

# Regulatory Impact Statement

## Regulation of competition in international shipping

### Agency Disclosure Statement

- 1 This Regulatory Impact Statement has been prepared by the Ministry of Business, Innovation and Employment.
- 2 It provides an analysis of options to strengthen the oversight of agreements between international shipping carriers. This is to reduce the risk of carrier agreements having anti-competitive effects that are not sufficiently offset by benefits in shipping supply. Where this risk eventuates the cost is borne by our exporters and importers in the form of higher shipping rates, reduced frequency and reliability of services, and less efficient vessels and operating practices. These outcomes weaken New Zealand's international competitiveness with flow-on effects through the rest of the economy.
- 3 The key limitation of the analysis is the lack of detailed information about actual negotiated freight rates, terms and provisions of service contracts, relationships between operating costs and freight rates and the nature of arrangements between carriers. Any analysis would assess arrangements to see whether they raised competition concerns and where they do, investigate the costs and benefits to New Zealand associated with the restrictive trade practice. As there is no effective regulatory oversight of these agreements, there is no public record of them or any analysis of their actual effect.
- 4 The starting point for this analysis is the New Zealand Productivity Commission's International Freight Transport Services Inquiry that recommended strengthening the regulation of competition in international shipping. Officials have built on this analysis by considering:
  - a. Views from stakeholders;
  - b. A review of the economic literature on the liner shipping industry;
  - c. Experiences of regulatory regimes in other countries; and
  - d. Experiences of regulatory regimes in similar industries.
- 5 The recommended option of applying the Commerce Act to international shipping would use an established framework to strengthen the regulation of competition in the provision of liner shipping services to and from New Zealand. The benefits of this option are not able to be quantified, but the proposal should minimise the risk of detriment from anti-competitive behaviour. Any additional compliance costs on shipping lines in complying with this regime are also difficult to quantify, but are likely to be justified given the benefits from a more robust regulatory oversight. Furthermore, steps such as the production of guidance material should mitigate these costs.

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## Background

- 1 In March 2011, the Government asked the Productivity Commission to undertake an inquiry into international freight transport services. The context for the inquiry was that increasing international trade is a critical part of achieving productivity growth for New Zealand. Given that freight transport costs currently represent a sizeable proportion of international trading costs for New Zealand firms, it is important to ensure that New Zealand's infrastructure and regulatory regimes are effective in promoting accessibility and efficiency in international freight transport services.
- 2 The Chair of the Productivity Commission, in his foreword to the report, noted that New Zealand importers and exporters spend about \$5 billion on freight services each year. The Commission looked at whether the efficiency of these services could be improved. For businesses this would mean more competitive exports and higher profits. For consumers it would mean cheaper prices and greater spending power. He identified that as the most remote developed country in the world, having highly efficient international freight services is crucial for New Zealand's economy and for the wellbeing of its citizens.<sup>1</sup>
- 3 The terms of reference required the Productivity Commission to consider the effectiveness of current regulatory regimes (including those in the Civil Aviation Act 1990 and the Shipping Act 1987) and the potential costs and benefits of alternative regulatory regimes with international comparisons.
- 4 In respect of international shipping, the Productivity Commission found that the performance of the freight system could be improved by strengthening the competition regime in international shipping. The Commission recommended:
  - Removing the Commerce Act exemption for ratemaking agreements, which are agreements that fix prices, or limit capacity with the intent of raising prices. This would allow the Commerce Act's authorisation mechanism to be used to assess whether these agreements are in the public interest, and
  - Continuing to exempt non-ratemaking agreements but making the exemption conditional on filing the agreements on a public register.
- 5 While the Productivity Commission noted that the defining characteristics of a rate-making agreement is that it include agreement to set or manage freight rates on a route and/or to limit capacity in order to raise rates above what they would be absent the agreement, it never defined what constitutes a non-ratemaking agreement.
- 6 A non-ratemaking agreement may be an agreement that is not a ratemaking agreement, although this is not explicit. Alternatively, in discussing non-ratemaking agreements, the Productivity Commission may have been referring to consortia or operational agreements that are widespread in international shipping. These cover a range of operational matters including agreements between carriers to jointly operate a network of services, to share vessels on a service and/or to buy or swap container slots on vessels.<sup>2</sup> Such agreements may limit capacity albeit not with the purpose of raising rates above what they would be absent the agreement.

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<sup>1</sup> Productivity Commission, *International Freight Transport Services Inquiry*, April 2012, p iii.

<sup>2</sup> A service is a group of vessels operating on a single route according to a fixed schedule. For example a typical weekly service to Singapore requires 6-8 vessels.

- 7 This paper continues to use the terms ratemaking and non-ratemaking but notes that there is no settled definition of the terms, nor do the terms distinguish between conduct that is pro or anti-competitive or conduct that restricts output and conduct that enhances output.

### ***Why international shipping was exempt from the Commerce Act***

- 8 The Productivity Commission report noted that:

*Collaborative agreements are often protected from the normal competition scrutiny that countries apply to all other industries. Many governments around the world exempt liner shipping collaboration from the full application of domestic competition laws (or 'anti-trust' laws). Each jurisdiction has taken a slightly different approach (Ministry of Transport, 1983; Appendix D).*

*New Zealand is one of the countries that offer exemption. Shipping lines that run freight services to and from New Zealand are exempt from the Commerce Act 1986.*

*The basis for the exemption is a judgement of net benefits. Governments have judged that liner collaboration is likely to deliver benefits that outweigh the cost of less competition. The net benefits are considered to be clear enough to justify a 'block exemption' for all collaboration of a certain type, rather than a provisional exemption that requires shipping lines to prove the benefits of their collaboration on a case-by-case basis.*

*A number of governments (not including New Zealand) have reviewed the basis for these competition law exemptions over the past decade or so. In particular, these governments have questioned whether agreements that set rates and limit capacity (mainly conference agreements) deliver clear net benefits.<sup>3</sup>*

- 9 In its 2002 report on *Competition Policy in Liner Shipping*, the OECD noted that co-operative behaviour in liner shipping has historic origins in the late 19th century where the introduction of fast steamships brought about instability in the relatively young liner shipping sector. The industry was characterised by cutthroat competition between sailing ship operators and new and emerging steamships. There was further competition between steamship operators and shippers (including exporters and importers) took advantage of overcapacity in the industry to obtain lower freight rates.
- 10 Rather than limit shipping services to those instances when carriers could expect compensatory returns (e.g. by providing irregular services based on full ship-loads), the liner operators opted for formal arrangements between themselves to limit capacity and fix rates. In this way, they thought they could still provide the value of a fixed port rotation while reducing their exposure to destructive competition.<sup>4</sup> Despite economic, political and social changes, these formal arrangements still characterise the industry today.<sup>5</sup>

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<sup>3</sup> Productivity Commission, *International Freight Transport Services Inquiry*, April 2012, p226.

