Cabinet Economic Growth and Infrastructure Committee

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Summary of Paper

25 March 2013

Response to New Zealand Productivity Commission's Freight Inquiry: Regulation of International Sea and Air Freight Competition

Portfolio Commerce

Purpose This paper seeks agreement to legislate to transition the regulation of competition for international shipping from an industry specific regime in the Shipping Act to the general regime in the Commerce Act.

Previous Consideration In August 2012 the Cabinet Economic Growth and Infrastructure Committee agreed to invite the Commerce Committee, as part of its consideration of the Commerce (Cartels and Other Matters) Amendment Bill (the Bill), to consider transitioning international shipping and international civil aviation from industry specific regimes to a competition regime that is governed by the Commerce Act 1986 [EGI (Min (12) 19/3].

Summary

Sea freight

Collaboration between international carriers is commonplace to ensure a reliable and efficient sea freight service. In recent times this collaboration tends to be through operational agreements that look to share assets to achieve economies of scale, rather than through shipping conferences that discuss price and rate levels without any efficiency justification.

The industry-specific regime under the Shipping Act 1987 does not provide effective oversight of competition in the international shipping sector. In the absence of effective oversight, there is a risk that the prices paid by consumers of the services are higher than they would be in a competitive market. This increases the costs of imports and exports.

Three options have been considered for dealing with the issues:

- one of the recommendations in the Productivity Commission's Report into international freight transport services recommended removing the exemption for rate-making agreements and establishing a register for non –rate making agreements;
- adopting a registration regime similar to that used in Australia where both rate making and non-ratemaking agreements are exempt provided they are registered;
- transitioning to a Commerce Act regime.

The option of transitioning to a Commerce Act regime is preferred over the Productivity Commission recommendation. The Commerce Act seeks to distinguish between pro and anti-competitive conduct. The Act recognises that some arrangements may limit competition but result in such efficiencies that they would result in benefit to the public. Parties can apply for authorisation of these arrangements.

The Commerce Act is already used to regulate competition in other highly regulated sectors and there is no reason to treat international shipping differently. The Act, as amended by the Bill is designed to support and facilitate beneficial collaborative activity which is a feature of international sea freight services.

A number of measures will be incorporated to address concerns of the sector, including a transitional period (**page 3**).

International air services

Competition in international air services is currently regulated by both Part 9 of the Civil Aviation Act 1990 and the Commerce Act. Certain international air services trade practices can be exempted from the Commerce Act if they meet criteria in the Civil Aviation Act and are authorised by the Minister of Transport.

The Productivity Commission recommended, subject to a review of passenger service impacts, that the government consider adopting a Commerce Act-only regime for regulating international air services, or if this was not done, reviewing and updating the current regime.

The Minister is supportive of transitioning the regulation of competition in international aviation to a regime that is wholly governed by the Commerce Act. The Minister of Transport has indicated that a review of the Civil Aviation Act is to be undertaken. If the review is managed in a timely way, it would not defer any benefits from an improved regime.

Regulatory Impact Analysis

A Regulatory Impact Statement is attached at **page 18**. The Regulatory Impact Analysis Team has reviewed the RIS prepared by MBIE and the associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Baseline Implications

The Commerce Commission would incur some initial one-off costs in providing guidance on the application of the Commerce Act to international shipping agreements. The costs of considering clearances would range from $50,000 - $200,000, and for authorisations from $150,000 to $500,000. The Commission should be able to manage some of the costs within baselines, and a portion of the costs would be met by application fees, which are under review. If the Commerce Commission comes under financial pressure as a result of undertaking these new activities, the need for additional funding will need to be assessed at that time.

Legislative Implications	A Commerce (Cartels and Other Matters) Amendment Bill has a category 3 priority (to be passed if possible in 2013) on the 2013 Legislation Programme. The Bill is currently before the Commerce Committee, and the Committee is due to report the Bill to the House by 14 May 2013. The amendments proposed in the paper will be submitted to the Commerce Committee for its consideration for incorporation in the Committee's report back.
Timing Issues	See above.
Announcement	None indicated.
Consultation	The Minister of Commerce indicates that the Minister of Finance has been consulted. The Minister indicates that discussion is not required with the government caucus or with other parties represented in Parliament. Paper prepared by MBIE. Treasury, Transport, MPI and the Commerce Commission have been consulted. MFAT and DPMC have been informed. Relevant stakeholders have also been consulted.

