



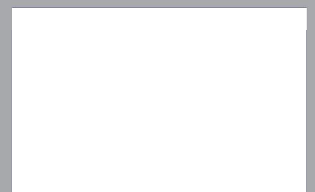
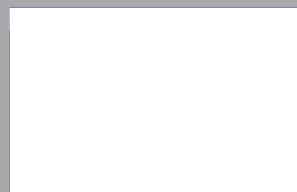
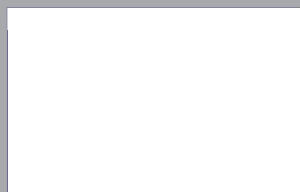
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Department of Infrastructure Energy and Resources, Tasmania

Furneaux Shipping

Final Report

January 2010





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Key Findings and Conclusions

- » The Department of Infrastructure, Energy and Resources engaged GHD to undertake a study of Furneaux Island shipping to report on:
 - the likely service level that would be provided under stand-alone commercial arrangements between freight demanders and shipping service providers, in the absence of Government intervention;
 - differences (if any) between that level of service and the Government's stated objectives in relation to an 'essential' shipping service – i.e. the scope of market failure; and
 - potential and preferable mechanisms for the Government to address any identified market failure.
- » GHD met with shipping users and other stakeholders during a site visit to Flinders Island to gain an understanding of the freight market, the nature of trade to and from the islands, how demand changes throughout the year and the potential for future significant changes in demand levels. These meetings also provided an insight into some of the wider contextual issues associated with the current shipping operations.
- » The Furneaux Island freight task is primarily driven by the need to service the livestock industry, in particular, demand generated by the export of live animals from the Islands to markets in Tasmania and Victoria (contributing over half of the total annual freight volume), and imports of farming inputs such as fertiliser and machinery. While the majority of the freight task is related to the livestock industry, the needs of the communities and other industries located on the islands generates the majority of the remaining volume such as bulk fuel and general cargo.
- » Freight demand for the Furneaux Islands, and in particular Flinders Island, is highly seasonal, reflecting the nature and timing of the livestock industry. The freight task is further affected by the imbalance that results from the nature and scale of industries on the islands, showing a distinctly higher export task.
- » The subsidy provided by the State Government under the existing contract with Southern Shipping Pty Ltd has in recent times been supplemented by the introduction of the Intrastate component of the Tasmanian Freight Equalisation Scheme to shippers. The introduction of that scheme has led to some double subsidisation; however, it is unlikely to have been substantial. The existence of the scheme is unlikely to have stimulated additional demand for freight services to and from the islands; rather, it has resulted in substitution of demand for sailings from the Islands to Tasmania rather than Victoria.
- » Seasonal and imbalanced trade flow to and from the Islands presents challenges in consistently meeting demand. However, there is significant shipping capacity currently available to service the Islands' needs. In terms of service numbers, there has been a very high level of shipping visitation to and from the Islands in recent times, with some 392 vessel movements in total for the 2008-09 Financial Year. In that year, there were 157 'export' trips from Flinders Island to Tasmania, 29 export voyages to Victoria and 152 'import' trips from Tasmania to Flinders Island.



- » While the focus of this study did not extend to customer satisfaction levels, it is noteworthy that there is a high degree of, but not unanimous, dissatisfaction with the level of service provided by the current contracted operator, Southern Shipping. Concerns relate to issues such as the reliability of the service (particularly for services over and above the contracted minimum weekly service), the past performance of the business in meeting peak demand, the condition of freight after transit and other business decisions and practices of the Company that impact on service delivery to customers. These issues point to users' concerns about service quality aspects, rather than the essential model of Government support for Furneaux Island shipping.
- » A key issue from the perspective of the current operator is the sustainability of the service in light of the entry of non-contracted operators. Given the level of shipping capacity available under the contracted arrangements relative to prevailing demand, opportunistic entry by other service providers presents risks to the commerciality of the core contracted service and to the level of funding required to be provided by Government.
- » Some of the issues currently facing the Government in relation to Furneaux Island shipping appear to relate to a mismatch between the parties contracting for the 'essential' shipping service, and those receiving the service. Consideration could be given to better align the parties, by providing Island stakeholders a formal role in the contractual arrangements and engagement processes.
- » The scope for this study required us to examine the underlying commerciality of Furneaux Island trade. Our modelling suggests that the market opportunity is a commercial proposition, given existing loads and prevailing freight rates. Minimal Government intervention would be required to ensure a weekly service between Flinders Island and Tasmania, though some form of agreement might be required to attract a commercial operator to visit Cape Barren Island on a monthly basis.
- » For the service to be sustainable, it must meet the needs of both shippers and the operator, that is, servicing the base level of demand at prices that deliver a reasonable commercial return for the operator. The current arrangements present a good mix in this regard, and significant changes that challenge the balance in favour of shippers or the shipping provider present material risks to the sustainability of the service.
- » It is noted that the 1995 contract between the Transport Commission and Southern Shipping for Furneaux Island shipping, which accompanied the introduction of the *Matthew Flinders III* onto the route, was prepared in the context of the service being commercially viable. Our modelling suggests that given the prevailing level and type of trade currently available under the existing freight rates, this intention remains valid.
- » The other significant finding is that left to the market, peak demand may not be met at the time (ie the week) in which it is presented, depending on vessel capacity servicing the islands.
- » In short, the scope of market failure in relation to a minimum level of service appears limited, and on this basis, a 'light handed' approach to Government involvement in the market appears appropriate under the existing policy settings.



- » The existing contract model manages some, but not all, of the risks that would otherwise present in a pure market environment. It works to assist in keeping capacity available on the route to service base level demand, while allowing the operator freedom to seek commercial opportunities beyond the minimum contract obligation. This is a good feature of the current arrangements as it potentially reduces the level of subsidy that would otherwise be paid by the State Government resulting from fixed freight rates, particularly during periods of low demand. However, seasonal peak demand, which far exceeds the once-per week sailing capacity mandated under the contract, potentially has competing commercial priorities for the contracted operator, and could place capacity provision beyond the minimum requirement at risk, if more lucrative opportunities present.
- » Risk allocations in the current contract appear appropriate, noting that there are some risks that are effectively impossible to transfer from Government in meeting essential shipping services for the Islands. The contract provides strong mitigation against the risk that the freight task, due to its industry driven profile and volume, would not be generally appealing to the open freight market beyond irregular and opportunistic supply. Nonetheless, the current contractual arrangements, because of the way in which they are structured, arguably give the Government a more extensive involvement in the market than may be needed.
- » The options for supporting Furneaux Island shipping can be grouped as follows:
 - No involvement – leave it to the market;
 - Status quo, that is a primary contract with a third-party single provider, and variations on the status quo;
 - Government owning the vessel and contracting the right to operate the service using it;
 - Government delivering the service;
 - Furneaux stakeholders (Council or a representative body of shippers) owning the vessel and contracting the service; and
 - Furneaux stakeholders (Council or a representative body of shippers) owning the vessel and operating the service.
- » Of these approaches, the status quo with some improvements to the contract to drive performance is recommended. The current contract lacks clear performance parameters and the absence of incentives and penalties based on performance diminishes the incentives on the service provider to meet stakeholder needs. In addition, customers of the service have no clear role in the arrangements. It is suggested that these issues be addressed in preparing any subsequent contracts to underpin the service.
- » Alternative support models, such as Government ownership and community-based models, transfer a range of risk to parties not well equipped to manage them and are likely to result in higher costs.
- » Our modelling does not lead us to conclude that Southern Shipping does not require a subsidy to operate under the prevailing freight rates.
 - Given the loads available, it would appear that there is, for most of the year, substantial excess capacity for the Islands with both the *Mathew Flinders III* and the *Southern Condor* both available (leaving aside other capacity such as Les Dick Shipping's *The Statesman*).



- To service the Islands with two ships, Southern Shipping has (almost) twice the crew costs, faces the capital cost of two vessels and faces much higher fuel costs to move the same volume of freight. On the other hand, these costs can be offset by the application of the vessels to other commercial opportunities (Southern Shipping does currently do this, for example, the movement of explosives from Eden, and cattle from King Island).
- » Without access to substantial detailed financial information on the costs currently facing specific operators, it is not possible to determine the commerciality (or otherwise) of the service from the perspective of that operator or the level of any subsidy that might be required to retain them on the route.
- » In summary, this study has found little evidence of widespread market failure in the Furneaux Island shipping market, at least in relation to services to Flinders Island. It is recognised that a change in policy that would leave Island shipping purely to the open market would give rise to some risk, principally around freight rates and surety of capacity principally during periods of low demand, and is unlikely to be politically acceptable. That said, there appear to be no grounds to move substantially in the opposite direction and introduce a Government-owned or community-owned service, and there are solid arguments for not doing so. By contrast, we would suggest that there is a compelling case for substantial improvements in the nature of the contract between the Government and the service provider to drive improved performance. To better align the contracting and service parties, the Government may consider giving Island representatives clearer roles and responsibilities under the contract, and could move to more of a funding role whilst retaining key controls to manage financial risk.



1. Introduction

Currently, the majority of shipping services to the Furneaux Islands are provided by Southern Shipping Pty Ltd, who is the Tasmanian Government contracted operator for provision of minimum service levels to Flinders and Cape Barren Island. Some shipping services (around 10 per cent of total traded volume) are provided by LD Shipping, under private commercial arrangements with Flinders Island freight demanders.

There are mixed perceptions regarding the quality (broadly defined) of the shipping services provided by the contracted operator. The Flinders Council has commissioned a review of the Islands' shipping infrastructure needs, and the optimal shipping arrangements for the Islands. The Tasmanian Legislative Council is also undertaking an Inquiry into various Tasmania Island shipping issues, including those related to the Furneaux Islands.

Within this broad context, the Department of Infrastructure, Energy and Resources has engaged GHD to undertake a more narrowly defined study of Furneaux Island shipping to report on:

- » the likely service level that would be provided under stand-alone commercial arrangements between freight demanders and shipping service providers, in the absence of Government intervention;
- » differences (if any) between that level of service and the Government's stated objectives in relation to an 'essential' shipping service – i.e. the scope of market failure; and
- » potential and preferable mechanisms for the Government to address any identified market failure.

The primary inputs to this Study were:

- » information gathered through consultation with Furneaux Island freight demanders and the Flinders Council;
- » information obtained from discussions with Southern Shipping;
- » trade data provided by Tasports Pty Ltd, which detailed shipping movements between Furneaux Islands, mainland Tasmania and Victoria for 2008-09; and
- » a financial model of a 'typical' shipping operator providing shipping services to the Islands, developed by GHD as a part of this study.

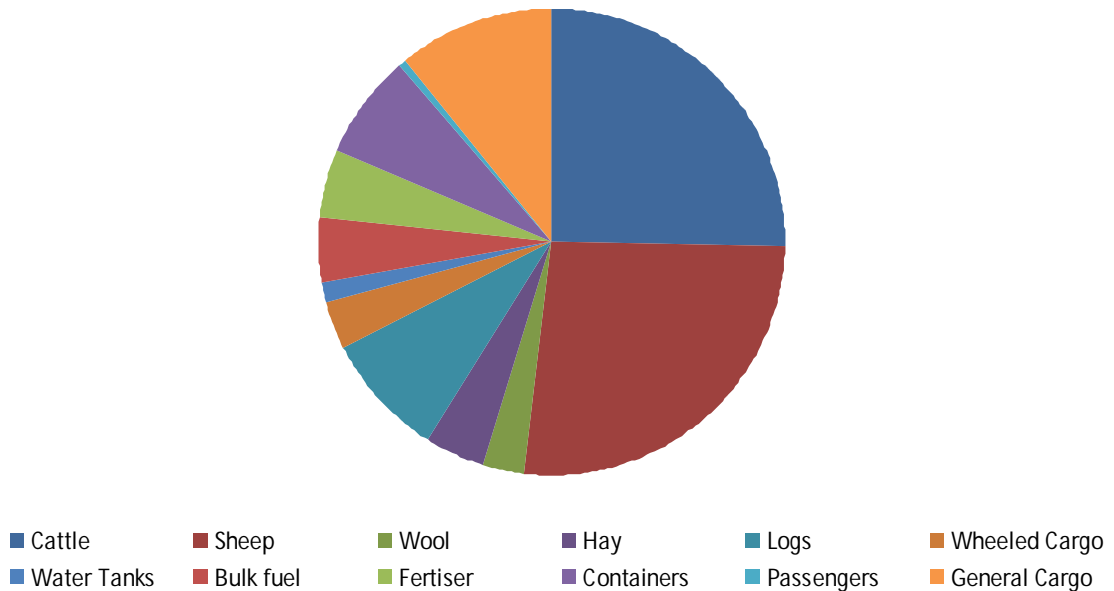


2. The Furneaux Shipping Market - Demand

2.1 Composition of Trade

The Furneaux Island shipping market¹ is primarily driven by livestock exports from the Islands. This is demonstrated in Figure 1, which shows the composition of total trade to and from the Furneaux Islands in 2008-09. Livestock movements account for over half of total volume, with general cargo (including containerised freight) accounting for the next largest share at around 18 per cent, and logs accounting for around 9 per cent albeit for a period of approximately 3 months.