<sup>4</sup> Competition is said to be 'destructive' when it leads to prices below costs (in other words, marginal cost pricing is inadequate to recover large fixed costs) and thus generates market instability.

<sup>5</sup> OECD, *Competition Policy in Liner Shipping*, 2002, p18.

- 11 Shipping lines have continued to argue that the industry is unique in that there is a real need for capacity control and rate-fixing to ensure stable international shipping services. More particularly:
- Shipping lines operate a service where ships must sail at set times irrespective of the amount of cargo they have on board;
  - Failure to provide such a regular service would undermine the value to shippers;
  - In order to provide scheduled services at frequent intervals, carriers must be able to field several similar ships on any given trade route;
  - Purchasing and operating these ships requires a substantial capital outlay;
  - Carriers face unbalanced trade flows and therefore capacity deployed in sufficient quantity for the dominant flow will often be far in excess of the amount needed for the return leg; and
  - Shipping lines operate in a relatively uniform product market where there has traditionally existed little differentiation between operators.<sup>6</sup>
- 12 The special characteristics of the liner shipping industry were noted by the International Container Lines Committee (ICLC) in its submission to the Commerce Committee.
- 13 To date the exemption for international shipping seems to have been given on the basis that there would be risk in New Zealand being out of step with its trading partners and that this might result in a deterioration of the quality or frequency of service. There does not appear to have been any analysis of whether there are competition implications of the arrangements and to the extent there are, whether the arrangements can be justified on the basis that they provide such benefit to New Zealand that a block exemption should be granted.

## **Status Quo and Problem Definition**

- 14 In its submission to the Commerce Committee, the ICLC put forward:

*No case has been made that there is a problem with the status quo i.e. the existing system with broad exemption and sector-specific intervention powers with the Ministry of Transport works adequately.<sup>7</sup>*

### ***New Zealand's regulatory approach is an outlier and provides insufficient oversight***

- 15 New Zealand is relatively well served by liner shipping operators; with 18 international container line shipping companies operating in New Zealand, including nine of the 16 largest shipping companies. In general, these shipping companies operate regular services to and from New Zealand, visiting up to 11 ports. These services are generally on a fixed day, weekly basis between ports in New Zealand and our main trading partners, or via hub ports. New Zealand shippers can also charter vessels as required.
- 16 In comparison with most other countries, New Zealand's regulatory regime is an outlier. Although many countries still provide some form of exemption to international shipping, New Zealand's exemptions apply widely and without the limiting conditions found elsewhere.

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<sup>6</sup> OECD, *Competition Policy in Liner Shipping*, 2002, p18.

<sup>7</sup> International Container Lines Committee, *Submission to the Commerce Select Committee on the Commerce (Cartels and Other Matters) Amendment Bill*, 18 October 2012.

- 17 The exemptions for international shipping are provided in section 44(2) of the Commerce Act 1986 and section 14 of the Shipping Act 1987, and collectively exempt the international carriage of goods by sea from Parts 2 and 4 of the Commerce Act.
- 18 Sector-specific regulation is provided by sections 4-10 of the Shipping Act 1987. This regulation seeks to promote fair dealing and safeguard competition in New Zealand's outward shipping services. However, this regime is ineffective in achieving this purpose and has never been used because:
- It gives the Minister of Transport an ability to investigate unfair practices but sets a high threshold for initiation of an investigation.
  - It contains only limited powers for the Minister to remedy any problem. There is no ability to impose penalties or conditions. The Minister can only direct carriers to provide information and to enter into negotiations with exporters.
  - The provisions only apply to outward shipping - it provides no oversight of competition in import shipping.
  - Institutionally, the Ministry of Transport has no standing investigative capacity or procedure.
- 19 As a result of the inadequate regulatory regime, there is no oversight of competition in the industry and international shipping is essentially unregulated.

***The lack of effective oversight exposes exporters and importers to a risk of anti-competitive outcomes***

- 20 By exempting international shipping from competition law and operating a weak sector-specific regime for export shipping only, New Zealand is exposed to the risk that agreements between carriers have anti-competitive outcomes that are not sufficiently offset by benefits in shipping supply.
- 21 If the risk eventuates, the cost is borne by our exporters and importers in the form of higher freight rates, reduced frequency and reliability of services, and less efficient vessels and operating practices. These outcomes reduce New Zealand's international competitiveness with flow-on effects through the rest of the economy.

***What do we know about competition (or lack thereof) in international shipping?***

- 22 In its report on Competition Policy in Liner Shipping, the OECD observed:

*The difficulty in assessing the validity of the pro- or anti-exemption position has always been the availability (or lack thereof) of the detailed information necessary regarding actual negotiated freight rates, terms and provisions of service contracts, relationships between operating costs and freight rates and the nature of arrangements among carriers. In an ideal world, a regulatory agency would be able to proceed in a logical fashion to investigate the benefits/disadvantages of anti-trust arrangements. This would entail making an assessment as to these practices, impacts on competition, the net balance of benefits and dis-benefits flowing from these measures and an investigation of alternative approaches to achieving the benefits resulting from these actions.<sup>8</sup>*

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<sup>8</sup> OECD, *Competition Policy in Liner Shipping*, April 2002, p11.

- 23 These observations were consistent with those of the Australian Productivity Commission in its review of the regulatory regime governing competition in international liner shipping. The Commission noted that attempts to establish that agreements enable carriers to exploit market power and earn above normal rates have been hampered by a lack of available data.<sup>9</sup>
- 24 The Australian Productivity Commission's recommendations were therefore based on the following sources:
- Views from stakeholders;
  - A review of economic literature on the liner shipping industry;
  - Experiences of regulatory regimes in other countries, particularly the EU; and
  - Experiences of regulatory regimes in similar industries i.e. those that offer regular scheduled services and have relatively high fixed costs.
- 25 In the absence of a regulatory regime that would enable access to required information, this analysis has drawn on the same sources as the Australian Productivity Commission.

