the underpinning rationale, the assistance calculation mechanism was developed to address a specific issue; the sea freight cost disadvantage. The merits of any alternative proposal should be assessed against its capacity to address and remove this distortion while subscribing to principles such as certainty, responsiveness to changing circumstances, relative simplicity, sending the right market signals regarding economic efficiency etc.

In this context, any proposed alternatives for remedying this distortion should also be compared with the current parameter based mechanism.

² Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. 32

The assumption that assistance should be linked to the relative freight cost disadvantage naturally calls for a variable assistance mechanism based on actual disadvantage incurred.

A “flat rate” approach, while administratively attractive, does not meet the fundamental test of being linked to the relative sea freight cost disadvantage and is not supported as the basic platform for calculating and delivering freight assistance.

Australian Paper recognises the concerns expressed by the Productivity Commission regarding the extent to which the current calculation parameters reflect actual practice and the apparent volatility of past estimates. Annual incremental changes and refinement of the parameters was recommended by the TFES Review Authority in 1998. The absence of adjustments since the current assistance calculation mechanism was introduced is progressively undermining the robustness of the scheme.

There is a pressing need to institute the annual adjustment process as originally envisaged by the TFES Review Authority. Australian Paper strongly supports the industry recommendation that a framework be developed for this process. This would identify and explain the methodology to be employed in adjusting the parameters, the supporting data requirements and how they might be collected and determine the annual date on which the adjustment would be implemented.

Importantly it would aid in accurately measuring the sea freight cost disadvantage that is essential to any comparative evaluation of alternative assistance mechanisms.

Australian Paper regards rorting in any form as unacceptable. In particular, assistance recipients who seek out and/or provide distorted wharf-to-wharf invoices in the interests of seeking overcompensation³ should be penalised. It is expected that the consultative process for developing the parameter framework would also potentially identify parameter based measures to identify any potential rorting.

The Tasmanian Freight Equalisation Scheme is as relevant today, if not more relevant, as when it was first implemented. In an environment that has seen the emergence of highly competitive global markets and a focus on productivity and performance improvements for Australian land transport networks, TFES is crucial to the equitable participation of Australian Paper in the Australian sector of the global paper market.

Australian Paper looks forward to working with the Productivity Commission in an effort to more accurately and realistically identify the true benefits of TFES and to assist it in assessing any alternative concepts or enhancements to the existing mechanism for calculating assistance levels.

³ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.58

INTRODUCTION

Australian Paper has reviewed the Productivity Commission's Draft Report of its Inquiry into Tasmanian Freight Assistance Arrangements released on 8th September 2006 and has identified some serious concerns regarding the nature of the findings and proposals presented.

Australian Paper's initial concerns emanate in four key areas:

1. The rationale underpinning the Tasmanian Freight Equalisation Scheme and extent to which this has been developed and provided guidance for the Productivity Commission;
2. The manner in which the continuing benefits as well as the cost of the TFES were assessed;
3. The quantification and calculation of the comparative freight cost disadvantage experienced by shippers eligible for TFES assistance; and
4. A discussion of mechanisms for delivering assistance and the relevant parameters of the current arrangements.

The Productivity Commission has provided opportunity for comment on its draft report in writing or by attending the public hearings. The mechanism for providing comment requests that where a submission is to be presented at a public hearing (to be held over the period 17 to 20 October 2006) the Productivity Commission has requested that these be received by the Commission by 11 October 2006 with all other submissions to be received by 27 October 2006.

Through this Initial Rejoinder Submission, Australian Paper is adding to its previous tabled submission and looks forward to expanding on this rejoinder submission through the public hearing process.

A final submission will be lodged with the Productivity Commission by 27 October 2006.

1. RATIONALE UNDERPINNING TFES

In its draft report the Productivity Commission recognised that “...the cost of shipping a container across Bass Strait can be more than double the cost of road transport for a similar distance on the mainland.” However, the Productivity Commission suggests that “...there is no economic rationale for providing freight assistance to Tasmanian firms simply to equalise their freight costs with mainland producers” and that “if a broader objective of regional development is intended, a sea freight subsidy is unlikely to be the most economically efficient way of meeting this.”⁴

While Australian Paper acknowledges that a clearly defined rationale would more readily facilitate the Productivity Commission’s deliberations regarding the Tasmanian Freight Equalisation Scheme, it is clear that there are some statements which can be drawn on to provide guidance. In particular the Department of Transport and Regional Services provides the following statement regarding TFES:

