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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

DRAFT REPORT ON TASMANIAN FREIGHT SUBSIDY ARRANGEMENTS

PROF M. WOODS, Presiding Commissioner

TRANSCRIPT OF PROCEEDINGS

AT HOBART ON TUESDAY, 17 OCTOBER 2006, AT 10.03 AM

Continued from 25/09/06 in Canberra

PROF WOODS: Ladies and gentlemen, welcome to the Hobart public hearings of the Productivity Commission inquiry into Tasmanian Freight Subsidy Arrangements. I'm Mike Woods, I'm the presiding commissioner for this inquiry. As most of you will be aware, the commission released and issued a paper on this matter in April this year setting out the terms of reference and some initial issues for consideration. A draft report was released on 8 September.

The commission has met with a wide cross-section of people and organisations interested in this issue. We talked to groups from a diversity of backgrounds, listening to their experiences. We received a considerable number of submissions from interested parties. I would like to express our thanks and those of the staff for the courtesy extended to us in our travels and deliberations so far, and for the thoughtful contributions that so many have made already in the course of this inquiry. These hearings represent the next stage of the inquiry. There's an opportunity to submit any final submissions by 27 October. The final report will be signed by myself by 21 December.

I'd like these hearings to be conducted in a reasonably informal manner and remind all participants that a full transcript will be taken and made available to all interested parties. At the end of the scheduled hearings I'll provide an opportunity for any person present to make an unscheduled oral presentation should they wish to do so. I would like to welcome to the hearings our first participants, Major Tasmanian Manufacturers, presented by Mr David Quinn. Could you, please, for the record state your name, title and organisations that you are representing?

MR QUINN: Thank you. My name is David Quinn. I'm presenting today on behalf of the Major Tasmanian Manufacturers, refer page 10 of the Productivity Commission Report, and I have been engaged by the group as a consultant to present this joint submission.

PROF WOODS: Thank you very much. Would you like to make an opening presentation?

MR QUINN: Certainly. The issues that I'm going to be covering today are who are the major Tasmanian manufacturers, what is the economic contribution that they make to Tasmania each year. I couldn't let the prime minister's comments go unnoted, so I'll be commenting on the bipartisan federal state, liberal, labour support for the scheme and then moving very quickly onto how can we ensure that TFES is operating as intended for the benefit of all Tasmanians, and dare I say, all Australians as well. Finally, I'll be listing some industry commitments and their commitments to work with the Productivity Commission, commitments to work with government to enhance the operation of the current scheme.

Tasmania's major manufacturers, Norske Skog, Simplot Australia, Australian Paper, Cadbury Schweppes, J. Boag and Son, Cascade, McCain Foods. When the Productivity Commission's report was released at the start of the Tasmanian school holidays quite a few of us were enjoying a little bit of warmer weather. When we got back to our jobs we found that we had two to three weeks to prepare for today. Australian Paper decided to invite other major manufacturers to a meeting and I was engaged to facilitate discussion at that meeting.

Coming out of the meeting we found that we had a lot of issues in common in terms of support for the scheme and the benefits that it provided but also, as mentioned earlier, some possible improvements to the scheme. To save the commission staff doing the numbers, the total TFES payments to these companies in the 2004/2005 year, $42.7 million, which is 47.4 per cent or thereabouts of the scheme. So you have nearly half the recipients of the scheme represented by this submission.

So what does the government and the Australian tax payer get in return for their support of these industries, not just through TFES, but through any other contribution the government may make? Collectively they provide over 3100 direct jobs, 9600 indirect jobs. One of the things that's also happened in the Tasmanian economy, and dare I say the Australia economy as well over recent years, a lot of the indirect jobs that exist today were once upon a time direct jobs. So as a result of outsourcing, there is still a very direct link between these people and the services they provide, for example, people harvesting trees for paper making, they're now individual contractors or employees of contractors where once upon a time they would have been included in the direct jobs.

These companies pay over $195 million in wages each year in Tasmania, and if you add up all the wages paid in the manufacturing sector in Tasmania it's about 800 million, so it's roughly 25 per cent if you look at it in that way. On top of that they undertake major capital investment and when you're looking at the companies involved the capital investment is huge. So typically 10, 20, 30, 50, 100 million, or in the case of the Boyer mill it was $350 million in the late 80s, early 90s to reinvest and keep the company in Tasmania. They pay huge amounts in state and federal taxes. So these are some of the returns that directly go back to government.

Because of their size and the nature of their businesses across the state, they effectively underwrite the infrastructure that's provided for the use of all Tasmanians, road, rail and shipping. They often represent the base load on those modes of transport, and without them the viability of many of those operations would be lost. In short, if these companies weren't in Tasmania or were lost, it would have a devastating impact on the Tasmanian economy.

One of the points that is often glossed over or missed out is that many of the jobs lost, if that was the case, would not be replaced on the mainland, but they would move offshore, they would move to China, Indonesia, Korea. Once upon a time the competition in the paper industry, for example, was Europe. These days the competition is right on the doorstep with new paper machines, new facilities and so Australia is doing very well to continue to be able to compete.

There would be an adverse effect on Australia's balance of trade, balance of payments if these industries were lost, and frankly economic models that you do, whilst they get the direction of change correct if they're been done rigorously, they often don't do justice to the true value of what these industries provide. So as I always put it, you need to do a reality check. So your model will tell you one thing, but then you need to go face to face and find out with the major industries what would be the implications, what would be the impacts, if you didn't have this form of assistance or support.

Now, fortunately TFES is strongly supported by the prime minister, the Tasmanian premier, the Commonwealth and Tasmanian governments, and has been so for the last 30 years, liberal, labour, indifferent, it's always had support. The prime minister's statement, and I just want to read it so that it's on the record:

> The government will not be phasing out the Tasmanian Freight Equalisation Scheme and will not be abolishing the Tasmanian Wheat Subsidy Scheme. The Tasmanian Freight Equalisation Scheme was introduced by a coalition government in 1976. The scheme remains an important element of Australian government programs that equalise cost disadvantage between the states and the territories.

That's a media release, it's on the net, 7 September 2006. In response to that the Tasmanian premier wrote to the prime minister on 19 September 2006 saying that:

> The current arrangements are critical to Tasmania's continued economic growth. The benefits are spread across our entire economy, not just those involved in the freight task. These arrangements have a history of bilateral support over a thirty-year period.

The premier then went on to offer ongoing assistance to ensure that this inquiry by the Productivity Commission was successfully concluded and that the second part of the terms of reference looking at improvements to the scheme was properly addressed. So turning to the Tasmanian Freight Equalisation Scheme. From our perspective, the rationale for the scheme and Commonwealth government policy is 100 per cent crystal clear. It's not our job, in a way, to put that case to the

Productivity Commission. It's really a matter for the Commonwealth government and state government to make clear their support for the scheme.

We see TFES as a vital equity measure, not anti-competitive or market distorting. Indeed, it's there to correct other distortions in the market and provide equity of access for Tasmanian manufacturers. The certainty that TFES has provided over the last 30 years has encouraged industry to continue to reinvest in Tasmania and that in turn has provided major productivity gains. The Tasmanian government has sought information from industry on this particular point and the government's submission, which I understand will be made in Launceston tomorrow, will detail case studies of where there has been investment, reinvestment and the productivity gains associated with that.

The scheme has served all stakeholders well for the last 30 years and most importantly it is still providing significant benefits to the Tasmanian and Australian economies. So where to from here? Given the prime minister's statement that TFES is going to continue, what does this mean for the current inquiry by the Productivity Commission, and how can we all deliver on the prime minister's statement that:

> The government will continue to review Tasmanian freight subsidy arrangements to ensure they are operating as intended and to the benefit of all Tasmanians.

When industry met there was a very common view that in light of the prime minister's statement there would be benefit in the government revising the current terms of reference to ensure that it has the appropriate focus so that the Productivity Commission, that industry, that the employees of industry, are not left hanging in terms of just what is meant. We also didn't want the issue to drag on forever and so we suggested, and we have suggested to government, that the terms of reference should be just clarified or direction given, and increasing the time frame of say three months would allow for some of the additional discussions, face-to-face meetings to take place.

We think it's beholden on both the commission and the industry to work cooperatively and constructively, and that's been the relationship to date and we very much want that to continue. A starting point which we would like to suggest would be the one-on-one dialogue with industry participants, and just clarifying once and for all where the benefits are, what the implications would be if the scheme was lost or substantially reduced, and we also see it very important to have site visits, because if you have a site visit you can actually understand all the additional measures and steps that needs to be taken in order to transport product across Bass Strait, and frankly I think the commission and its staff will be blown away, as indeed I as a humble consultant have been blown away, when you look at the steps that these industries have taken over the years to get freight at the cheapest, least damaged possible way across Bass Strait.

So turning quickly to industry's commitments, and I think that there's a fair bit of meat in this section and it's where the discussions over the next two days in Tasmania and the hearing in Melbourne could perhaps flesh some of it out. Industry is committed to vigorous competition and continuous improvement, in fact, that's what industry has to do in order to survive. We will work cooperatively and constructively with the commission and with government, and indeed if one of the outcomes of the current inquiry is to suggest that there should be a reconstitution of the TFES review authority to drill down into some of the detail, then we'll happily work with that as well. We're happy to support greater transparency so that government, industry and the community at large can have confidence that the current arrangements are fair and equitable.