### **Stakeholder submissions to the New Zealand Productivity Commission and Commerce Committee**

- 26 Submissions were made by a range of exporters: large firms, small firms and industry bodies such as Export New Zealand and the New Zealand Shippers' Council.
- 27 Kotahi (a joint venture between Fonterra and Silver Fern Farms) in a submission to the Productivity Commission, noted:

*Collaborative VSA agreements between shipping lines had enabled an increase in average vessel size calling New Zealand, reducing the average cost per unit of capacity to the carrier. However, this has been at the expense of freight owner choice in service delivery. Carrier collaboration has also arguably been used to artificially constrain capacity creating an environment whereby a reduction in the cost to serve has rarely translated directly into a price to service reduction to freight owners.*

*It should be noted that use of collaboration to artificially constrain capacity is a relatively recent phenomenon. Historically the ability for carriers to collaborate has serviced NZ well, facilitating the introduction of scale operations and reducing the volatility of supply by improving the financial sustainability of services for the carrier community. This highlights that carrier collaboration can and has worked but given the increased global financial pressures facing lines, NZ would benefit from additional protection from carriers obtaining unfair advantage.<sup>10</sup>*

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<sup>9</sup> Australian Productivity Commission, *Review of Part X of the Trade Practices Act 1974: International Liner Cargo Shipping*, February 2005, p83.

<sup>10</sup> Kotahi, Submission to the Productivity Commission's Issues paper, response to question 20.

- 28 Southern Fresh Fruit Exports Ltd, a smaller exporter of fresh fruit but with business operations in other countries (South Africa and Chile), submitted to the Commerce Committee that the contention from the International Container Lines that a problem does not exist hides the reality of the current situation. More specifically Southern Fresh Fruit Exports noted that:
- The submission was prompted by the US\$1500 increase for all containers from New Zealand imposed by Maersk. The increase was followed within hours by other major shipping lines.
  - Reefer rates out of New Zealand to key markets in Asia cost up to 149% more than the rate that is being paid for a similar service from the same product group from South Africa. The routes are comparable in that it is a 14-day service from South Africa to Singapore, as it is from New Zealand to Singapore.
  - Vessels serving New Zealand had dropped from 2800 TEU (twenty foot equivalent unit) to 2300 TEU over five years.
  - There had been cost cutting and service degradation in the shipping industry. Ships to Europe had begun slow steaming, and as a result took 34 days instead of 29. That was a 17 percent speed reduction, which would result in a 20 percent fuel saving.
- 29 Southern Fresh Fruit Exports is of the view that horticulture was a marginal business with 20 percent of product selling at good margins, 20 percent selling at a loss and 60 percent selling at a marginally good return. The US\$1500 increase in shipping costs would make horticulture not even a marginal business but unsustainable.
- 30 The New Zealand Shippers' Council, a body representing exporters and importers, submitted to the Productivity Commission:
- Collaborative agreements are necessary to guarantee levels of service to and from countries like New Zealand at reasonable cost. The problems for importers and exporters occur when price and capacity information is exchanged allows the opportunity for uncompetitive behaviour. It is likely that such behaviour has occurred...*
- 31 Similarly, Export New Zealand in its submission to the Productivity Commission noted:
- One of the benefits to exporters of Shipping Line Conferences is that the shipping lines cooperate on dispatch of ships, which means we get more frequency of service than we might otherwise get in NZ and a better utilisation of space. Frequency of service is important to exporters who are trying to get goods to customers in a timely fashion and particularly for perishable goods that have a limited shelf life.*
- On the negative side of the ledger, the consolidation of capacity after the global financial crisis could mean that shipping lines have more market power than was previously the case.<sup>11</sup>*

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<sup>11</sup> Export New Zealand, *Submission to the Productivity Commission regarding the Enquiry into International Freight Transport Services*, 31 August 2011, para 4.1 and 4.2.

- 32 Other evidence that could indicate that the market for liner shipping is not as competitive as it could be, includes:
- The Productivity Commission also did a case study comparing prices for containers from Australia and New Zealand to the same third-country ports (Singapore, Shanghai and Long Beach California) and found evidence of considerably higher sea-freight rates on New Zealand services compared with Australian services. These price differences were not fully explained by plausible estimates of cost differences.
  - Several submitters to the Commerce Committee noted recent price increases of \$1,500 per refrigerated container. This was introduced by one shipping company and shortly after adopted by others, without obvious justification for the increase. Submitters noted that the price increase was significant given the global overcapacity of refrigerated containers that has existed since 2008.
  - Shippers have indicated that the prices for refrigerated containers from New Zealand are high relative to other countries at a similar distance from markets. One example provided of prices for South Africa and New Zealand to the same third-country Asian ports (Hong Kong, Singapore, Port Klang Malaysia), showed reefer rates out of New Zealand to cost up to 149% more.
  - Shippers noted that prices are based on the type of cargo carried rather than on carrying costs plus a competitively derived margin. For example, apple exporters pay around twice the rate that a butter exporter would per container. This may indicate that carriers are charging what the market will bear, rather than for the costs of providing the service.
  - Shippers noted that since the global financial crisis, New Zealand prices have remained consistently higher, and shown less volatility in downward pricing, than in other countries.
- 33 Finally, in discussions with officials, representatives of the International Container Lines Committee mentioned that the average return on routes that service New Zealand was between 3% and 4% return, whereas across the global network the return was 1%. While these figures alone do not demonstrate that anti-competitive rents are being earned, rather they demonstrate that the routes to and from New Zealand are relatively profitable.

#### **Review of the economic literature on the shipping industry**

- 34 It has been argued that the liner shipping industry has economic characteristics, which differentiate it from other industries, particularly in relation to cost structures. These characteristics are said to render the industry susceptible to instability and deserving of an exemption from competition law.
- 35 The Australian Productivity Commission reviewed the literature in relation to these arguments and found that while there are theoretical arguments in favour of 'destructive competition', the empirical evidence is not compelling. Competition is said to be 'destructive' when it leads to prices below costs (in other words, marginal cost pricing is inadequate to recover large fixed costs) and thus generates market instability.