The Minister of Commerce recommends that the Committee:

Background

1 note that international shipping is currently exempt from the application of the Commerce Act 1986 and subject to an ineffective sector-specific regime under the Shipping Act 1987;

2 note that international civil aviation trade practices can be exempt from the Commerce Act 1986 if authorised by the Minister of Transport under the Civil Aviation Act 1990;

3 note that the Business Growth Agenda includes action points to strengthen rail, sea and air infrastructure, more specifically, to respond to the Productivity Commission's freight inquiry and removing the exemptions from general competition law for shipping;

4 note that the government has set a goal of exports making up 40 percent of Gross Domestic Product by 2025 and that improving the efficiency of international freight transport services through more appropriate regulatory regimes that promote greater transparency and competition is one concrete step that the government can take to achieve this objective;

Productivity Commission Report on International Freight Transport Services

5 note that the final report of the New Zealand Productivity Commission on International Freight Transport Services, tabled on 24 April 2012, made a number of recommendations relating to competition regimes for international shipping and civil aviation. More particularly, the Productivity Commission:

5.1 found that the performance of freight transport services could be improved by strengthening the competition regimes in both sectors; and

5.2 recommended changes to the competition regulatory regimes that apply to international shipping and international civil aviation, including removing the exemption from the Commerce Act for international shipping rate making agreements and establishing a register for non-rate making agreements.

6 note that the joint study by the Australian and New Zealand Productivity Commissions – Strengthening trans-Tasman economic relations – found that the exemption from competition law for international shipping rate making agreements in both jurisdictions is no longer necessary and removing it would generate gains;

Commerce (Cartels and Other Matters) Amendment Bill

7 note that the regulation of competition in international shipping and international civil aviation is currently being considered by the Commerce Committee as part of its consideration of the Commerce (Cartels and Other Matters) Amendment Bill;

8 note that the Commerce Committee is due to report the Bill back to Parliament by 14 May 2013;

9 note that submissions to the Productivity Commission and the Commerce Committee had mixed views on the merits of transitioning the regulation of competition in international shipping and international civil aviation to a regime under the Commerce Act 1986, with exporters generally in favour and international shipping carriers generally opposed;

10 agree that:

10.1 the carriage of goods by sea to and from places in New Zealand should be subject to the generic competition regime under the Commerce Act 1986 after a suitable transitional period; and

10.2 at the conclusion of the transitional period, the sector-specific regime covered by the Commerce Act exemption in the Shipping Act 1987 would be repealed;

11 agree that the transitional period would be for one year from the date of enactment of the Commerce (Cartels and Other Matters) Amendment Bill;

12 agree that parties to agreements between carriers may apply to the Commerce Commission within the transition period outlined above for clearance or authorisation to confer Commerce Act immunity on the agreements;

13 agree that the Commerce Commission should be required to consider applications for authorisation of restrictive trade practice agreements within 120 working days, with any time extensions to be agreed with the applicant;

14 direct the Ministries of Business, Innovation and Employment, Transport and Foreign Affairs and Trade to work with carriers on the Pacific Island routes to assist their transition to the new competition regime;

15 invite the Commerce Commission to provide, within six months following the enactment of the amending legislation, guidance to interested parties on how the Commerce Act 1986 would apply to international shipping;

16 note that a review of the Civil Aviation Act is being undertaken and this review will consider how to strengthen the regulation of competition for international civil aviation services;

17 direct the Ministry of Business, Innovation and Employment to recommend to the Commerce Committee that amendments be made to the Commerce (Cartels and Other Matters) Amendment Bill to give effect to the above proposals;

18 invite the Minister of Commerce to instruct the Parliamentary Counsel Office to draft amendments to the relevant legislation to give effect to the above proposals and any technical consequential amendments.

Bob Macfarlane
Committee Secretary

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Cabinet Economic Growth and Infrastructure Committee

Response to New Zealand Productivity Commission's Freight Inquiry: Regulation of International Sea and Air Freight Competition

Proposal

1 This paper seeks Ministers' agreement to transitioning the regulation of competition for international shipping from an industry specific regime in the Shipping Act to the general regime in the Commerce Act.

