



FUTURE OF *SPIRIT*
OF TASMANIA III
AND THE SYDNEY –
DEVONPORT
SERVICE

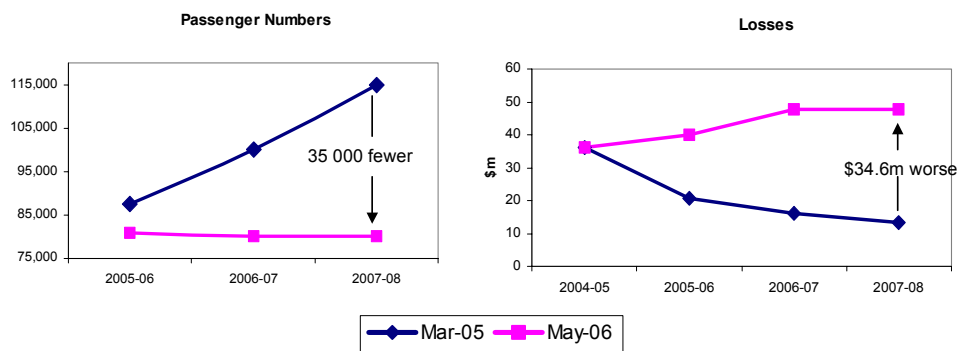
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1. EXECUTIVE SUMMARY

- On 24 May 2006, Treasury was requested by the Treasurer to prepare a report in response to information provided by the TT-Line Board detailing the performance of the Sydney service.
- The Board report highlights that the Company's performance and outlook are significantly worse than the expectations set at the time of the Government's decision to retain the Sydney service in March 2005.
- Increases in costs, particularly fuel, coupled with a failure to achieve budgeted passenger numbers, have resulted in the Board estimating that the *Spirit of Tasmania III* (SOT III) service will record much higher cash shortfalls than previously expected.
- The magnitude of the shift in TT-Line's outlook is evident in the charts below:



- *Spirit of Tasmania I & II* have also been affected by these factors. The Melbourne service is now expected to require a significant cash injection in 2006-07 if the Sydney service is retained.
- TT-Line now estimates that it will require funding of at least \$38.5 million in 2006-07 for it just to remain solvent.
- This outlook has led the TT-Line Board to recommend to Government that, in the absence of a substantial increase its funding from Government, the Sydney service should be ceased and SOT III sold.
- TT-Line's immediate funding request does not portray the true financial requirements of the Company. On its current forecasts, it will not be able to pay down debt or meet capital expenditure needs. Retaining the Sydney service on an ongoing basis will require higher levels of direct support from Government, around \$50 million per annum on Treasury's estimate.
- Further risks exist, particularly in relation to passenger numbers and higher fuel costs, which could increase the level of support required.

- The cost of retaining the small number of additional ship-based tourists is likely to be greater than \$4 000 per head. Gross spending by ship-based visitors is less than \$2 000 per head.
- The market demand for vessels such as SOT III is currently strong. Sale proceeds are expected to extinguish most of the debt owed on the vessel. These conditions may not last.
- TT-Line expects that most of its SOT III employees could be relocated to the Melbourne service, diminishing the need for redundancies.
- A return to the Melbourne-only service will bring over 90 per cent of the passengers that are achievable under the status quo. Many of the remainder are still expected to arrive by air.
- There may be a small negative impact on the Tasmanian tourism sector, particularly in regional areas.
- If a decision is made to sell SOT III, it is essential that there is no debt legacy left with the Company. Treasury estimates that TT-Line will require funding of \$22.5 million to transition back to a Melbourne only service in 2006-07.
- A return to a Melbourne only service will not solve all of the financial problems facing TT-Line. Further assistance may be required to ensure that the business is placed on a sustainable footing. This situation will be monitored as part of the annual Business Plan review.
- A sale of SOT III would allow the Company to focus on improving its core Melbourne to Devonport service. Given the threats currently facing the Melbourne service, this is critical.
- In Treasury's view, the level of funding required to continue the Sydney service is not supportable.
- Treasury recommends that the Government endorse the TT-Line Board's recommendation to immediately cease the Sydney to Devonport service and sell SOT III.

2. INTRODUCTION

On 24 May 2006, the Department of Treasury and Finance (Treasury) was requested by the Treasurer to provide advice on a report prepared by the TT-Line Company Pty Ltd (TT-Line) Board on the current and future performance of the *Spirit of Tasmania III* (SOT III). The TT-Line report details the performance of the service against expectations set at the time of the Government's decision to retain the Sydney service in March 2005.

The TT-Line report highlights that the Company's estimated loss for 2005-06 will be significantly higher than the \$20.7 million forecast in March 2005. In addition, the revised forecasts show that the substantial gains expected in passenger numbers over the next two years will no longer eventuate.

This outlook, combined with a significantly higher cost structure, primarily due to rising fuel costs, and the prevailing market for the sale of SOT III has led the TT-Line Board to conclude that from a commercial perspective the Sydney service should be ceased and SOT III sold. The Board has identified that the Government must either substantially increase its funding to the Company or support its sale recommendation.