36 More particularly, the report found:

- The importance of economies of scale in liner shipping means that price discrimination between cargoes and/or between shippers, as opposed to solely cost reflective pricing, can be an efficient mechanism for recovering high fixed costs.
- The industry is characterised by the widespread use of surcharges, such as for bunker fuel, terminal handling and peak season. Surcharges can be a means of passing on unavoidable costs associated with container shipments to shippers. However, they can also enable carriers collectively to impose price increases on the market. Surcharges are generally not subject to negotiation with shippers.
- Concern about 'destructive competition' has been a powerful argument used in support of allowing ocean carriers to confer and form conferences to control the supply of shipping capacity and set freight rates on trade routes. However, there is a lack of evidence to support that concern.
- Shipping lines enter into agreements for the purpose of limiting competition and/or realising operational efficiencies. While some agreements – those involving vessel sharing agreements, slot swaps and slot charter agreements may be appropriate responses to industry cost structures and characteristics of shipper demand, agreements that limit competition (such as discussion agreements) appear less justifiable on efficiency grounds.
- Operational agreements have the potential to benefit carriers and shippers through cost reductions and greater flexibility in service delivery, however, benefits will only be passed through to shippers under competitive conditions.

37 In relation to competitive conditions, the report found:

- Barriers to entry to a new route are not especially high and may be limited to redeployment of ships, marketing and administration. However, factors such as high worldwide demand for capacity, the desire to maintain networks and strategic conduct by incumbents, may raise these costs and reduce the degree of contestability on a route.
- While the liner shipping market, like any market, needs to be well informed to function properly, the high level of exchange of commercial information on price and quantity among carriers can be a means of enforcing collusive agreements and may result in a limiting of competition.

### **Experiences in other countries**

38 A number of jurisdictions never exempted shipping from their competition laws including Norway, South Africa, Brazil, Russia, Turkey, India and Malaysia. However, of those that have, there has been a trend towards narrowing the scope of the exemption, particularly in the EU and US.

## *European Union*

- 39 The EU reviewed its exemption for international shipping with changes coming into force in 2009. The EU approach is informative as it seeks to focus on the substance of the arrangements, not the form. The Regulation states that the legal form of the arrangements is less important than the underlying economic reality.<sup>12</sup> As discussed in paragraphs 5 to 7, ratemaking and non-ratemaking agreements are not defined terms and tend to focus on the form of the arrangement rather than the substance.
- 40 More specifically, the EU repealed the exemption so that shipping lines are no longer able to fix prices or capacity. The exemption also draws a distinction between arrangements that are efficient and generally help to improve the productivity and quality of liner shipping services and those that represent an unjustified limitation of capacity and sales, including through the joint fixing of freight rates or market or customer allocation that are unlikely to bring any efficiency.
- 41 The EU Competition Commission, in a letter to the New Zealand Productivity Commission, noted that:
- The EU had not experienced 'destructive competition' in the three years since repeal of its exemption. Rather there are still many carriers on EU trades and they offer even more capacity than before the repeal.
  - The liner industry is no different from other fixed-schedule, high-fixed-costs transport industries that function well under the standard competition law regime.
  - The EU repeal has not led to significantly increased concentration. In any event, consolidation (subject to merger control) is preferable to cartels, as it can improve efficiency and increase competition.
  - The argument that without a cartel exemption, the carriers would reduce investment in their key assets (i.e. container ships) does not hold. The EU has observed that a number of carriers are expecting the delivery of many large vessels earmarked for the Asia-Europe trade. Moreover, regardless of any liner cartel exemption or repeal, the prospect of operating newer, larger and more efficient vessels can act as a strong incentive to invest in new vessels.<sup>13</sup>

## *United States*

- 42 Prior to the passage of the United States Ocean Shipping and Reform Act (OSRA) in 1998, there were strong impediments to individual Conference carriers' ability to negotiate rates with shippers. Conferences were required to publicly post tariffs and negotiated individual services contracts with the Federal Maritime Commission (FMC). The transparency of rate information meant that rival carriers knew the terms and conditions that were being offered by their conference partners.
- 43 The reforms abolished the requirement that service terms be made public. The effect of the reforms was that shippers and individual carriers could negotiate confidential services agreements. The reforms were designed to encourage competition between carriers. As a result, very little traffic now takes place directly under conference terms.<sup>14</sup>

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<sup>12</sup> European Union, Commission Regulation (EC) No 906/2009, Official Journal of the European Union.

<sup>13</sup> European Commission, Directorate-General for Competition, Letter to Murray Sherwin, 24 February 2012.

<sup>14</sup> OECD, *Competition Policy in Liner Shipping*, 2002, p 22-24.

## Australia

44 In 2005, the Australian Productivity Commission undertook a review of the regulatory regime that governs competition in international liner cargo shipping. A summary of the Australian regime is set out in an attachment to this paper.

45 The Commission found:

The wide variety of agreements registered have varying potential to provide a net benefit for Australia, depending on the nature of the agreement and the impact on competition in the trade routes on which they operate.

- Agreements on operational matters, such as joint scheduling and use of shipping assets, can, in principle, offer significant cost saving and pose little anti-competitive risk.
- Agreements which fix prices and control the supply of shipping to a trade route pose the greatest anti-competitive risks.

Evaluation and selective registration of agreements is therefore necessary if Australia is to be confident that only those that provide a net public benefit are allowed to operate.<sup>15</sup>

46 The Commission considered that the most effective way to do this would be to repeal the registration regime and, as occurs for other industries, rely on the general authorisation regime. The Australian Competition and Consumer Commission (ACCC) would assess agreements individually and authorise them where there is a net public benefit to Australia.

47 The recommendations were not implemented but officials understand that the Australian Department of Infrastructure and Transport agree in principle with the Commission's recommendations but due to the time lapse since the completion of the report, consider that it would be prudent to undertake further consultation prior to making any legislative changes.

## Regulatory regimes in similar industries

48 The Australian Productivity Commission found that there are strong parallels between transport industries such as airlines, road transport and rail freight, which offer regularly scheduled services and have relatively high fixed costs.