Executive Summary

2 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.

3 On 9 March 2012, Cabinet noted that one of the key challenges facing the New Zealand's economy was poor productivity growth over the past 10 years. In response to this challenge, one of the key objectives of the Government's Business Growth Agenda was to build a more productive and competitive economy [CAB Min (12) 8/4 refers]. To achieve this objective, the Government has set a goal of lifting the ratio of exports to gross domestic product to 40 percent by 2025. Improving the efficiency of international freight transport services through more appropriate regulatory regimes is one concrete step that Government can take to address the challenges, objectives and goals set out in the Business Growth Agenda.

4 In April 2012, the Productivity Commission presented its final report to referring Ministers. One of its more significant recommendations was to narrow the existing exemptions from the Commerce Act for agreements between competitors relating to international sea freight and international air freight services. For international shipping, the Productivity Commission recommended removing the exemption for rate-making agreements and establishing a register for non-rate making agreements. For international civil aviation, it recommended transitioning the regime to the Commerce Act. In their recent Going for Growth publication, the OECD endorsed these recommendations. The OECD is expected to reiterate this recommendation in its forthcoming 2013 country survey for New Zealand.

5 On 29 August 2012, as part of the Government's response to the Productivity Commission's report, Cabinet Economic Growth and Infrastructure Committee agreed to invite the Commerce Committee, as part of its consideration of the Cartels Bill, to also consider transitioning international shipping and international civil aviation from industry specific regimes to a competition regime that is governed by the Commerce Act 1986 [EGI Min (12) 19/3 refers].

6 Following public consultation by the Commerce Committee, I consider there is a case for repealing the industry specific regimes for international shipping and transitioning the sector to the general competition law, as set out in the Commerce Act. This policy should be given effect through amendments to the Cartels Bill. A summary of the reasons for this view are outlined below.

7 A case can also be made for transitioning international civil aviation to general competition law. I understand that planning for a review of the Civil Aviation Act 1990 is currently underway and this matter will be considered in more depth as part of that review.

The policy problem for international shipping

8 Collaboration between international carriers is commonplace to ensure a reliable and efficient sea freight service. In recent times, this collaboration tends to be through operational agreements that look to share assets to achieve economies of scale, rather than through shipping conferences that discuss price and rate levels without any efficiency justification. More specifically the Productivity Commission found:

> A number of indicators suggest that the international shipping industry is serving New Zealand is competitive. On the other hand, case studies show evidence of higher seas-freight rates on New Zealand services compared to Australian services that do not seem to be fully explained by cost difference.
>
> Ratemaking agreements are not currently in widespread use; however, there are likely to be net gains from taking a more pro-competitive stance towards international container shipping, with only a small risk of deterioration in services. A further benefit lies in the insurance against a future degradation of outcomes for New Zealand through carrier collusion as the market moves to constrain supply.[1]

9 These findings appear to be consistent with the OECD's review of competition in liner shipping, which found there was no convincing evidence that the practice of discussing and/or fixing rates and surcharges among competing carriers offers more benefits that costs to shippers and consumers.[2]

10 The industry-specific regime under the Shipping Act 1987 does not provide effective oversight of competition in the international shipping sector. In the absence of effective oversight, there is a risk that the prices paid by consumers of the services are higher than they would be in a competitive market. This increases the costs of imports and exports.

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[1] Ibid at p 235.
[2] OECD, *Competition Policy in Liner Shipping*, April 2002, p 5.

Options for reform

11 The following options have been considered:

a. adopting the Productivity Commission recommendation to remove the exemption for ratemaking agreements (ones involving price fixing or limiting capacity with the intent of raising prices) and continuing to exempt non-ratemaking agreements but making the exemption conditional on filing agreements on a public register;

b. adopting a registration regime similar to that used in Australia, where both ratemaking and non-ratemaking agreements are exempt provided they are registered; and

c. transitioning to a Commerce Act regime.

12 The option of transitioning to a Commerce Act regime is preferred over the Productivity Commission recommendation. The Commerce Act, as amended by the Cartels Bill, would be sufficiently flexible to permit the necessary degree of collaboration between international shipping lines.