This Treasury Report provides a review of TT-Line's position and assesses the claims made in the Company's report to Government. It concludes that the TT-Line Board's recommendation should be endorsed by Government.

3. KEY CHANGES

3.1 Background

The first 12 months of the Sydney service failed to meet all expectations. In November 2004, the Treasurer requested Treasury to prepare a comprehensive analysis of the future of SOT III, and provide advice on an appropriate course of action, to assist Cabinet in its deliberations on the future of the Sydney service.

Treasury completed this assessment and provided a report to Government on 2 February 2005.

The report noted that the rise of the low cost airline industry in Australia had proven to be a significant challenge to the Sydney service, resulting in a substantial shortfall in TT-Line's original passenger estimations. It also cast doubt on the reliability of TT-Line's revised passenger forecasts, recommending that Government prepare for a weaker result than that anticipated by the Company.

Taking into consideration the outlook and its assessment of the balance of risks, the Treasury report recommended that the Government determine to cease the Sydney service and sell SOT III. However, it also stated that, should the Government place a higher priority on non-financial objectives, and decide to retain the Sydney service, direct funding should be made available from the Budget at a level consistent with Treasury advice.

Ultimately, the Government announced on 15 March 2005 that it had determined to retain the Sydney-Devonport service for a three-year period and provide TT-Line with \$115 million in equity payments over that period to fund the losses that were expected to be incurred.

This decision was taken with an expectation, in line with TT-Line projections, of the core Melbourne service continuing to perform at acceptable levels and the Sydney service materially improving from the very poor performance of its initial year (primarily through a combination of increased marketing and fare reductions).

3.2 Changes

Since the Government's decision to retain SOT III in March 2005, there have been a number of significant changes facing TT-Line.

- The past year has shown that the lower fares for the Sydney service have attracted more passengers, but not enough to meet TT-Line's business plan for 2005-06. More significantly, the growth that was originally expected over the next two years is now not expected to materialise;
- At the same time, costs have increased markedly, particularly fuel, and the pressure from low-cost airlines has continued unabated;

- The core Melbourne service has also suffered cost increases and continued pressure from airlines. A lack of capacity on the Melbourne-Devonport route was part of the rationale for launching the Sydney-Devonport service. Capacity issues no longer exist – in fact, passenger numbers are down and predicted to fall further, and the Melbourne service is now operating at a loss;
- TT-Line’s viability is threatened by spreading its resources over two services that compete with each other for passengers. The Company has not faced a threat of this magnitude previously;
- The combination of rapidly increasing costs, lower passenger numbers and a subdued outlook has substantially changed the quantum of funding required to retain the Sydney service, and more broadly, to retain TT-Line as a solvent company. TT-Line believes that at a minimum, on a cash costs basis, the Company will require the \$25 million equity injection already budgeted, the annual appropriation of \$3.5 million to fund marketing campaigns for SOT III, and an additional \$10 million to fund the greater than expected losses. This will only cover the cash operating costs associated with the service;
- The market for the sale of SOT III is better than it was one year ago, as is the prospect for absorbing staffing on the Melbourne service;
- In contrast to its position in March 2005, the TT-Line Board has now recommended that it cease the Sydney service and focus on its core Melbourne service; and
- An increase in the funding required to continue the service comes against a backdrop of increased pressure from the community for more Government funds to be applied to core Government services.

4. FORECASTS

The following section focuses on the forecasts for passenger numbers and losses, and sets out the differences between the figures provided by TT-Line in early 2005 and the revised figures provided in May 2006. Freight forecasts have not been included as they are not a significant factor in the performance of the service.

4.1 Sydney service

Table 1 below compares the expectations for the 2005-06 year for the Sydney service.

Table 1: Sydney Service 2005-06 projections

	March 2005	May 2006	Change
Passenger numbers	87 520	81 000	↓ 6 520
Net Loss	\$20.7m	\$28.7m	↑ \$8.0m
Operating Cash shortfall	\$16.7m	\$24.7m	↑ \$8.0m

Revised passenger numbers are now expected to reach 81 000, some 7.5 per cent below Budget. The financial consequences of rising input costs, coupled with the strategy of growing passenger numbers by offering lower fares and more sailings, is evidenced by the increase of the Net Loss from \$20.7 million to \$28.7 million – an \$8 million greater loss than that expected only a year previously.

In March 2005, the Company's expectations were for strong growth in passenger numbers to continue into 2006-07 and 2007-08.

Table 2 highlights the stark difference in the March 2005 and May 2006 forecasts for 2006-07.