Rorting: we really would like to know whether rorting does or does not occur. We've all done our own little assessment on the figures that have been published. We've tried to work out where the dollars are going. The major manufacturers are very confident that they are not rorting the system. They go through individual audits done by independent parties, they pay for those audits, and they're provided to Centrelink. So if there is rorting by anyone in the system it's unacceptable and there should be measures taken to stamp it out so that everyone can have confidence in the scheme.

One of the things that apparently used to happen and something that we think would be very worthwhile is, within Centrelink or as a special but ongoing situation, to have people who are suitably skilled to look at comparable invoices, claims from comparable companies. If there's a 2, 3, 5 per cent difference that may well come down to people's negotiating skills, but if there's a 30/40 per cent difference in the transport cost for similar goods across Bass Strait then obviously there are some questions which should be asked. Now, that should be happening with or without this inquiry, but if this inquiry is going to become the trigger that re-institutes, if that's the appropriate words, some of these practices, then we would support that.

We would also support the use of wharf-to-wharf, because that does give a high degree of transparency and reduces the potential for anybody to claim more than they should be. So wharf-to-wharf is supported by the major manufacturers. We appreciate that this may cause problems for some other parties and that's something that would need to be talked through with them directly.

We believe that TFES should be linked to the relative freight cost disadvantage. We're not asking for more than that. We're just saying that that gives a benchmark. We also support an annual update of parameters. Now, usually when industry asks for an annual update they want a CPI increase. We're not asking for a CPI increase, we're just saying that look at what's happened in relative freight movements and, in fact, TFES could go up or down based on that. We want to be fair so that the scheme continues and we'll work with government and the Productivity Commission to help develop those arrangements. A lot of detail involved, so hence the comment about whether the TFES review authority would be the appropriate body to look at that.

Finally on the subject of industry commitments, the current mechanisms for calculating and claiming assistance, we don't believe that they are onerous and they are readily achievable by industry. They also provide an audit trail. So much as we usually argue in favour of more streamlining and less paperwork, we think that the current arrangements are reasonable. We will, however, support any improvements if people can make those, but we don't want something that doesn't provide a strong audit trail.

Turning to - I'm nearly at the end of my presentation - the question of flat rate. I think we were very surprised when the Productivity Commission put this up as a fall-back option, because having criticised the current scheme for not having a clear definable rationale et cetera, plucking out a flat rate, particularly a flat rate that would mean that every single manufacturer was worse off, was a little bit of a surprise to us. So we would like to know if there's any more detail or justification for the proposed figure of $400 per TEU.

The report was also - and this may have been just a simple error, but the report didn't make mention of south bound freight, and so we weren't sure whether as well as having the assistance reduced by up to 50 per cent we were also going to lose south bound freight. It's very clear that the major manufacturers would suffer if there was a flat rate of $400, but perhaps more importantly it would decimate small manufacturers.

In conclusion, Tasmania's major manufacturers are the backbone of the state's economy. If they weren't here Tasmania would have a very different economic climate. We support competition and we support continuous improvement. That's what we're doing in our day-to-day operation of our businesses. TFES is vitally important to the major manufacturers and it's also important to other industries in the state. Industry wants the current freight arrangements to continue but we're supportive of every possible effort to increase rigour and to otherwise enhance the scheme. So thank you very much, Mike.

PROF WOODS: Thank you for that presentation. Can I put on the record the appreciation of the Productivity Commission not only for your presentation this morning, but some of those Tasmanian major manufacturers that are included in your presentation for the work that they have also undertaken to present to the Productivity Commission is quite detailed, initial submissions and in several cases also rejoinders. So there is some serious analysis that has been undertaken and we have benefited in our deliberations from the work that those organisations have put forward to us. So thank you very much for that.

Perhaps the area where we could best explore during this hearing is to look at your support for a wharf-to-wharf proposal as a way of focusing the subsidy arrangements on overcoming the core, as you put it, of the freight cost disadvantage, the Bass Strait component. It is a matter that was addressed in our draft report because we saw that as a potential way of improving the efficiency and effectiveness of the subsidy arrangements. We continue, however, to have some concerns that such a proposal offers and we'd like to explore those with you.

If you could bear with me I'll sort of go through an agenda briefly, but then if we could come back and look at individual parts of that agenda. It's true that wharf-to-wharf does focus on the particular disadvantage that underpins the operational objective of this scheme, and that is Bass Strait. A significant concern, however, is that a lot of freight tasks are invoiced on a total door-to-door or some other combination of destination and origin which could potentially allow for non wharf-to-wharf components of that total freight task to be loaded into that item for the purpose of submitting a claim for subsidy. So that's one that I'd like to come back to.

The second is the question of incentives, and that is if the disadvantage is being fully rebated then what is the incentive on the part of the producer to minimise the cost of that component. A third concern is that it still relies on a duality of design, that is, you have a fixed road freight equivalent, however derived, and there are serious concerns with what that figure should be, from which you deduct a variable task oriented actual invoice, whereas if you had a high cost transport function, presumably the road freight equivalent would also be higher than a low cost, high volume producer who arranged a freight cost with a transport company. So how do you overcome the difficulty? So that's another one.

Then there are smaller issues that are fairly self-explanatory about reduced administrative costs and the like, and I don't think they need occupy too much discussion, I think they would be reasonably agreed that whatever is the simplest will reduce not only the costs of data entry and of checking the compliance audit, et cetera. But perhaps if you could bear with me and go back through those first three parts of that agenda. The first one, how do you overcome the incentive out of a total freight task to load costs into wharf-to-wharf?

MR QUINN: Okay. Firstly, I need to say that the major manufacturers, one of the questions that I asked them, how many people in the room are actually going door-to-door and how many are going wharf-to-wharf? The overwhelming answer was that the majors go wharf-to-wharf. There were a couple who went door-to-door on particular commodities, but they said, "We would be happy to go wharf-to-wharf on everything." So really I'm not the best person to answer it because the majors are already going wharf-to-wharf. By wharf-to-wharf we also include the consolidation costs which is another issue that wasn't really addressed in the report because of the way that the recommendations follow.

PROF WOODS: You're referring to the inter-modal transfer components, yes.

MR QUINN: The inter-modal, yes. So really not an issue for the major manufacturers that question, but we'd be happy to - - -

PROF WOODS: That doesn't mean that there's not an issue about scheme design though. It does mean that the major manufacturers may be able to most easily comply, but as an economist would you see though that there is a potential incentive to encourage some to load into wharf-to-wharf cost just through scheme design, because that's what we're particularly interested in.

MR QUINN: Through scheme design, yes.

PROF WOODS: Excellent, and that's something - - -

MR QUINN: So you have our support on wharf-to-wharf.

PROF WOODS: Thank you.

MR QUINN: Next issue. If only it was all so easy.

PROF WOODS: It's not easy in the sense that we still haven't overcome the problems of scheme design for those who have a total freight cost and therefore there is an incentive for some to be able to load non wharf-to-wharf into that particular component.

MR QUINN: Just as we have suggested face-to-face with the majors, it would be advantageous to have some one-on-one discussions with the people who are doing door-to-door and to understand if they really do have problems or it's just a complication they'd rather avoid. But it would certainly help in terms of auditing of the scheme in comparing like with like.

PROF WOODS: Absolutely.

MR QUINN: So we'd support that.

PROF WOODS: Very good.

MR QUINN: This incentive of being fully rebated.

PROF WOODS: Yes.

MR QUINN: I am yet to find - again, I asked the question of the major manufacturers, is there anybody who is being fully rebated, and the answer was no. I do a lot of - - -

PROF WOODS: So nobody is in class 1, or you are saying that - which I think we could dispute - - -

MR QUINN: Nobody is in class 1? Some of them are in the room. I don't think they are in class 1, so they're not being fully - perhaps I should leave that for individual companies to respond to you on.

PROF WOODS: I think so. Yes, why don't we do that.

MR QUINN: But I am not aware of any company that is being fully rebated. I should also say that I do a lot of work in the paper industry and paper makers get excited over 50 cents a tonne saving, so they get excited over - - -

PROF WOODS: It's a question of to whom the saving is. If it's to the company I can understand the excitement. If it's - - -

MR QUINN: No, it's a whole culture. It is a whole culture that pervades everything that they do.

PROF WOODS: Can I just interrupt at this point. For the benefit of the audience we do have a process at the conclusion of the hearing that if somebody wishes to make a statement, that's the appropriate time to do so. So those who are before me at the moment I take evidence from, but there will be an opportunity at the conclusion of the hearing for those who are currently in the audience who may wish to make a statement. Thank you.

MR QUINN: Your next one was on the duality of design, and I must confess I'm not the best person to speak on this particular issue. I think that the speaker following me is far more qualified to comment on the mechanics of the scheme, but industry would support annual reviews of the key parameters, and that might help keep things closer in check.

PROF WOODS: It has the potential to move the road freight equivalent in accordance with what is understood to be industry practice, but in looking at the figures closely we find it is notoriously difficult to come up with a single figure which would constitute road freight equivalents and, in fact, for the benefit of those who receive the subsidy, we published in our draft report all the various review results over the last decade or so because many people were saying that they were unaware of what the review outcomes were.