Figure 1: Trade Composition for Flinders Island, m³, 2008-09



Source: GHD estimates based on Tasports data

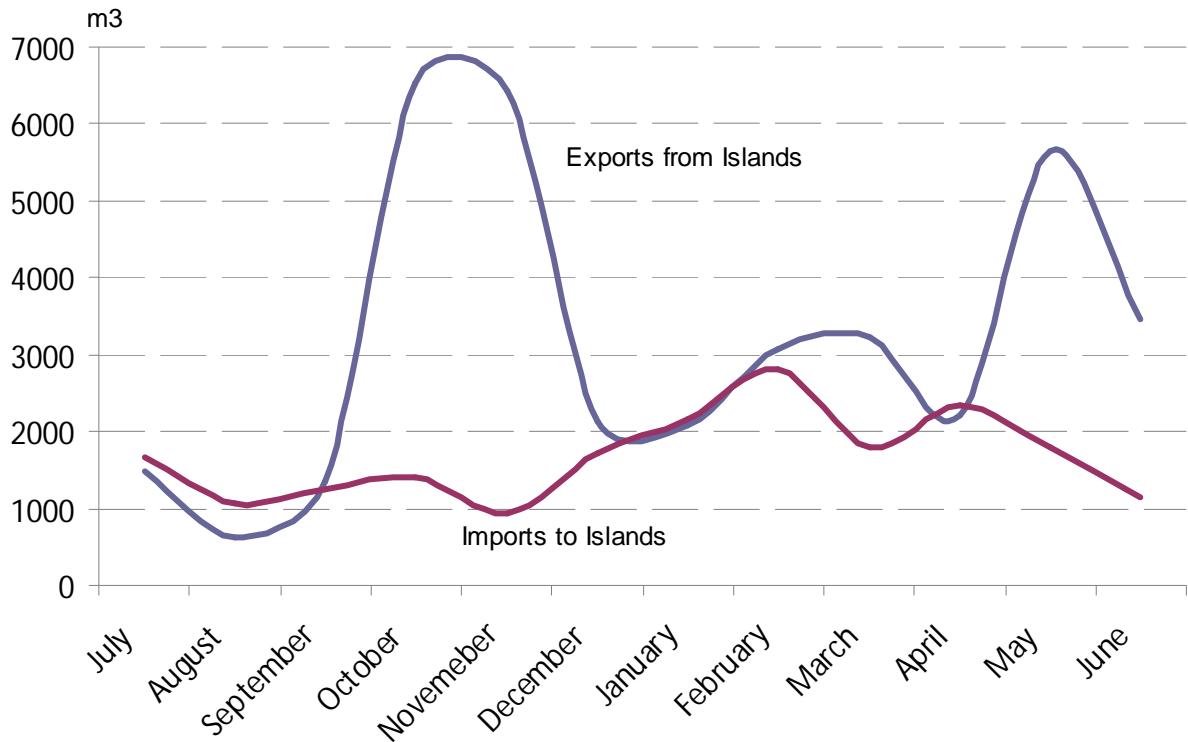
The balance of trade is heavily skewed by the export of livestock from the Islands, which is further affected by seasonal demand of the industry. The imbalance and seasonal nature of cargo is shown in Figure 2, which compares freight movements from the Islands (exports) and movements to the Islands (imports). The pattern of freight movement also clearly demonstrates a clear peak in export demand in the October-November period, when some 42 per cent of all livestock exports occur². A further 20 per cent of livestock exports occur in February-March, 10 per cent in May, with the remainder spread throughout the year.

¹ Robust and medium term data on the demand for shipping for the Furneaux Islands has been difficult to obtain. Data provided by Tasports for cargo movements to and from the Furneaux Islands for 2008-09 was the only disaggregate data available to GHD for this study.

² The distribution reflects the drought conditions that existed on the Islands during 2008-09, which led to some destocking on the Island and the import of hay. As a result, a higher export level with compressed peaks was observed for the period, beyond that which would typically occur. That being said, it could be reasonably argued that these peak conditions are reflective of a 'worst case' scenario that would need to be catered for in meeting Furneaux Island demand. Furthermore the period reflects the unavailability of one of Southern Shipping's vessels during the peak export period. The combined effect of these factors was to increase the peak of livestock movements in November. In a typical year, the November peak is unlikely be as pronounced, with some of that trade occurring in shoulder months, and the total volume of livestock exports being reduced.



Figure 2: Trade Balance from and to Flinders Island, m³, 2008-09



Source: Tasports, GHD estimates

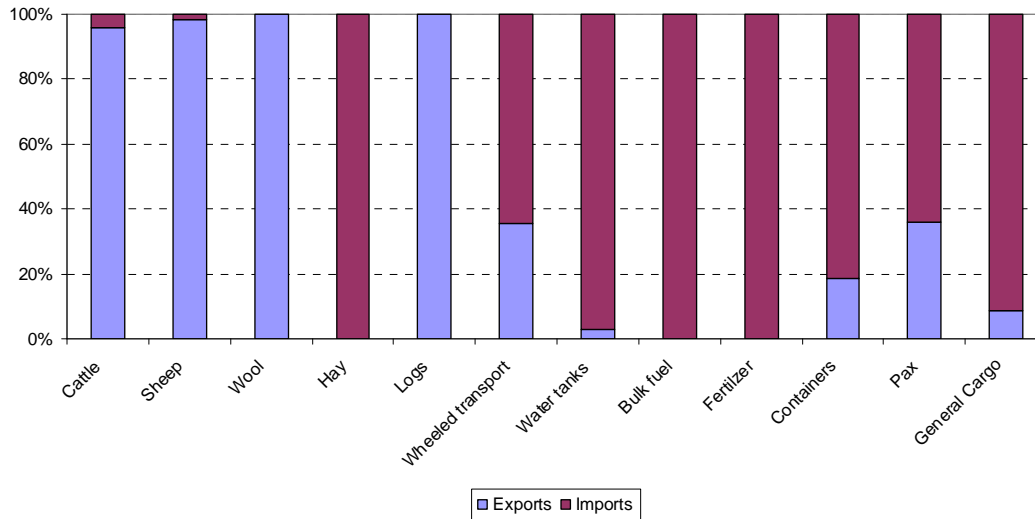
While the profile of import volume does not show the same degree of variation as exports, there are noticeable import peaks in April-May and November-February. The peak period in April-May is typical for the islands, where over 50 per cent of the annual fertiliser task occurs. The import peak over the period November – February of the sample year was primarily associated with the import of hay, and is atypical of island trade. This event was stimulated by drought conditions that existed at the time, and the need to import feed. This situation was further complicated by compression of the export peak to a spike, and the time required to meet the, then immediate, transport task with the available shipping capacity.

While it may appear rational that fertiliser, as a non time critical import, may be spread more evenly throughout the year, provided capacity for island imports can support the task when required, the timing of demand is typically influenced by the cashflow position of graziers following seasonal sale of livestock.

Figure 3 shows the balance of trade by cargo type. As expected, fuel and fertiliser are import-only cargoes, and logs and wool are export-only. The import of hay reflects the drought conditions that prevailed during 2008-09, and other cargos show a two-way trade.



Figure 3: Direction of trade flow by commodity, 2008-09



Source: Based on Tasports data

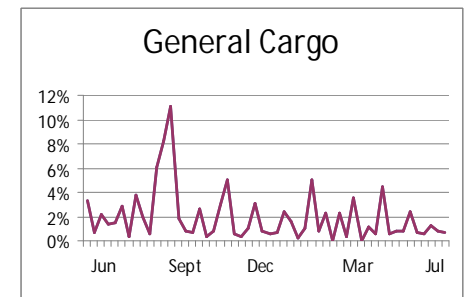
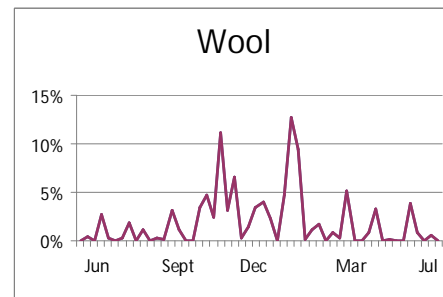
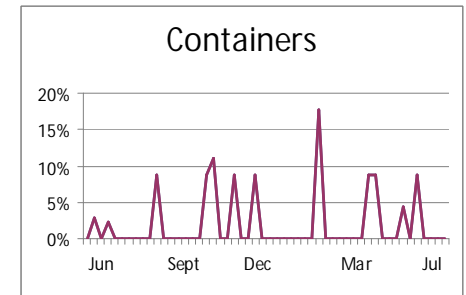
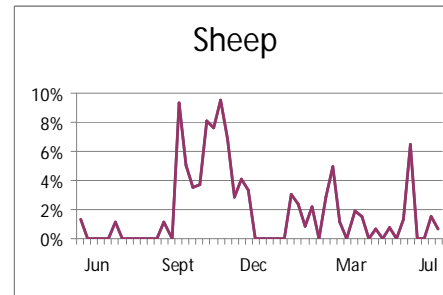
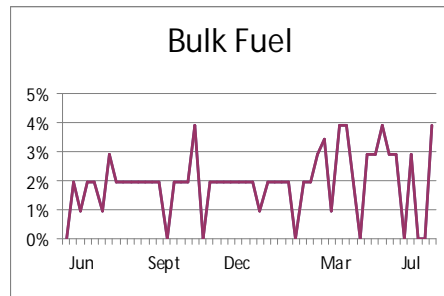
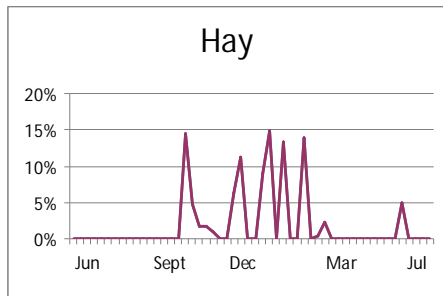
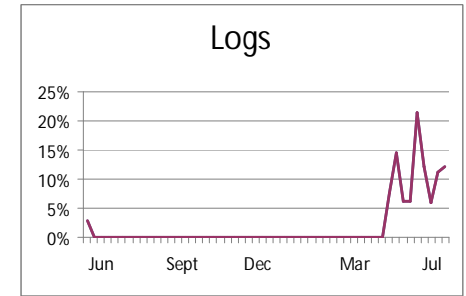
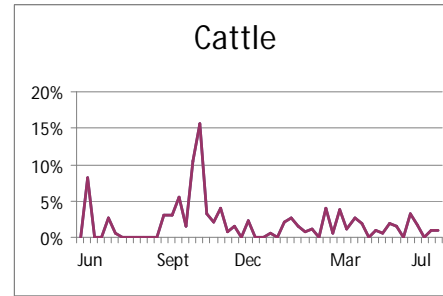
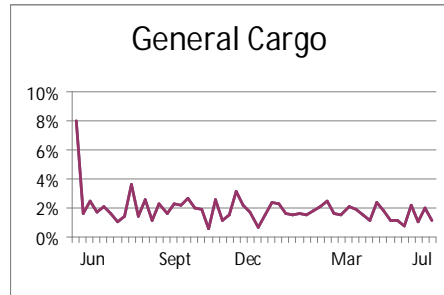
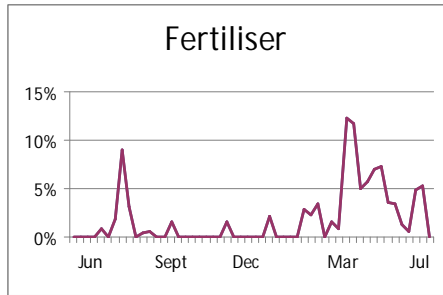
The timing of trade movement throughout the year for key cargos is different, as each have different stimulators of demand. Figure 4 demonstrates the, distribution of movements, both import and export, for each key commodity by week, where it was found that:

- » the peak in sheep and cattle exports coincides in Spring/early summer;
- » exports of wool exhibit two peaks in Spring and Summer;
- » movement of general freight and imports of bulk fuel are generally consistent across the year;
- » fertiliser imports peak in Autumn; and
- » log imports commenced in April³.