“The Scheme assists in alleviating the comparative interstate freight cost disadvantage incurred by shippers of eligible non-bulk goods carried between Tasmania and the mainland. Its objective is to provide Tasmanian industries with equal opportunities to compete in mainland markets, recognising that, unlike their mainland counterparts, Tasmanian shippers do not have the option of transporting goods interstate by road or rail.”⁵

From this statement it is clearly apparent that TFES is a mechanism that contributes to equity for Tasmanian industries competing in the national economy. “The rationale for its existence is the requirement that all Australian States be treated equitably with respect to accessing the benefits of interstate trade.”⁶ Arguably the underlying impetus for establishing the Scheme can be attributed to the level of past investment in interstate transport infrastructure by successive Commonwealth Governments, current policies impacting on the efficiencies of maritime coastal shipping and even actions such as the recent endorsing of a reduction in the level of competition in coastal shipping between the Australian mainland and Tasmania. It can even be argued that the foundation stones on which TFES is based are principles founded in social and state equity.

That other states and territories also suffer degrees of freight cost disadvantage is readily acknowledged but the Productivity Commission’s attention is drawn to the preceding discussion regarding rationale. TFES is not based around compensation for remoteness and distance from markets (beyond the intrinsic requirement that transport implies carriage between two points) rather it is a reflection of inequities in access and the development and investment that has occurred in transport infrastructure.

⁴ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. XII

⁵ Department of Transport and Regional Services, <http://www.dotars.gov.au/transport/programs/maritime/tasmanian/index.aspx>, 9 June 2006

⁶ Australian Paper, Productivity Commission Inquiry into Tasmanian Freight Assistance Arrangements Confidential Submission; June 2006 p.2

It is of considerable concern that the Productivity Commission has recognised that there “... *remains scope to further improve the pricing and regulatory regimes that apply to transport infrastructure*”⁷ but then suggests that it is “... *better to continue to address directly those policies that create distortions ...*” in preference to targeted assistance. While it is readily acknowledged that “... *a review of cabotage is clearly beyond the scope of this inquiry*”⁸ it is perceived that the presence of such policy initiatives underpins the equity concerns that TFES addresses. The Productivity Commission’s attention is drawn to the recurring attempts to reform the maritime sector which have met with limited success and the concurrent success of reforms in standardising the interstate rail network and improvements in road infrastructure. In the absence of uniform and concurrent success in regulatory reform and infrastructure investments that deliver efficiency dividends, it is appropriate that those being disadvantaged be assisted. Australian Paper looks forward to the day when such distortions can be removed but it refutes the implied assertion that Tasmanian shippers should carry the cost for some indeterminate period until they are corrected.

The Productivity Commission has asserted that assistance targeted at offsetting “... *disadvantage in one input - in this case sea freight - is unlikely to be the most economically efficient approach to meeting regional development objectives*”⁹ and also suggests on this basis that if this is the objective “... *then a more targeted program may be warranted.*” TFES is a program targeting a discrete disadvantage that is not incurred across all economic activity within Tasmania. Notwithstanding the absence of a rationale for the scheme that addresses the desires of the Productivity Commission, the targeted nature of freight assistance in offsetting a very specific anomaly associated with inequity has always been regarded as a key strength of the existing approach.

It can also be implied from comments that “... *TFES reflects and earlier era’s approach to industry assistance*” and “... *at a time when such ad hoc assistance was widespread*” that there are no significant market failure arguments that can be brought to bear and the “... *focus on undertaking economy-wide reforms ...*”¹⁰ is a preferable approach. In response it is suggested that the targeted nature of the scheme can be regarded as addressing a significant and specific failure but rather than being a market failure, it is the failure or inability of Government policy to institute reform with equitable impact across different modes. The continuation of the TFES program, rather than being a legacy from an earlier approach, reflects the recognition 30 years ago of an anomaly between the treatment of states which subsequent policy movements and adjustments have not remedied.

⁷ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. XIX

⁸ Ibid., p.37

⁹ Ibid., p. XX

¹⁰ Ibid., p. XX

That the subsidy is only “... *directed at producers of eligible non-bulk goods ...*” while the “... *freight cost disadvantage affects all goods ... transported in either direction ...*”¹¹ is an interesting observation but is only meaningful to the extent that there is an additional requirement for an extension to the rationale to include the impacts on the eligibility criteria.