So we took the opportunity of our draft report to reveal those to all concerned, and as you look across the range of road freight equivalents, in 98/99 a dry freight RFE was proposed at $262, and BTRE in 02/03 came up with a figure of $324. For those of you who have the draft report I'm looking at page 16, but all of them have qualified heavily their estimates, in part because the transport industry in itself is notorious for not making public the particular rates it actually strikes with clients as distinct from some scheduled rates that it is willing to make available.

MR QUINN: I'm aware of some of the confidential submissions that provided actual hard data - - -

PROF WOODS: Yes, and we've - - -

MR QUINN: - - - and there is a wide variation, just as there's a wide variation on power prices or other things.

PROF WOODS: Absolutely. Which is the point about deducting a single rate from a variable rate to assume therefore that somehow you have something that approximates freight cost disadvantage, but that's a design issue, as you point out, that we can pick up.

MR QUINN: Yes, and there wouldn't be any problem from major industries' perspective in having some belt and braces system whereby nobody can get paid more than the freight cost disadvantage. I think that goes without saying.

PROF WOODS: That is something we've explored and several participants have put forward, and in fact one of the other presenters today have put forward proposals that the freight cost disadvantage be refined to reflect the situation of the individual company. Now, for a major where you have a significant payment and a reasonably stable pattern, that may have some advantages, but if you're talking about 1300 claimants, 600 of which churn on an annual basis, then the administrative costs of trying to be so specific become horrendous and I think would outweigh any benefits that are obtained from fine tuning. So I'll pick up that debate with others during the course of these hearings. Minor matters of administrative costs and the like I think we have common agreement that - - -

MR QUINN: We do.

PROF WOODS: **- - -** to the extent we can reduce those, then that benefits all sides, tax payers, recipients, and the administrative departments. I'm pleased to note the support of the major manufacturers that they would be happy to move into line across the total range of their freight to having wharf-to-wharf separate invoices, so that deals with that particular component.

Moving then to flat rate, you used various descriptions of it which are on the record, and that's fine. The attempt there is to overcome what we see as some of the design inefficiencies. You quote some interesting analysis which we would appreciate getting detail of as to the impact it would have on the major Tasmanian manufacturers. From our interrogation of the database such as it is, and many participants in this process have drawn attention to the inaccuracies of that database, but given that that's a starting point then with qualifications, we understood that a $400 flat rate would result in 30 per cent of the claims receiving the same or marginally more per TEU than they currently do and, of course, that would include a number of the major manufacturers, ie, the group who you are currently representing.

If that's not the case, then either the Centrelink data is not accurately portraying the actual circumstances, that's one option. A second option is that your data might be based on this year and therefore we're not up to date with that. A third option is that we've somehow confused our analysis, and I sincerely hope that's not the case but we always remain open to that possibility which is why we do produce a draft report to allow any errors of analysis on our part to be exposed, and we're perfectly willing if that's the case to redo that and to correct any errors on our part. But I am surprised by your figures. Is there any more detail you can provide this morning or is that something that we're better off - - -

MR QUINN: I think it will be picked up by individual companies, but can I just say that your three options, I think it's got to fit into one of those three categories because one of the companies said to me that they had done the analysis and it was $1.2 million worse off is what they were going to be. Another company indicated that they were between 20 and 30 per cent worse off depending upon how certain things were going to be looked at. When I tabled those figures in general terms at one of our meetings then other people said, "No, ours is up to 50 per cent," and those people, some of them will be making further presentations over the next couple of days.

PROF WOODS: Was there anyone quietly in the corner who didn't offer a view who may actually be better off?

MR QUINN: Some people said, "We haven't done the sums and we'd need to look at the detail," but no-one said that they would be worse off.

PROF WOODS: Would be better off.

MR QUINN: Sorry, would be better off. That was a bad slip there.

PROF WOODS: No, I understand.

MR QUINN: No-one said that they would be better off.

PROF WOODS: No. All right. Well, quite seriously we would put on notice that we will take up then with the major manufacturers what is driving those results and why that is different from our analysis of the database.

MR QUINN: On the south bound freight, was that just a slip in the report that it wasn't mentioned or - - -

PROF WOODS: It wasn't mentioned but there was no intended change in the fact that there is south bound and that we'd be looking at some form of a flat rate there as well for the current product range.

MR QUINN: Industry thought the $400 figure was simply a way of reducing overall costs of the scheme by 30 per cent or something.

PROF WOODS: I think it would be a better portrayal to say that we were keen not to significantly increase the level of subsidy to those who are currently receiving it, and hence our analysis that 30 per cent of payments would be at or slightly more than current TEU payments, but that then is now a matter for further analysis.

MR QUINN: Those figures don't accord with ours so - - -

PROF WOODS: No, and that's fine. We will - - -

MR QUINN: - - - that's good that we're going to get to the bottom of it.

PROF WOODS: - - - chase that through, but it's also then recognising that there is a difference potentially between what the current subsidy compensation for freight cost disadvantage is relative to actual freight cost disadvantage. Now, we look forward to and have received in a couple of cases further submissions from those in industries who would be more significantly affected. Several - and they're on the public record, rejoinder submissions were coming, for instance, from the vegetable industry and we're very grateful for that.

What we need to explore there is the fact that again in the design of the scheme you are subtracting a common road freight equivalent from a variable invoice. If they have a higher cost of transport by ship for their product, significantly above in many cases, above what most of your client base has, we need to investigate what their road cost would also be. Presumably it also would not be exactly the same as the rates that you can achieve by negotiation, and we need to explore that component because to the extent that there is some variability in the road freight equivalent, then the current design of the scheme doesn't reflect that and so you are only varying the top end of the payment subsidy calculation, not both components.

Now, I don't know how you get hand signals into the transcript, but we will know what we mean. We can work our way through that. So we're keen to explore that side because what it may mean is that the level of disadvantage as subsidised may not actually represent the level of disadvantage that they would have through a road freight equivalent, but that's a matter for debate not with your client base.

MR QUINN: But given that we cover about half - - -

PROF WOODS: You cover half the payments.

MR QUINN: - - - of the scheme - - -

PROF WOODS: Absolutely.

MR QUINN: - - - then I think you could be comfortable that the - we don't actually call it a subsidy, we call it assistance because it's there for a particular reason, not just because people like us. So at least half your scheme is rigorous and has rationale and appropriate levels of payment.

PROF WOODS: Thank you. In view of the time and that we have other participants scheduled to appear, I think we have usefully explored not only the matters raised in your presentation, but gone into some more detail on several of the options and I'm grateful for that. We've identified some further areas that we would like to follow up in terms of reconciling the different responses to our proposal and particularly the analysis of the impact that it would have, and we note in particular the offer for the further dialogue with the Tasmania major manufacturers that you are representing and we will take that up as we need to explore these issues. Are there any concluding comments that you wish to make?

MR QUINN: No, thank you very much for the opportunity.

PROF WOODS: I appreciate the time and effort and the quality of the work that's gone into it, thank you very much.

MR QUINN: Thank you.

PROF WOODS: If I could call a temporary pause while we arrange for the next participants to come forward.

PROF WOODS: I'd like to resume the hearings after that short break and invite Australian Paper to make a presentation. For the record and so that we can get sound allocations, could each of you please give your name, title and organisation you are representing.

MR RUZSICSKA: Manfred Ruzsicska, I'm a strategic adviser with M-Strad, here on behalf of Australian Paper.

DR RYDER: Jon Ryder, general manager of Tasmania and Shoalhaven Australian Paper.

MR FRYETT: Matthew Fryett, commercial manager for the Tasmanian mills.

PROF WOODS: Thank you very much, and some in the audience have reminded me of the acoustics in this room, so when you are speaking to me if you could also be mindful that they would like to hear this discussion. Do you have an initial presentation that you wish to make?

MR RUZSICSKA: Yes. I'll run through this presentation but first of all John will open.

DR RYDER: Yes, thank you. Without striking fear into employees and the stock market, I believe this is a hypothetical situation, but if the freight equalisation scheme were to be taken away from Australian Paper I can categorically state that we would not be in Tasmania manufacturing paper. I would very strongly doubt whether Australian Paper would be able to move the operations to mainland Australia, and therefore our business would be lost to Australia and Tasmania.

Secondly, I'd like to state that Australian Paper is right behind the first presenter, David Quinn, in all the points that he was making today, and thirdly there was some question in debates between you and David earlier, Tasmania's operations would be directly affected to the tune of $1.2 million if we went to the flat-rate scheme of $400 a tonne. So I'd like to hand over to Manfred who is our technical specialist and an economist in his own right.

MR RUZSICSKA: Thank you, John. Just in terms of giving a quick bit of context too for your benefit, my background with Tasmanian Freight Equalisation Scheme actually goes back to 1996 or particularly the 97-98 review which put the current calculation methodology into place and as such I understand some of the drivers behind some of the parameters and the like. So I guess some of that commentary that I might make actually comes from being privy to some of the TFES deliberations in preparing where the model that has actually been put forward and adopted.

PROF WOODS: We're very grateful for you being ongoing involved in this and that has been reflected in the quality of some of the submissions that have come to us. So thank you for that.

MR RUZSICSKA: Thank you. In this presentation today one of the things I won't be touching on is issues that are potentially commercially in confidence. I won't be dealing with any of the facts and figures from an Australian Paper perspective. The presentation is very much more along the lines of theoretical arguments, theoretical discussion and some of the concepts and some of the underlying principles. Having said that, the particular approach that Australian Paper has taken to looking at this particular issue has very much reflected what's in the review authority's terms of reference, in that the first step was: how important is this scheme to Australian Paper's participation in the national economy, reflecting section 5A of the terms of reference; how well does current assistance levels actually deliver on the actual freight cost disadvantage in Australian Paper's experience, and then, in fact are there actually better ways of delivering on it?

