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**PRODUCTIVITY COMMISSION INQUIRY**

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7 FEBRUARY 2014

**TASMANIAN  
SHIPPING AND  
FREIGHT**

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**SUBMISSION FROM**

**TT-LINE COMPANY PTY LTD  
(TT-LINE)**

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## 1. Introduction

TT-Line Company Pty Ltd (TT-Line) is pleased to make a Submission in response to the Productivity Commission's Draft Report on Tasmanian Shipping and Freight.

TT-Line's Submission of 13 December 2013 provided background on TT-Line and TT-Line operations as well as highlighting the issues pertinent to a review of shipping across Bass Strait, the Tasmanian Freight Equalisation Scheme (TFES) and the Bass Strait Passenger Vehicle Equalisation Scheme (BSPVES).

The Draft Report raises a number of issues regarding Tasmanian shipping which, while involving TT-line, are properly matters for the Tasmanian Government to respond to, in respect of its role as owner of TT-Line and its role with regard to transport policy and tourism policy.

This Submission concentrates on issues directly related to TT-Line's operations and the markets for sea-freight and passenger services across Bass Strait; viz

- a. whether TT-Line (and, by extension, the other sea-freight carriers) capture the bulk of the TFES subsidy, as alleged in the Draft Report
- b. whether TT-Line captures the bulk of the BSPVES subsidy, as alleged in the Draft Report
- c. The strategic, financial and management expectations that TT-Line's owner, the Tasmanian Government, has for TT-Line, which relates to the question of whether TT-Line conducts itself in a non-commercial and inefficient manner, and therefore distorts the markets TT-Line operates in, as alleged in the Draft Report
- d. The competitive pressure applied by the presence of TT-Line (as per the Draft Report's Information Request 3).

## 2. Users of Bass Strait shipping services get the benefit of subsidies

### 2.1 The TFES subsidy

As the Draft Report correctly notes, the incidence of a subsidy i.e. who primarily benefits from it, depends on the relative price elasticities of demand (shippers) and supply (shipping companies). The Draft Report conducts its analysis in terms of demand and supply curves.

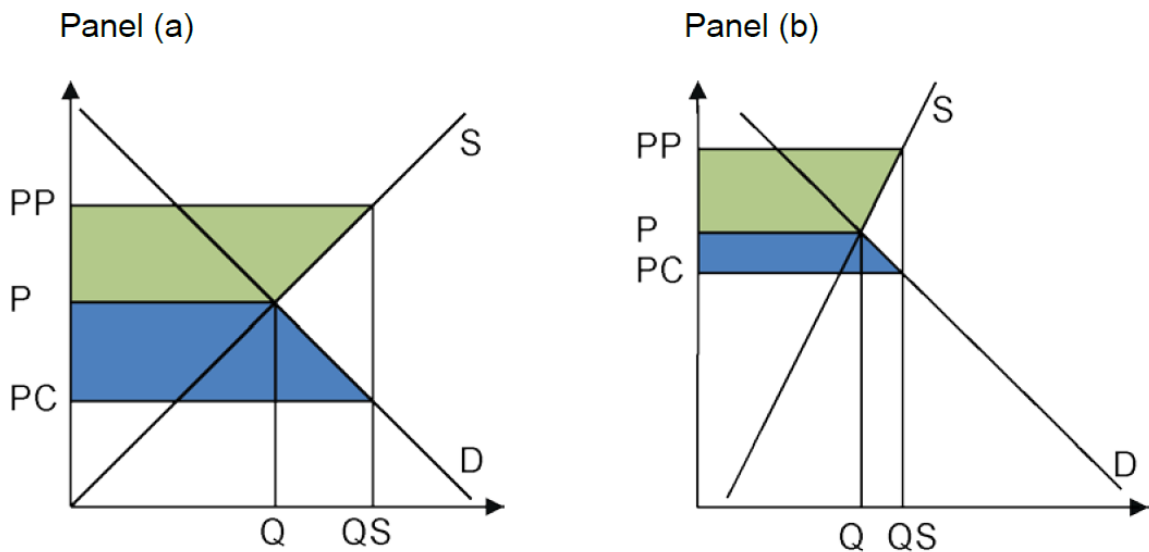
As is shown in this chapter, it is the shippers – the users of the freight transport service supplied by shipping companies – who are the overwhelming beneficiaries from the subsidy. This is contrary to the conclusions drawn in the Draft Report.