Table 2: Sydney Service 2006-07 projections

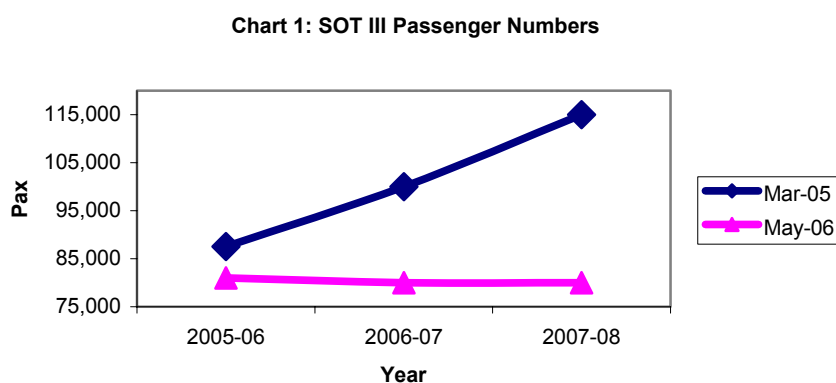
	March 2005	May 2006	Change
Passenger numbers	100 000	80 000	↓ 20 000
Net Loss	\$16.3m	\$28.7m	↑ \$12.4m
Operating Cash shortfall	\$12.3m	\$24.7m	↑ \$12.4m

The tourism market more broadly has moved against TT-Line, with BDA Market Research stating that domestic tourism is predicted to decline nationally and preference for Tasmania as a 'preferred' holiday destination is also falling. The BDA data shows that this is quite different to the situation that existed in recent years, with preference for Tasmania peaking in 2003-04.

This outlook has resulted in a revised expectation of 80,000 passengers in 2006-07, 20,000 less than that Budgeted for. The financial impact of the revised forecasts can also be clearly seen in Table 2. Significantly, the revised cash loss is \$24.7 million, meaning all of the \$25 million Government had set aside as a conservative provision

to fund the budgeted losses and debt obligations, would now be exhausted by operating cash shortfalls. It is also worth noting that Government had budgeted \$25 million as a ‘worst case’ scenario and was hopeful of a stronger result.

Chart 1 below demonstrates just how dramatically the passenger situation has changed with the revised forecasts compared to what was expected only a year earlier.



4.2 Melbourne Service

The revised forecasts for the Melbourne service under the status quo show that it too is now expected to make a Net Loss of \$11.4 million in 2005-06 and \$19.1 million in 2006-07. The revised cash position for 2005-06 is barely positive at \$1.1 million, however, in 2006-07 the projections are for this to also turn negative with a cash deficit of \$6.6 million now expected. This is set out in Table 3 below.

Table 3: Melbourne Service – Status Quo¹

	2005-06		2006-07	
	March 2005	May 2006	March 2005	May 2006
Passenger numbers	424 500	358 000	437 235	350 000
Net Loss	\$1.7m	\$11.4m	\$0.2m profit	\$19.1m
Operating Cash	\$14.4m	\$1.1m	\$16.3m	(\$6.6m)

1. Assumes that the Sydney service is maintained.

The combination of the \$24.7 million revised cash loss estimated for SOT III, and the \$6.6 million shown above for the Melbourne service, brings the 2006-07 funding requirement – simply to fund cash operating losses on the two services – to \$31.3 million, and does not include any provision for the repayment of debt or capital expenditure.

4.3 Whole of Company

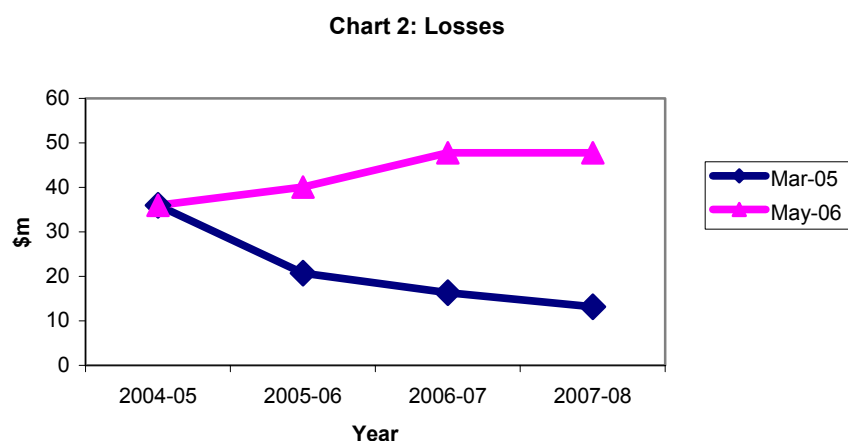
The drastic increase in the funding requirement just to finance cash operating costs, coupled with a weak outlook for growth, has lead TT-Line to develop 2006-07 revised forecasts on a ‘with SOT III’ and ‘without SOT III’ basis. These are set out in Table 4 below.