By no means is, if you like, Australian Paper wedded to specific minutiae of the scheme, however, unless something better is actually presented I guess it's a question of looking at the merits of it. The approach that I'd like to actually take in running through this is to quickly discuss the rationale, a benefit assessment that has been undertaken in relation to the contribution the TFES makes and I should emphasise that this particular concern of Australian Paper deals only with the Tasmania Freight Equalisation Scheme and not the wheat freight scheme.

Then we're actually have a quick look at this quantification of the sea freight cost disadvantage, what is actually means, some of the assistance mechanisms and a comparison of, if you like, the current variable approach to the flat-rate approach, the parameters, the rorting and wrapping up with some of the key points. I propose to run through this fairly quickly, but at the same time if you'd like to interrupt me at any stage feel free to do so.

In terms of the rationale as Australian Paper put forward in its rejoinder submission, it's perceived that there is a fairly clear rationale for the scheme's existence and that rationale is actually evidenced in the Department of Transport and Regional Services' statement on their web page in terms of what the objectives of the scheme are. I'll read it out for the purposes of the record:

> 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.

The key aspect of that is the concept of equality or equity and that's embodied in that particular objective in two locations: one is in relation to comparative interstate, and the second, in relation to equal opportunities. This notion of equity between the states is embodied in this objective and arguably that is the underpinning rationale. The basis on which this inequity is actually addressed is the freight cost disadvantage. So we actually have embodied in that particular statement what the rationale is; it's not, if you like, clearly enunciated as might be the preference for the Productivity Commission, but certainly from an Australian Paper perspective we feel that there is a fairly clear rationale for the scheme in place, which has been supported by some of the government pushes since in terms of the Prime Minister's statements and releases et cetera.

So moving then on to the benefit assessment, Australian Paper has real concerns which reflect some of the industry concerns that have been put forward as well in relation to how the benefit assessment has been undertaken and the extent to which it actually reflects the practice out there. In particular the Productivity Commission has indicated a fairly heavy degree of reliance on the Monash Multi-Regional Forecasting Model that has been put forward by the Tasmanian government that was undertaken.

One of the concerns with the Multi-Regional Forecasting Model has been the extent to which it actually addresses some of the key issues that have been raised, in particularly that issue of import substitution and the actual ongoing flow down multiplier type effects into the broader economy. We're talking about things like David raised earlier on regarding - we have this direct employment and the indirect employment and we felt that a lot of those features weren't recognised. But coming back to this notion of the import substitution, investigations with the Monash University who has actually put together the Multi-Regional Forecasting Model indicates that - and I quote again here for the purposes of the record:

> The main reason the model reduces Australian imports by the level it does is simply due to the closure of the model. It is assumed that TFES does not alter the level of Australia's balance of trade and that the Australian government is assumed to have a target for external liabilities and will adjust macroeconomic settings accordingly.

This notion of a closed model implies that any function or any activity that's undertaken in a Tasmanian context will be relocated elsewhere within the Australian economy.

PROF WOODS: In aggregate - not industry by industry.

MR RUZSICSKA: Yes, in aggregate.

PROF WOODS: So we're not assuming that paper closure in Tasmania equals paper increase in the mainland. It's saying that within the total economy there is closure, but you look at input-output analysis per industry per cell and if there isn't paper on the mainland then you don't suddenly create paper on the mainland; you redistribute the benefit to other industries.

MR RUZSICSKA: Yes, correct.

PROF WOODS: We're not talking mills for mills.

MR RUZSICSKA: We're not talking about the same jobs or the same industries necessarily.

PROF WOODS: No.

MR RUZSICSKA: What we're saying is that if we actually have a situation in a closed model situation that the loss of 100 jobs, if you like, in one area will be equated to 100 job gains in another area.

PROF WOODS: Absolutely.

MR RUZSICSKA: They may be in totally different industries et cetera.

PROF WOODS: Yes, like mining industry in WA.

MR RUZSICSKA: Exactly.

PROF WOODS: Who are crying out for workers.

MR RUZSICSKA: However, in terms of actually assessing the impact of a program such as the Tasmanian Freight Equalisation Scheme to actually undertake that in a closed context actually understates the import substitution effect because the quantification of the Australian government's targets for external liabilities and the sort of mechanisms that they might need to put in place to actually achieve that aren't necessarily reflected in the closed model. Indeed, arguably in the past the measures that the Australian government has actually instituted wouldn't be targeted at addressing something at this level. So the notion of the closed-model process we feel grossly understates the actual import substitution effects.

PROF WOODS: It is a finer gradation than perhaps presented, in the sense that you do need some form of closure and so we're talking about the relative difference of the export orientation of industries supported by TFES, compared to export orientation for the economy as a whole. So we're talking a margin on a margin; we're not talking absolute loss of exports for those industries that may decline as a result of removal of TFES.

MR RUZSICSKA: Yes.

PROF WOODS: We're only talking about relative differences, so it's a much smaller margin than perhaps people might understand from your presentation.

MR RUZSICSKA: Yes, having said that, I guess probably the emphasis that I would make is that most of the large recipients, and indeed if we look say at the fruit and vegetable producers and Australian Paper and a number of the other major producers who constitute a much larger share of TFES, the exposure to import substitution of TFES recipients is probably far greater than the broader Australian economy, and as such its distortion, using a broader Australian model to apply to something like TFES, probably understates the impact, the substitution impact.

PROF WOODS: As long as we understand that we're talking about the relative margin, not the absolute amount.

MR RUZSICSKA: The second significant concern in relation to the elasticities of substitution, and it was felt that the model and indeed some of the commentary in relation to position in the broader Australian market, companies like Australian Paper and indeed a number of the other majors deal what are essentially generic products in a global market place, and as such their competitive position is not reflected by some disproportionate advantage in terms of being located in Tasmania.

PROF WOODS: No, we have no dispute with the observation that Australian Paper deals in more generic product and its elasticity is higher. To the extent that the elasticities may be higher for some industries, doesn't change the sign that ultimately you'd generate at the bottom, it just changes the gross quantums on both sides, but the sign wouldn't significantly change. So your net conclusion would be similar, but the quantums that you would ascribe to it may be different.

MR RUZSICSKA: Yes. I guess, probably the issue here is that one of the things in the benefit assessment which was of particular concern to Australian Paper, was that the benefit that was supposedly accruing to Tasmania was at the expense of the rest of Australia, and that if we actually look at that a lot of the benefit that might flow - the benefits that flow to Tasmania are not necessarily at the expense of the rest of Australia in that those benefits would actually flow offshore, they wouldn't transfer elsewhere in the Australian economy because of that greater exposure to the global market because of the generic product. The next thing I'd like to briefly cover is the notion of the sea freight cost disadvantage.

PROF WOODS: Sorry, if I can pause there, did you wish to go through your other modelling issues such as leakage and the like, or should we just take that - we've got your submission and we understand your issues and we could debate, but we're probably heading into some more esoteric areas, so we're probably better off focusing on - - -

MR RUZSICSKA: I'm happy to - I guess I'm very conscious of the fact that we have a fairly constrained time frame.

PROF WOODS: Okay.

MR RUZSICSKA: I'm happy to go into some of those in more detail.

PROF WOODS: We'll take that as read and - - -

MR RUZSICSKA: Some of them we may well capture through the discussion on parameters - - -

PROF WOODS: That's fine.

MR RUZSICSKA: - - - particularly where it comes to things like leakage and the ability to capture benefit.

PROF WOODS: Thank you.

MR RUZSICSKA: The sea freight cost disadvantage, if you like, forms the basis of the Tasmanian Freight Equalisation Scheme, and so we'll just take the opportunity here to actually quantify what the sea freight cost disadvantage is to make sure that we all have, if you like, an agreed platform for moving forward. The sea freight cost disadvantage effectively materialises itself through three different factors. The first of these is the additional transfer costs that anybody shipping across Bass Strait incurs, namely, there's an additional unload and load function that needs to be undertaken and as a consequence of these additional transfer costs it is incumbent to actually look at the marginal cost of transporting freight from the conceptual wharf gate to wharf gate - sorry, the marginal cost of transporting by land over that distance.

There has been some discussion, and it hasn't been too clear at times, as to whether or not the road freight equivalent is based on the freight rate that you might actually get for moving something 420 kilometres. In reality it shouldn't be the road freight rate for 420 kilometres, it's the road freight rate for moving something 420 kilometres as part of a broader line haul operation. So in terms of actually defining the disadvantage that's, if you like, the first step.

PROF WOODS: Although the inter-modal component does pick up part of that process.

MR RUZSICSKA: The inter-modal component does not look at the load and unload. The inter-modal component looks at, if you like, undefined on-costs. The definition of the sea freight cost disadvantage was the wharf gate to wharf gate, and included in the wharf gate to wharf gate was that load and unload component. The inter-modal cost component related to the additional stuffing and destuffing costs, some of the efficiency losses and such like.