Intuitively, the supply curve shows the price shipping companies require to be paid per unit of freight (or freight kilometre) given how much they ship. If this price does not vary much with how much they ship, then the presence of a subsidy will make very little difference to how much they finally receive, and the effect of the subsidy will be essentially to reduce the amount paid by shippers, dollar for dollar.

Equally, the demand curve shows the price shippers are willing to pay for each unit of freight (or freight kilometre) of transport that they purchase. If this price does not vary much with the amount of transport services they are prepared to purchase, then the presence of a subsidy will make very little difference to how much they finally pay, and the shipping companies will effectively retain the subsidy for themselves.

It is the interaction of how much shipping companies require to be paid and how much shippers are willing to pay that determines how much of the subsidy reduces the amount paid by shippers and how much of it goes into increasing the price received by shipping companies.

Box 3.3 (p83) of the Draft Report illustrates two cases. Panel (a) in this box shows the case where linear demand and supply functions have about the same slope (in absolute terms) and so have the same price elasticity, for each price-quantity pair. Panel (b) shows the case where the supply curve is steep (implying small price elasticity) and the demand curve relatively flat (implying relatively large price elasticity). In this case most of the subsidy is captured by the suppliers (the shipping companies), in the sense that the increase in the price they receive (relative to the price they would receive absent the subsidy), is greater than the decrease in price paid by shippers.



The Draft Report’s clear implication, by illustrating the theoretical case where most of the subsidy is captured by the shipping companies is that is what is happening in practice. However, this is not true.

In the Overview at page 11, the Draft Report states

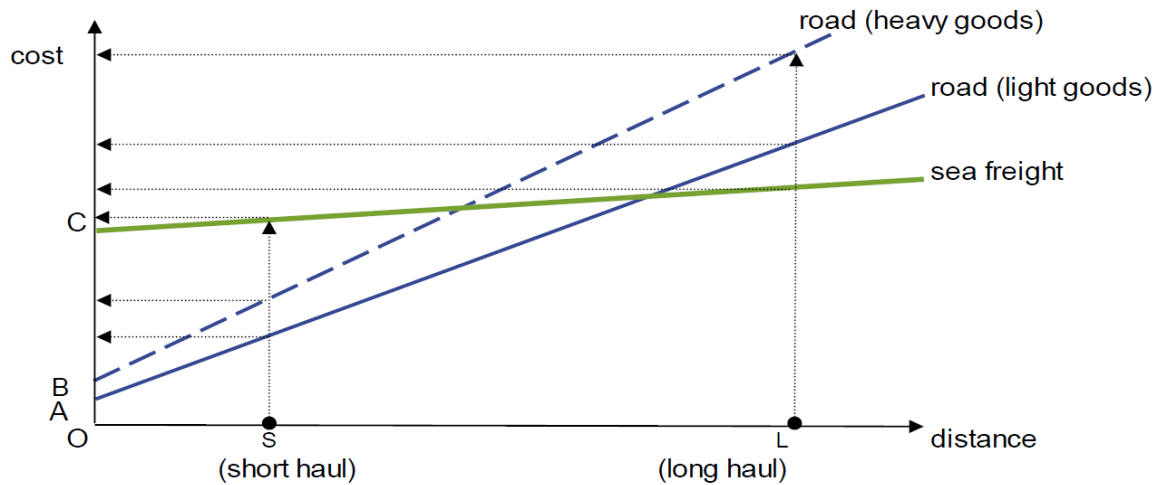
*“If supply is less responsive than demand, then suppliers will get relatively more of the subsidy than users or consumers – who in many cases are the intended beneficiaries”.*

This is simply wrong – the suppliers do not get more of the subsidy than the users – and the evidence that contradicts this is provided elsewhere in the Draft Report.

Box 2.3 at page 53 shows stylised cost structures for road and sea freight. It shows, correctly, that sea freight is characterised by relatively large fixed costs (about 80 per cent of total costs) and small marginal costs which grow hardly at all at larger levels of shippers’ output, or as the Draft Report puts it

*“running a fully laden vessel costs little more than an empty one (or a vessel carrying empty containers)”.*

### Freight cost by mode of transport and distance travelled



Source: PC (2006c).