While the Productivity Commission was to “... *provide recommendations on an appropriate future approach and/or arrangements*” it is clear an absence of a clearly enunciated rationale should not in itself be a reason for recommending the current arrangements be phased out.

¹¹ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. XVII

2. BENEFITS ASSESSMENT

The Productivity Commission has categorically stated that “*The benefit to Tasmania comes largely at the expense of activity elsewhere in Australia and at a net cost to Australia overall.*”¹² The Productivity Commission’s legislative guidelines require it “... to encourage the development of efficient and internationally competitive Australian industries...” and “... to improve the productivity and economic performance of the economy” while taking into account “... the impacts of policies on the Australian community as a whole.”

Given this ‘charter’, it is of concern that in evaluating the impact of TFES to the Tasmanian economy and on Australia overall there is little evidence of original research having been undertaken by the Productivity Commission. Indeed there appears to be reliance on work the Tasmanian Government commissioned using the Centre of Policy Studies at Monash University, the applicability and accuracy of which has been questioned by many sectors of Tasmanian industry.

While Australian Paper is not calling into question the Monash Multi-Regional Forecasting (MMRF) model as an instrument for determining economy wide impacts, it is of extreme concern that the model’s results are on the one hand discounted by the Productivity Commission as being an “upper estimate” while on the other, practical evidence suggests that the estimates are a gross understatement.

These concerns are broadly grouped into the assumptions regarding the ‘closed’ nature of the model, estimates of the elasticity of substitution, other modelling assumptions and conflicts with practical evidence provided by industry.

2.1 ‘Closed’ nature of the MMRF

The MMRF is a computable general equilibrium model with a range of variables that can be adjusted in accordance with clients’ perceived requirements. In assessing the impact of TFES the model is understood to have been closed on the assumption that in the long run a change in Tasmanian economic activity will be balanced by a commensurate increase in economic activity elsewhere in Australia. Australian Paper views the consequent model output as providing an inappropriate basis for assessing the impact of TFES.

In the MMRF output provided it is assumed that TFES does not (can not) effectively alter the level of Australia’s balance of trade. The Australian government is assumed to have a target for external liabilities and will adjust macroeconomic settings accordingly to maintain equilibrium. However, to appropriately assess an industry assistance program such as TFES, a closed system will

¹² Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.41

underestimate the impact on industries that operate in a globally competitive market and will not point to the underlying changes and investment required to maintain equilibrium.

MMRF contains detailed equations relating to domestic/import substitution by each regional user. The model is limited in its ability to recognise that some products can not be produced in states outside Tasmania. To capture this idea would require suitable disaggregation of the respective industries and the Productivity Commission is requested to take this into account in any consideration of the model's findings.

2.2 Elasticities of Substitution

The Productivity Commission suggests that the MMRF estimates are generous because of a perception that the elasticities of substitution are lower than the standard assumptions used. This position is based on "... a degree of product differentiation based on its Tasmanian origin and associated brand recognition."¹³

Australian Paper regards this suggestion as being of particular concern as, in keeping with many major industry assistance recipients; it provides products that are subject to extremely high levels of substitution. Products such as paper, newsprint, vegetables (fresh, frozen and chilled), timber etc. are largely generic in nature and highly sensitive to price competition especially from international suppliers.

However, while the elasticity of substitution is high, the 'closed' nature of the economy appears to simultaneously suggest an overstating of the potential cost to the mainland economy.

2.3 Other Modelling Assumptions

The Productivity Commission has raised the key issue that the lack of a Bass Strait competitive shipping market has a consequence of limiting the extent of benefits claimed as flowing to Tasmania.¹⁴ Recognition that the Bass Strait shipping market is much less than fully competitive is a position strongly supported and advocated by Australian Paper.

However, while the Productivity Commission has recognised that not all shipping benefits will flow to Tasmania, the commensurate increase in benefits to the mainland also needs recognition. It behoves the Productivity Commission to quantify the significance of such impacts and the extent to which it diminishes/eliminates the argument that the Tasmanian benefit is at the expense of the rest of Australia.

In a similar manner the observation that TFES recipients are wholly or partly owned by mainland or foreign nationals with the attendant

¹³ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. 52

¹⁴ Ibid., p. 52

flow of profits away from Tasmania¹⁵ also needs to be addressed. The extent of any benefits of ownership flowing to the mainland needs quantification in the same manner as the change in benefit flows resulting from a less than competitive shipping market.