The second major area in which sea freight cost disadvantage is incurred is the landside transport inefficiencies as a consequence of using short haul land transport for part of a line-haul task, ie, the trucks that companies are using to get their good to the wharf are generally not of the same efficiency level as if you were actually a line-haul operation. You might, in fact, be using a standard semi instead of where you might be using a B-double somewhere else, or a B-double tautliner indeed.

The third area is this notion of optimising of the freight task around shipping. In essence what we mean here is that when I ship freight by sea I want to minimise my sea freight cost and therefore I want to maximise how much I can get into any container. I'll put 18 tonne into a container hypothetically if I get it, combined with the weight of another two tonnes for the box, I've got 20 tonne, and I can only put one of those onto a standard trailer because if I put two on I'm breaking the road rules. The reality of it though is if I was moving that same product on a interstate line-haul operation that was totally land based, I would be able to put 26 tonne on, 28 tonne, depending on what the airbag suspension limits might be and the like for one single flat-top, never mind if we actually go to a B-double-type operation. So the basis of actually assessing the sea freight cost disadvantage needs to consider that the different efficiency gained, if you like, through interstate land transport operations.

So having actually looked at those elements, what I'd like to now come to is this notion of the alternative assistance mechanisms. The suitability of any mechanism that is actually put in place to determine the assistance levels that should be paid needs to be related to that notion of sea freight cost disadvantage, and indeed without measuring the sea freight cost disadvantage it's difficult to conduct a comparative assessment of alternatives.

What we're effectively saying here is there needs to be that quantification, recognising that that quantification is, in fact, difficult doesn't detract from the fact that it needs to be undertaken. This assistance regime is about actually compensating for an inequity that is embodied in sea freight cost disadvantage. We need to know what is that sea freight cost disadvantage, and recognising the earlier concerns you had in terms of actually calculating that as far as road freight equivalents go, I will come to that.

As such, any consideration of the flat-rate mechanism, essentially the assistance to a flat-rate approach is actually discounted because it's unrelated to the magnitude of the disadvantage being experienced. A flat-rate mechanism is effectively some arbitrary measure of saying, look, this is the average amount or the minimum amount of disadvantage and we're going to apply that to all, and because of that it will actually be inequitable in its impact across different shippers. I think that that's recognised in the Productivity Commission's report, it's just a question of how we actually come about an assistance mechanism that will actually deliver appropriate levels of assistance.

PROF WOODS: Hasn't a single road freight equivalent got exactly those same characteristics, it applies to all, its derived parameter? I mean, what characteristic differences does a flat rate have from the current utilisation of a RFE?

MR RUZSICSKA: The current approach, if you like, the current calculated disadvantage approach says that a company shipping across Bass Strait pays X dollars to move its goods across, and the road freight that it would pay to move those same goods on land is y and will take the difference is the sea freight cost disadvantage. A flat-rate approach doesn't recognise that there is variability in sea freight.

PROF WOODS: But the y is constant without variability in the current approach, isn't it?

MR RUZSICSKA: That's right.

PROF WOODS: Apart from the loading for reefers but that washes out.

MR RUZSICSKA: Indeed, arguably having a constant Y or a constant road freight equivalent is a better reflection of the competitive marketplace than an alternative flat-rate approach because the - - -

PROF WOODS: I'd like to explore - I mean, finish your presentation, but I noted you were responding in non-verbal communication at the debate earlier, so if we could pick that up at the end of your presentation.

MR RUZSICSKA: I'm happy to come back to that - - -

PROF WOODS: That would be good.

MR RUZSICSKA: - - - when we actually get into the parameters.

PROF WOODS: Thank you.

MR RUZSICSKA: So the flat-rate mechanism, if you like, is seen as being unrelated to the actual magnitude of disadvantage. It's inequitable in terms of its impact and because of that it actually creates a greater distortion in the marketplace because, if you like, the people will start moving around, they will respond differently to the marketplace because they're getting different levels of assistance and so they will choose and make decisions regarding about how they ship not reflected on the actual transport efficiencies, but reflecting minimising the sea freight cost disadvantage against a distorted transport assistance.

PROF WOODS: Can you therefore categorically state that all current claimants only choose the freight approach at the moment that is the most efficient, and that none of them choose the freight approach that maximises their subsidy and therefore minimises their net payment for freight?

MR RUZSICSKA: I couldn't categorically state that because I don't have access to all that information, but I'd certainly lean far more in that general direction.

PROF WOODS: It was just that you were presenting one as having one characteristic and therefore implying that the other had the opposite characteristic. I would be surprised if you were able to be so categorical.

MR RUZSICSKA: Yes. Certainly, I don't think there's ever any certainties - - -

PROF WOODS: Thank you.

MR RUZSICSKA: - - - but I would certainly lean much more in that direction because of the nature of the mechanism. Because of that, the flat rate, if you like, because of the preceding three points, it's actually seen that the flat-rate mechanism is far less likely to actually deliver on the program objectives as outlined by the Department of Transport and Regional Services.

PROF WOODS: I understand.

MR RUZSICSKA: Remembering that the objective here is not about putting in place incentive mechanisms to drive down costs, it's not about actually - - -

PROF WOODS: Is that not a worthy objective to have in its own right, however?

MR RUZSICSKA: That's an implementation objective.

PROF WOODS: I would have thought that was an economic objective.

MR RUZSICSKA: It's an objective for the administration of the scheme, but not an objective for the scheme as such.

PROF WOODS: For the economy?

MR RUZSICSKA: Not even for the economy.

PROF WOODS: To have incentives to minimise overall freight costs.

MR RUZSICSKA: They will be achieved through having a variable calculation assistance mechanism, it's the incentives mechanism that you actually employ to drive down costs. A flat-rate mechanism arguably, and in that regard certainly from a Productivity Commission perspective, I would agree a flat-rate mechanism certainly does impose a lot more incentives; however, it doesn't meet the core criteria of accommodating equitably the actual sea freight cost disadvantage, and it's a question of which one is the priority objective for the program, and if that is the compensation for freight assistance, that has to be pre-eminent and then the incentives mechanisms need to feed into that in terms of delivering.

In terms of the parameters, effectively we have six parameters that are recognised in the calculation of TFES freight assistance, again for the record, road freight equivalents, the door-to-wharf and wharf-to-door adjustments, the route scaling factors, inter-modal cost adjustment, median wharf-to-wharf disadvantage, and heavy weight adjustment. Conceptually the first four of these are purely about identifying and quantifying the sea freight cost disadvantage. The last two are really about determining how much assistance gets paid.

So in terms of actually looking at this calculation methodology the first four are about saying how much disadvantage is an individual shipper experiencing according to the invoice presented, and the last two say how much are we actually going to provide in assistance based on that disadvantage. In terms of the road freight equivalent and the like, I am happy to come back to those now, or if you prefer to explore them in a moment.

PROF WOODS: You finish your presentation.

MR RUZSICSKA: Okay.

PROF WOODS: I'll try and stop cutting in.

MR RUZSICSKA: Not a problem. Certainly from the perspective of all of these parameters, annual adjustment of the parameters is seen as something that is incredibly important. The Tasmanian Freight Equalisation Scheme Review Authority in its 98 report actually recommended annual adjustments. The annual adjustment process is seen as being essential to continuing to send the right market signals to the users of shipping services. Indeed, the lack of actual implementation of that annual adjustment process over the last half a dozen years plus has actually meant that the signals that are being sent are progressively starting to fall out of sync with the actual, if you like, behaviour of the industry in relation to Bass Strait shipping in relation to securing transport services.

Those sort of notions, I'll just have a very quick digression here, say the door-to-wharf adjustment factor which has been recognised in the Productivity Commission, we've got a number of different variables in here, we acknowledge that in the past some of these reviews have not been implemented because it's perceived that they won't have a particularly great impact, and the first round of adjustment would notionally save potentially half a million dollars. We're talking about the movement here from $230, the current value that was set in 1999 or 98 and implemented in 99, to the value that I think the BTRE found in 2001 was 244. I'll just confirm that.

PROF WOODS: Page 15, CIE came up with 244.

MR RUZSICSKA: 99/2000 Centre for International Economics, and the Centre of International Economics actually they determined the parameter values for the review authority in 98. If that $244 door-to-wharf adjustment had been implemented at that juncture, from that point on it would have saved half a million dollars plus a year to the scheme. In terms of what's currently a $90 million scheme, that might not be seen as a great deal, but what it would have done is anybody that actually has a door-to-wharf adjustment factor of less than $244, they would have very quickly moved from a door-to-wharf to a wharf-to-wharf approach, and as such the median would have progressively moved out and we would have slowly had that incentive mechanism moving everybody to the wharf-to-wharf approach that the major manufacturers, the presentation by David, and indeed Australian Paper's position supports, we would have had that natural progressive move.

In that regard a lot of these parameters need to be finetuned. There needs to be that interim adjustment process to ensure their currency, and indeed there's comment that can be made against each of those parameters but we'll save that for subsequent discussion. I'll just take one step back, I haven't got a slide on this. The concept of rorting: rorting is effectively seen that rorting can actually be achieved - conceptual rorting can be achieved in three different ways, and recognising that probably the key thing is that if there are in fact mechanisms there for rorting it would be very nice to be actually able to quantify how significant this rorting impact is.

PROF WOODS: We concur.