Table 4: 2006-07 Forecasts for TT-Line

	With SOT III	Without SOT III	Change
Passenger numbers	430 000	410 000	↓ 20 000
Net Loss	\$47.8m	\$9.9m	↓ \$37.9m
Operating Cash	(\$31.3m)	\$2.4m	↑ \$33.7m

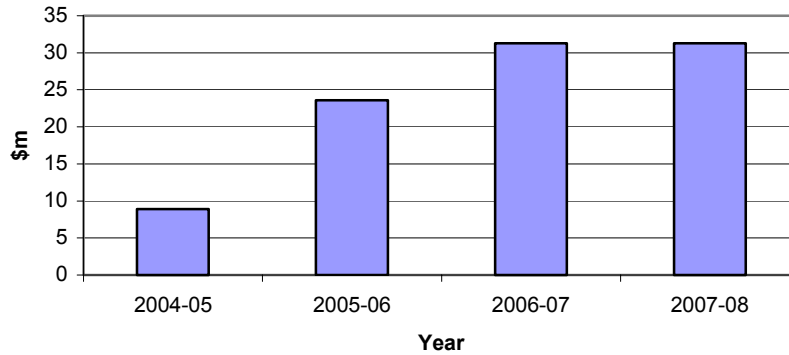
The table demonstrates the ‘real’ cost of maintaining a Sydney service going forward, taking into account the impact of SOT III on the Melbourne service.

The widening gap between the original and revised financial forecast for TT-Line can be seen in Chart 2 below.



The revised operating cash losses for the Company are shown in Chart 3, highlighting the deteriorating cash performance over time. It should be kept in mind that the amount shown below does not include any provision for the repayment of debt or capital expenditure.

Chart 3: Cash Losses under Status Quo



TT-Line has indicated that it would require \$38.5 million in funding in 2006-07 to ensure its solvency going forward. This consists of the existing budget allocation of \$25 million, \$3.5 million for marketing and an additional \$10 million to cover the higher than expected losses on Sydney, the unexpected operating losses now expected on Melbourne and as a buffer against other unexpected cost increases.

In conclusion, the information provided by TT-Line indicates that the minimum level of funding required to finance cash shortfalls and ensure TT-Line's solvency in 2006-07 is \$38.5 million. When compared to the cash losses shown above of \$31.3 million, and after taking into account marketing, this leaves only a \$3.7 million buffer against any further adverse movements. The sensitivity analysis in section 6 demonstrates the ease with which this buffer could be eroded.

In addition, this level of funding will not result in a sustainable business.

4.4 Sustainable funding needs if SOT III retained

For the SOT III service to be run as a long term, sustainable business, it must take into account the need for capital expenditure and the requirement to pay off debt. Funding only operating cash shortfalls is not sustainable.

In the case of a temporary downturn, where stronger future performance will generate cash to retire debt and fund capital expenditure, a case could be made that it may be appropriate to adopt such a strategy. This is clearly not the case in respect to the TT-Line.

To continue the Sydney service on a long-term basis, the amount of Budget support required can therefore be broken down as follows:

Table 5: Sustainable Funding Requirement

	SOT I & II	SOT III	Total
Cash shortfall	\$6.6m	\$24.7m	\$31.1m
Marketing	-	\$3.5m	\$3.5m
Debt amortisation¹	\$12.5	\$4m	\$16.5m
TOTAL	\$19.1m	\$32.3m	\$51.4m

¹ Depreciation rates are used as a proxy for debt amortisation, given debt funding for the acquisition of SOT I and III

Assuming that the TT-Line's current projections for passengers and costs represent the medium term future for the business, TT-Line will require a funding injection of more than \$50 million each year to be able to operate both services on a sustainable basis.

5. RISKS

While the outlook presented by TT-Line is bleak, there is a number of additional risks that need to be noted.

TT-Line has a poor track record when it comes to accurately estimating passenger numbers and financial performance. The Company's original case for SOT III vastly overestimated passenger numbers and anticipated that the service would be able to operate on a stand alone basis, without the need for Government assistance.

In March 2005, when it became apparent that the service would indeed need to be substantially subsidised by Government, TT-Line again estimated strong passenger growth and a reducing financial burden on Government going forward. Treasury did not accept those estimates as realistic, and recommended that additional funding be made available to cover higher than expected losses from the Company not being able to achieve its forecasted passenger growth.

TT-Line also expected the Melbourne service to maintain its operating position with no requirement for Government support on either an operating basis or to repay debt. Further to this, there was no indication that the Company foresaw the key risks that could impact upon the achievement of these forecasts. These are risks that have now eventuated.

Significant risks are evident in relation to TT-Line's revenues and costs.

From a revenue perspective, a more severe downturn than anticipated in the tourism market could negatively impact passenger numbers. A general downturn in domestic economic conditions could also have this effect.

It should be noted that the 80,000 passengers forecast in the revised estimates for 2006-07 and 2007-08 represents the peak number of passengers on the service to date. It may be appropriate to suggest that a more established and familiar service will combat some of the expected general downturn in the tourism industry, but TT-Line's expectation that 80,000 passengers will be maintained despite deteriorating market conditions may be optimistic.

In regard to costs, fuel price remains a key risk. Fuel makes up a substantial proportion (around 20 per cent) of operating costs and has been responsible for a large share of the cost increases to date (TT-Line advises that it has increased by 34 per cent over the past year). It is quite possible that fuel prices will continue to rise at a rapid rate. The TT-Line Revised projections assume that fuel costs increase by 10 per cent for 2006-07. Increases in excess of 10 per cent will further increase the Company's losses.