But in competitive markets marginal cost curves are also supply curves, which mean that the supply curve in the analysis of the incidence of the TFES subsidy in Panel (b) in Box 3.3 at page 83 should be drawn as having a flat slope, the opposite of how it is drawn.

What about demand? The price elasticity of demand for a service depends principally on the ability of users to substitute to comparable services. If competing services are highly substitutable, then users will be relatively sensitive to changes in price.

In this regard, the Draft Report at page 17 says, correctly:

*“Various characteristics of Bass Strait shipping constrain competition for container traffic on that route ... Bass Strait shipping faces no competition from road and rail alternatives. Only air transport provides a potential substitute, and only for time-sensitive and/or high-value commodities in small consignments.”*

This is all true, and it means that the demand for Bass Strait freight shipping services is likely to be price-inelastic i.e. the demand curve is likely to be steep.

The Draft Report also suggested that what is needed is a low cost, lower quality service. Given that such a large proportion of costs to run a service across Bass Strait are fixed, the duration and quality of service would have negligible effect on freight charges.

Summarising, the Draft Report’s own analysis implies that the supply curve of Bass Strait shipping is likely to be flat, and the demand curve is likely to be steep. This is the opposite of how they have been depicted in Box 3.3 at page 83 in the Draft Report’s discussion of subsidy incidence.

This means that contrary to what the Draft Report concludes, its own analysis suggests that it is the users of the service that receive the great majority of the benefit of the subsidy.

In fact, taking at face value the Draft Report's statement that "running a fully laden vessel costs little more than an empty one" (p53) then just about all of the subsidy accrues to the users of Bass Strait freight shipping services.

## 2.2 The BSPVES subsidy

As with the TFES the Draft Report implies that TT-Line is the primary beneficiary of the subsidy, stating at page 85

*"The extent of subsidy 'leakage' is difficult to assess without detailed modelling. However, the characteristics of this specific market combined with pricing over time suggests that TT-Line receives at least some of the benefit of the subsidy ... Initially, there was a sharp fall in real fares when the subsidy was introduced (chapter 2, figure 2.8). Since then real fares have steadily increased which could signify that some of the subsidy is being captured by TT-Line".*

In fact, as with the TFES subsidy, TT-Line does not receive any of the BSPVES subsidy. It is the passengers who obtain all of the benefit of the subsidy, taking account of supply and demand price elasticities.

The Draft Report does not analyse the costs of providing the passenger service across Bass Strait, but simple introspection suggests that the marginal cost of an additional vehicle on a TT-Line ship must be very low. To illustrate, suppose a TT-Line ship is about to sail with 99 cars on board, when at the last minute another passenger shows up with a car. How much extra does it cost TT-Line to sail across Bass Strait with 100 cars rather than 99? The answer is: effectively zero.

In other words, the supply curve for passenger services is flat.

As for demand, once again, the analysis in the Draft Report provides the answers, or at least suggests them. At page 99, the Draft Report says

*"Demand for sea travel on TT-Line may have become less responsive to price changes (such as discounting) due to the availability of cheaper air travel and cheaper vehicle rental".*

The Draft Report then cites a submission by Department of Infrastructure and Regional Development (DIRD) which appears to say that fly-drive holidays to Tasmania do not compete with sea-travel holidays where travellers bring their own car.

This analysis implies that the demand for sea-travel on TT-Line is relatively price inelastic.

Summarising, as with the freight market, once again the analysis points to the conclusion that the supply curve for Bass Strait sea passenger travel is flat and the demand curve is steep.

Once again, this implies, contrary to what the Draft Report concludes, the entire subsidy goes to the users of the service, with none going to TT-Line.

How to explain the rise in real passenger fares over time which the Draft Report claims is evidence that TT-Line is capturing “at least some of the benefit of the subsidy”?

The answer to this question is also found elsewhere in the Draft Report. Immediately after concluding that TT-Line is capturing some of the subsidy the Draft Report notes that in TT-Line first submission, TT-Line argued that indexation by CPI is inadequate because maritime costs have grown, and continue to grow, faster than consumer prices. Over the past five years, TT-Line’s operational expenses have grown at a rate higher than CPI.