49 In many OECD countries, moves to deregulate these industries have been opposed on the grounds that it would give rise to 'destructive competition'. Yet deregulation of these industries has typically been successful. The OECD found:

*The cost structure of the industry is not significantly different from that of other transport industries and returns in liner shipping are similar to those of other scheduled transport providers. While it is true that ships cost considerably more than say, a new lorry or locomotive each ship can also earn significantly more revenue. Seasonal and directional trade imbalances are not unique to the liner sector and must be faced by most transport service providers – in some cases these imbalances pose much more of a problem since some vehicles are not as standardised as container ships. In the end, liner shipping is about as 'different' from other industries as, for example, trucking is to freight air services or freight air is to rail freight – with the exception that price-fixing is allowed in liner shipping and nearly universally disallowed in these other industries.<sup>16</sup>*

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<sup>15</sup> Australian Productivity Commission, *Review of Part X of the Trade Practices Act 1974: International Liner Cargo Shipping*, 23 February 2005, p xxvi.

<sup>16</sup> OECD, *Competition Policy in Liner Shipping*, April 2002, p75.

- 50 There are many similarities between airlines and liner shipping. Airlines maintain a scheduled service irrespective of the number of seats filled and often operate with excess capacity. Fixed costs are extremely high and operating costs are low, which gives rise to similar load factor management issues to those in liner shipping. Airlines practice price discrimination and peak load pricing. The industry is said to be subject to low rates of profitability. Finally, airlines can benefit from economies of network size and scope.
- 51 Previously the way in which airlines cooperated was through a tariff setting mechanism and associated arrangements agreed through the International Air Transport Association (IATA). These arrangements are similar to conference and discussion agreements in the shipping industry but have been phased out as the industry has evolved.
- 52 Today alliances and joint ventures are prominent features of the airline industry. Code share agreements allow an airline that does not provide a direct flight to a location to provide transit for its customers through a number of interconnecting flights provided by codeshare partners. Codeshare agreements allow an airline to benefit from network economies and differentiate their service, without committing a large amount of capital.

#### *Regulation of competition in international civil aviation*

- 53 In New Zealand, the regulation of competition in international civil aviation is markedly different to that in shipping despite both industries having strong parallels.
- 54 Competition in international air services is currently regulated by both Part 9 of the Civil Aviation Act 1990 and the Commerce Act 1986. Certain international air services trade practices can be exempted from the Commerce Act 1986 if they meet criteria in the Civil Aviation Act and are authorised by the Minister of Transport.
- 55 Currently, the main problem with the regime in the Civil Aviation Act is that it is outdated, as opposed to shipping, which is unregulated. More specifically, since the Civil Aviation Act was enacted, while elements of the IATA system remain important, airlines have increasingly undertaken the cooperation necessary to provide global services through global marketing alliances and integrated bilateral alliances. The regime for considering these arrangements has not changed leading to the following issues:
- The specific statutory criteria are more suited to agreement on tariffs than broader cooperative agreements.
  - The specific statutory criteria do not explicitly allow for a full consideration of costs and benefits of arrangements.
  - The process set out in the Civil Aviation Act does not explicitly provide for a transparent process or consultation with interested parties.
  - Alongside shipping, international civil aviation represents an anomaly in the area of competition law. Decisions on aviation agreements are made by Ministers based on advice from aviation experts (or by aviation experts under delegated authority) rather than being made by an independent regulator with competition expertise.
- 56 Despite the issues with the regulatory regime, decisions on civil aviation matters might usefully inform participants in the liner shipping sector about how collaborative arrangements in a similar sector are considered. In particular, shipping companies may wish to have regard to applications for authorisation under the Civil Aviation Act or the Australian Competition and Consumer Act.

## **Objectives**

- 57 The overarching public policy objective is to promote open and competitive markets in international shipping for the long-term benefit of consumers in New Zealand, including businesses, exporters and importers.
- 58 To achieve this, the regime should have the following characteristics:
- Minimise risk of detriment resulting from anti-competitive behaviour.
  - Enable shipping lines to engage in collaborative activity that enhances productivity.
  - Ensure that the benefits of collaborative activity are shared between shipping lines and users or acquirers of shipping services. Benefits might include decreased cost, which may be passed through as a decrease in price. Other benefits might include increased network coverage, increase frequency and reliability of service.
  - Achieve its purpose in a way that minimises business compliance costs and government administration costs.

## **Regulatory Impact Analysis**

- 59 Four options were considered to strengthen the oversight of competition in international shipping. These options include:
- Retaining the status quo where international shipping is essentially unregulated;
  - Adopting the Productivity Commission recommendations, which would remove the exemption for ratemaking agreements and exempt non-ratemaking agreements provided they are registered;
  - Applying the Commerce Act to international shipping; and
  - Strengthening the Shipping Act.
- 60 Table 1 assesses the options against criteria reflecting the objectives in paragraph 58 above.

**Table 1 - Analysis of options to strengthen the oversight of competition in international shipping**

Options	Criteria				
	Minimises risk of anti-competitive detriment	Enables shipping lines to engage in collaborative activity that enhances productivity	Ensures that the benefits (price and quality) of collaborative activity are shared between shipping lines and users or acquirers of shipping services	Regime minimises administrative costs	Regime minimises business compliance costs
<b>Option 1: Status Quo</b>	✘ The regime in the Shipping Act does not protect against anti-competitive behaviour nor does it provide effective remedies.	✓ Shipping lines can engage in collaborative activity but there is no requirement that it enhance productivity.	✘✘ If the market is not competitive, the benefits of collaboration may be retained by shipping lines and not be passed through to users or acquirers of shipping services.	✓✓✓ Regime is not used thus no costs are incurred. However, if invoked would require developing procedure and commissioning investigation.	✓✓✓ Regime is not used so no costs are incurred. However, if invoked, carriers may be subject to ministerial directions in providing services.
<b>Option 2: Productivity Commission recommendations</b> Rate-making agreements subject to the Commerce Act. Operational agreements (or consortia) would be exempt if registered.	✓ Assumes that ratemaking agreements are always anti-competitive. Operational agreements can also give rise to anti-competitive outcomes, including higher prices, reduced frequency, reliability and innovation.	✓✓ Depends on whether rate-making agreements can be defined to only relate to activity that is output restricting, not collaborative activity that enhances productivity.	✘ If the market is not competitive, the benefits of collaboration may be retained by shipping lines and not be passed through to users or acquirers of shipping services.	✘ Costs increase due to registry and oversight of price fixing effected through rate-making agreements.	✓ Agreements will need to be assessed to see whether they meet the criteria for registration.
<b>Option 3: Apply the competition regime in the Commerce Act to international shipping</b>	✓✓✓ Established framework that seeks to distinguish between collaborative activities that are pro and anti-competitive.	✓✓✓ Established framework that seeks to distinguish between collaborative activity that enhances productivity and activity that restricts productivity.	✓✓✓ Greatest potential for ensuring outcomes that promote competition or are in the long-term benefit of users of shipping services and consumers more generally.	✓ Administration costs increase, reflecting a more robust process, however, the regime is administered by the Commerce Commission so administrative costs would only increase at the margin.	✓ Agreements will need to be assessed to see whether they raise competition issues. Sector-specific guidelines are proposed to minimise increase.
<b>Option 4: Strengthen the Shipping Act</b> Minister's ability to investigate suspected unfair practices strengthened, penalties introduced, regime extended to imports.	✓✓ Sector-specific regime could be amended to minimise risk of anti-competitive behaviour but would seek the same outcomes as under general competition law.	✓✓ Sector-specific regime could be amended but would seek the same outcomes as under general competition law i.e. that anti-competitive behaviour is prohibited and can only be authorised where it is in the net public benefit.	✓ Action could be taken to strengthen competition, but investigative function in the Ministry of Transport at risk of being crowded out by competing policy priorities.	✘ Costs increase in line with strengthened Minister's powers.	✓ Costs will depend on the design of the regime.