Higher than expected rises in other costs could also negatively impact on the financial performance of the Company. TT-Line states in its Report that it is facing cost increases for items such as wages and supplies, but is unable to recoup these through fare increases for fear of further reducing passenger numbers.

6. SENSITIVITY ANALYSIS

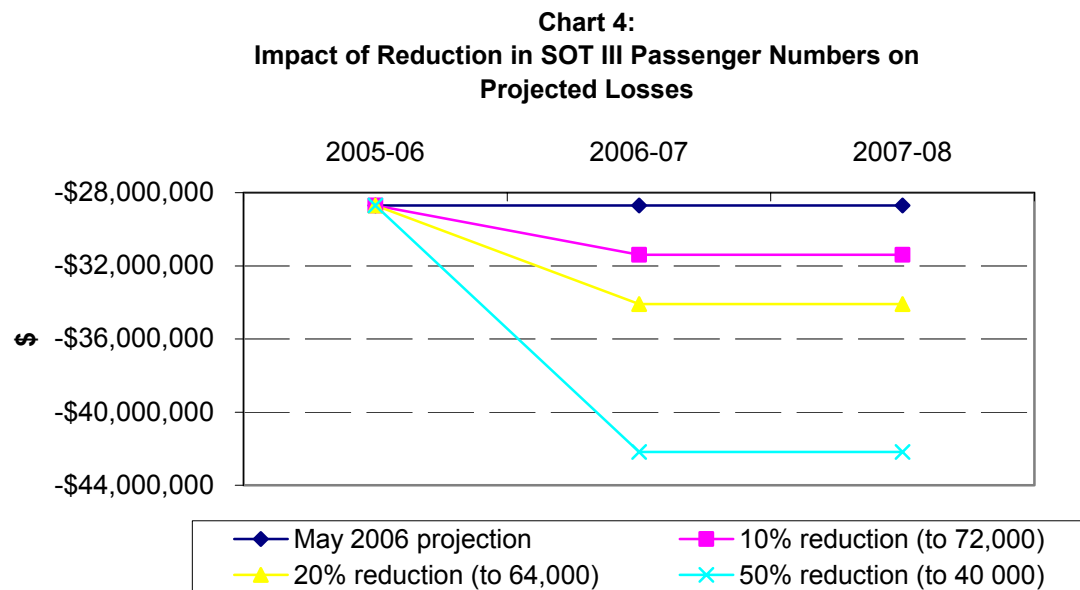
The two key variables that will affect the performance of TT-Line going forward are passenger numbers and fuel costs. The Company has little direct control over these variables as they are driven by national and international circumstances.

A sensitivity analysis demonstrating the impact of potential changes in these inputs on the May 2006 TT-Line forecasts is provided below.

6.1 Passenger Numbers

Chart 4 shows the impact of a significant reduction in passenger numbers compared to the May 2006 forecasts for SOT III as provided by TT-Line. The chart assumes that the revised passenger forecasts for Melbourne remain stable.

The potential for TT-Line to alleviate the financial impacts of a reduction in passenger numbers through cost cutting measures – such as further changes in the sailing schedule – has not been modelled. Such action could potentially reduce the additional loss modelled below. However, given the changes the Company has already made, and the fact that its cost structure is largely fixed, most of the flexibility it had to adjust its sailing schedule for reduced passengers has already been realised.

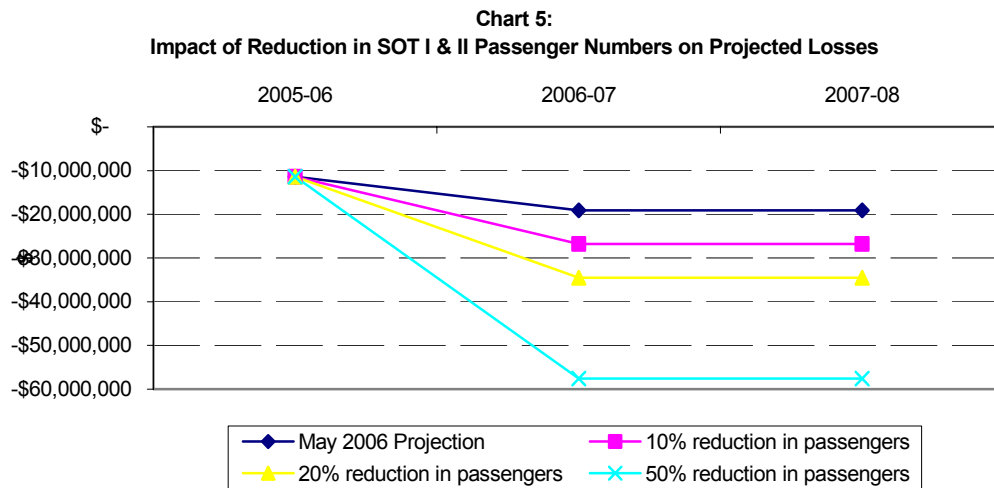


Note: It has been assumed that each passenger lost has a negative impact on revenue of \$322, which is the current total yield per passenger (including vehicle and food revenue).