In other words, maritime costs have also grown in real terms, and this is what has driven increases in real fares.

In conclusion, as the Draft Report notes at page 85, when the subsidy was introduced, real fares fell sharply, which was entirely consistent with the benefit being captured by the users of the service. Over time, fares increases have been driven by cost increases. This has nothing to do with the incidence of the subsidy.

### **Other matters relating to the BSPVES**

The Draft Report repeatedly states that the purpose of the BSPVES is to support tourism in Tasmania.

The Draft Report also concluded that (just about) the only people who travel by sea across Bass Strait are what it calls ‘Grey Nomads’ (Draft Report, p84), presumably retirees who have a lot of time on their hands.



This is an interpretation that has no official basis. The Ministerial Directions for the Operation of the Bass Strait Passenger Vehicle Equalisation Scheme (latest version 11 June 2013) do not, and as far as TT-Line is aware, have never, made any reference to the promotion of Tasmanian tourism. Rather, the purpose of the scheme is to lower the cost of travel to an “eligible passenger who is booked to travel on a Bass Strait passenger service or a Bass Strait vehicle service” (paragraph 4.1).

Similarly, the DIRD, in its Monitoring Report 14 (January 2014) states (p1) that

*“the aim of the Scheme is reduce the cost of sea travel across Bass Strait for passengers accompanied by an eligible vehicle”.*

The important words here are “across Bass Strait”, because the subsidy is available to all Australians. Logically, if the objective of the BSPVES was to promote tourism in Tasmania, it would only be available for tourists visiting Tasmania.

The Draft Report also states that further evidence of the Scheme’s “ineffectiveness” in promoting Tasmanian tourism is the decline in the ratio of sea passengers to air passengers in Tasmania (figure 3.4, p101).

While, as noted above, the premise that the purpose of the Scheme is to encourage travel to Tasmania is wrong, the declining ratio of sea travel to air travel passengers would not support that Draft Report’s conclusion even if the premise was right.

The reason that sea travel to Tasmania has grown slower than air travel is that TT-Line’s capacity to take additional passengers has been constrained during peak periods. It is relatively easy for airlines to add more capacity to routes to fly more passengers into Tasmania if the demand is there. Airlines do not have to purchase more planes to do so. TT-Line can only realistically sustainably increase its passenger load to Tasmania by investing in another ship. This would be a large, lumpy investment that would be feasible only if there is sufficient demand for freight voyages as well as passenger voyages, if port access issues can be resolved and if a suitable vessel can be procured.

As the Draft Report notes, at page 118, the nature of Bass Strait conditions, and other factors, requires purpose-built vessels. These are expensive.

As noted in TT-Line submission of 13 December 2013, there is currently a need for replacement or additional capacity.

### **2.3 Recommendation**

TT-Line recommends that in its Final Report, the Productivity Commission changes its conclusions with respect to the incidence of the subsidies to make them consistent with its own analysis i.e. that the overwhelming beneficiaries of the TFES and BSPVES subsidies are the users of these services.

### **3. Accountability**

#### **3.1 Introduction**

The Draft Report says that it is not apparent from the TT-Line Arrangements Act 1993 what the underlying objectives are for government ownership of TT-Line and operation of a shipping service across Bass Strait.

It then muses that absent any explicit objectives, the Productivity Commission can't assess whether the operation of TT-Line is achieving those objectives effectively or efficiently, and asks whether government ownership of TT-Line might result in higher economic costs for the services provided by TT-Line.

The Draft Report cites claims made in a submission by RDA-Tasmania that the provision of a government owned service is “interventionist and an unwelcome intrusion into the market”, which “could potentially distort the true market price of shipping”.

The reasons for government-ownership of TT-Line are properly ones for the Tasmanian Government to articulate. However, TT-Line rejects the notion that it operates on a non-commercial basis and hence “distorts the true market price of shipping”. On the contrary, TT-Line operates on a fully commercial basis.

TT-Line fully complies with the policy of Competitive Neutrality, as prescribed by the Office of the Tasmanian Economic Regulator and the Department of Treasury and Finance. This includes paying, if applicable, a Guarantee Fee to Treasury which offsets any advantage that TT-Line may obtain by obtaining debt finance at the Tasmanian Government's credit rating.