Level of contribution to objectives ✓ low; ✓✓ moderate; ✓✓✓ high: ✘ makes no contribution to objective ✘✘ works against achievement of objective

## Discussion of options

### **Option 1: Retain the status quo – competition in international shipping unregulated**

61 As set out in the discussion of the problem, the status quo is that international shipping lines are essentially unregulated. This means that there is significant risk that arrangements that are entered into between shipping lines are hard-core cartels.

62 As the OECD has previously noted:

*Cartels harm consumers and have pernicious effects on economic efficiency. A successful cartel raises prices above the competitive level and reduces output. Consumers (which include businesses and governments) chose either not to pay the higher price for some or all of the cartelised product that they desire, thus forgoing the product, or they pay the cartel price and thereby unknowingly transfer wealth to the cartel operators.<sup>17</sup>*

63 From the point of view of New Zealand exporters and importers there is a risk:

- that prices charged by shipping lines are above those that would be expected in a competitive market;
- that the frequency and reliability of the service is less than what would be expected in a competitive market;
- some marginal products may not be exported or imported due to the cost of transport being above the competitive cost;
- goods sold in international markets are not as competitive as they could be, this is especially problematic where inputs into the production process are also imported.

### **Option 2: Adopt Productivity Commission's recommendations**

64 The key difference between Option 2 and the Commerce Act option is the treatment of operational agreements or consortia. These are the bulk of agreements on New Zealand's shipping routes. Discussions with the International Container Lines Committee suggest that there are two or three discussion agreements (these cover prices and capacity) and between 25 to 35 operational agreements. With option 2 all operational agreements, if registered, would be exempt from the Commerce Act.

65 Conceptually option 2 appears to have merit, as it attempts to focus Commerce Act scrutiny onto conduct that is likely to be intentionally detrimental, i.e. price fixing and capacity limitation to increase price. However option 2 is not favoured as it could take a form over substance approach. Operational agreements can give rise to anti-competitive outcomes, including higher prices, reduced frequency, reliability and innovation.

66 This was recognised by the EU in the development of its current exemption. That exemption aims to exempt arrangements that give rise to efficiencies but not those that are an unjustified limitation on capacity and sales.

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<sup>17</sup> OECD, *Hard Core Cartels: Recent Progress and Challenges Ahead*, p 8.

67 The risk associated with operational agreements is also evident from:

- Fonterra's experience reflected in the Kotahi submission to the Productivity Commission that stated: "Collaborative vessel sharing between shipping lines have enabled an increase in the average vessel size calling New Zealand, reducing the average cost per unit of capacity to the carrier. However, this has been at the expense of freight owner choice in service delivery. Carrier collaboration has also arguably been used to artificially constrain capacity creating an environment whereby a reduction in the cost to serve has rarely translated directly to a price to serve reduction for freight owners."
- The APEC study on operational agreements,<sup>18</sup> which indicates that some aspects of non-ratemaking agreements can be anti-competitive including the ability to: restrict competition from current or potential competitors; influence the behaviour of agreement members; increase market concentration and market share, and to exchange information on confidential contracts.

68 Further, Option 2 would be inconsistent with the way the Commerce Act regulates other sectors where competition scrutiny focuses on the outcomes of agreements between competitors (e.g. having the effect or likely effect of restricting output), rather than the form or type of agreement.

69 A registration regime could be carefully designed so that only pro-competitive, efficiency enhancing arrangements are registered, however, this would essentially duplicate the clearance regime in the Commerce Act.

70 If poorly designed there is a risk that arrangements that give rise to anti-competitive detriment are allowed or that pro-competitive arrangements are discouraged. As alluded to in paragraph 68, this would be more likely where the definitions of ratemaking and non-ratemaking were based on the form of the arrangement rather than the substance.

#### ***Option 4: Strengthen the regime in the Shipping Act***

71 In the same way that adopting the Productivity Commission's recommendations could be made to work, it would also be possible to strengthen the Shipping Act. Again the objective would look to deter anti-competitive behaviour in international shipping and consequently the regime would look to distinguish between behaviour that is pro and anti-competitive. Such a regime is likely to be closely aligned with the principles underlying the Commerce Act.

72 The disadvantages of this option would largely be institutional. The Ministry of Transport would be responsible for carrying out the competition assessment rather than the Commerce Commission, and they may not have the same competition expertise. The boundaries between the industry-specific regime in the Shipping Act and the Commerce Act could also raise some complexity. For example where shipping agreements impact on non-shipping markets, such as the provision of port services, the boundaries of responsibility may not be clear.

#### ***Option 3: Apply the Commerce Act***

73 Options 2 and 4 could draw on concepts that are already well established under general competition law. As a result, our preference is not to duplicate regimes but rather to rely on and apply the Commerce Act to international shipping.