MR RUZSICSKA: Of course that's very difficult. At the moment we have allegations of the rorting. The Productivity Commission has validly defined a mechanism by which rorting could be potentially be undertaken. Whether or not it is is an unknown but certainly I think that the mechanism to address rorting, whilst a flat-rate assistance mechanism might address that, any mechanisms to address rorting need to be offset against, if you like, the punitive measures that are almost being imposed on people that aren't rorting and we need to balance the greater good against the lesser evil. So in that regard the notion of rorting needs to be more closely considered in terms of alternatives, and as David pointed out, any measures to support a minimisation of rorting are encouraged and mechanisms need to be put in place through fine tuning the existing calculations.

So in terms of the key points, from an Australian perspective we do have a rationale for the scheme. That scheme is equity and it's embodied in the DOTAR's web site statement for the scheme, the objective for the scheme. The benefit assessment is considered to be a little inaccurate and it could benefit probably from a greater involvement from industry in terms of actually identifying and defining the import substitution impacts. The proposed flat-rate approach is actually perceived as not delivering on the program objectives as well as the current calculated levels of assistance methodology, and certainly the parameters need adjustment and refinement; no two ways about that. That's clearly apparent and we are about six years behind where we should be. And allegations of rorting need to be quantified and where present severely dealt with. Certainly as - - -

PROF WOODS: How do you propose they be quantified?

MR RUZSICSKA: What we need to do is to get a better handle on it in terms of identifying them. I recognise there are difficulties with the data set and I think that the Productivity Commission has been put in a slightly invidious position in that regard and my sympathies, but in terms of actually - or in the absence of actually being able to quantify the level of rorting it is a case of putting in mechanisms that we can safeguard against it and possibly with putting those safeguard mechanisms in place within an existing framework, within the existing calculated disadvantage approach, you might see a shift afterwards that you are able to attribute to and identify the level of rorting after the event.

PROF WOODS: Yes.

MR RUZSICSKA: In terms of actually responding then, Australian Paper has three suggestions: the first is that TFES be retained in its current form until such time as a better more equitable methodology can be proven up. That includes quantifying the disadvantage. We need to have a better handle on how any alternative mechanism to the current mechanism will deliver on the assistance program objectives. The second is that a framework needs to be developed and implemented for the annual adjustment of parameters. This was a recommendation of industry through the joint TFGA-TCCI submission and that's something that the Australian Paper strongly supports.

Such a framework of reviewing of parameters on an annual basis would ensure that industry can contribute the right information to actually support the development of the right parameters and adjusting them accordingly, and as a consequence of that, we will actually end up with a situation where equitable assistance levels will be restored. We will send the right signals to the market. We will reset incentive mechanisms and the like but industry needs to be involved in that process so it knows how it can contribute in terms of that data and information.

The third thing is that mechanisms need to be instituted to enable rorting - and I should have corrected this actual presentation slightly here - but in the interests of what I had printed out I have left it as it is. There's a spelling mistake there. Mechanisms need to be instituted to identify potential rorting and allow remedies to be applied. The Productivity Commission has certainly identified one mechanism. Hypothetically you might turn around and say, "Well, if we actually have a clear requirement in terms of - or a statement in relation to any invoices that are submitted you might be able to actually get around some of those inclusions that the industry might be putting into its wharf-to-wharf." I have shot through that fairly quickly, I hope.

PROF WOODS: Thank you very much. I appreciate the time that you have put in to that and I thank Australian Paper for their first submission preceding the release of the draft and the subsequent submission. There is a lot of useful material in the first submission that I would have liked to have debated but having put a Commercial-in-Confidence tag across all of that unfortunately that means that we can't explore that in this forum and I think that is to some disadvantage of the transparency of the process but nonetheless.

Can I just, first of all, a very minor factual question. Australian Paper, does it classify as a class 1 shipper for the purposes of calculating the amount of rebate?

MR RUZSICSKA: Class 2.

PROF WOODS: Class 2? All right, that explains some of that. We have the database and that just - - -

MR RUZSICSKA: I believe it's almost all freight is class 2. If there is something of class 1, I don't think it will be in a material sense - - -

PROF WOODS: No, that's fine.

MR RUZSICSKA: If I can just add on that particular aspect, it was raised before this notion of incentives for people that are actually receiving 100 per cent notional assistance for the sea freight cost disadvantage. I guess it goes to the underlying objective an intent of the scheme. If the intent and objective of the scheme is that you are actually assisting people for a freight cost disadvantage incurred due to an inequity then arguably all people should receive 100 per cent compensation. Of course realistically that is totally ludicrous because it will remove that incentive for people to pursue lower freight rates.

When the review authority came up with the current tiered arrangement the structure of that arrangement was to recognise that larger shippers who negotiate the lowest freight rates have probably got the least room to move in terms of actually pursuing further gains and as such their efforts in pursuing their current freight rates needs to be recognised. The second thing is that larger shippers, whilst they might, say, a class 2 shipper with each additional dollar, they will only receive 75 cents. Conversely for every dollar that they can reduce freight rates they will pocket 25 cents.

PROF WOODS: At the margin.

MR RUZSICSKA: At the margin.

PROF WOODS: Absolutely.

MR RUZSICSKA: Given the scale of their operations that 25 cents actually becomes quite significant and as such there's a real impetus there for them to continue to pursue lower freight rates. The second, I guess, extension of that is the potential for leakage that you alluded to earlier on and part of that is through this incentive mechanism. How much incentive does industry actually have? A number of the shippers actually are both in the export and the interstate markets. There isn't, or it's understood that there is no actual discrimination between the freight rates they pay. They pursue the lowest freight rate because the shipper that the shipping service provider, Toll, has no real idea of whether or not the product is destined for an export market. Potentially the Productivity Commission is probably in a better position to actually pursue some additional information from outside to compare the likes of operation for somebody like Coles or Safeway or the like to actually undertake and see whether there is, on a like-for-like basis, any potential there for leakage.

PROF WOODS: We are certainly exploring all possible avenues to chase through comparable data. Can I also seek a clarification arising from your presentation because my understanding of your conclusion was that you are proposing the retention of the current scheme and yet I understood from the presentation preceding yours that there was general agreement amongst the major participants in this subsidy arrangement to move to a wharf-to-wharf. Can I just understand where Australian Paper sits in that debate?

MR RUZSICSKA: Australian Paper supports the move to a wharf-to-wharf operation. Indeed, the current mechanism would naturally shift progressively to a wharf-to-wharf approach. The current door-to-wharf adjustment factor - if the parameters were instituted, if the annual adjustment process were instituted, we would already have effectively moved to that process.

PROF WOODS: I'm not sure that the parameter adjustments would have moved everyone to that level but I completely agree with you that if the trend is to adjust the door-to-wharf, wharf-to-door over 230 then you will get a progressive migration and interestingly the savings are not just in the amount that you can calculate as the difference between the counter-factual and the current but there is a dynamic effect there of changing behaviour and changing the invoicing arrangements which I suspect, although you can't calculate it, would have a greater than half million dollar impact.

MR RUZSICSKA: I think that the support for the wharf-to-wharf approach as with any major change there needs to be transition provisions. Indeed, the Productivity Commission has recognised that that, even with its proposals for flat rate, the move to wharf-to-wharf can be achieved, if you like, by emphasising some of the existing mechanisms, I guess, in - - -

DR RYDER: Perhaps I can clarify it.

PROF WOODS: Yes, please.

DR RYDER: The statement and the presentation is that AP would like the scheme to continue to be applied as the scheme is given to AP at the moment which is indeed wharf-to-wharf.

PROF WOODS: All right. So in effect because you operate on a wharf-to-wharf you are happy with that core component of it and aren't offering a view then on the rest of the scheme other - that you would be quite happy, for your purposes, the scheme was directed at the core of wharf-to-wharf. Thank you. That's quite helpful. Now, road freight equivalent, just to come back to that one. That still lies at the core of wharf-to-wharf, but as I referred to earlier, it has exactly the same characteristics of flat rate in that it is a "one figure applies to all". It doesn't differentiate between those who are high cost freight movers and those who are lower cost freight movers.

There is an issue as to whether the variability for sea freight is higher than for road freight and that's something that needs to be pursued with those who might be affected by that, but do you have any disagreement that RFE has the same characteristics for that part of the process that flat rate does?

MR RUZSICSKA: The road freight equivalent - I guess the thing is that across different industries there is likely to be far less variability in the road freight equivalent that they might be paying. The road freight industry is far more competitive. We have a lot more players in the marketplace. We have a lot of two and three-vehicle owner operator-type enterprises. Certainly the cost structures of the road freight industry and the competition for freight means that even a small shipper is able to command relatively speaking a fairly attractive road freight road.

The same can't be said when we come to sea freight. If you like there isn't the same degree of competition and as such the ability to obtain a competitive freight rate is far less for a smaller shipper. That's at one extreme. The second one then is in terms of this notion of actually having somebody that is forced to pay a higher freight rate for land-based transport will necessarily incur higher sea freight rates. Probably the best example there is when the current arrangements were put in place, it was recognised that there was a disparity at that stage between refrigerated containers and non-refrigerated containers, and hence the 10 per cent variation, but for actual reefer containers moving by sea that figure was, if I recall correctly, something like double. The freight rates are something like double so, if you like, the relative differences are much greater.

Subsequent analysis has actually suggested that many of the operators who actually engaged in moving refrigerated containers and using pantechs and the like, those sort of disparities have been whittled way to some extent. Certainly it would be desirable, if you like, to have a case-by-case analysis of sea freight cost disadvantage and calculate assistance accordingly, but the reality of it is that that's not practical.