In this chapter we set out the expectations that TT-Line's owner has for the company and its reporting requirements.

### 3.2 TT-Line Governance

TT-Line Pty Ltd is a company subject to the Corporations Act 2001, the Competition and Consumer Act 2010 and other relevant statutes. In this respect it is no different to a privately owned company.

While not listed, TT-Line complies with the relevant sections of the ASX Corporate Governance Council's Corporate Government Principles.

TT-Line has a Board of Directors comprising seven independent directors and the company's CEO. The Board is responsible for the overall performance of the business in achieving TT-Line's objectives.

The company issues an annual report which contains comprehensive externally audited financial statements.

The company is subject to public scrutiny through GBE hearings.

### 3.3 Members' Statement of Expectations

The Members' Statement of Expectations is a document prepared by the Minister of Infrastructure and the Treasurer, in consultation with TT-Line, that sets out, *inter alia*, the purpose and strategic expectations and the financial and commercial management expectations, that the Government has for the company.

The latest version of this document, dated June 2012, is available from TT-Line's website.

It states that TT-Line's principal objective is to be a successful company by operating in accordance with sound commercial practice and as efficiently as possible.

The Strategic Expectations for TT-Line in managing its core business are, *inter alia*, to

- provide a safe, reliable and efficient shipping service across Bass Strait;
- manage financial performance and business risk; and
- ensure the fleet remains fit for purpose and meets the needs of its customers in terms of meeting growth in passenger and freight demands.

In terms of financial performance, TT-Line is expected, *inter alia*, to

- meet its financial and commercial targets
- implement the business strategies contained in its Corporate Plan; and
- proactively identify and implement operational efficiencies and productivity measures to enhance its financial performance.

In terms of pricing, TT-Line is expected to set prices, fees and charges, which

- meet the objectives of efficiency and financial sustainability;
- comply with all legislative and regulatory instruments; and
- deliver a commercial rate of return on assets employed as set out in the Statement of Corporate Intent.

### **3.4 Reporting to Treasury**

As well as TT-Line's own specific reporting requirements, TT-Line must comply with the guidelines issued by the Department of Treasury and Finance for all Tasmanian Government-owned businesses.

Reporting requirements include:

- Quarterly reports, which are a formal requirement under section 57 of the Government Business Enterprises Act 1995. These reports must include financial statements, results against key performance targets, commentary on performance and explanations for material variances from budget, revisions to likely year-end financial results and explanations of material variances, current estimates for financial returns to Government and explanations for any material variances from the Corporate Plan, and capital expenditure for the quarter and explanations of material variances from budget
- a Half Year Report, which is a formal mechanism for reporting performance to the Shareholding Ministers for the six month period ending 31 December each year. This report includes financial statements for the quarter, year to date and prior year to date, and other material similar to that contained in the quarterly reports

- an Annual Report, in accordance with the Corporations Act 2001, and the Treasurer's GBE 08-55-04 Annual Report and Statement of Compliance. Annual Reports going to back to 2006/07 are available on the TT-Line website
- an Annual General Meeting no later than 30 November each year, unless Shareholding Ministers have approved an extension.

TT-Line must also have regard to other Treasury governance guidelines, which cover board performance and appointments, corporate planning, director and executive remuneration etc.

TT Line is transparent in reporting at the unit level, passengers, passenger vehicles and freight TEU's transported year on year in contrast to its competitors which are therefore unavailable for outside scrutiny.

In summary, not only is TT-Line obligated to be run like a private commercial enterprise, TT-Line's reporting and accountability requirements are if anything more onerous than those imposed on private commercial enterprises, certainly those that are not publicly listed.

## 4. Competition in the Bass Strait shipping market

In its Information Request 3, the Draft Report asks

*“To what extent does the government-owned TT-Line provide competitive pressure in the Bass Strait shipping market? Would a scenario with only two commercial shippers provide a more cost-effective outcome?”*

Three companies provide freight shipping services in this market: TT-Line, Toll and SeaRoad.

The Draft Report notes that both shipping companies and shippers see the market as competitive, and so does the Tasmanian Government.