13 The Commerce Act seeks to distinguish between pro and anti-competitive conduct. The prohibitions in the Act focus on harm to competition, however, the Act also recognises that some arrangements may limit competition but result in such efficiencies that they would result in benefit to the public. Parties can apply for authorisation of these arrangements.

14 The amendments in the Cartels Bill clarify that pro-competitive collaborative activities are permitted, not prohibited. The Bill does this through the collaborative activity exemption and the new clearance regime. Clearance provides confirmation to the parties that a proposed arrangement is not prohibited under the Act.

15 The Commerce Act is already used to regulate competition in other highly regulated sectors and there is no reason to treat international shipping differently. The Act, as amended by the Bill, is designed to support and facilitate beneficial collaborative activity which is a feature of international sea freight services.

Stakeholder concerns

16 Stakeholders' main concerns relate to ensuring that any changes do not impose unnecessary compliance costs and that Commerce Commission decisions are made in a timely manner. A number of measures are proposed to address these concerns:

a. A transitional period of one year is proposed to enable shipping companies to prepare for the Commerce Act regime.

b. As part of this transition, parties to international shipping agreements should be able to apply to the Commerce Commission for clearance or authorisation, which would have the effect of conferring immunity on the agreements if granted following a case by case assessment.

c. Within six months after the commencement of the transitional period, the Commerce Commission would issue guidance on the application of the Commerce Act to international shipping agreements.

d. The Commerce Act would be amended to provide that the Commerce Commission must consider applications for authorisation of restrictive trade practices within 120 working days, with any time extensions by agreement with the applicant.

e. Officials would work with carriers operating on the Pacific Island trade route to assist them with the transition.

Process

17 Legislative changes to give effect to the decisions in the paper could be made through the *Commerce (Cartels and Other Matters) Amendment Bill* (the Cartels Bill). The Bill is currently before the Commerce Committee and the Committee is due to report back to Parliament by 14 May 2013. The Ministry of Business, Innovation and Employment will advise the Committee of the decisions on this paper for the Committee's consideration as part of its report back on the Bill.

Background

18 In 2011/12, the Productivity Commission undertook 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. Freight transport costs currently represent a sizeable proportion of international trading costs for New Zealand firms. The Productivity Commission estimated that for both sea and air freight, import and export costs are about 2.7 percent of GDP. Consequently, 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.

19 In its Final Report, the Productivity Commission recommended changes to the competition regulatory regimes that apply to international shipping and international civil aviation. The Productivity Commission found that the performance of freight transport services could be improved by strengthening the competition regimes in both sectors.

20 More specifically, the Productivity Commission recommended:

For international shipping,

- the exemption for rate-making agreements should be repealed; and
- an exemption for non-ratemaking agreements should be retained but these agreements should be placed on a public register administered by the Minister of Transport.

For international civil aviation,

- subject to a review of passenger specific impacts, that the Government should consider adopting a Commerce Act regime for regulating international air services.

21 As part of the Government's response to the Productivity Commission's report, Cabinet agreed to invite the Commerce Committee considering the Cartels Bill to also consider the case for reform of the industry specific regimes for international shipping and international civil aviation. In particular, the Committee was invited to consider whether arrangements in these sectors should be subject to general competition law under the Commerce Act 1986 and oversight by the Commerce Commission, rather than the current sector specific regimes [EGI Min (12) 19/3 refers]. The Commerce Committee is due to report back on the Cartels Bill and the transport regimes by 14 May 2013. The decisions on this paper will inform the departmental report to the Commerce Committee on the Cartels Bill.

Current arrangements for international shipping

22 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.

23 International container lines may enter into the following agreements in relation to the supply of sea freight services:

Ratemaking agreements-

- conference agreements – to set rates and manage capacity on a specific trade route; and
- rate discussion agreements – to discuss advised rates and capacity management for a specific route.