2.4 Conflicts Practical Evidence Provided by Industry

It is also of concern that the Productivity Commission has included commentary that “Overall, however, mainland producers collectively lose, as the market advantage for Tasmanian competitors from the northbound element of the TFES is greater than the advantage to mainland businesses from the southbound element”¹⁶ (emphasis added). This implies that the market advantage correlates with the relative directional imbalance in assistance payments.

By implications this suggests that if the eligibility criteria were broadened to include more southbound freight this relative disadvantage would disappear.

The use of the word “lose” also suggests that there is an advantage or opportunity foregone by mainland businesses as a consequence of TFES assistance to Bass Strait shippers. The Productivity Commission has suggested that this is because the gains to activity in Tasmania are “... *estimated to come at the expense of activity elsewhere in Australia and at a small net cost overall.*” However, there is compelling evidence, that Australian Paper has previously supplied, which demonstrates that production from its Tasmanian facilities is not transferable to the mainland and any reduction would be met through additional international imports. This is also the case for a significant number of other manufacturers.

The Productivity Commission cited a number of submissions detailing the significant adverse impacts should TFES assistance be withdrawn. However, it subsequently suggests that some caution needs to be placed on the treatment of these predictions. In particular, quotes such as “*Many participants provided calculations showing that event with TFES, their freight costs are still higher than mainland competitors. Yet, their Tasmanian product is competitive – often as a result of specific cost advantages and/or the development and servicing of niche markets or seasonal production.*”¹⁷ That companies are able to survive in spite of higher costs should not be taken as some basis for caution regarding their claims of competitive position.

While Australian Paper operates in a highly competitive market, the critical determinant is not whether the freight rate in absolute terms is higher or lower than a competitor, rather it is a question of whether

¹⁵ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. 52

¹⁶ Ibid., p. 51

¹⁷ Ibid., p. 45

the final sale price remains competitive. In providing an equitable access to transport across Bass Strait Australian Paper is able to compete on an equal footing in mainland markets. The development of niche markets, seasonal production, continuous improvement in production efficiency etc. all demonstrate that producers such as Australian Paper are actively pursuing every opportunity and vestige for cost reductions. They should not be treated as a cause for underestimating the significance of each dollar of TFES assistance.

The Productivity Commission's Draft Report draws on the output of the MMRF to highlight that "... *TFES may have increased overall Tasmanian ... employment by about 2 percent (... 4000 jobs).*"¹⁸ A cursory investigation of selected TFES recipients suggests that this estimate considerably understates TFES's significance to employment in Tasmania. A sampling of assistance recipients suggests that the direct employment in TFES assisted companies is likely to be in excess of 6,000 with an additional 21,000 plus full-time jobs depending on the operation of these companies. Given this understatement and the globally competitive environment in which many of the employers operate; Australian Paper believes that the estimated employment impacts are grossly understated.

It concerns Australian Paper that the veracity and robustness of the estimated impacts, especially as they relate to employment, import substitution and consequent aggregate economic impact have not been tested with the industries that are most directly affected.

Australian Paper offers to work cooperatively and constructively with the Productivity Commission to support the development of a sound foundation that reflects actual practice as a basis for any recommendations.

¹⁸ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. 50

3. QUANTIFICATION OF SEA FREIGHT COST DISADVANTAGE

The Productivity Commission's Terms of Reference are explicit in the need to 5b "*quantify any comparative freight cost disadvantage*" and 5c "*assess the effectiveness of the current scheme arrangements as a mechanism for addressing any freight cost disadvantage.*" It is acknowledged that the accurate undertaking of this aspect of the Productivity Commission's brief is particularly complex and **Australian Paper retenders its confidential submission and, in particular, Section 5: Calculation of Assistance with the following supplementary comments and observations.**

In drawing conclusions in relation to the Draft Report of the Productivity Commission, Australian Paper is limited in its analysis to the nature of data contained therein and this approach has intrinsic risks of over/underestimating the full impacts. However, it is important that the Productivity Commission, in meeting its obligation to quantify the freight cost disadvantage, make an accurate assessment of current shipper behaviour together with conclusions regarding the level of entitlement, eligibility etc.