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<sup>18</sup> Liner Shipping Competition Policy: Non-Ratemaking Agreements Study, APEC Transport Working Group, November 2008.



- 74 The Commerce Act seeks to distinguish between pro and anti-competitive conduct. The prohibitions in the Commerce Act focus on harm to competition. The Act also recognises that some arrangements may limit competition but result in such efficiencies that they would result in benefit to the public. The Act therefore provides a procedure for authorisation of these arrangements.
- 75 The amendments in the Commerce (Cartels and Other Matters) Amendment Bill have been designed to facilitate collaboration between competitors where the purpose of the collaboration is to achieve efficiencies or increase productivity. This is achieved primarily through clarifying the scope of prohibited conduct, that being hard-core cartel conduct. It does this by introducing an exemption for collaborative activity.
- 76 The new collaborative activity exemption is broad and focuses on the substance of the activity, not the form of the arrangement. As a result, it should apply to all pro-competitive collaborations, including those entered into by shipping lines and airlines. Where firms come within the exemption they are not acting as a hard-core cartel. The collaborative activity exemption has been designed so that businesses can assess for themselves whether their proposed collaboration falls within the exemption.
- 77 The amendments also introduce a clearance regime to help businesses manage any residual risk that their proposed collaborative activity might be in breach. The clearance regime allows parties to a proposed collaborative activity to approach the Commerce Commission to test whether the collaborative activity raises competition issues. Clearance provides confirmation that the collaborative activity is not prohibited under the Act.
- 78 To help manage any uncertainty over how the Commerce Commission will approach the new exemption, Cabinet has invited the Commerce Commission to develop guidelines. Firms would also be able to refer to the Commerce Commission's clearance decisions. It is the Commerce Commission's practice to produce written reasons for its decisions. Over time, it is anticipated that these will form a body of precedent. Firms would be able to review these decisions to better understand the Commission's analytical framework and decision making process.
- 79 In terms of cost, as mentioned above, the regime has been designed so that businesses can self-assess. Depending on the complexity of the collaborative activity and the amount of management time required to make an assessment, officials estimate that the cost of such an assessment is likely to range from \$500 to \$15,000. Based on estimates in relation to merger clearances, officials estimate the costs associated with applying for clearance would range from less than \$50,000 to \$200,000 for complex arrangements. To some extent the clearance regime transfers the cost of assessing risk to the Commerce Commission.
- 80 In terms of timing, where parties self-assess, such an assessment could be undertaken in-house and relatively quickly. Alternatively parties may seek to rely on legal advice. If a firm decides to apply for clearance, the Commerce Commission should assess a routine clearance in less than 30 working days but may take up to 60 working days where the proposed activity raises complex issues. Authorisation generally takes longer because the Commerce Commission is required to publicly consult. The Commerce Commission has developed a streamlined authorisation process for routine matters, which would take around 4 months. Complex matters may take between 6-12 months to fully consider.

- 81 Where shipping lines consider that their proposed collaborative activity lessens competition but can be justified on public benefit grounds, parties may apply to the Commerce Commission for authorisation of the proposed arrangement. Authorisation is essentially a limited one-off exemption from competition law. Authorisation is more costly as it requires the parties to justify why the proposed arrangement should be authorised. Parties often submit expert economic evidence on the benefits associated with the proposed arrangement. Officials estimate that routine authorisations may cost as little as \$150,000; however, more complex authorisations can cost upwards of \$500,000.
- 82 Many of the arrangements that are entered into by shipping companies and airlines are unlikely to breach the Act. Initially shipping lines may apply for clearance in relation to proposed arrangements, however, as they become more familiar with the Commerce Commission's analytical framework and approach, they may look to self-assess or rely on legal advice.
- 83 Past experience under the Civil Aviation Act suggests there will be roughly one new civil aviation agreement authorisation per year on average. Given that there are approximately 25 to 30 agreements that involve the provision of services on routes to and from New Zealand, during the transitional period there are likely to be up to five applications for authorisation and 10 applications for clearance.
- 84 So while a transition to the Commerce Act would result in an increase in compliance costs, these costs are reflective of a more robust regulatory regime.
- 85 Other mechanisms to help minimise costs associated with a transition to the new regime include:
- Inviting the Commission to provide guidance on how the regime would be applied to arrangements commonly used by shipping lines. The Commission is likely to draw on the approach in other countries and analysis in similar industries such as civil aviation.
  - Providing a transitional clearance regime to allow the sector to test existing arrangements with the Commission.
  - Providing a generous transitional period is proposed before competition law applies. This should give the container lines time to assess existing arrangements to ensure they comply.
- 86 In relation to the administrative costs with the regime, these will increase relative to the status quo, however, utilising the Commerce Commission's existing expertise and resources should minimise any increase in administrative costs.

*The extent to which the Commerce Act could deter beneficial international shipping activity*

- 87 The key risk raised by the ICLC is that repealing the exemption might deter shipping lines from servicing routes to and from New Zealand. This is unlikely for the following reasons:
- The changes being made to the Commerce Act by the Commerce (Cartels and Other Matters) Amendment Bill will make it easier for businesses to undertake efficiency-enhancing collaborative activity without risk of breaching the Commerce Act.
  - New Zealand's shipping routes are typically more profitable for carriers than other routes.
  - All carriers are familiar with operating in jurisdictions where competition law applies to carrier agreements.

- 88 In our view this assessment also holds for routes to and from the Pacific. The ICLC submitted that the particular economic, logistical, commercial and social attributes of Pacific Island trades are even less commercially-friendly than New Zealand routes. The lines carry low value products in small volumes, over long distances, to underdeveloped markets. Furthermore, there is an imbalance in volume on the return leg to New Zealand. The ICLC submitted that these circumstances make it essential to have rationalisation and careful tailoring of capacity to match demand, and some certainty around pricing, in order to sustain reasonable services in these trades.
- 89 As previously noted, the Commerce Act, as amended by the Commerce (Cartels and Other Matters) Amendment Bill, does not prevent any of these activities where they enhance outcomes relative to that which would otherwise be provided. Nor are any associated compliance costs likely to prevent shipping lines from approaching the Commission for clearance or authorisation if needed.