³ Log exports relate to the current harvesting contract, and are expected not to continue in the medium to longer term

Figure 4: Distribution of cargo movements between the Islands to Tasmania, 2008-09

Trade from Tasmania to the Islands



Source: Based on Tasports data



2.2 Future Changes in Trade

Discussions with Island stakeholders revealed that the forward profile for shipping demand is unlikely to change significantly in the coming years. Stakeholders were generally unable to identify any likely or potential developments on the island that would materially increase the volume of trade for either imports or exports.

- » Livestock representatives indicated that as the Island recovers from drought, stocking levels could reasonably be expected to increase over time, with the growth in livestock primarily arising from on-island breeding, rather than importation.
- » Improvements in general stocking rates are likely to compound the peaks in shipping demand, as the additional livestock are exported at sale, rather than broaden and diversify trade across months. However, if and when drought conditions return, a compression of peak demand will be likely to return, placing additional stress on ship export capacity from the islands.
- » The current activity associated with softwood log shipments from Flinders Island is not a long-term sustainable trade. It is understood that this trade reflects the once-off harvesting of existing plantations that have not been replanted⁴.

The single identified significant growth prospect was from the Island's largest farming operation, Markarna Grazing Company. Their current plan is to double exports in the short-medium term. This would represent a notable change in the shipping market, with the export of an additional cattle further adding to the peak demand periods (there would also be higher levels of fertiliser imports). Such a development would increase the potential for opportunistic market entry if the existing operator were not able to provide the additional capacity required; though with two ships, multiple weekly sailings and the implementation of a second deck on one of the vessels, it is not obvious that this would be the case. Currently, Markarna exclusively uses LD Shipping for the transport of livestock and general freight on an inducement basis, which is complicated by the beneficial commercial arrangements outside the Government Contract, between the parties.

2.3 Implications of the demand profile

The nature of the shipping demand profile for the Furneaux Islands has implications for the underlying commerciality of shipping operations. From the perspective of a shipping operator, a steady annual demand profile with a balance in import and export movements is ideal as:

- » it allows for a degree of optimisation in vessel capacity, avoiding periods of significant under/over capacity, which significantly assists in maintaining profitability; and
- » a balanced trade means that import and export sailings are all contributing to cash flow, and vessel repositioning with low vessel utilisation to service 'one way' trade is kept to a minimum.

⁴ The trading data for 2008-09 contain 3 months of log exports, so the share of logs in overall trade for 2009-10 and 2010-11 would be expected to be considerably higher, falling to zero in 2011-12 onwards.



Clearly, the seasonal and imbalanced trade for the Furneaux group do not reflect these optimum conditions. Given the short steaming time between Flinders Island and Tasmania, the seasonal change in freight demand is readily managed by additional sailings. Satisfying peak demand of the island is assisted by the current operator's ability to use a second vessel from its fleet; however, if the second vessel is not actively engaged in other commercial operations outside peak demand, there is a significant cost imposed on the shipping operator for providing ad-hoc additional capacity to meet the Furneaux Island's freight task.

Based on the position of the current operator, there is substantial capacity available to meet the Islands' shipping needs, given the sailing time of around 8 hours from Bridport to Lady Barron and the availability of two vessels. With sufficient crew and efficient loading and unloading facilities, a daily shipping service would be possible with the vessels currently available, where there sufficient demand to warrant such capacity.

The imbalance in trade is perhaps a greater consideration from the perspective of the shipping market than the seasonality of trade. A commercial shipping operator needs to consider the costs and revenues available from round trips, and where trade is unbalanced, the cost of 'back haul' at low levels of capacity utilisation have to be outweighed by the net revenues available from meeting the primary market. In an open market, high demand for exports from the Islands could be matched by higher shipping charges, to offset the low utilisation levels arising from the return passage to reposition the vessel for the next export sailing. In the absence of any Government involvement in the shipping market, it would not be unexpected to find differential shipping rates applying during the year. While such an outcome might not be well received by Island stakeholders, from an economic perspective, this would not, in principle, be an inappropriate market signal.

While there is a material level of trade between Flinders Island and Tasmania, in overall shipping terms, the total volume of trade is relatively small, and there are very limited opportunities for growth. In the absence of a large positive economic shock on the Islands, the market is unlikely to represent a significant commercial opportunity, the consequence of which is that shipping services are likely to be provided by small/niche service providers that typically operate less sophisticated businesses than larger scale shipping companies. That is not to suggest that a well-run, focussed business cannot provide an efficient, effective and reliable business, rather that the rewards for doing so are likely to be relatively modest. However, this type of operation would struggle to cope, with an optimal capacity vessel, with the demands placed upon it during peak periods.

2.3.1 Freight Rates

Another important consideration for Furneaux Island trade is equity. Freight costs are likely to have a significant bearing on the level of economic activity on the Islands. It is understood that the Government has a policy objective of ensuring that the costs of sea freight to and from the islands is reasonable, in the sense that it does not place Islanders at significant disadvantage, relative to other Tasmanians. It is noted that subsidy arrangements do not seek to achieve a specified outcome, unlike the TFES for example, which seeks to equalise the cost of road and sea freight over comparable distances. Rather, the subsidy is effectively a balancing factor in meeting two broad goals, namely 'affordable' or 'equitable' freight rates, and a 'reasonable' level of return to the shipping service provider.



Given the relatively high cost and limited capacity of airfreight, in the short to medium term, Island residents and businesses are 'captive' customers for the established shipping business, and could potentially be subject to rent seeking activity by it⁵. Under the current arrangements, this is managed through the setting of freight rates under the contract between the shipper and the Government⁶.

Given the existence of a subsidy in the current contractual arrangements, the implication is that freight rates that reflect the cost of delivering freight services, given prevailing demand conditions, are higher than considered reasonable from an equity perspective. Where market conditions place upward pressure on freight rates (eg cost increases), the degree to which these are passed on to Island freight demanders at contract reset periods is a matter of judgement for Government (during the contract period, these risks are borne by the shipping operator, other than fuel price risk, which is shared between the shipper and customers).

2.4 Tasmanian Freight Equalisation Scheme – Intrastate extension

From 16 November 2008, the TFES was extended to cover sea freight shipped between the Furneaux Islands and the mainland of Tasmania⁷. The subsidy is paid to shippers (not shipping service providers) of non-bulk cargoes to alleviate the sea freight cost disadvantage.

Under the general TFES, Tasmanian producers of a comprehensive range of goods are eligible for assistance in sending their goods to the mainland, provided those goods are for sale or use within Australia (not for export). Under the equivalent Intrastate component of the TFES, imports of the same Tasmanian-made goods to the Furneaux Islands are also eligible for a subsidy, provided those goods are for permanent use or sale on the Islands. The same applies in reverse, that is, goods made on the Furneaux Islands for permanent use or sale in Tasmania are eligible for financial assistance.

- » For example, Tasmanian-made beer is eligible for assistance if the beer is transported by sea to the mainland for sale within Australia. Tasmanian-made beer is also eligible for the intrastate component of the TFES if it is shipped to Flinders Island for sale. Beer manufactured on Flinders Island would also be eligible for assistance under the Intrastate component if it were for final sale in Tasmania (and under the northbound component of the broader TFES if it was shipped from Flinders Island to the mainland directly). Beer produced elsewhere in Australia and transported to Flinders Island for sale would not be eligible for either the TFES or the Intrastate component.

Under the general TFES, the 'Southbound Component' enables raw materials or equipment made in Australian (not imported) brought into Tasmania by sea by persons or businesses in the manufacturing, mining, agriculture forestry and fishing sectors to be eligible for assistance, provided those goods are not:

- » of Tasmanian origin;
- » fuels and lubricants;
- » bulk cargoes;

⁵ The relative ease at which Les Dick Shipping has entered the market indicates that there are relatively low barriers to entry, which suggest that monopolistic behaviour is unlikely to be exercised on a sustained basis. Nonetheless, the potential for modest levels of 'gouging' remains a risk.

⁶ The contract states that both parties to the contract recognise that the combination of freight rates, expected demand levels and the level of subsidy combine to yield a fair and reasonable commercial return for the shipping provider.

⁷ The subsidy was already available for shipments between the Furneaux Islands and mainland Australia under the general TFES. The intrastate component came into effect for Flinders Island on 1 July 2008.



- » building and construction equipment; or
- » motor vehicles to be registered for use on public roads.

To be eligible for support under the equivalent Intrastate component of the TFES, the raw materials or equipment must be made in Tasmania and imported by Furneaux mining, agriculture forestry and fishing operators (in the case of imports to the Islands), or made on the Furneaux Islands and used by Tasmanian mining, agriculture forestry and fishing operators (in the case of exports from the Islands).

- » For example, Tasmanian manufactured stock feed shipped to Flinders Island for use on the Island would be eligible for support under the Intrastate component, where as, stock feed manufactured in Victoria and resold in Tasmania and sent to Flinders Island (or shipped directly to the Island) would not be eligible for support under the Intrastate component (as it is not manufactured in Tasmania).

There is no additional support available under the TFES Intrastate component for Furneaux Island freight demanders in eligible sectors for goods not manufactured in Tasmania, though the 'standard' southbound support still applies (eg. the purchase of a mainland-made tractor by a Cape Barren Island farmer would be eligible for the southbound assistance, but no additional support is available under the Intrastate component).

Given the lack of detailed commodity and origin shipping data available for this study, it has not been possible to accurately identify the level of 'double subsidy' available to Furneaux residents from the operation of the Intrastate component of the TFES and the contractual arrangements with Southern Shipping. However, several observations are noteworthy.

- » Prior to the introduction of the Intrastate component, the TFES subsidised the shipment of livestock from the Islands to the mainland, but not to Tasmania. Livestock representatives noted that the introduction of the Intrastate component has seen a shift of livestock movements from Victoria to Tasmania for processing. In terms of double subsidy, prior to the introduction of the Intrastate component, Island shippers received the benefit of both the TFES and the Tasmanian subsidy when exporting to Victoria, and the same is true with the implementation of the Intrastate component. That being said, where livestock is shipped to Tasmania rather than Victoria, the cost of sea freight is lower, potentially increasing margins for Island farmers, depending on the relative market prices for livestock in Tasmania and Victoria.
- » Feedback from Island stakeholders is that the implementation of the Intrastate component is unlikely to stimulate any additional economic activity on the island – its main impact will be to improve margins.
- » The payments under the TFES are made to shippers, not buyers of goods. In the case of Island operators exporting eligible goods (eg livestock, wool), the subsidy is of direct benefit and is able to be captured. However, in the case of imports to the Islands, the degree of benefit flowing through to Island residents is a function of the elasticity of demand for goods on the Island, and where demand is relatively inelastic (as it is generally expected to be), there is little incentive for Tasmanian shippers to pass the benefit of the subsidy onto island residents.
- » The 'double subsidy' available to operators in the mining, agriculture forestry and fishing operators on Flinders Island is limited to imports of Tasmanian made raw materials and equipment.
- » There is no double subsidy for fuel or building and construction equipment (or other ineligible goods under the TFES), which are key imports to the Islands.



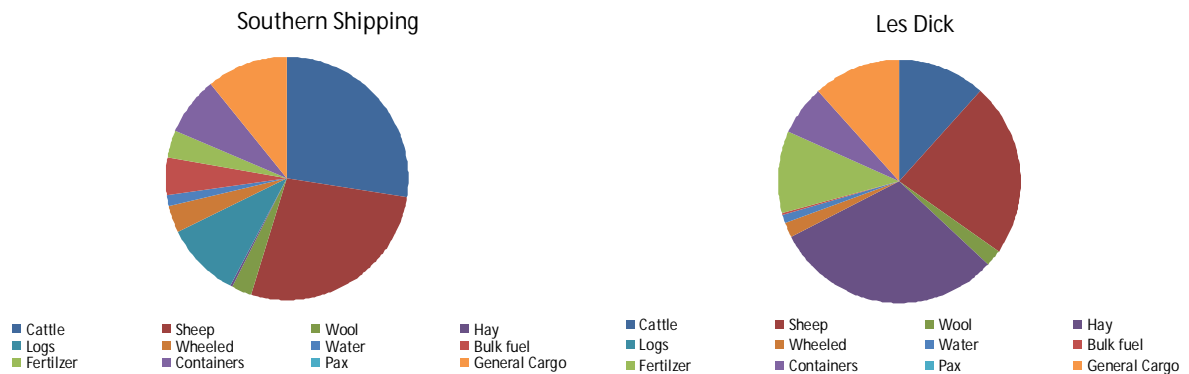
Overall, it is expected that the introduction of the Intrastate component of the TFES is unlikely to have resulted in a significant level of double subsidy to Island residents (though some double subsidy almost certainly exists). As such, the Intrastate component of the TFES is unlikely to obviate the need or appropriateness of any Tasmanian shipping subsidy, to the extent that the Tasmanian subsidy was appropriate in the first instance, which is discussed below.