In its examination of the trends in freight rates the Productivity Commission provides the comment that "*in contrast to the reductions in Bass Strait shipping rates, the reduction in road freight rates has been modest*" and that "*the difference between rates has declined over time.*"¹⁹ At first glance this implies that there has been a diminution in the level of disadvantage although the Productivity Commission has recognised that most of this decline has occurred during the 1980's.

It is observed that the current arrangements for calculating assistance were developed in 1997/98 and implemented in 1999. As highlighted in its June submission "*there has been the widespread adoption of higher productivity vehicles and the introduction of mass management schemes which return a productivity dividend for improved regulatory and safety compliance.*"²⁰ In Australian Paper's experience, the rate of change in these road transport productivity improvements and the consequent effective freight rates have matched and outstripped the decline in effective sea freight rates.

The Tasmanian Freight Equalisation Scheme is a highly targeted assistance program and it is suggested that the application of broad historical trends that precede the current framework for calculating assistance is likely to result in erroneous conclusions regarding the general trends in relevant sea freight cost disadvantage.

The underlying issue is not the direction of movement but calculation of actual disadvantage. In this regard the Productivity Commission has received evidence suggesting that even after receiving

¹⁹ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.26

²⁰ Ibid., p.12

assistance “...*there is still a disadvantage, varying generally from 3 to 20 per cent although some goods face higher disadvantages.*”²¹

Quantification of the sea freight cost disadvantage is vital to assessing the effectiveness of the current and any proposed alternative mechanisms.

²¹ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p. 32

4. ASSISTANCE MECHANISMS

As a precursor to the discussion of alternative assistance mechanisms, Australian Paper has reviewed the assessment of the existing scheme's design undertaken by the Productivity Commission.

Australian Paper agrees with the Productivity Commission that *“the view that it is possible to compensate shippers for a notional sea freight cost disadvantage without distortionary consequences is found to be flawed.”*²² It is unclear who has expressed this view but it is acknowledged that any intervention in the market will by its nature have a distortionary impact. Consequently the issues are the magnitude of the distortion, whether the distortion is material in the context of addressing the program objectives and whether the concerns are appropriate.

It is recalled that while there may be conjecture regarding the underpinning rationale, the assistance calculation mechanism was developed to address a specific issue; the sea freight cost disadvantage. The merits of any alternative proposal should be assessed against its capacity to address and remove **this distortion** to the competitive market place while subscribing to principles such as certainty, responsiveness to changing circumstances, relative simplicity, sending the right market signals regarding economic efficiency etc. It also needs to be cognisant of where power resides in the marketplace as far as the determining of freight rates and the possible behaviour of market participants.

In this context, any proposed alternatives for remedying this distortion should be compared with the current parameter based mechanism. This underpinning assumption that TFES assistance should be linked to the relative freight cost disadvantage calls for a variable assistance mechanism based on actual disadvantage incurred.

A “flat rate” approach, while administratively attractive, does not meet the fundamental test of being linked to the relative sea freight cost disadvantage and is not supported as the basic platform for calculating and delivering freight assistance.

A “flat rate” assistance approach is only supported as an optional mechanism for delivering assistance in relation to LCL shipments and for smaller shippers who find the current approach administratively onerous.

However, Australian Paper also recognises the concerns the Productivity Commission has expressed regarding the extent to which the current calculation parameters reflect actual practice and the apparent volatility of past estimates which have not been implemented.

²² Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.26

4.1 Parameters

4.1.1 Road Freight Equivalent cost

In its draft report the Productivity Commission observes that there is “... *considerable imprecision in the benchmarks used ...*” and that “... *it is not practical to estimate a notional road freight equivalent cost for each shipping task.*”²³ These program implementation issues are acknowledged. However, it is apparent that there remains scope for refining and clarifying the basis on which the applicable Road Freight Equivalent (RFE) is calculated.

In particular it is apparent that the basis of determining the RFE should be the marginal cost of transporting freight by road over a comparable distance which is equal to the wharf-gate to wharf-gate sea freight component. It is also evident that the major recipients of TFES assistance operate significant mainland interstate freight operations. This provides a uniquely accurate basis for ensuring internal consistency in the development of an appropriate RFE. Major shippers are well placed to provide an accurate assessment of the marginal tonne kilometre freight rate for their product and what this would equate to given the stowage characteristics of the Bass Strait freight movements.

An RFE parameter developed external to such a process is more likely to result in an assessment error and result in the calculation of inappropriate levels of assistance.