#### *Risk of regulatory inconsistency with key trading partners*

- 90 Some stakeholders raised the risk that moving to a Commerce Act regime would put New Zealand ahead of our key trading partners in terms of reform. Certainly this option would put New Zealand ahead of China, the United States, Australia, Singapore and Japan. It would make New Zealand consistent with jurisdictions that do not exempt shipping from competition law including Norway, South Africa, Brazil, Russia, Turkey, India and Malaysia, and the European Union that has a conditioned exemption for operational agreements.
- 91 For our key trading partners it is not expected that this option would compromise any trade agreements or moves to achieve closer economic relations. This is because compared to the status quo the preferred option moves New Zealand's regulation closer, rather than further away from that of our trading partners because New Zealand is currently an outlier.
- 92 Of our main trading partners the preferred option would be most similar to the European Union. Both systems have an exemption for operational agreements if they meet certain conditions. However our system would differ in not having a blanket prohibition against rate-making agreements (including discussion agreements). New Zealand would permit all agreements that benefit New Zealand.

## **Consultation**

### **Consultation with government agencies**

- 93 The options in this RIS are discussed in the Cabinet paper. The Treasury, Ministry of Foreign Affairs and Trade, Ministry of Primary Industries, Ministry of Transport, Department of Prime Minister and Cabinet and the Commerce Commission were consulted on the Cabinet paper.

### **Consultation with external stakeholders**

- 94 The Productivity Commission had previously undertaken two rounds of consultation with a wide range of stakeholders in the freight sector on the issues addressed in this RIS.
- 95 The Commerce Committee called for public submissions on the proposals to transition international shipping to a Commerce Act-only regime. Ten written submissions were received in response with three opting to appear before the Committee.
- 96 The Committee also authorised officials to seek further views from submitters on the potential impact of the proposals. Officials had 12 subsequent meetings with individual stakeholders and informed parties.

### *Views on transitioning international shipping to a Commerce Act-only regime*

- 97 In terms of stakeholder views on the merits of transitioning international shipping to a Commerce Act-only regime, shipping lines favoured maintaining the exemption for international shipping for the following reasons:
- The shipping industry should be treated differently from other industries because of the large capital investments, high fixed operating costs, maintenance of regular schedules, volatile peak and off-peak demands, structural overcapacity problems on routes, and the high risk of 'rate wars' threatening viability of routes.
  - There is no evidence that there is a problem with the status quo. The market for shipping services is currently competitive and all agreements operating on New Zealand routes are beneficial to New Zealand.
  - The sector-specific regime outlined in the Shipping Act is satisfactory, and provides potentially very intrusive powers to the Minister to intervene if any market abuse is identified. Carriers note that no complaints have been made under this regime.
  - Removing the exemption would be out of step with virtually all other Asian and Pacific Rim countries and major trading partners.
- 98 In contrast, all other stakeholders were of the view that ratemaking agreements should not be automatically exempted from the Commerce Act. Export New Zealand stated that the lack of transparency around rate setting currently leads to speculation among exporters that there is a lack of competition in how rates are set.
- 99 However, the great majority of these stakeholders did not support removing the exemption for operational agreements. They were concerned that regulation of these agreements could discourage operational cooperation causing the shipping lines to lose economies of scale which could discourage carriers from serving New Zealand. These outcomes would reduce services and choices for shippers. This would be particularly severe for routes to the Pacific Islands where trade volumes are even smaller than New Zealand's.
- 100 There was also concern that removing the exemption would put New Zealand's regulatory system out-of-step with most of its trading partners.
- 101 However, a minority supported removing the exemption for operational agreements, as these agreements can achieve the same outcomes as ratemaking agreements. For example if the agreements restrict capacity to achieve higher prices. Other views expressed were that there does not appear to be any reason why the shipping industry requires more latitude than other industries. The proposed collaborative activity exemption in the Commerce (Cartels and Other Matters) Amendment Bill will provide the necessary flexibility for shipping lines to enter into bona fide collaborations regarding the capacity and frequency of services.

### **Conclusions and Recommendations**

- 102 To strengthen the oversight of competition in international shipping the Ministries of Transport and Business, Innovation and Employment recommend removing the exemption from the Commerce Act and repealing the alternative regime provided by the Shipping Act.
- 103 While the benefits are not able to be quantified, the new regime would enable some oversight of shipping agreements in order to identify and deter anti-competitive conduct. Such conduct may include fixing prices to shippers, limiting capacity (other than in response to changes in demand), or allocating markets or customers. Also some efficiency gains of collaboration by carriers may not be shared with shippers.

- 104 This anti-competitive risk is exacerbated when the firms concerned are facing financial pressures caused by the global economic downturn. If this risk eventuates, the cost is borne by importers and exporters, with flow on costs to the wider New Zealand economy. Regulatory economics and international experience shows that an exemption from competition law is not required for international shipping carriers to provide an effective sea freight service.

## **Implementation**

- 105 The removal of the Commerce Act exemption for international shipping would be effected through the Commerce (Cartels and Other Matters) Amendment Bill. It is expected that this Bill will be enacted during 2013. However, the proposals in this RIS would not apply immediately as the industry requires time to become familiar with a new regime and to develop certainty about what is required.
- 106 It is proposed that the Commerce Act apply three years from the Bill's enactment date. This would give the container lines three years to self-assess whether their agreements are likely to comply with the Act and if not, to seek a clearance or authorisation from the Commerce Commission.
- 107 At the beginning of this transition period, the Commerce Commission would issue guidelines explaining how the Act applies to international shipping and the steps container lines can take to ensure compliance. These guidelines would illustrate the types of agreements that are likely to require a clearance, or an authorisation, as well as those agreements requiring no action other than a self-assessment.
- 108 The Commission would also undertake publicity to ensure carriers are aware of the Commerce Act regime.

## **Monitoring, Evaluation and Review**

- 109 The Commission records and reports on its clearance and authorisation activity through its quarterly reporting. Within this reporting the Commission would be asked to specifically separate out its activity that has resulted from the proposals in this RIS.
- 110 This reporting would enable the Ministry of Business, Innovation and Employment, as part of its monitoring function, to report to the Ministers of Transport and Commerce on any issues arising during the transition period.
- 111 Once the proposals have been fully implemented, a qualitative assessment of the effectiveness of the Commerce Act regime for international shipping would be undertaken as part of the wider assessment planned for the initiatives in the Commerce (Cartels and Other Matters) Amendment Bill.