While a further reduction in passengers on SOT III does not appear to have a large effect (eg an additional \$2.6 million for a 10 per cent, or 8 000 reduction in passengers), this is largely the product of the scale of the loss already expected. However, as this funding would need to come from the Budget, the real issue is what core Government services could otherwise be funded with \$2.6 million. To put this in perspective, \$2.6 million could fund more than 30 additional teachers or nurses.

The impact of a fall in passenger numbers forecast for SOT I & II is considered below. The same assumptions referred to in relation to SOT III hold true and assumes that the May 2006 passenger number forecasts for Sydney remain stable.

A fall in the number of passengers forecast for SOT I & II would substantially increase the loss forecast. As shown in Chart 5 below, a 10 per cent fall in passengers (equivalent to 35 000 passengers) on the Melbourne service increases the net loss by almost \$8 million.

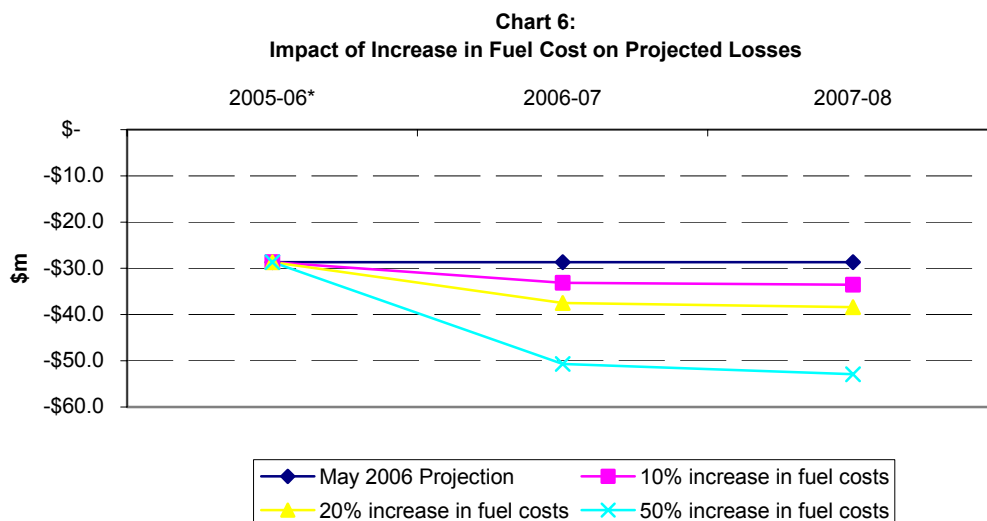


Note It has been assumed that each passenger lost has a negative impact on revenue of \$220, which is the approximate current total yield per passenger (including vehicle and food revenue).

6.2 Fuel

The impact of increases in fuel costs on the May 2006 projected losses is shown in Chart 6 below.

The May 2006 forecast includes a 10 per cent increase in fuel costs for 2006-07. Chart 6 shows the sensitivity of TT-Line as a whole to increases in fuel prices. If the Company experienced similar fuel price increases during 2006-07 to that of 2005-06 (34 per cent), a further \$9.6 million in direct Government funding would be required.



Higher fuel prices than the revised forecasts and/or lower passenger numbers are certainly a possibility. The sensitivity analysis shows that it is not unrealistic to consider an outcome for TT-Line that is in excess of \$10 million worse than that predicted by TT-Line currently.

It is worth noting that the Company's ability to deal with large and sustained changes in costs is very limited. As noted in its Report, TT-Line is finding it very difficult to pass-on cost increases in fares.

The demand for travel on TT-Line is reasonably price sensitive. The central element of the 2005 SOT III retention strategy was a 30 per cent decrease in passenger fares (no change in vehicle fares), which coincided with a 23 per cent increase in passengers¹.

Increases in fares to recoup increases in costs can be reasonably expected to have a detrimental impact on passenger numbers.

For the Sydney service to return to the level of financial performance that was expected in March 2005 would require the Company to raise revenues by around \$15 million. Leaving aside any demand impact from price increases, recouping \$15 million from 80 000 passengers would require each passenger to pay almost \$190 more. This represents an increase in fares of over 50 per cent. Treasury does not have access to accurate data on the price elasticity of demand for the Sydney service, but using the 2005 price/demand impacts as a broad proxy, a price increase of this magnitude would be expected to reverse all of the gains in passenger numbers achieved to date. Clearly, achieving a break-even position for the Sydney service is impossible (with its current cost structure).

¹ It is not possible to determine the extent to which the price reduction directly stimulated this additional demand given the dynamic nature of the tourism industry.

7. MARKET FOR THE SALE OF SOT III

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8. FUNDING REQUIREMENT

If a sale of SOT III is to take place, there will be associated costs that will need to be funded. Given TT-Line's weak financial position, this funding requirement will fall to Government.