PROF WOODS: No.

MR RUZSICSKA: You could never actually achieve that. Conceptually it might be desirable but we need to actually come to a point of something that can be implemented as well, and as such, the flat-rate approach to the RFE is a far more equitable means of actually calculating where people are likely to be at in terms of sea freight cost disadvantage.

PROF WOODS: But it still does have the same basic characteristics of one rate applies to all from which you then deduct a variable actual invoice to calculate so it doesn't target the actual disadvantage. It derives a notional disadvantage. Can I go back to a couple of other matters; one, almost an aside, but you berate us for not having conducted original research in our modelling, relying on the Monash Multi-Regional Forecasting Model. Are you aware of better models that would be well suited that we should have purposefully cranked out ourselves or can we collectively agree that for the purposes of illustrating net effects that this is an appropriate way of doing so that is most efficient?

MR RUZSICSKA: I think that the Monash Multi-Regional Forecasting Model is recognised internationally as being particularly good.

PROF WOODS: I would have thought so.

MR RUZSICSKA: It's broadly recognised and I don't think there is an issue with that. It's a question of how it is actually implemented to assessing the Tasmanian freight equalisation scheme. In that regard industry has some concerns, and indeed, Australian Paper has some concerns, with how the model is actually being used to undertake this assessment. From that perspective it was felt that the Productivity Commission may well have been better placed to actually pursue its own independent running of that model rather than relying on a mechanism that was run by somebody else.

PROF WOODS: We did closely look at it and we noted that it had been done for the Tasmanian government and we have debated some of the features of that so we were happy to use it to illustrate the general point.

MR RUZSICSKA: I think that any assessment needs to be, if you like, benchmarked against actual practice, and that probably is the underlying concern is that some of the figures, say in relation to the number of people that might be affected in the paper industry and the like, don't withstand scrutiny when it's actually checked against actual impact.

PROF WOODS: That's a very good point because if brings me to the next question, and that is the statement that was made at the commencement of your presentation that the TFES is a key determinate of the ongoing presence of Australian Paper in Tasmania. How does the TFES subsidy which based on our figures for last year came out at 6.2 million if my memory serves me correct, and I can go back - yes, 6.2 million - comparing that with changes in wages, changes in interest rates, changes in exchange rates, there are many costs that Australian Paper incur, why is this the particular one that all things hinge on and not variations in the others, and presumably you're going to tell me that your viability actually hinges on them all collectively, but for some reason you seem to point to this one as being the most fundamental and crucial to your existence in Tasmania. Can you sort of elaborate for me?

MR FRYETT: I think the reason we're focusing on this one in this particular case because it's the TFES that is actually under review and not the other items. Your comment is quite right. In terms of our productions costs the exchange rate is a big component, raw materials are a big component as well, and all of those fundamentally contribute to our operations. In terms of this scheme, certainly if it wasn't available, and in terms of our transport component, we'd become uncompetitive in the domestic market, so it takes away a disadvantage from our point of view.

PROF WOODS: Are you happy to put on the record, just so that there's some transparency in this discussion, how that 6.2 million relates to your total transport costs and how your total transport costs relate to your total production costs?

MR FRYETT: I haven't got that information with me at present unfortunately.

PROF WOODS: Could you give that some consideration, because the points can be made, but if they can be backed up with publicly available information then they become either more powerful or get seen to be in the context that they actually are. So I would urge yourselves and for the benefit of the broader audience that to the extent that some of those key figures can be made available then the power of the argument becomes much more apparent. So if you could take that back with you and if some supplementary information could be made on the public record we would be very grateful, and we do have the benefit of your earlier detailed confidential submission but I would hope that on reflection some parts of that could also be put into the public debate.

As you'd appreciate the Productivity Commission is sort of here collectively under our act on behalf of the Australian community as a whole. We're not driving our own agenda, we're here under our act to consider the wellbeing of the whole Australian community, and transparency in analysis and releasing draft reports, holding public hearings, et cetera, is very important to the integrity of our recommendations so if you could assist us in that area that would be great.

MR RUZSICSKA: Could I add one small observation in relation to that?

PROF WOODS: Please.

MR RUZSICSKA: In absolute terms the dollar value of the freight equalisation in terms of its contribution to the cost structures or offsetting the costs structures of a particular enterprise are probably not discretely that important and need to be considered in the context of the marketplace in which they operate.

PROF WOODS: Absolutely.

MR RUZSICSKA: Because there are some companies out there that potentially for a particular product a $1 shift might be what breaks them, regardless of whether that $1 is 20 per cent or 100 per cent of the TFES that they receive.

PROF WOODS: The Productivity Commission is well aware of price points and margins in terms of firm viability, so we do also take that into account, but nonetheless my point remains that if some of this contextual information could be on the public record it does help drive that debate. We've probably exhausted the RFE component by Australian Paper acknowledging that it focuses on wharf-to-wharf. I think we've pursued sufficiently the incentives that the current door-to-wharf and wharf-to-door deductions generate and agree with you about that should they move progressively that we would have both an absolute change but a dynamic change which may extend beyond that.

Leakage is something that you referred to and we probably don't need to debate it in the modelling sense, but do you have any sense - I mean, you're familiar not only with the Australian Paper submission but I suspect you're probably fairly familiar with the TFGA submission and others as well. In that broader context, do you have a sense of that 90 million how much is actually appropriated by other than Tasmanian producers, because in your submission you - Australian Paper correctly identified - makes reference to the reduced competition that may arise not only immediately but perhaps in the longer term from the Toll Patrick situation et cetera. So if there is reduced competition does that increase the scope for appropriation of subsidy through higher freight rates and do you have any sense of magnitude?

MR RUZSICSKA: Firstly, in relation to the issue of magnitude, no - fairly short. The understanding in terms of leakage is that it probably is not significant if it does exist, mainly because of the competition that has existed up to date between the two major shipping operators. In terms of future potential for leakage, that's something that would be a concern in that we have a situation where we are moving towards an effective monopoly provider in shipping services; however, having said that, that does not necessarily say that that leakage will be just totally related to TFES.

If there is potential to exert market power here it will probably manifest itself across the full range of freight activity, and to the extent that other shipping companies might be able to leverage off that with higher freight rates and the like, I wouldn't necessarily consider that to be leakage per se, it's more an expression of market power.

PROF WOODS: But isn't that a concern? If this scheme is directed to assisting Tasmanian producers and yet some of that subsidy is appropriated by others, isn't that of concern for the economy generally and for Australian tax payers as a whole that that's a consequence of this current scheme design?

MR RUZSICSKA: Yes, that would be, and I think that that's why part of the - if you like, there needs to be mechanisms put in place to actually ensure that it doesn't happen, and part of that would be to monitor existing freight rates to see what actually is happening and to try and identify some of the market forces that might be out there, and certainly as they materialise, if they materialise, it may well be possible to identify mechanisms to combat.

PROF WOODS: Monitoring freight rates would actually require somebody to reveal what those freight rates are. If Australian Paper wishes to be the first to do so in a public environment that would be terrific.

MR RUZSICSKA: I think that underlying it we actually have a situation at the moment where Centrelink collects a raft of data - - -

PROF WOODS: It does.

MR RUZSICSKA: - - - which details exactly - I mean, from that, depending on how you approach it, the analysis can be undertaken to determine if there is any unexpected shifts or movements in freight rates. From that parcel of information it is altogether possible that somebody could actually make some recommendations regarding actions.

PROF WOODS: Both of us have variously commented on the data.

MR RUZSICSKA: I mean, the data is certainly - there is a time series of data available now. I'm not aware of the quality of it but I know that there is some question marks about it. Certainly from the point of view of how that data is collected, it may be in the interests of future adjustments and parameter refinements it might actually be desirable to make a better data collection mechanism in place.

PROF WOODS: Absolutely. All right. I think we have probably explored in this forum most of the issues that are useful but are there concluding comments that you wish to make or matters that we haven't covered that you wish to deal with? No?

MR FRYETT: Just to pick up on David Quinn's presentation, no doubt from the major industrialist's extension, the invitation to visit our site and get a full understanding of the extent to which we are actually trying to control our transport costs independent, if you like, of freight equalisation, so bringing back to the point of, no, we don't get the full rebate. We are only getting 75 per cent so it's - - -

PROF WOODS: 75 per cent of the margin?

MR FRYETT: Yes, of the margin, so it's inherent on us to actually look at ways in which we can transport more efficiently and from Australian Paper's point of view we extend you the invitation to come and sight that for yourself.

PROF WOODS: You are very kind and we appreciate that and we will respond to that invitation. Anything from yourself?

MR RUZSICSKA: Not at this stage.

PROF WOODS: Again I would like to place on the record the gratitude of the commission to the work that Australian Paper has put in to the various submissions and today's presentation is a way of assisting the commission in its deliberations so thank you very much. If I can then call forward the next participant which is Cadbury. Thank you very much. For the record if you could please provide your name, title and organisation that you are representing.

MR DAVIES: I am Owen Davies. I am the operations manager for Cadbury Schweppes in Tasmania and I am representing Cadbury Schweppes.

PROF WOODS: Thank you very much. Do you have an opening presentation you wish to make?