3. The Furneaux Shipping Market - Supply

There are currently two shipping operators servicing Flinders Island, namely Southern Shipping and Les Dick Shipping. Southern Shipping carries around 90 per cent of all movements to and from the Island, with Les Dick Shipping accounting for around 10 per cent. The profile of each service is shown in Figure 4. The profile of the Les Dick service reflects one of an 'opportunistic' service that reflects the shipping needs of specific customers (primarily Markarna Park), rather than the general shipping needs of the Furneaux Islands.

Figure 5: Composition of commodity movements by shipping company, 2008-09



Source: Tasports, GHD estimates

In recent years, the Islands have received a surprisingly high level of service given the prevailing level of freight to be moved, and the capacity of vessels on the route (of both Southern Shipping and Les Dick Shipping), as is shown in Table 1.

Table 1: Vessel movements to and from the Furneaux Group, 2008-09

Load Port	Discharge Port							Total
	Bell Bay	Bridport	Cape Barren	Lady Barron	Port Welshpool	Preservation Island	Whitemark	
Bell Bay				27				27
Bridport			13	125		2	2	142
Cape Barren		10						10
Lady Barron	15	142	7		29			193
Port Welshpool				16				16
Preservation Island		1						1
Smithton				1				1
Whitemark		1			1			2
Total	15	154	20	169	30	2	2	392

Source: Based on Tasports data



Over the year 2008-09, there were 142 Southern Shipping export journeys to Bridport, and some 125 import trips from Bridport to Lady Barron by that shipper (the contract commitment is 52 return journeys).

Table 2: Distribution of Southern Shipping sailings, 2008-09

Sailings per week	Bridport to Lady Barron	Lady Barron to Bridport
0 sailings per week	1	1
1 sailing per week	9	13
2 sailings per week	22	12
3 sailings per week	11	14
4 sailings per week	6	4
5 sailings per week	3	6
8 sailings per week		1
9 sailings per week		1

Source: Based on Tasports data

Les Dick Shipping made 27 shipments from Bell Bay to Lady Barron, with only 15 return trips carrying any freight, making that service a net-import service to Flinders Island. The imbalance of trade for Les Dick Shipping is more pronounced (and in the opposite net direction) than it is for Southern Shipping, which had 142 sailings from Flinders Island to Bridport and 125 sailings in the reverse direction.

3.1 Opportunistic entry

Stakeholder discussions suggest that some Island residents are increasingly seeking to use LD Shipping in preference to Southern Shipping, as they consider the performance of Southern Shipping very poor.

Users of LD Shipping have indicated that they have been able to achieve significant cost savings through using this alternative service by comparison with Southern Shipping, despite the former receiving no Government subsidy. Such a claim is not surprising, given that as an opportunistic operation, LD Shipping can choose when it provides a service (presumably on the basis of capacity utilisation) and is not required to provide services that are not in its commercial advantage. As such, average freight rates can be lower than for a service that is required to be operated year round, regardless of volume.

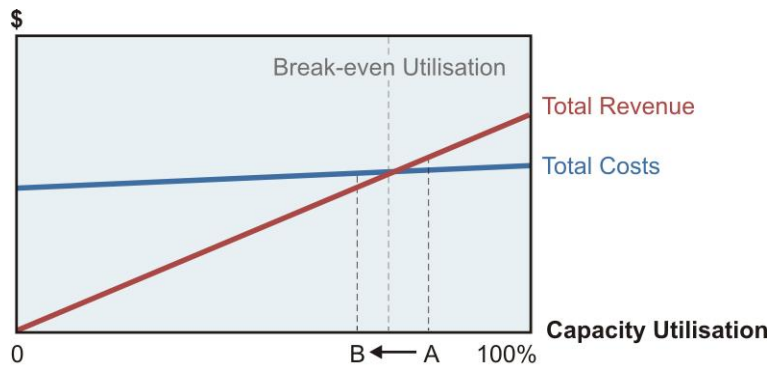
One of the potential major disadvantages of an opportunistic service from the perspective of freight demanders is the lack a fixed schedule and the inability to plan. When questioned on this, users of LD Shipping indicated that their shipping needs can be determined one to two weeks in advance and LD Shipping is able to respond with this level of notice, provided certain minimum volume levels are met. In general, livestock shippers indicated that the use of on-line livestock auction arrangements (the primary means by which livestock are traded by island farmers) provide for delivery within a two-week period (rather than, say, next day delivery). This means that their shipping needs are readily observable and predictable in advance. It also means that 'cherry picking' services by market shipping providers are feasible.



Given the prevailing shipping volumes and the effective capacity of shipping available from Southern Shipping with its two vessels, the shipping market for the Furneaux Islands has natural monopoly characteristics.

The commerciality of shipping operations is heavily dependent on capacity utilisation, given the high proportion of fixed costs in operating the business (from the perspective of both a per service basis and an overall basis). The marginal costs associated with carrying additional volume on a per-service basis is very low, so that the marginal revenues arising from changes in volume flow largely to the profit/loss of that service. This is illustrated in Figure 6 below, which is an illustrative example demonstrating that a loss of volume (from level A to level B) may result in a marginally profitable service becoming loss making.

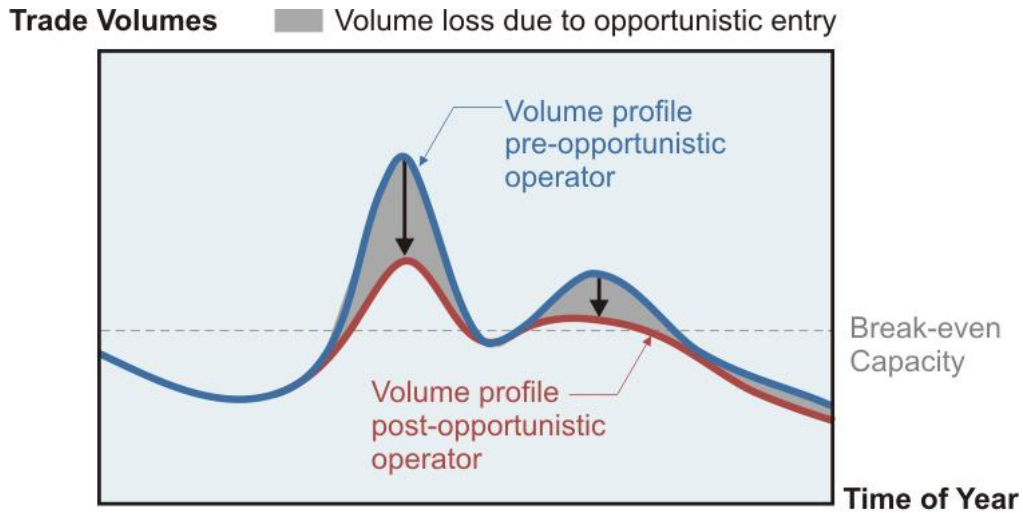
Figure 6: Illustrative impact of changes in capacity utilisation



Source: GHD

Having established a service timetable, the objective for the shipping operator is to achieve the highest level of capacity utilisation possible. This is of importance to the Government, as high levels of capacity utilisation within the contracted schedule reduces upward pressure on subsidy levels. This is demonstrated in Figure 7, which illustrates the impact of an opportunistic operator in the peak trading periods. In this illustration, an operator is contracted by Government to provide a regular minimum service year-round. In many months, the volume of trade is insufficient to warrant a commercial sailing, but in some months, activity levels greater than the contracted levels are commercial (eg. peak livestock exports). The subsidy level under the contract provides the shortfall in funding to ensure that the shipping operator can earn a normal rate of return across the year. Should an opportunistic market operator provide some of the shipping services at peak times that could have been met by the contracted operator, the loss in revenue will largely flow directly to the profitability of the contracted operator (as the off-setting cost savings will be relatively small), which will place upwards pressure on subsidy levels. In effect, the entry of the opportunistic operator results in a potential transfer from Government to the opportunistic operator.

Figure 7: Impacts of opportunistic entry for the contracted shipping company



Source: GHD

In considering the appropriate shipping rates and any associated shipping subsidies paid for the Furneaux services, the potential for opportunistic entry is an important consideration. In setting rates for the subsidised services, regard will (and should) be had to:

- » the total year-around costs of operating the service, which will include the capital costs of the ship, operating costs, overheads and voyage costs;
- » other revenues available to the contracted operator; and
- » the sharing of costs between shipping users and the Government.

This analysis will have an average cost focus.

From the perspective of the opportunistic operator, the fixed cost of operating a shipping business can be appropriately considered 'sunk', so that the commercial decision for the opportunistic operator is much more closely related to the marginal voyage costs associated with particular short term (daily/weekly) opportunities (this would include a consideration of the opportunity costs of other trades forgone in obtaining a trade for the Furneaux Islands and repositioning costs). The differences in perspectives between marginal voyage costs (and therefore shipping charges) and average service costs creates the grounds for opportunistic entry at reduced rates, to the detriment of the contracted regular service operator, and potentially to the Government as funder of the subsidy.



4. Current support arrangements

In order to gain an understanding of the profile of the Furneaux Island shipping market, GHD visited Flinders Island at the commencement of the study to meet with shipping users and other Island stakeholders. The focus of discussions was on the nature of trade to and from the islands, how demand changes throughout the year and the potential for future significant changes in demand levels. These meetings also provided an insight into some of the wider contextual issues associated with the current shipping operations.

There is a wide range of concerns held by Island residents regarding the performance of the shipping services provided by Southern Shipping. These relate to issues such as the:

- » reliability of the service;
- » inability of the existing operator to meet peak shipping demands, particularly livestock exports;
- » handling of cargos and damage to goods shipped;
- » inability of Island businesses to receive appropriately environmental control of chilled and frozen goods;
- » level of customer focus of the Company (eg lack of responsiveness, friendliness, approachability, assistance);
- » honouring of commitments made by the Company and its employees (eg the timing of the replacement of the second deck on one of the vessels);
- » expansion of Southern Shipping into road freight and the displacement of Island-based business.

The discussions with Island stakeholders did not reveal fundamental concerns with the essential nature of the arrangements between Government and Southern Shipping – the majority of the issues tended to be a function of the business practices of the current service provider.

- » For example, the two principal sources of delays are weather conditions in Bass Strait and access issues at Bridport. Weather delays could reasonably be (fairly regularly) expected in servicing the Furneaux Islands, given their location at the eastern end of Bass Strait. However, delays arising from the river at Bridport are a feature of the business decision of Southern Shipping (to base its operation at Bridport), and are not fundamental shortcomings of the existing approach to securing shipping service for the Islands.
- » In recent times, there has been growing evidence of cash flow issues for Southern Shipping reaching the public domain. Some of these issues have a bearing on the ability of the Company to meet its minimum service contractual obligations (eg. action by Tasports to deny access to wharf facilities at Lady Barron). Again, this does not suggest the underlying arrangements to support shipping to the Islands is fundamentally flawed, rather, the business practices of a particular service provider are having an impact on that business performing its obligations under the contract.

As the focus of this study is on the underlying structure of the support arrangements for Island shipping, rather than a review of the performance of Southern Shipping under the contract, the primary issue is to consider whether the issues currently presenting in relation to the service are a function or consequence of the structure of the fundamental support model.



There is certainly scope for the contractual arrangements to be enhanced to address some of the legitimate concerns of Island stakeholders. For example, the only reference to the quality of the service to be provided is in Clause 6.1(b), which states that Southern Shipping will “provide the Shipping Service in accordance with the best accepted standards of service, safety and reliability”.

The contract does not contain any performance indicators that define the parameters of ‘best accepted standards of service’, nor does it provide any rewards for good performance, or penalties/ sanctions where poor performance is delivered (other than the potential for suspension or termination of the contract, which is unlikely to be triggered unless there is a material non-performance issue).