Three factors will determine the amount of funding that is required:

- (i) the cash position of the Melbourne service
 - estimated to be a surplus of \$2.6 million;
- (ii) holding costs associated with the sale of SOT III
 - TT-Line estimates this to be \$12.7 million for a full year (berthing/layup costs, financing costs);
- (iii) the net sale proceeds after debt retirement
 - (A\$7 million) at book value and current exchange rate

Each of the estimates above could vary significantly throughout the year and it is not possible to determine the total funding requirement for 2006-07 at this time.

The actual sale value will be a function of the demand for the vessel and the prevailing AUD:EUR exchange rate. The actual performance of the Melbourne service will only be known at year-end and could also be greater or lesser than the amount budgeted, especially with a change as significant as the removal of the Sydney service. Holding costs will also vary depending on the length of time that it takes to sell the ship.

The 2005-06 Budget allocated \$25 million as an equity injection for TT-Line in the 2006-07 financial year. The TT-Line Report suggests that \$15 million of that payment would be required to write-off all debt associated with SOT III and return the Company to a more healthy cash position.

Treasury considers it prudent to allow for the majority of this payment to be made to the Company to fund:

- the transition costs associated with exiting the Sydney service;
- retirement of the debt held against SOT III after sale proceeds; and
- support for TT-Line's on-going Melbourne service

Specifically, it is recommended that a provision of \$22.5 million be made consistent with a conservative assumption with regard to sale value and a reasonable provision for holding costs.

As discussed above, retaining both Melbourne and Sydney services on an ongoing basis would require Budget funding of around \$50 million annually. No provision has been made in the forward estimates for any payment to TT-Line after 2007-08. As a result, the continuation of the status quo would be at the expense of core spending in priority Government areas.

It must be noted that the return to the Melbourne-only service will not solve all of the financial problems facing TT-Line. The forecasts provided by the Company in its report highlight that even with 410 000 passengers and almost 70 000 TEUs of freight, the Company will operate at a loss of almost \$10 million in 2006-07.

This level of financial performance provides no material buffer to enable the Company to deal with unplanned cost increases or withstand swings in demand. Importantly, it provides only minimal scope (around \$3 million annually) to reduce existing debt levels or fund any capital expenditure. Unless the service can achieve and maintain higher levels of patronage or improve efficiencies, this is not a sustainable position.

Maintaining a small positive operational cash flow means that TT-Line will not face insolvency and should not require annual payments from Government. However, the Company is unlikely to generate sufficient funds to replace the two Melbourne vessels at the end of their useful lives (or build enough cash to fund major refits). Unless there is an ongoing improvement in the performance of the Melbourne service, TT-Line is likely to erode the shareholder value provided to it via the Government's funding of one of the two Melbourne ships, some \$160 million.

Treasury recommends that this issue be monitored annually as a part of TT-Line's annual business plan review process.

9. IMPACT ON TOURISM INDUSTRY

TT-Line believes that substitution between the Melbourne and Sydney services is such that a return to a Melbourne-only service will result in the loss of just 20 000 passenger crossings (or 10 000 people) to the Company. This means TT-Line would still deliver 95 per cent of the estimated passenger numbers that could be achieved in continuing both services.

- TT-Line expects to achieve 410 000 passenger movements in 2006-07 under a Melbourne-only service.

The expectation that three quarters of passenger numbers from the Sydney service will be captured by the Melbourne service may be optimistic. The original business case for the introduction of the Sydney service concluded that two-thirds of all travellers on the service would have otherwise travelled on the Melbourne service. Taking this information, a more conservative estimate of the loss in TT-Line patronage is around 27 000, which still represents only 6.3 per cent of passengers that TT-Line estimates it could carry with both services.

The important issue for Government, from a whole-of-State perspective, is how many interstate visitors might be lost. Given that around 70 per cent of patronage on the Sydney service is inbound tourism to Tasmania, and assuming the higher estimate of passenger number reductions discussed above, around 9 500 interstate visitors would be lost to the TT-Line.

Treasury believes that the majority of these visitors would be expected to still travel to Tasmania for the following reasons:

- the sea-experience is a trigger for only a very small proportion of TT-Line customers;
- the past year has demonstrated that air access to Tasmania remains very strong and at reasonable cost; and
- the Melbourne service is highly flexible and can expand to meet the market.

However, air-based visitors do have a different profile to sea-based visitors. Data from Tourism Tasmania indicates that ship-based visitors stay longer in the State (around 15 nights on average, compared with 8 nights for air visitors), spend more (\$1 900 per head compared with \$1 300 per head) and are more likely to visit regional areas.

It is reasonable to conclude that while there may be some small dislocation within regional tourism areas due to lower ship-based visitation, the total reduction in ship-based visitors is relatively small (6.3 per cent) and the impact on the overall tourism industry is likely to be minimal.

By comparison, the level of subsidy required to deliver an additional 9 500 ship-based visitors is a minimum of \$38.5 million (TT-Line's estimate), or more appropriately, around \$50 million on a longer-term sustainable funding model. This equates to a subsidy of \$4 100-\$5 300 per visitor. This compares to a gross spending level of around \$2 000 per visitor. Treasury's view is that this level of subsidy cannot be justified.