MR DAVIES: Thank you, yes. First of all, I would like to thank you for the opportunity to present here and also I would like to reaffirm our support of David Quinn's presentation earlier. What I thought I would do is just go through our operation in the region to give you a little bit of perspective of our business and then go through to the TFES directly. Cadbury Schweppes operates a number of factories in the region, 27 altogether, across 10 countries, producing 200,000 tonnes of confectionery and some 700 million litres of soft drink. A little more specifically we manufacture in Tasmania, Victoria, Dunedin, Malaysia and China and India chocolate. The reason I isolate those factories is because the technologies and the products that those factories make are quite similar as opposed to the others are quite different; chewing gums and other jellies.

PROF WOODS: Yes.

MR DAVIES: So that just gives you an idea of the distribution of our operations in the region. The reason I wanted to highlight this nature of our business really is to point out to the commission the international nature of our business in the region and the frequent analysis that we, when we are doing investment proposals, go through to compare the best place to invest, the best place to source product by product, and there's a lot of inter-ANZ movements of product, for example, depending on which operation's able to deliver more equitably and also between our (indistinct) operation in Malaysia and from our operation in Jakarta.

So there's a lot of comparisons of total delivered cost basically that we look at and in that context the role of the TFES in terms of its impact on our total delivered cost is significant. Just looking a little bit more locally, our business was established here in Tasmania in 1921 and we employ more than 800 people directly. We pay $54 million as wages to Tasmanians and we also buy a significant quantity of milk from the north of the state. We spend 86 million approximately in Tasmania each year, that includes the milk and the wages.

We produced 44 million tonnes product in 2005 and I guess of most significance is that 96 per cent of that product is exported from the Tasmania and approximately 10 per cent is exported from the country; about half of that, 10 per cent goes to New Zealand, the other half goes to other countries in the Asia-Pacific area. In addition we also operate a tourist facility which is the second biggest in the Tasmania and is certainly a significant tourism drawcard for the city of

Hobart.

A detailed slide just giving you some indication of our ongoing level of investment in the state in our manufacturing operations. You can see there are two large spikes which I'll come to on one of the subsequent slides as to what they were and what their significance was to our operation. This is a slide showing over time our rising manufacturing output because of our ongoing investment in the state. Just onto some details on the TFES impact, the TFES covers roughly 50 per cent of our transport costs to the mainland. I noticed that was a question you did address to Australian Paper.

PROF WOODS: Yes, thank you.

MR DAVIES: That's the approximate cost and contribution. It has been a very important factor impacting on three major investment decisions that we've made as a business to invest here in Tasmania dating back to 1993 when we made a significant reinvestment in our moulding and manufacturing capability. Generally with each of those major investments we've managed to find enough positive elements to stay in the state to offset a number of the negative elements in the state and certainly one of the ongoing negative elements in the state is the freight and the TFES is a critical ongoing offset factor to this freight disadvantage for our investment decisions.

The milestone investment decisions that our business has made from 1993 echoing the graph that I showed you a little earlier: we invested $30 million in 1993 for our main block moulding and wrapping operation; another big investment in 2002 for our smaller format moulding and wrapping and we have an investment currently in the pipeline approved and under way which is reinvesting in our large block moulding and wrapping operations. The equipment is due to be delivered late this year, to be installed early next year. Over that time our output has risen from just over 30,000 tonnes to 44,000 tonnes as a result of that investment and over that time we've invested $86 million in our plant.

One of the confidential analysis that we submitted to the Productivity Commission which were showing actual costs: what I thought I would do here is just give you a version that's perhaps more suitable for public knowledge just using percentages. We basically compared our Hobart/Melbourne route of 620 kilometres with the Adelaide/Melbourne route of 720 kilometres, being similar lengths. Without the TFES contribution the Hobart/Melbourne route was 100 per cent more expensive than our Adelaide to Melbourne route on a pallet basis, or 99 per cent or effectively double the rate on a per tonne basis. After the TFES contribution the Hobart/Melbourne route was 14 per cent still than the Adelaide/Melbourne route on a tonne basis.

Our conclusion from this analysis is two-fold: one that the analysis is not excessive and doesn't over-compensate us for the cost disadvantage of moving freight across the strait, and also that within the current cost structure there is remaining incentive for our business to reduce the costs through more effective negotiation with our freight providers.

So I just have one more slide which is really a summary slide. We have a long history of manufacturing investment in Tasmania. Recently we've invested heavily within the context of the TFES and we do operate in a very competitive global market and the TFES contribution is very important to us in keeping our total delivered cost of manufacturing from the Tasmanian manufacturing operation competitive. We do believe - certainly our analysis that we've done, points to the fact that the adjustment from the TFES is fair and not over compensating our business.

PROF WOODS: Thank you very much. If I can pursue a couple of questions, and we're grateful for the information that you've provided to us. You note that the TFES has the effect of bringing down to a margin of 14 per cent, which is still significant, the disadvantage of movement across Bass Strait compared to a road freight task. So that would be inclusive of all of the costs associated with sea freight including the additional buffering to prevent damage through the sea journey and water intrusion and the complete costs structure including all associated costs that are involved in shipping across water compared to land haulage.

MR DAVIES: No, not at all. That really is only a comparison of the transport costs, for example, working capital increases and any other costs associated with a longer supply chain are not part of that evaluation, only the shipping cost.

PROF WOODS: So it would be helpful if you could either now, and perhaps supplemented by some dot points later, just take me through some of the other costs that are involved in relying on shipping compared to a road based freight task.

MR DAVIES: Certainly. We could certainly address that in some detail in a rejoinder submission if that would - - -

PROF WOODS: Yes, provided it doesn't incur too much effort on your part, but if you could pull that together, but for today's purpose could you possibly just identify some of those.

MR DAVIES: Certainly. The first one would be working capital, both ways finished goods working capital, for example, to contrast our operation in Victoria, where our distribution nationally comes from Victoria, our chocolate operation in Victoria is the same site as the distribution. Our operation in Victoria would basically ship same day ex manufacturing. Our typical lag within our supply chain that the Bass Strait introduces is approximately four to five days in terms of guaranteed delivery to customers. We can expedite with additional expense to shorten that supply chain, but that's our typical supply chain cost.

The same would apply with coming the other way with high-cost ingredients coming down to us. The working capital is something that we bear for some of those ingredients. Some of them our vendors carry that cost but ultimately pass that cost onto us for the high-working capital, sugar for example, cocoa products from Singapore is probably marginal because they get shipped either to Hobart or to Melbourne.

PROF WOODS: Do you bulk sea freight your sugar down from Queensland or do you rail and - - -

MR DAVIES: No, all our sugar is supplied ex Victoria in 20-tonne containers. Packaging materials are probably the other one where we get substantial quantities of packaging materials, some of them from Tasmania and so they're not an issue, but many of them from Victoria. So an increase in working capital with that extended supply chain as well. But we haven't attempted to quantify those working capital.

PROF WOODS: No, but they are still relevant considerations - - -

MR DAVIES: Certainly, yes.

PROF WOODS: - - - in this process. Do you use rail on the mainland then, so you've got another inter-modal change as well? I notice you were quoting here Melbourne/Adelaide road freight comparison, but if you used rail does the cheaper cost, to the extent it is, of the rail actual component offset the inter-modal costs of transfer from truck to rail and rail back to truck?

MR DAVIES: I can't answer that with any authority. My understanding of our interstate operation is that exclusively use trucking and not rail, but I'm not a hundred per cent sure.

PROF WOODS: No, that's fine. Cadbury, according to our draft report, received 5.1 million in 04/05, that's consistent with your own figuring in that area.

MR DAVIES: Yes.

PROF WOODS: Do you know whether you're a class 1, class 2, class 3 shipper?

MR DAVIES: No, I'm sorry, I don't.

PROF WOODS: Okay. We can find that out through the database but it will just help understand the incentive factors. Do Cadbury Schweppes support the position earlier that wharf-to-wharf is an appropriate way to go?

MR DAVIES: Indeed we do.

PROF WOODS: Do you have any views additional to those that have been discussed earlier about the relative merits of wharf-to-wharf versus flat-rate subsidy arrangements?

MR DAVIES: I know that the flat rate that's being considered by the Productivity Commission is approximately half of the contribution we get from TFES currently. As to the application of a different flat rate, a lot of our freight by container attracts a very similar level of contribution from the TFES, though we do have a number of different container sizes that we use and that does affect the current model, but our view would be that a flat rate wouldn't reflect the true costs of shipping across Bass Strait.

PROF WOODS: Do you feel when you are negotiating your shipping rates that there is a competitive environment whereby you are able to achieve the lowest shipping cost as part of your total transport costs?

MR DAVIES: I do confess to not being an authority on that. All of our commercial negotiation is conducted out of our procurement division in Victoria. I do know that in the next year we will be negotiating freight, so I'm not in a position to comment on the aspects of competition.

PROF WOODS: No, that's fine. Are there other matters that you would like to raise with us, or any concluding comments that you would wish to put?

MR DAVIES: No, thank you.

PROF WOODS: I'm again very grateful for you coming along and for providing this. Now, that can go on the public record as a supplementary submission from Cadbury Schweppes. Thank you very much. Are there any others present who wish to make comment or give evidence today? That being the case the hearings are adjourned and will resume tomorrow morning at 9 am in Launceston. Thank you very much for your participation.

AT 12.21 PM THE INQUIRY WAS ADJOURNED UNTIL
WEDNESDAY, 18 OCTOBER 2006

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