Improvements in the contract could provide stronger incentives for good business practices and improved service delivery, without substantially changing the fundamental model (see Section 6.1.1). It would be inappropriate for the Government to be involved in the operational issues of the shipping provider (eg. checking how a service provider is managing stranding risks, or ensuring crew wages been paid) – the legitimate role for Government is to ensure performance under the contract - an outcomes focus, rather than an input focus should be maintained.

Another feature of the contract that should be reviewed is the ambiguity around the freight rates to be charged. Clause 6.1(e) states that rates of not more than those specified in the schedule can be charged, whereas Clause 7 mandates the use of the schedule charges. While ordinarily it may not be in the business interest of the shipping service provider to price below the specified rates, in the face of opportunistic competition, flexibility to match competitive rates should be allowed.

4.1 Implications of the current model

A central feature of the existing arrangements is that the primary contract is between the Government and the shipping operator, whereas services are provided to Island residents⁸. This apparent misalignment is the source of considerable angst for all parties, as accountabilities are blurred. For example:

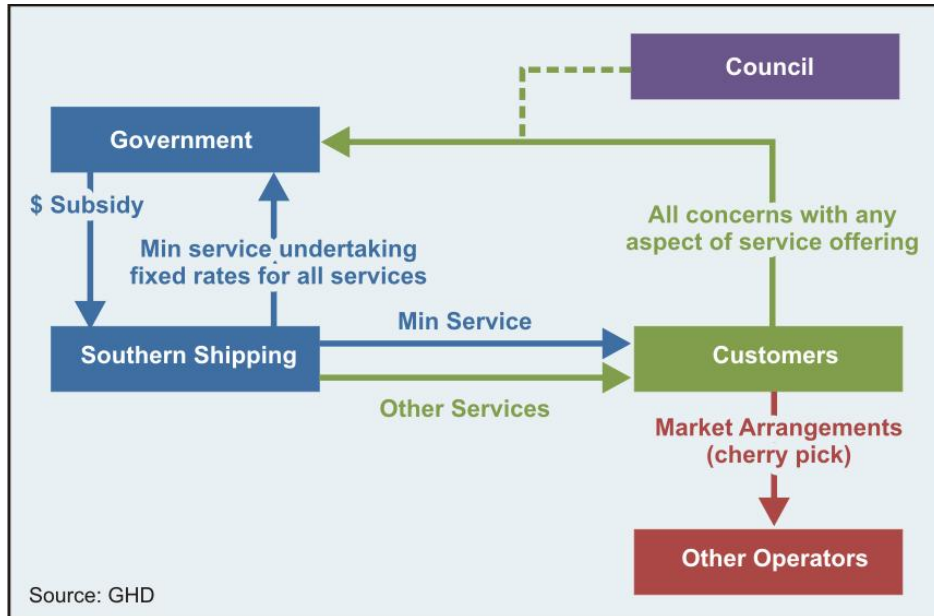
- » Island users are not party to the contract, and have no formal standing under the contract (though through the Shipping Committee, there is considerable opportunity for them to be heard⁹);
- » the Government is drawn into issues that are not of direct relevance to the contract - Island residents do not differentiate between contracted and non-contracted services; and
- » there are no natural incentives to maximise trade with the contracted shipper, so that opportunistic market entry (to the detriment of the contracted service) is more likely.

This is represented in Figure 8.

⁸ Although there are individual contractual arrangements between shippers and the shipping operator for every cargo shipment.

⁹ The consultation process identified mixed views on the effectiveness of the mechanisms employed by DIER to give Island stakeholders a ‘seat at the table’.

Figure 8: The Contractual Arrangements to Supporting Furneaux Island Shipping

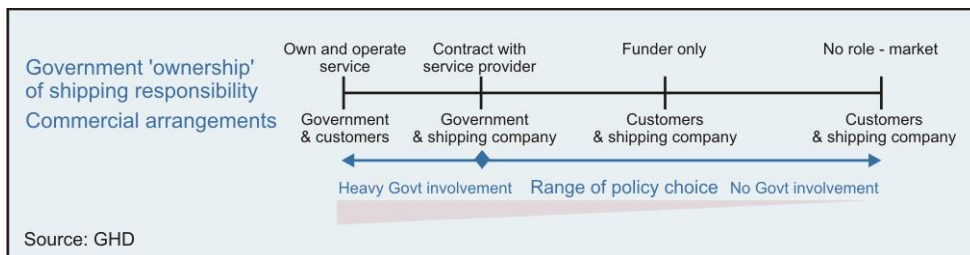


Discussions with Island stakeholders reveal that one of the (unintended) outcomes of the existing arrangements is that the Government is perceived as being responsible for the provision of shipping services to the Islands, and, therefore, responsible for fixing a raft of concerns associated with it.

This is an important consideration, as the degree of ownership of the 'responsibility' for shipping services is one of the key policy options for Government to consider in setting the framework for supporting Furneaux Island shipping, to the extent that any degree of Government involvement is warranted at all. This is shown in Figure 9.

- » At one end of the continuum is a Government owned and operated service, and the other is a fully market situation. A low involvement role would see the Government as a funder of services only to ensure its policy outcomes are delivered¹⁰.
- » Related to this is the consideration of the commercial arrangements that underpin the service. At the Government ownership end of the continuum, commercial arrangements are between the Government as service provider and shippers. At the other end of the continuum, shipping services are contracted between the shipping company and customers, with the Government having no role.

Figure 9: Policy Choice for Government



¹⁰ For example, the current arrangements between Aurora and the Government for the provision of pensioner discounts. The Government plays no role, and is not seen to play any role, in the provision of the service.



The primary driver for determining the degree of Government involvement in the provision of services will be the perception of market failure. The current arrangements for supporting Furneaux shipping are towards the 'heavy Government involvement' end of the continuum, and there have been public calls for a move further to the left. As discussed later in this report, there is not an overwhelming case for an increase in Government involvement in the service and arguments in favour of less.



5. Furneaux Shipping – potential market outcomes

5.1 Introduction

A key aspect of this study is to identify likely shipping service delivery outcomes for the Furneaux Islands in the absence of Government involvement in the market.

To address this question, a financial model of a 'notional' shipping business (referred to as FIBSS – Furneaux Island and Bass Strait Shipping) has been developed. The model does not seek to replicate the business of Southern Shipping (or any other specific shipping operator), but is informed by Southern Shipping operations by two means:

- » in relation to costs, information provided by Southern Shipping on some of the costs it faces in operating its services; and
- » in relation to demand, shipping activity that reflects Southern Shipping (and to a lesser extent, LD Shipping) actual service delivery.

The model has not been constructed to examine the commercial performance of existing operators, or to examine in detail the issues relating to the appropriate level of any subsidy. To do this would require substantially more comprehensive financial information on Southern Shipping than has been available to GHD during this study.

The key features of the FIBSS business are:

- » A single vessel with a cargo capacity of 225 tonnes;
- » The vessel is valued at \$2.5m, and depreciated over 25 years using a straight-line method;
- » Vessel financing is over 10 years, with a weighted average cost of capital (debt and equity) of 10 per cent per annum;
- » The vessel requires a crew of 6 (plus contingency for leave/sickness), with an average crew cost of \$100 000 per member;
- » Vessel maintenance costs of \$150 000 pa (6 per cent of capital costs);
- » Insurance costs of \$175 000 pa;
- » Steaming time of 8 hours between Tasmania and Flinders Island (reflecting the Bridport – Lady Barron service);
- » Weather delays of 1 day per 10 sailings;
- » Fuel consumption of 100l per hour, at a cost of \$1.31/l¹¹;
- » Overhead/office/admin (i.e. land-side) costs of \$350,000 per annum.

These assumptions have been reviewed and independently verified by Thompson Clarke Shipping Pty Ltd as being reasonable, and consistent with current market conditions for similar type vessels.

¹¹ This price is based on \$1.50/litre of Diesel, less the diesel fuel rebate

¹³ For example, that vessels reported DWT is 270, and taking into account its bunker fuel and water capacity, it could carry 225 tonnes.



For the purpose of modelling, it is assumed that wharfage charges are a direct passthrough to customers (no margin is made by FIBSS on wharfage).

In relation to demand factors, the model assumes the current shipping rates under the, and the demand profile is that of the Furneaux Islands in 2008-09 as discussed in Chapter 1.

5.1.1 Differences between FIBSS and Southern Shipping

- » The primary difference between the notional FIBSS business and Southern Shipping is that FIBSS has only one vessel, which is broadly similar to the *Matthew Flinders III*¹³. Southern Shipping's fixed costs will be substantially higher given its ownership and deployment of the second vessel. On the other hand, FIBSS services only the Furneaux Islands and does not take up other commercial opportunities as is the practice of Southern Shipping (bringing additional revenues).
- » FIBSS is solely a shipping business – the model does not consider the other services that are currently provided by Southern Shipping, such as road transport.
- » It is noted that Southern Shipping faces wharfage charges from Tasports for its cargos on the Islands, which are passed through to customers. It operates from leased Crown-owned facilities at Bridport and as such faces a fixed annual charge, rather than commodity-based wharfage charges. Southern Shipping charges customers the same for wharfage at Bridport as it is charged by Tasports on the Islands. To the extent that this creates net positive (or negative) revenues for Southern Shipping, the FIBSS model does not replicate these.
- » The detailed cost structure of the Southern Shipping business may be significantly different from that of FIBSS, as it reflects the actual circumstances of the business (eg. property costs, non-crew staffing levels etc).

5.2 Modelling outcomes

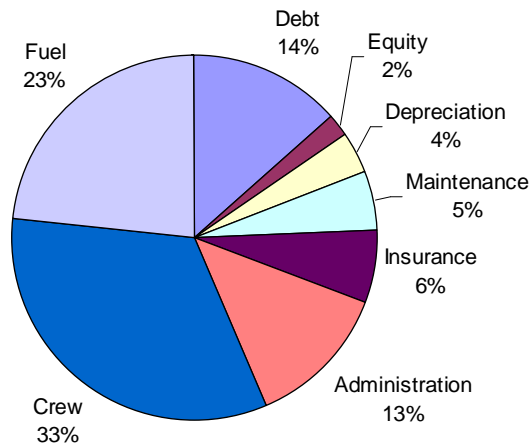
Based on the cost assumptions above, the key cost outcomes for FIBSS are:

- » total fixed annual costs of around \$2.1 million, which includes ship financing costs, crew costs, maintenance, insurance, and depreciation. For the purposes of modelling, the only voyage-related cost is fuel (which is not included in the \$2.1 million).
- » a daily cash cost of around \$5300, which needs to be recovered regardless of sailing;
- » a per return voyage cost between Tasmania and Flinders Island of \$12 400.

The cost profile of a return Tasmania-Flinders Island crossing for FIBSS is shown in Figure 10. Around one-quarter of the total return voyage costs are fuel, and one-third are crew costs.



Figure 11: FIBSS Vessel Operating Costs



Source: GHD

Figure 11 shows how many return voyages would be required to meet the demand for shipping to and from the Furneaux Islands, given the assumed 225 tonne capacity of the FIBSS vessel. Several observations are of key importance:

- » In all but one week, at least one return sailing would be required;
- » In most weeks, 3 or fewer sailings are required. While FIBSS could achieve a return sailing in a 24 hour period (given assumed loading and steaming times), given weather delays, it would be unrealistic to assume that 7 return voyages could be sustained. A more typical profile would be 3-4 sailings per week in busy periods.
- » Given the assumed performance of the vessels (loading time and passage speed), it would not be possible to carry all the freight in week 48¹⁴;

In order to examine the potentially likely level of activity, the FIBSS model looks takes a rational business decision, that is, service the maximum demand and only undertake voyages if the voyage cost is at least covered by the available revenues¹⁵. The predicted level of capacity utilisation factors is shown in Figure 12. It shows that FIBSS would generally be operating at between 50 per cent and 70 per cent capacity utilisation on a return voyage basis.