4.1.2 Door-to-wharf/wharf-to-door adjustments

The validity of the Productivity Commission’s observation regarding the potential for shippers to misuse the fixed deduction for door-to-wharf and wharf-to-door is acknowledged.

However, Draft Finding 5.2 that the incentive to use a fixed land freight cost estimate to advantage “... *cannot be eliminated within the current design of the TFES*”²⁴ is rejected.

It is observed that the effectiveness of the current model for calculating assistance was predicated on the need for annual adjustments to ensure its currency and that adjustment ‘shocks’ are minimised. In addition, the progressive implementation of adjustments to parameters such as the door-to-wharf amount would have progressively encouraged shippers to move to a wharf-to-wharf basis for claiming and discouraged claim-maximising behaviour. This concept is explained below:

²³ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.55

²⁴ *Ibid.*, p.63

The current door-to-wharf adjustment factor of \$230 was determined in 1997 by comparing the median door-to-door claim with the median wharf-to-wharf claim. Shippers with door-to-wharf costs of less than \$230 will naturally tend to maximise their claims and lodge these on a wharf-to-wharf basis. As these shippers leave the pool of wharf-to-wharf claimants, the median of remaining shippers will naturally increase. This is evidenced in the Productivity Commissions draft report which suggested a revised value of \$244 for the door-to-wharf factor in 2000. Had this rate been implemented, the incentive point for moving to wharf-to-wharf claiming would have risen and in subsequent years the incentive point would have slowly crept up and provided a natural and continuing incentive to move to wharf-to-wharf claiming.

It is conservatively estimated that a \$244 door-to-wharf adjustment factor, if implemented in isolation, would have returned a saving in the order of \$890,000 annually (based on current volumes) with further cumulative savings with each annual adjustment. Implementing the current parameter estimate of \$280 would have delivered annual savings in the order of \$1.78 million but more importantly would have progressively enhanced the scheme's integrity and addressed some of the criticisms being levied at the current methods of calculating assistance.

The Productivity Commission cites current BTRE estimates that the implementation of the 2002-03 parameters would have led to a small reduction in the order of \$1.3 million²⁵ but there is no consideration of the cumulative impacts that implementation might have had. It concerns Australian Paper that perceived estimation and data problems have constrained confidence in the findings but that no remedial action has been taken in this regard.

4.1.3 Route Scaling Factors

Australian Paper fully acknowledges the concerns expressed by the Productivity Commission regarding the use of route scaling factors. While the population of claims on specific routes may be small and the potential for variation in the scaling factors is large, the underlying consideration should be the extent to which these factors reflect actual practice.

In a similar manner, the variation that potentially creates competition at the borders should be addressed from the perspective of how well the mechanism addresses the identified disadvantage rather than the extent of competitiveness problems. Indeed it would seem that there is scope for this issue to be addressed relatively easily with either the requirement to lodge claims on a wharf-to-wharf basis and/or adjusting the catchments currently defined as Victoria and New South Wales.

4.1.4 Intermodal Cost Adjustment

Draft Finding 5.4 *"The intermodal cost allowance provides an incentive for shippers to seek wharf-to-wharf invoices that include as*

²⁵ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.16

many intermodal services as possible, to which the allowance is then added. This results in a higher TFES rebate.”²⁶

The TFES Review Authority in its 1998 report defined the wharf-gate to wharf-gate costs as the “... reported or notional blue water charges, container hire and wharfage...” To the extent that shippers seek artificially inflated invoices, the issue should be treated as rorting with remedial measures developed and implemented promptly.

4.1.5 The median wharf-to-wharf disadvantage

While the median wharf-to-wharf disadvantage has shown considerable volatility, Table 2.3²⁷ suggests that the median value has trended downwards. This would appear to imply that the incentive mechanism is effective and it is further observed that this downward trend was without any cumulative effect that might have been realised if the median value had been gradually adjusted in keeping with the original design intent of the scheme.

The progressive implementation of incremental changes was intended as a mechanism to avoid shocks (either down or up) and to facilitate longer term planning. In this regard, there may be scope for the introduction of a smoothing mechanism such as a 4 period moving average to ensure an incremental approach to adjustments.

The reported 40% increase in the median value using 2004-05 data is cause for some concern and the Productivity Commission’s clarification is sought as to what if any significant changes have occurred to the underlying pattern of freight rates. Certainly if there is no anomalous event/s that can be isolated, then there may be need for a review of the basis on which this parameter is determined.