Non-ratemaking agreements-

- alliance agreements – to jointly operate a network of vessel services;
- cooperative working agreements – regarding joint services generally involving two parties;
- equipment interchange agreements – for a group of ocean carriers to jointly use and manage a pool of equipment;
- non-rate discussion agreements – for a group of ocean carriers to discuss service-related and capacity-management matters (e.g. determination of ports of call and coordination of use of port terminals and related third party services);
- sailing agreements – regarding coordinated sailings; and
- vessel sharing agreements – regarding sharing of vessel space (space, slot charters and/or swaps).[3]

24 According to the International Container Lines Committee there are currently 25 to 30 agreements that relate to sea freight services to and from New Zealand. The majority of these are non-rate making agreements. Conference agreements are no longer in operation. There are three discussion agreements currently operating for trade to and from ports in New Zealand and ports in North East, South East Asia, Australia and the United States.

25 The United States Federal Marine Commission reports that six carriers with a combined market share of 78 percent participate in the United States to Australasia Discussion Agreement (USADA), and five carriers with a combined market share of 89 percent participate in the Australia and New Zealand to United States Discussion Agreement (ANZUSDA). A sizable portion of the trade is made up of carriers who provide service through transhipment arrangements. These carriers are also involved in a series of vessel sharing agreements.

26 The International Container Lines Committee advised that the Pacific Island discussion agreement has not been active for two years. Instead agreements on the Pacific Island trade routes range from revenue and cost pooling, to sharing vessel operations to simple trade access arrangements. The United States Federal Marine Commission reports that five carriers serve the Pacific Island routes.

27 Historically international shipping has been exempt from general competition laws in New Zealand. This was consistent with the approach followed in other countries. An exemption was considered necessary to allow shipping lines to control supply and set prices in order to ensure reliable shipping services.

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[3] Productivity Commission, *International Freight Transport Services Inquiry*, April 2012, p225-226.

28 Alternative but ineffective sector specific competition regulation is provided in the Shipping Act 1987. The Act sets out a regime whereby the Minister of Transport may initiate an investigation into unfair practices. Aside from a possible perception around the independence of decision making, the regime sets a high threshold to initiate an investigation and contains only limited powers for the Minister to remedy any problem. There is no ability to impose penalties or conditions. Furthermore, the provisions only apply to outward shipping, providing no protection for importers. From an institutional perspective, the Ministry of Transport has no standing capacity or procedure to investigate complaints and, as a result, the regime has never been used.

Concerns with Current Arrangements

29 Given the lack of oversight of international shipping in New Zealand, it has been difficult to assess whether this weak regulatory arrangement has resulted in poorly performing markets. This lack of direct evidence has been the experience with similar reviews by overseas agencies.

30 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.[4]

31 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.[5]

32 The Australian Productivity Commission's recommendations were therefore based on the following sources:

a. views from stakeholders;

b. a review of economic literature on the liner shipping industry;

c. experiences of regulatory regimes in other countries, particularly the EU; and

d. experiences of regulatory regimes in similar industries i.e. those that offer regular scheduled services and have relatively high fixed costs.

33 In developing the recommendations in relation to international shipping, regard has been had to the same sources.

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[4] OECD, *Competition Policy in Liner Shipping,* April 2002, p11.
[5] Australian Productivity Commission, *Review of Part X of the Trade Practices Act 1974: International Liner Cargo Shipping,* February 2005, p83.

Views from stakeholders

34 Submissions on the state of competition in the markets were inconclusive. New Zealand shippers generally raise concerns about the high level of information exchange between carriers relating to pricing and capacity. They suggest some arrangements are leading to higher shipping rates than would be expected in a competitive market. At the same time, submitters acknowledge the advantages other collaborative service arrangements offer New Zealand in creating shipping networks with sufficient frequency and geographic coverage.

35 Kotahi (a joint venture between Fonterra and Silver Fern Farms) in a submission to the Productivity Commission, noted:

> Collaborative [vessel sharing] VSA agreements 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.
>
> 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 served 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.[6]

36 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:

a. 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. The US$1500 increase in shipping costs would make horticulture an unsustainable business.

b. Reefer rates out of New Zealand to key markets in Asia that cost up to 149 percent more than the rate that is being paid for a similar service for 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.

c. 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. This has not resulted in lower fuel surcharges.

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[6] Kotahi, Submission to the Productivity Commission's Issues paper, response to question 20.