The numbers of return voyages from Tasmania over the year are as follows:

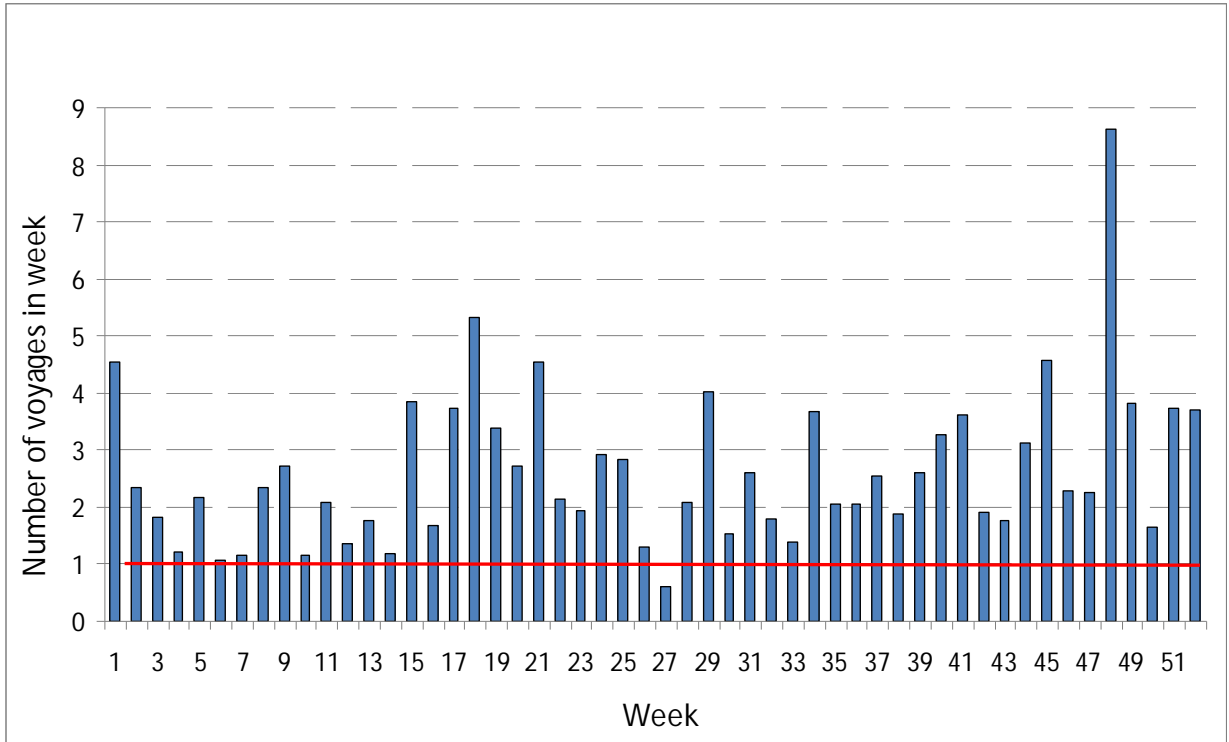
- » 157 to Flinders Island;
- » 7 to Cape Barren (which does not meet the policy objective of one visit per month); and
- » 39 to Port Welshpool.

¹⁴ This unusually high level of freight reflects the movement of both logs and a high number of sheep exports from Flinders Island to Tasmania. It is conceivable that some of this freight could be shifted to the following week to and all time-sensitive movements could be achieved.

¹⁵ For example, assume that in a week export loads were 1.2 voyages of capacity and import loads were 0.4 voyages of capacity. FIBSS would look to service the export trade and examine the voyage cost required to capture the marginal 0.2 of the export trade, and if this outweighed the voyage cost, the model would predict 2 return sailings in that week. If not, the balance of 0.2 voyages would carry over to the subsequent week and only one crossing would be made.

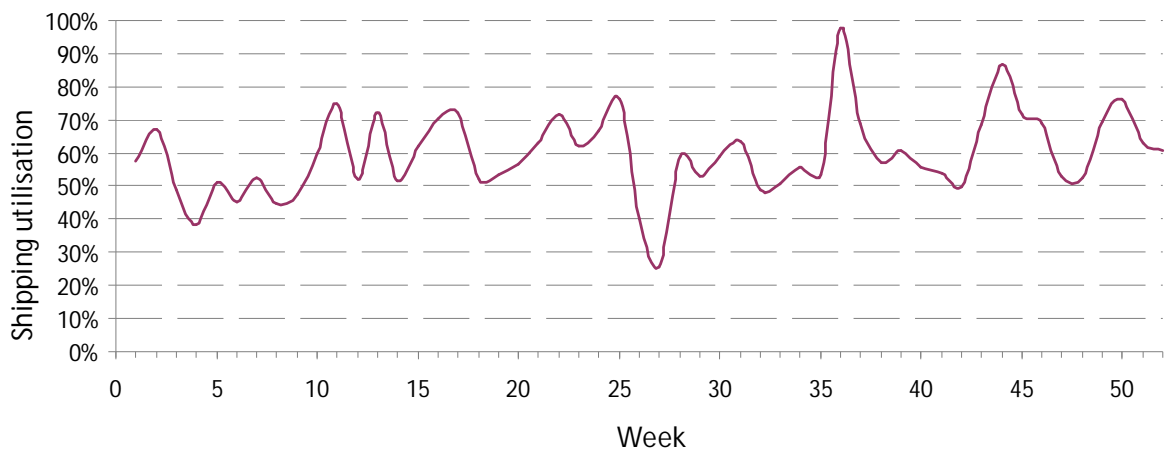


Figure 11: Number of FIBSS voyages required to service Furneaux Island demand



Source: GHD

Figure 12: FIBSS sailing profile and utilisation levels



Source: GHD

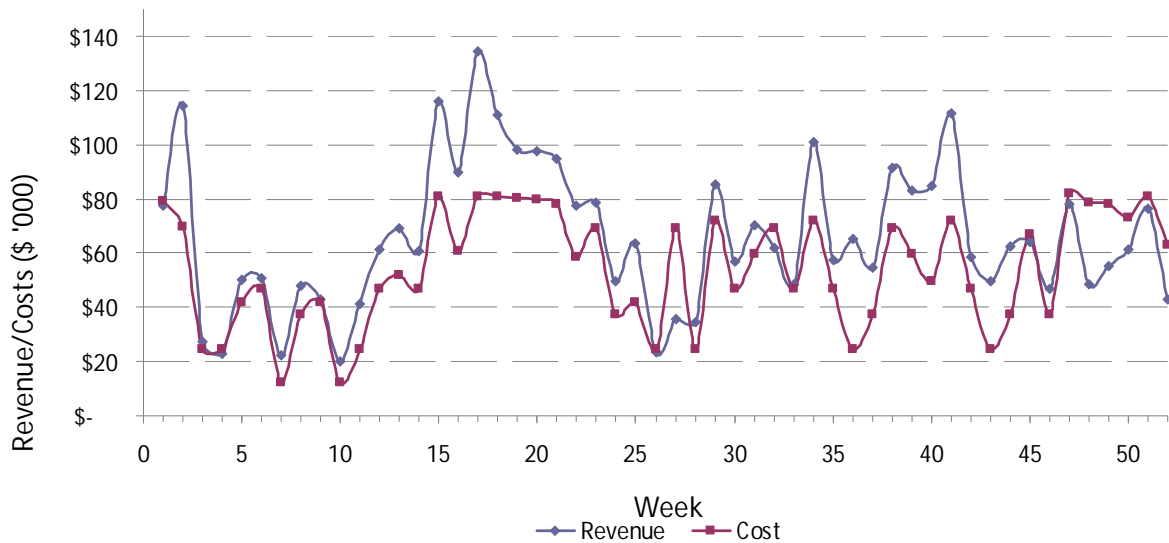


To examine the financial performance of the business, current freight rates have been utilised¹⁶. No subsidies from the Government have been considered.

It is estimated that on the basis of the demand assumptions, total revenues of \$3.43 million are available to cover the costs of operating the service and providing a return. On this basis, FIBSS is soundly performing business, as the estimated total costs to service this demand are \$2.85m, including all financing costs (debt and equity returns) and depreciation, leaving an 'excess revenue' of around \$600 000 pa ('excess' revenues being revenue above that required to cover all cost, including depreciation and a reasonable return to the business owner). In terms of free cash flows, the business would generate around \$750 000 over the year.

The profile of revenues and costs during the year is shown in Figure 13. The first peak in shipping demand in Spring yields good returns for the business, due to the volume of cattle moved (cattle are good margin business). This is in contrast to the second peak in July, where the increase in volume is due to the movement of sheep and logs, which under the assumed tariff structure are poor margin commodities.

Figure 13: FIBSS revenues and costs over the year



Source: GHD

¹⁶ The trade data available for this study is highly aggregated, whereas the pricing arrangements under the contract are detailed (eg. movements are recorded as 'cattle', whereas differential rates are applied to bulls, cows, calves, vealers and stud bulls). To address this mismatch in data, a range of assumptions have been made about the composition of aggregate data to determine average prices to be applied to freight movements. There was no information available on the revenue arising from the shipment of logs, and a price of \$5 per log has been assumed (which by comparison with rates specified in the contract is very low – telegraph poles are \$188 each, and a 200mmx6m post is \$10.84).



5.3 Sensitivity analysis/limitations

Given that log movements are time-limited, and the import of hay reflected drought conditions in 2008-09, the FIBSS model was run excluding these demands. The key changes in result were:

- » 19 fewer sailing between Flinders Island and Tasmania were conducted (there was still at least one sailing per week undertaken);
- » total costs were reduced by around \$50 000, reflecting lower fuel costs;
- » revenues fell by around \$139 000; and
- » 'excess' revenues decreased by around \$90 000.

The conclusion to be drawn from this analysis is that the robustness of the FIBSS business is not dependent on the 'temporary' volumes of logs and hay.

A key assumption in the modelling is that one ship of 225t is available to service the needs of the islands. The model shows that there were 11 weeks out of 52 where the demand presented in that week¹⁷ could not all be moved in that week. The 'lack' of capacity most acutely arose in the spring peak livestock export period.

It is understood that one of Southern Shippings vessels is to have a second deck fitted that will be used for carrying livestock. Depending on the capacity of that additional cargo space, this should substantially reduce, if not eliminate, the under capacity issue. The FIBSS model suggests that there are substantial funds available from 'excess' revenues to fund such an expansion in capacity.

Another key assumption in the FIBSS base case is that there are no delays to sailings arising from access to port facilities in Tasmania (or other ports visited), though rough weather delays are taken into account. Information on the number and length of delays caused by blockages in the river at Bridport was not provided for the study. While factoring in such delays would have a positive impact on modelled costs outcomes, the larger impact would be on effective capacity. Where delays occurred in peak shipping periods, the ability of FIBSS to meet the export demands on Flinders Island at the time that demand was presented could be significantly impacted. Where this freight is time-sensitive, the impact on Island stakeholders (as opposed to the financial consequences for the shipping business) could be material.

If it was assumed that the business operated from Bell Bay, rather than Tasmania, the ability of FIBSS to service the peak demands of the island with a single vessel is further diminished. The number of weeks for which there is a carry over of freight increase from 11 to 23. In terms of financial impacts, the additional fuel costs arising from the additional steaming time add around \$1000 per Flinders Island return journey. The business could withstand the additional fuel costs associated with the additional steaming time from the 'excess' revenues, alternatively, if this were passed through in freight rates, rates would need to increase by around 17 per cent to offset the higher fuel costs.

¹⁷ It should be noted that this based on actual freight movements demand in 2008-09, which reflected the existence of 3 vessels



5.4 Conclusions

The modelling of the Furneaux Island shipping market suggests that the scope of market failure is not substantial. The volumes of trade are material, and at prevailing freight rates, a small shipping operator could run a profitable business servicing the Islands without the need for any subsidy. The level of service to Flinders Island would essentially meet the Government's 'essential service' policy objectives, whereas the level of service to Cape Barren Island would fall short of the Government's objective of a once-per month service.

It is noted that the 1995 contract between the Transport Commission and Southern Shipping for Furneaux Island shipping, which accompanied the introduction of the *Matthew Flinders III* onto the route was prepared in the context of the service being commercially viable (see Recital C of the Contract). The analysis above suggests that given the prevailing level and type of trade currently available under the existing freight rates, this intention remains valid.

This is not to conclude that Southern Shipping does not require a subsidy to operate under the prevailing freight rates. Given the loads available, it would appear that there is substantial excess capacity for the Islands with both the *Mathew Flinders III* and the *Southern Condor* both available, leaving aside LD Shipping's *The Statesman* (which is understood to have a capacity of 900 tonnes).

To service the Islands with two ships, Southern Shipping has (almost) twice the crew costs, faces the capital cost of two vessels and faces much higher fuel costs to move the same volume of freight. On the other hand, these costs can be offset by the application of the vessels to other commercial opportunities (Southern Shipping does currently do this, for example, the movement of explosives from Eden, and cattle from King Island). Without access to substantial financial data, it is not possible to estimate the level of subsidy that would be required to ensure that a reasonable rate of return.

The other significant finding is that peak demand may not be met at the time (i.e. the week) in which it is presented, depending on the capacity of the vessel servicing the islands. The Government's stated objectives are to ensure that at a minimum, there is a weekly service to Flinders Island.