4.1.6 Future Parameter Adjustments

The absence of any incremental adjustments has undermined the effectiveness of the incentive effects contained in the current assistance calculation mechanism and also generated the potential to realise a ‘shock’ adjustment which the annual adjustment process was intended to avoid.

It is apparent that avoidance of implementing these fine adjustments is partly attributable to a lack of confidence in the parameter estimates generated but also partly the perception that any adjustment would be of negligible impact. There is a pressing need to institute the annual adjustment process as originally envisaged by the TFES Review Authority.

It is apparent that with the benefit of a broadly understood adjustment methodology, industry would also be in a position to ensure that appropriate input data is able to be collected in a uniform manner on a continuous basis that would afford a robust annual

²⁶ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.65

²⁷ Ibid., p.16

adjustment cycle and alleviate 'confidence in parameter estimates' concerns.

Australian Paper strongly supports the industry recommendation that, *"in consultation with industry, a framework should be developed for the annual adjustment of assistance parameters. This framework would identify and explain the methodology to be employed in adjusting the parameters, the supporting data requirements and how they might be collected and determine the annual date on which the adjustment would be implemented."*²⁸

It is noted that the Productivity Commission considers "...rigorous parameter reviews should be conducted every five years..."²⁹

The TFES Review Authority identified that it is "...necessary to review and where significant change has occurred, adjust key parameters on an annual basis if the scheme is to remain a 'live' scheme."³⁰

Australian Paper supports this latter position as a way of ensuring that the correct signals are being sent to the market. In an environment where reviews are conducted quinquennially, producers and manufacturers will be inclined to delay investments late in the review cycle pending the outcome of reviews. In addition, the accumulated adjustment potential may lead to shocks in either upward or downward directions both of which are counterproductive from an industry planning perspective.

4.2 Rorting

Australian Paper regards rorting in any form as unacceptable. In particular, assistance recipients who seek out and/or provide distorted wharf-to-wharf invoices in the interests of seeking overcompensation³¹ should be penalised.

However, in assessing and designing remedial mechanisms to address rorting, consideration needs to be had for:

- the magnitude of the problem (how significant is it?); and
- the need to minimise any adverse impact on the claimants who are behaving within the spirit of the assistance program.

Consultation with industry is considered to be an essential part of any remedial mechanisms as participants in the program are likely to be able to best identify cost effective solutions to ensuring the spirit of the program is upheld.

²⁸ TFGA & TCCI, Productivity Commission Inquiry into Tasmanian Freight Assistance Arrangements, Submission; June 2006 p.26

²⁹ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.82

³⁰ TFES Review Authority, Advisory Opinion, 1998 p.2

³¹ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.58

5. CONCLUSION

The Department of Transport and Regional Services has provided good guidance as to the Australian Government's policy objectives for the Tasmanian Freight Equalisation Scheme program.

In particular the Department provides a very specific objective in terms of providing Tasmanian industries with equal opportunities to compete in mainland markets by assisting in alleviating the *comparative interstate freight cost disadvantage*.³²

Australian Paper strongly supports an approach to delivering freight assistance that is based on calculating the freight cost disadvantage. A 'flat rate' approach is regarded as being less than optimal in this regard.

In the absence of some clear measure of how well an alternative mechanism is estimated to perform against the stated program objective, the existing Tasmanian Freight Equalisation Scheme mechanism is strongly preferred.

However, Australian Paper does recognise the need for improved accuracy in the calculation of disadvantage and broadly supports initiatives such as the development with industry of a transparent framework for improving the quality of parameters used in calculating disadvantage.

Australian Paper regards rorting in any form as unacceptable. In particular, assistance recipients who seek out and/or provide distorted wharf-to-wharf invoices in the interests of seeking overcompensation³³ should be heavily penalised.

Australian Paper looks forward to continued involvement with the Productivity Commission's inquiry into Tasmanian Freight Assistance Arrangements and welcomes the opportunity to present this submission at the Public Hearings.

³² Department of Transport and Regional Services, <http://www.dotars.gov.au/transport/programs/maritime/tasmanian/index.aspx>, 9 June 2006

³³ Productivity Commission, Tasmanian Freight Subsidy Arrangements – Draft Report, Sept 2006, p.58