37 Export NZ would like to see more transparency and scrutiny over any agreements around the setting of rates. They submit:

> The lack of transparency around rate setting currently leads to speculation amongst exporters that there is a lack of competition in how rates are set. Just recently all major shipping lines have announced significant increases in rates – a "rate restoration" increase in the cost of Reefer Containers by $US 750 a 20' reefer and $US 1500 for a 40' reefer. Not only are these significant price increases, (one small exporter tells us it will add an additional $100,000 to their transport costs) but the fact there seems to be uniformity in the prices increases from all the lines for ships going from New Zealand to Asia is of concern.[7]

38 The New Zealand Shippers' Council submits:

> International shipping is a competitive industry where there are several carriers or carrier groups on any trade route. Where this is not present competition diminishes and in rare circumstances a monopoly exists...New Zealand has attracted many carriers in the past and benefited from sufficient capacity to enable goods to be received or exported but capacity has diminished in the previous two years as carriers have formed [vessel] sharing arrangement(s). Collaboration 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 [as this] allows the opportunity for uncompetitive behaviour. It is likely that such behaviour has occurred.[8]

39 In contrast, the International Container Lines Committee submits that the sea freight markets are competitive. They point to low barriers to entry and exit in the markets, a decline in ocean freight-rates over time, and some countervailing bargaining power by large shippers (such as Kotahi and Carter Holt Harvey).

Review of the economic literature

40 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.

41 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.

Experiences of regulatory regimes in other countries

42 The European Commission repealed its liner shipping exemption for rate making agreements in October 2008. In 2010 it retargeted the exemption for non-rate making agreements to only apply if the parties to the arrangement held less than a combined 30% market share and the agreement did not impose restrictions on the supply of services to shippers that fix prices, limit capacity or allocate markets. The EU Competition Commission, in a letter to the New Zealand Productivity Commission, outlined its experiences following these reforms. It noted that:

a. The EU had not experienced 'destructive competition' in the three years since repeal of its exemption for rate making agreements. Rather there are still many carriers on EU trades and they offer even more capacity than before the repeal.

b. The liner industry is no different from other fixed-schedule, high-fixed-costs transport industries that function well under the standard competition law regime.

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[7] Export New Zealand submission to the Commerce Select Committee.
[8] Submission to the Productivity Commission Inquiry, responses to Q19 and Q20, page 8.

c. 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.

d. 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.[9]

Experiences of regulatory regimes in similar industries

43 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. 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 and 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.[10]

44 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 marginal 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.

45 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.

46 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. These arrangements are subject to case by case assessment by competition or transport authorities in most jurisdictions around the world.

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[9] European Commission, Directorate-General for Competition, Letter to Murray Sherwin, 24 February 2012.
[10] OECD, *Competition Policy in Liner Shipping*, April 2002, p75.

Conclusion on concerns with current arrangements

47 Collaboration between carriers on joint or coordinated services is desirable to ensure a reliable and effective sea freight service. However, the current network of agreements between carriers that have a high combined market share on many routes facilitates a high level of coordinated action. The lack of transparency and high levels of information exchange raises concerns that parties may engage in anticompetitive conduct that is not required to provide an efficient service, such as 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.

48 This anticompetitive 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.

Transition to a Commerce Act regime

49 The following options to strengthen oversight of competition in international shipping have been considered:

a. adopting the Productivity Commission recommendation to remove the exemption for ratemaking agreements (ones involving price fixing or limiting capacity with the intent of raising prices) and continuing to exempt non-ratemaking agreements but making the exemption conditional on filing agreements on a public register;

b. adopting a registration regime similar to that used in Australia, where both ratemaking and non-ratemaking agreements are exempt provided they are registered; and

c. transitioning to a Commerce Act regime.

50 In thinking about the options, it is helpful to focus on the objective of the regime. All three options are seeking to deter anti-competitive conduct and consequently are looking to distinguish between behaviour that is pro and anti-competitive.

51 This paper recommends transitioning to a Commerce Act regime as it has an established framework that focuses on conduct that lessens competition but has no offsetting productivity gains. The Cartel Bill currently before the Commerce Committee will clarify the distinction between anticompetitive cartel conduct and pro-collaborative activities that have offsetting efficiency benefits. It also provides for parties to apply to the Commerce Commission to obtain comfort that their arrangement does not contravene the Act through a new 'clearance' regime. While the Bill includes a new criminal offence for cartel conduct, this offence is targeted at harmful conduct where parties acted with intention and without an honest belief that they were engaged in a collaborative activity.