6. Potential Support Models

A useful framework for considering potential support alternatives is an examination of the risks of the service and their allocation. Some of the primary risks associated with Furneaux Island shipping are described in Table 3 below.

Table 3: Key risks in Furneaux Island Shipping – with the contract in place

Risk	Description and incidence under existing arrangements
Operating risks	These are risks associated with the operation of the shipping service, which either impact on the cost of services, or the ability to deliver them. Some of the key operational risks include equipment failure and maintenance, staffing availability and changes in costs. Under the current arrangements, these risks are borne by the shipping operator, although indexation of freight rates provides some mitigation.
Vessel availability	In the short term, the ability to service the Islands is dependent on the vessels in the fleet of the service provider (in this case, the <i>Southern Condor</i> and the <i>Matthew Flinders III</i>). Under the current arrangements, this risk is borne by the shipping operator (except in the case of a force majeure event). The existence of two vessels is a robust approach to mitigating this risk.
Vessel Value	Changes in the value of the vessel will arise from normal decline in value with age, acceleration or retardation in the decline in value from maintenance practices, and changes in the general market for shipping. Under the current arrangements, this risk is borne by the shipping operator.
Fuel costs	Under the current contractual arrangements, this risk is partly borne by Southern Shipping and partly carried by shippers in freight rates as fuel levies are imposed once fuel costs reach certain threshold levels.
Volume	Changes in the level of activity in the Furneaux Island group will impact on the level of demand for shipping services. Under the current arrangements, this risk is borne by the shipping operator.
New entry	The risk that another shipping service provider will enter the market, on either an opportunistic basis or under medium-term contractual arrangements with Island users. Under the current arrangements, this risk is borne by the shipping operator.



Risk	Description and incidence under existing arrangements
Alternative opportunities	The attractiveness of providing services to the Furneaux Islands is relative to the alternative routes that could be serviced by the vessels. Under the current arrangements, Southern Shipping is free to utilise its vessels to pursue alternative opportunities provided that the minimum service levels are delivered. Under the current arrangements, the risk of changes in the value of alternative opportunities is borne by the shipping operator.
Scope of 'essential' services	Creep in the scope of 'essential services' – currently the scope of essential services are defined as a once-per-week crossing between Tasmania and Flinders Island and a once-per-month visit to Cape Barren Island. Changes in the scope of 'essential services' are likely to impact on the level of subsidy required. Under the current arrangements, this risk is borne by Government.

Source: GHD

The risk allocations described in Table 3 reflect the situation **within the contract period**. There are several risks that arise, or change in nature, at the time of contract renewal. A key risk for Government is the availability of alternative opportunities. Changes in the market for Bass Strait trading (or more widely) could have a material bearing on the attractiveness of servicing the Furneaux Group. For example, growth in livestock trading from King Island could see the relative attractiveness of Furneaux trade fall, which could place upwards pressure on freight rates or the level of subsidy paid in order to retain service levels.

There is a material risk that at the end of the contract, no shipper participates in a re-tender of the opportunity and that service providers opt to forgo the benefits, costs and risks of being the contracted service provider and rather offer services under market arrangements – at frequency and cost of their choosing. The current contractual arrangements provide the equivalent of a regulatory environment for Furneaux Island shipping (at least in relation to a minimum number of services and the price for all services). Discussions with Island stakeholders indicate that these are valued outcomes from their perspective. Actions by stakeholders that materially decrease the attractiveness of the current contractual model and increase the appeal of market arrangements may effectively 'deregulate' the shipping market, and this may expose Island freight demanders to reasonable market outcomes (such as variations in shipping regularity or pricing volatility) that may be less attractive than the current arrangements.

A contract reset also enables a reallocation/resetting of some of the risks that have been borne by the shipping operator during the life of the contract. Key risks in this regard are those linked to cost management, and volume levels. Depending on the nature of the tender process, service providers would be able to adjust the subsidy bid or freight rates and indexation arrangements to shift some of these risks to Government or users.



It is also recognised that given the nature of Furneaux shipping, the allocation of risks in contracts do not necessarily reflect the ultimate allocation of risks in the political context. If a contracted shipper was to lose the availability of the servicing vessel (eg. it suffered major damage or was sunk), while the contract might allocate the risk of securing a replacement vessel to the service provider, there would most likely be immediate calls from the community for the Government to intervene and ensure services were maintained. Recent experience in relation to the Furneaux Islands highlights the inability of the Government to allocate some risks.

6.1 Potential service delivery models

There are four broad potential models to deliver Furneaux Island shipping, namely:

- » Contractual arrangements with a primary (privately owned, third party) shipper - status quo and variations around it;
- » Shipping services provided by Government, either through DIER, an existing government-owned business or a new government-owned business;
- » Shipping services provided by Island stakeholders, potentially a consortium of service users or the Flinders Council; or
- » No centralised contractual arrangements, rather a market response by shipping operators and freight demanders.

6.1.1 Status quo and variations

Status quo with enhanced KPIs

As noted in Section 4, there appears to be no fundamental shortcomings in the existing approach of contracting a minimum level of service at regulated freight rates. Enhancements to the contract, particularly the inclusion of KPIs and performance incentives and sanctions could improve this approach. The disconnection between the contracting parties and the parties to the services does give rise to some complications.

The contract for minimum service levels approach is utilised in Western Australia in securing sea freight services to the North West Coast of that state through to Darwin. The route is considered non-commercial (as it is primarily north-bound trade and is highly seasonal), and in 1995, the Government-owned shipping business was replaced with contractual arrangements with the private sector. The WA Government is seeking to impose a range of new KPIs into the next contract, as it considers the current arrangements too passive to drive good performance¹⁸.

Potential changes that could be considered for the Furneaux Island contract include:

- » The provision of a base level of subsidy that is payable regardless of performance, perhaps 70 per cent of the existing subsidy level;

¹⁸ Discussion with WA Dept of Transport



- » The balance of the subsidy would be allocated to a small number of performance indicators, and payment would be based on the achievement of those performance standards. Input from Island stakeholders, as the principal beneficiaries of the service, would be appropriate in determining which indicators would be included in the contract, to ensure that performance was geared towards those things that Islanders deemed critical. For example, one third of the performance-related funding (i.e. 10 per cent of the total subsidy) might be based on the reliability of the service (eg. delays during a period being less than a pre-determined level, which would make an allowance for typical weather delays).
- » Consideration could also be given to the imposition of poor performance sanctions under the contract.¹⁹ For example, if complaints in relation to damaged goods over a period reached a predetermined level, a penalty of 5 per cent of the subsidy would be imposed. Alternatively, a user satisfaction survey could be implemented, the outcomes of which could have financial consequences for the operator (poor performance having a sanction, good performance having no penalty/bonus, and exceptional service having a bonus).

With the introduction of KPIs into the contract, the Government could consider giving Island users a more formal voice and role in contract management. Discussions with Island stakeholders indicated a reluctance to use formal grievance procedures to record service complaints (there seems to be a view that nothing will change as a result of making the effort). If under a revised contract there were rewards and sanctions for good and poor performance, based on the submission of formal feedback from users, there would be an incentive for users to provide feedback, and an incentive for the shipping service provider to respond and improve services.

The Government could also give Island stakeholders or their representative an involvement in the selection process of the service provider selected through a competitive process. This may create a degree of 'ownership' in the outcome that appears to be lacking under the current arrangements.

Transfer of contracting responsibility to Island Users

An extension of this concept would be to transfer the responsibility for the contract to a representative organisation of Island users (which could be the Council or, preferably a specially convened representative organisation). The Government would continue to provide the same level of funding for the service as under the current arrangements, and could, as a condition of funding, retain the approval of the contract to ensure that its policy objectives are being met and the scope of 'essential' services is not broadened. It could also retain some control (such as a veto power) over the selection of service provider under a competitive process.

Under this approach, the Government could reserve the right to observe the administration of the contract, and could continue the Shipping Committee. Alternatively, the Government involvement in shipping issues could be limited to the provision of funding.

The advantage of this approach is that it aligns the contract with those parties that are providing and receiving the shipping services. It removes that Government from need to be involved directly in the resolution of service issues.

¹⁹ Payments to electricity customers by Aurora's network for outages above a prescribed level are a useful example.



Another advantage of this approach is that it more easily enables Island users to contract for improved service levels. Users could offer their own additional funding for superior service delivery over and above the minimum levels²⁰.

6.1.2 Government ownership/control

Under this approach, the Government would acquire a vessel(s) for the service and either:

- » tender the right to operate the vessels under the contract, or as a more fundamental change
- » operate the service directly, or through a government-owned business.

Vessel ownership with third-party operations

This approach is broadly similar to the current arrangements that apply for the delivery of ferry services to Bruny Island.

Some stakeholders consider the ownership of the vessel(s) that service the Islands as the critical element in ensuring sustainable service delivery. They contend that if a service provider were not meeting service delivery obligations under the contract, it would be easier to find an alternative operator than it would be to find an alternative ship owner/operator.

There is some intuitive appeal in this argument. The financial resources required to assemble a business to operate a vessel is significantly less than that required to own or charter a vessel at market rates, which potentially widens the contestability of the arrangement. On the other hand, the Government would likely deal only with business of reasonable financial standing if it were to charter its vessel over a reasonable period, so the additional scope for contestability is not assured.

Under this approach, the vessel could be made available to the operator at a nominal charge, so that rather than providing a cash subsidy on an annual basis as under the existing model, the subsidy is effectively funded upfront through the vessel acquisition costs²¹. Finding the capital required to finance a vessel is a major drawback of this approach, unless once-off Budget funding could be identified (offset by lower annual outlays for the contract subsidy).

Ownership of the vessel by Government would remove the risk that alternative opportunities could draw the vessel away from the route, leaving the Furneaux Islands without a service provider.

On the other hand, a number of other risks are transferred to Government under this approach. As owner of the vessel, the Government would bear ship value risk, and also would carry some risk associated with the proper maintenance and care of the vessel under charter. These risks are commonly managed under charter arrangements, and would not be considered material barriers to the implementation of this approach.

Under the charter arrangements, the key risk of operations, availability and volume all reside with the operator and are not transferred directly to Government.

²⁰ It is noted that when the prospect of Island users paying additional funds was raised with Island stakeholders, the response was one of surprise – the idea of Island residents contributing additional finances to the service had clearly not been contemplated.

²¹ Good practice reporting would require transparent reporting of the level of subsidy in any case.



Government ownership and operations

This approach would see the Government effectively taking full responsibility for Furneaux Island shipping. Governance options to implement this approach include operating the service within the General Government sector (presumably as part of DIER), or via an existing government-owned business (probably Tasports/Northwest Shipping and Towage or TT-Line), or via the creation of a new specific purpose business.

This approach would see the transfer of all the key risks of the business to Government. Given the analysis contained in Section 5, it is difficult to see the market failure justification for this level of Government involvement in the Furneaux Island shipping market.

Operating the business would most likely be a significant distraction from the core business of DIER or the existing government-business entities. There are substantial overhead costs associated with the establishment of a new government-owned business, which make this approach unattractive.

The overall direction of business ownership by Government in Tasmania (and elsewhere) has been to devolve commercial activity to the private sector. Recent privatisations of the Tasmanian Government's road maintenance business, its grain storage business, printing business and even its cemetery give a strong policy direction. In other jurisdictions, Governments have divested themselves of a range of business activities, including shipping operations (eg. WA North West Shipping). Overall, Government ownership and operations should only be considered backstop strategy once other options have been exhausted.

6.1.3 Council/community ownership/control

It has been proposed by some stakeholders that the preferable approach is for the shipping service to be owned and operated by interest on the Islands. For example, some Council members suggested that a Council-owned business would ensure the primary focus of the shipping business is the best interest of the Islands. Similar arguments have been advanced in favour of a community ownership model, where Island freight demanders collectively own, and potentially operate, the shipping service. The implicit assumption under either of these approaches appears to be that the Government continue to fund the subsidisation of services.

A major drawback of the community ownership approach is the absence of strong commercial drivers for the operation of the business and the potential for the scope of 'essential' service to creep over time. Under the current arrangements, commercial drivers are reasonably clear. Southern Shipping must provide a weekly return service to Flinders Island and a four-weekly service to Cape Barren Island, and may on a commercial basis:

- » service to Clarke Island and Victoria;
- » provide within-weekly services to Flinders Island (and within-monthly services to Cape Barren Island); and
- » pursue other commercial opportunities for its vessels (eg services to King Island), provided that it meets its minimum service delivery obligations.