Treasury acknowledges that the comments above deal only with the direct reduction in ship based interstate visitors as a result of such a decision. An additional consideration is the impact that there may be on confidence levels. A poorly communicated decision to sell SOT III may result in some loss of confidence in the tourism industry, but this can be managed.

Treasury expects that there will not be significant employment impacts emerging from the end of the Sydney service. Accurate estimates of the relationship between marginal tourism spending and employment outcomes are not available. In its 2005 Report on SOT III, Treasury suggested that \$1 million in marginal spending would generate around 5 jobs. The worst-case assumption on the loss of spending is around \$18 million (this assumes that none of the passengers lost to TT-Line visit Tasmania by air). Such a loss in spending could reduce job numbers by around 90. However, given the strength of the Tasmanian economy and skill shortages in many industries, it is highly unlikely that a material reduction in total employment numbers will be sustained.

10. OPTIONS

Alternative operating models for maintaining a Sydney service were investigated as part of Treasury's 2005 Report. The two alternative models were:

- retain SOT III for peak Sydney service and charter in off-peak; and
- retain a once-per-week Sydney service using one of the Melbourne vessels and sell SOT III.

Both of these models were deemed to be unviable by Treasury and TT-Line at that time and would only appear worse in the current climate.

Therefore there are 3 core options to consider.

Option 1: Continue to operate SOT III and provide further equity funding

- This option would maintain the status quo and would be consistent with the Government's previous announcement to operate SOT III on a three-year trial basis.
- The Government would need to provide further funding to the level of at least \$10 million in 2006-07, in addition to the \$25 million (plus marketing) budgeted.
- This quantum of funding would have to come from Departmental savings, or through forgoing other Government initiatives that could have otherwise been funded.
- No budget provision is in place past 2007-08. Maintaining both services on an ongoing basis would require at least \$38.5 million annually to fund operating cash shortfalls. On a full cost sustainable basis, this requirement increases to around \$50 million.
- Further risk exists that could increase the quantum of funding required.
- The competition for passengers between the two services will continue to erode the feasibility of the core Melbourne service.
- There is no justifiable basis for providing the level of subsidy for interstate visitors implied by the level of funding that would need to be provided to TT-Line to maintain the Sydney service. The financial consequences of this option far outweigh the direct and indirect benefits gained from maintaining a Sydney – Devonport link.

This Option is not recommended.

Option 2: Continue to operate SOT III by increasing TT-Line's debt cap

- This option would enable TT-Line to continue to operate the Sydney service in the short term without an immediate impact on Government spending.
- This would not be a sustainable means of continuing the service, and at some point, the decision would have to be made as to how the debt will be repaid and how the service could continue on a sustainable basis.
- TT-Line will not be able to service its existing levels of debt – given the outlook – let alone service an increased amount.
- TT-Line was unable to repay any of its existing debt obligations in 2005-06, even with a \$25 million equity injection from Government. There are no prospects of the Company being able to repay any of its existing debt in the short to medium term.
- This Option may have served a purpose if there was a fundamental reason to defer the decision until more evidence was available on the performance of the service or to overcome a temporary cyclical downturn. However, all of the information that is available demonstrates that the failure of the Sydney service is a structural, as opposed to cyclical, problem.
- Increasing TT-Line's debt cap would only provide an unsustainable short-term solution to the problem.

This Option is not recommended.

Option 3: Cease the Sydney service immediately and sell SOT III

- Returning to a Melbourne-only service provides the only means to return the core business to acceptable performance levels. Enabling the Board and management to focus on the core business is critical given the financial situation the Melbourne service is facing.
- This approach eliminates intra-company competition for largely the same passengers;
- Pursuing a sale in the near future would take advantage of strong market demand for RORO ferries. In this climate, it is possible that SOT III's sale could eliminate the majority of the debt associated with the ship, although some contribution from Government will likely still be required;
- TT-Line's debt would be reduced to a more appropriate and manageable level;
- The level of debt in the Public Non Financial Corporations (PNFC) sector would reduce by \$100 million. A substantial contingent liability for General Government would also be eliminated;

- TT-Line believes that 95 per cent of the passengers (or 93 per cent under Treasury assumptions) expected to visit the State under the May 2006 forecasts for 2006-07, will be retained through the Melbourne only service. The remainder could be reasonably expected to visit the State via the strong air links that exist;
- TT-Line has indicated that it could re-allocate most of the staff on the Sydney service to the Melbourne service.

This Option is recommended.

11. RECOMMENDATIONS

That the Government:

- (i) endorse the position of the TT-Line Board and seek an immediate sale of SOT III;
- (ii) agree to the principle that there should be no debt legacy from SOT III, which could further depress the Company's performance on its core Melbourne service; and
- (iii) allocate up to \$22.5 million of the \$25 million budgeted as an equity injection into TT-Line in 2006-07 towards sale costs and debt retirement, with the final amount to be determined by the Treasurer.