52 The generic regime under the Commerce Act (as amended) would mean that collaborative agreements between shipping companies would be:

a. allowed to operate with no involvement of the Commerce Commission if the arrangements have a pro-competitive purpose and do not substantially lessen competition;

b. authorised by the Commerce Commission if the arrangements lessen competition, but the efficiency gains outweigh the anti-competitive detriment; or

c. prohibited if they are anti-competitive (i.e. result in higher prices or lower quality to customers, with no offsetting pro-competitive benefits).

53 The other options could also be made to work. For instance, the exemption for liner shipping agreements could be specified more narrowly to focus on non-rate making agreements. Any rate making agreements that fix prices to shippers, limit capacity (other than in response to changes in demand) or allocate markets would be subject to the Commerce Act in the normal way. Shipping lines could apply to the Commerce Commission for clearance or authorisation of these arrangements on a case by case basis. Similarly, a registration regime could be designed to ensure that only pro-competitive agreements were registered. However, the Commerce Act regime is considered to be able to address stakeholders concerns.

Issues to be addressed in transition

54 One of the key issues raised by stakeholders was whether the regulatory regime would result in increased compliance costs and regulatory uncertainty such that it would lead to a deterioration in the level and quality of shipping services to and from New Zealand. The International Container Lines Committee outlined risks from the removal of the exemption relating to:

a. Loss of frequency

b. Volatility and potential loss of market supply / capacity

c. Diminished flexibility including port calls, times of sailing, tailored collection services

d. Exit of shipping lines, leading to reduced choice of sea freight services

e. Reigniting the debate on whether "hubbing" to and from Australia is a more desirable or likely outcome, which would add additional time to the transit of cargoes and additional costs associated with double handling.

55 This is unlikely for the following reasons:

a. The changes to the Commerce Act being implemented through the Cartels Bill will enable businesses to undertake efficiency-enhancing collaboration, and the risks of 'no collaboration' as outlined above should not arise.

b. Shipping routes to and from New Zealand are typically more profitable than other international routes. The costs to the parties of ensuring their arrangements comply with the Commerce Act would be unlikely to make these routes commercially unattractive.

c. Where similar exemptions have been removed in other jurisdictions, this has not deterred shipping services, suggesting it is unlikely to occur in New Zealand.

d. All carriers are familiar with operating in jurisdictions where competition law applies.

56 Concerns related to uncertainty and costs could be addressed through a number of mechanisms. Shipping lines are likely to want to review existing arrangements to ensure they comply with the Act. According to the International Container Lines Committee there are currently 25 to 30 agreements that relate to services to and from New Zealand. To assist with the review, a three-year transition period is recommended. This would give shipping companies sufficient time to assess their agreements.

57 Other mechanisms to help manage risk include:

a. Inviting the Commerce Commission to provide specific guidance material on how the Commerce Act will apply to international shipping is also recommended. Early release of this guidance (within six months of the start of the transitional period) would assist the parties to understand any matters to be addressed in their agreements.

b. Providing for the parties to be able to apply for to the Commerce Commission for clearance or authorisation for these arrangements, if required, within the transitional period.

c. The Cartels Bill currently provides a statutory timeframe for the Commission to consider clearance applications of 30 working days (or such longer period as may be agreed with the parties). A statutory timeframe could also be specified for authorisations of agreements to give parties some certainty. The Commission's output agreement currently specifies a timeliness performance measure to have decisions made on average within 120 working days. This measure could be included in the Bill, with the ability for an extension by agreement.

58 Some stakeholders have expressed concern that a Commerce Act regime would put our regulation ahead of our key trading partners. For example, Australia has a registration regime for all agreements, subject to certain conditions and with the Australian Competition and Consumer Commission (ACCC) having powers of investigation. However, many countries are moving to remove the exemptions for liner shipping or impose further industry-specific regulation to minimise anticompetitive detriments. The Commerce Act as amended should result in outcomes that similarly distinguish between behaviour that is pro and anti-competitive. The regimes in other countries use different mechanisms to do this, with greater or lesser success. Officials in Australia acknowledge that their registration regime could be improved. The recent joint study by the Australian and New Zealand Productivity Commissions' on *Strengthening Trans-Tasman Economic Relations* recommended removing – preferably on a coordinated basis – the exemptions for international shipping rate making agreements from competition legislation.