Southern Shipping is under no obligation to undertake additional sailings at below commercial capacity thresholds. This is important, and the level of subsidy under the contract reflects the commerciality of these arrangements (see Clause 7.1).



Where there are mixed drivers in operating the shipping business (eg. the interest of the Islands), different service level decisions may be made. A simplified example illustrates this point.

Week	Load available	Commercial decision	Island interest decision
1	1.2 ship loads	1 journey, take that which is time sensitive and take balance in following week	Make 2 journeys
2	1.1 ship loads	1 journey, take that which is time sensitive and take balance in following week	Make 2 journeys
3	1.6 ship loads	2 journeys	2 journeys
Total journeys		4	6

Under this scenario, the total amount of freight moved is the same, and the revenue available is also the same, but the cost of service deliver under the second decision framework is much higher, which would place upwards pressure on the level of subsidy needed to secure these services. This is not to suggest that the Council or a representative body of Island shipper would be unable to make clear business decisions, but to highlight the risk of ‘capture’.

Another drawback of the community own and operate approach relative to the current arrangements is the degree to which the Government can shield itself from the risks that have been appropriately allocated to the shipping service provider under the contract. It is relatively straight forward for the Government to hold a private company to the terms of its contract, though there will inevitably be political pressure for the Government to intervene to address manifestly poor performance (as is currently being witnessed). For example, if a vessel’s engine was to suffer a significant problem and costly repairs were required, there would be little expectation that the Government would provide financial support to fund the repairs - it would be generally recognised that this is a legitimate risk in operating a shipping business. By contrast, if the service was owned and operated by the Flinders Council, there would be significant pressure on the Government to assist in funding repairs if these were at the direct expense of other Council services.

It should also be recognised that the size of the shipping business is large relative to that of the Council. While, the modelling undertaken as a part of this study suggests that the turnover of the shipping business (under existing contracted freight rates) is around \$3.4 million²². By comparison, the revenue of the Council in 2008-09²³ was \$4.2 million, with the Council incurring a \$312 000 deficit in that year. While it is noted that the performance of Southern Shipping currently provides a material (and arguably unwanted) distraction for the Council from its core business, the level of attention that would be required to successfully operate a shipping business is likely to be materially higher.

²² Access to the financial records of Southern Shipping was not possible for this study.

²³ 2008-09 was the latest Annual report available from the Council website.



These concerns would be materially greater for a 'cooperative' model involving Island freight demanders.

The situation on Lord Howe Island is illustrative in considering some of the potential drawbacks of local involvement in shipping operations. The Lord Howe Island Board is the Island's largest single freight demander (for fuel for electricity production, construction material etc) and has had successive contractual arrangements with a shipping provider to provide freight services.

While these arrangements prevailed, of the 29 referrals to the NSW Independent Commission Against Corruption associated with the Island, 19 related to shipping arrangements, and of those 19, 16 related to the Board²⁴. During the 1990s, Lord Howe Islanders established a rival business (LHI Seafreight Pty Ltd) to compete against the service contracted by the Board.

To address conflict of interest issues, the Board divested itself of the contracting responsibilities, which have been transferred to the NSW Government (Department of Commerce), such that the Government contracts with the private sector to supply freight services for the Board's needs (not the general needs of the Island). Businesses and residents on the island also utilise the service (but are free to use any sea freight service on offer), which is provided on a once per two-week basis (weather/tidal delays often means that there are 3 weeks between services) at freight rates established under the contract. It is understood that there is no subsidy accompanying the contract – the operator's revenue is based on the freight carried, and there are no guaranteed minimum levels (although the transfer of fuel for electricity generation is a relatively steady base load). With the implementation of the State government contractual arrangements, there has been rationalisation of capacity, such that there is now a single operator providing services.

6.1.4 Market arrangements

The analysis undertaken as a part of this study did not suggest that there was fundamental market failure in Furneaux Island shipping, at least in relation to a weekly shipping service to Flinders Island. Some caution is required, as this analysis was based on 2008-09 freight data only. Nonetheless, the freight task is material, and with the application of existing freight rates, a commercial return is likely to be available. The entry of LD Shipping in direct competition with Southern Shipping shows that the barriers to entry are relatively low.

In this context, the Government could choose not to enter into a centralised contractual arrangement with a shipping service provider at the expiry of the existing contract²⁵. This would parallel arrangements on King Island, where shippers are serviced at market rates and at market frequency²⁶.

On the basis that the freight task is sufficient to attract a service provider, the principal risk with this approach is the potential for Island shippers to face materially higher freight rates than under the existing arrangements as 'the market' settles on applicable freight rates.

There would also be limited capacity for service standards to be 'enforced', with the shippers' conditions of carriage being the only form of contract underpinning service deliver²⁷. An exception could be a large single freight customer that had sufficient volume to negotiate a stand-alone contractual arrangement.

²⁴ *Preserving Paradise: good governance guidance for small communities—Lord Howe Island*, ICAC, 2001, p7.

²⁵ Clause 10.5 of the contract is important in this regard. This clause requires the renegotiation in good faith of a further agreement for an additional 5 years (and an option for a second 5 year period) if the Government is satisfied with the performance of Southern Shipping under the contract and its ability to continue to do so.

²⁶ It is noted that the commercial opportunities and volume of trade available to the market from King Island are substantially greater than is the case for the Furneaux Islands.



Finally, of all options, this approach suffers the greatest risk of continuity of service in light of potentially attractive alternative opportunities.

6.1.5 Provide subsidy direct to shippers

An alternative support mechanism that could accompany a market-based Furneaux Island shipping model would be to provide a subsidy directly to shippers, much like the TFES. This would increase the 'purchasing power' of Island freight demanders, and could be used to offset an increase in freight rates arising from the removal of price controls under the contract. It could be applied to only specific commodities to achieve specific outcomes (eg. livestock movements in peak seasons, to increase the relative attractiveness of this market to ensure that demand is met as it emerges).

This approach is not attractive from several perspectives, relative to the current arrangements. Firstly, it is likely to be immediately 'captured' by shipping service providers with no additional policy outcome. Secondly, it would involve significant transaction costs, relative to the current contractual arrangements. Moreover, it does not materially address the risks arising from the market-based approach, particularly the risk of service continuity.

6.2 Summary

This study has found little evidence that there is widespread market failure in the Furneaux Island shipping market at least in relation to minimum services to Flinders Island. It is recognised that a change in policy that left Island shipping purely at market would give rise to some risk, principally around freight rates and surety of capacity, and is unlikely to be politically acceptable. That said, there are no grounds to move substantially in the opposite direction and introduce a Government owned or community owned service, and solid arguments for not doing so. By contrast, there is a compelling case for substantial improvements in the nature of the contract between the Government and the service provider to drive improved performance. To better align the contracting and service parties, the Government could consider giving Island representatives clearer roles and responsibilities under the contract, and could move to more of a funding role (whilst retaining key controls to manage financial risk). A summary of the assessment of the market support alternatives in Figure 14.

²⁷ These conditions are seldom negotiated – users accept the conditions or do not use the service.



Figure 14: Assessment of Furneaux Island shipping support models

Risk	Status quo with KPIs	Council managing contract	Govt owns vessel and contracts service	Government delivers service	Council/Community model	Market and Market with subsidy direct to shippers
Operating risks	< operator feels the + and - effects of risk in payments	< operator feels the + and - effects of risk in payments	= some operating risks can impact on the value of the vessel	= transferred to Government	= transferred to community, with exposures for Government	?
Vessel availability	?	?	?	= transferred to Government	= transferred to community, with exposures for Government	= no obligation to service Islands
Vessel Value	?	?	= risk transferred to Government	= transferred to Government	= transferred to community	?
Volume	?	?	?	= transferred to Government	= transferred to community, with exposures for Government	= no obligation to service Islands
New Entry	?	?	?	= transferred to Government	= transferred to community	?
Alternative opportunities	?	?	?	< vessels will remain on the run = less likely to seek commercial opportunities for vessels during contract (may impact on subsidy levels)t	< vessels will remain on the run = less likely to seek commercial opportunities for vessels during contract (may impact on subsidy levels)	= no obligation to service Islands
Scope of 'essential' services	?	? provided sufficient controls retained	?	?	= material risk of scope creep	< no scope defined, and no risk of creep
Summary	No reason not to implement	Aligns contracting and service delivery parties	Not recommended, but the better of the higher intervention approaches	Not recommended	The worst of all options	Not recommended

? = no change < = improvement = worse outcome



Appendix 1: Selected island services, key features

Introduction

This Appendix highlights the characteristics, regulatory and ownership environments of existing marine services linking Australian islands to the mainland. The services examined cover a wide range of distances and levels of service – from monthly services spanning over 2500 km to hourly services across distances less than 20 km. A common feature of these services is that all are privately operated, with most doing so without explicit operating support from the government. In several cases there is some indirect government support provided.

Island	Port connection	Dist. (km)	Frequency	Commodities	Ownership	Operation	Subsidy	Regulation
Lord Howe, NSW	Yamba, NSW	600	2 - 3 weeks	General cargo, fuel	Majority by residents	Private	No	Free market, but volumes scarcely able to support a 2nd vessel
Christmas	Fremantle, WA	2600	4 - 6 weeks	General cargo, phosphate	Private, (Cth owns Port)	Private	No	Free market
Cocos	Fremantle, WA	2770	4 - 6 weeks	General cargo	Private, (Cth owns Port)	Private	No	Free market
Bruny, Tas	Kettering, Tas	3	10/day	Cars, passengers	State govt	Private	Yes	Private operation with non-competition deal. Clawback of excess profits by govt.
Kangaroo, SA	Cape Jervis, SA	16	3 - 8/day	General cargo, cars, passengers	Private	Private	No	Restrictive operating conditions for sole operator: semi-exclusive rights to ports, price ceilings, quality and quantity floors

Sources: Attorney-General's Department (2008), ICAC (2001), Meyrick and Associates (2009), Tasmanian Government (2009)

Lord Howe Island

The Lord Howe Island “Island Trader” service crosses the 600 km gap from the mainland every 2 – 3 weeks, supplying general cargo and fuel to residents and tourists. The ship and its operations are run privately through Lord Howe Island Sea Freight Pty Ltd, which is majority owned by the Island's residents. It does not appear that the operators receive any direct subsidy; however, there has been suggestion that an earlier decision to award government contracts to the current incumbent may have constituted unfair assistance over the former rival vessel operator (ICAC, 2001).

Christmas and Cocos Islands

A vessel services Christmas and Cocos Islands at a frequency of 4 – 6 weeks. These services are primarily for supplying the islands, though some export of phosphate is conducted from Christmas Island. While the Commonwealth Government owns the ports on these islands, the shipping services operate at arm's length without subsidy or specific regulation (Attorney-General's Department, 2008).



Bruny Island

The 3 km gap between mainland Tasmania and Bruny Island is serviced by a state-government-owned vessel that mainly carries cars, passengers and supplies. The service is privately operated with a subsidy via a net cost contract – the operator collects revenues, but the state government sets prices, service levels and concessions. The cost of service under these arrangements was \$654,000 in 2008/09 (Tasmanian Government, 2009). Under the contract the current operator has exclusive rights to operate the routes, but does so on an ‘open book’ basis – a quarter of any profits reported in excess of 17.5 percent return on assets are returned to the government (Meyrick and Associates, 2009).

Kangaroo Island

A private firm, SeaLink, operates two vessels between Cape Jervis and Penneshaw on Kangaroo Island at a frequency of up to eight return journeys per day. This service mainly transports passengers, vehicles and freight (‘imports’ and ‘exports’). The operations of SeaLink are currently unsubsidised, though the present arrangements with the state government – due to expire in 2019 with the potential for a five year extension – grants the SeaLink semi-exclusive rights to the ports at Penneshaw and Cape Jervis. These semi-exclusive rights give SeaLink priority access to the ports for one hour on either side of scheduled departure and arrival times. This concession was granted to SeaLink on a number of conditions, including that:

- » the operator carries freight to and from Kangaroo Island within 36 hours of receiving it;
- » the price of freight is controlled in accordance with the Prices Act 1948;
- » services are provided year-round regardless of weather conditions; and
- » the operator is responsible for investing in new ferries and maintaining a ‘high level’ of passenger accommodation facilities (Meyrick and Associates, 2009).

There have been (thus far unsuccessful) attempts by the Kangaroo Island Development Board to seek State and Commonwealth Government subsidies for the service, using the Tasmanian Freight Equalisation Scheme as the precedent.

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