Nonetheless, despite this evidence, the Draft Report does not conclude that the market is competitive. It notes that there are barriers to entry into the market, and this may be inhibiting further competition.

A competitive market is one where no individual producer, or seller, can profitably raise its price on a sustained basis. That is, sellers either are price takers or must, at the very least, have to engage in meaningful negotiations with their customers to settle on prices (and other conditions of sale).

This has certainly been TT-Line’s experience. Our customers are well aware that if the commercial terms we offer are unsatisfactory to them, they have the option of taking their business to one of our competitors. Everybody in the industry, both buyers and sellers, understands this. Simplot’s experience, as set out in its submission and cited in the Draft Report (p116), is typical:

*“Simplot’s significant freight task is sought after by both major shippers, and therefore Simplot is able to perform a competitive tender process ... Simplot is comfortable with the competitiveness of Bass Strait Shipping”.*

From TT-Line’s viewpoint, an indication of competition in the marketplace is that over the years it has both gained business from and lost business to our competitors

In considering the hypothetical impact of removing TT-Line from the market, a number of factors have to be considered.

The first is that TT-Line has a market share of just under 20 per cent of the freight market, measured in TEUs. TT-Line has the smallest market share of the three shipping companies, but not so small that we can’t exert significant competitive pressure. Most importantly, TT-Line is the only one of the three shipping companies that offers only

shipping services. Both SeaRoad and Toll are vertically integrated companies that also provide transportation to and from the ports.

Removal of TT-Line from the market would leave not just a duopoly of SeaRoad and Toll, but a vertically integrated duopoly. The competitive dynamics in the market would be changed significantly.

It is well-known that a vertically integrated firm with market power can leverage that market power from one market to another. For example, hypothetically, absent TT-Line, the remaining duopolists could anti-competitively bundle trucking and shipping services, which would exclude potential entrants to either trucking or shipping or both.

While bundling need not be necessarily anti-competitive, it can be, and its anti-competitive forms are prohibited by section 47 of the Competition and Consumer Act 2010.

The presence of TT-Line as a stand-alone shipping company effectively stops anti-competitive bundling taking place by its vertically integrated competitors, because shippers have the option of purchasing their transportation services to the ports separately from their shipping services across Bass Strait.

It is noteworthy that the various competition assessments of mergers in the Bass Strait shipping market made by the ACCC were all conducted in an environment where TT-Line provided competitive pressure in the market. It is arguable that in a hypothetical case where TT-Line was absent, the ACCC would have been much less likely to have approved these mergers.

As things stand currently, shippers always have the option of taking their business to TT-Line's competitors if they find TT-Line's prices to be too high. The fact that TT-Line has a significant share of the market implies that our prices are competitive.

In the circumstances, it is difficult to see how a market with just Toll and SeaRoad as suppliers could provide "a more cost effective outcome". At best, there would be no change in the prices faced by shippers; at worst, they may face significant price rises as the vertically integrated duopolists exercised their market power.

It is also not the case that the exit of TT-Line from the market would see a more efficient use of existing capacity. The industry is currently at or near full capacity. There is minimal scope to more efficiently use existing capacity by concentrating the business of three suppliers of shipping services into two.

An expansion of existing capacity is required for the Bass Strait marketplace to remain competitive.



## 5. Opportunities for improving the TFES and BSPVES

TT-Line would like to reiterate some of the points raised in its submission of 13 December 2013.

In relation to the TFES:

- Greater transparency and efficiency in the process for claiming the rebate.
- The market has shifted and continues to move toward the use of trailers. The PC should consider if the structure of TFES adequately reflects the current and future trends in freight requirements.
- Application to export cargo.

In relation to the BSPVES:

- Equality of application. The current rebate under BSPVES applies to motorhome and caravans but not trailers. The PC should consider including trailers in the coverage of the scheme.
- Optimisation of the scheme. The PC should consider ways to optimise the application and operations of the scheme. This could include increasing the level of rebate, full equalisation for vehicles, inclusion of passengers to the rebate scheme and alternative mechanisms to better calculate the rebate.
- Rebate indexation. The PC should consider an alternative method to index the rebate level other than CPI. This is because increases in maritime operating costs are significantly above CPI.