Pacific Islands Trade Routes

59 A particular concern has been raised by stakeholders about the impact of transitioning to the Commerce Act on the Pacific Island trade routes. The New Zealand Shippers Council and the International Container Lines Committee submit that these routes are a special case. The low volumes of cargo on these routes make it more likely that agreements between competitors would be viewed as anticompetitive. There were also concerns that a net public benefit assessment by the Commerce Commission could not take into account the benefits to the Pacific Island.

60 Some transparency in relation to this agreement seems desirable. It is not clear that the Commerce Act is unable to address the concerns outlined, particularly if collaboration is required to ensure the viability of the service. Officials could work with the parties to assist them in making this assessment within the transitional period.

Strengthening the oversight of competition in international civil aviation

61 Airlines enter into a range of collaborative arrangements requiring varying levels of integration. These include:

- interlining - voluntary commercial agreement between individual airlines to handle passengers travelling on itineraries that require multiple airlines;
- shared lounge access and frequent flyer points;
- code sharing- where two or more airlines share the same flight;
- direct co-ordination on fares, routes and schedules;
- revenue, cost sharing and joint ventures; and
- mergers.

62 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.

63 At the time that the Commerce Act was passed, the primary mechanism through which airlines cooperated was the tariff setting mechanism and associated arrangements agreed through the IATA. Part 9 of the Civil Aviation Act was enacted to take account of a view that the IATA system was integral to international aviation, but at the same time was in direct conflict with the Commerce Act.

64 While the Civil Aviation Act limits the provisions that can be authorised as those relating directly or indirectly to tariffs and capacity, experience and precedent is that this covers most aspects of alliance agreements.

65 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:

a. The specific statutory criteria are more suited to agreement on tariffs than broader cooperative agreements.

b. The specific statutory criteria do not explicitly allow for a full consideration of costs and benefits of arrangements.

c. The process set out in the Civil Aviation Act does not explicitly provide for a transparent process or consultation with interested parties.

d. 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.

66 The Productivity Commission recommended, subject to a review of passenger-service impacts, that the Government consider adopting a Commerce Act-only regime for regulating international air services, or if this was not done, reviewing and updating the current regime to address issues.

67 The qualification regarding a review of passenger specific impacts was because the inquiry focused on international freight transport services. The Commission considered that a review of passenger service impacts would be worthwhile; nevertheless, the report notes that there is a prima facie case that the Commerce Act-only regime would promote efficiency in both passenger services and freight services.

68 Stakeholders have raised the following risks with a transition to the Commerce Act:

a. the administrative and business compliance costs may be higher under this option; and

b. whether the Commerce Commission can take into account the international obligations from air services agreements and the like.

69 In principle I am supportive of transitioning the regulation of competition in international aviation to a regime that is wholly governed by the Commerce Act 1986. The current regime under the Civil Aviation Act 1990 is outdated and is far less robust than the Commerce Act which is specifically designed to ensure that cooperative arrangements are given appropriate scrutiny and provide benefits to consumers.

70 Other advantages of applying the Commerce Act to civil aviation include:

a. greater transparency and clearly defined processes for input from interested parties;

b. independence of decision making;

c. access to the Commerce Commission's competition expertise; and

d. consistency with the Australian regime (many airline alliances involve trans-Tasman sectors, and therefore require approval from authorities in both Australia and New Zealand).

71 However, the Minister of Transport has indicated that a review of the Civil Aviation Act is to be undertaken. This review provides the opportunity for a further policy process to consider the passenger specific impacts and other stakeholder concerns associated with changing the competition regime for international air services. If the review was managed in a timely way, it would not defer any benefits from an improved regime.

Consultation

72 Interested parties including Export New Zealand, the New Zealand Shippers' Council, the Global Shippers Forum, the International Container Lines Committee, the Asian Shipowners' Forum, Port of Tauranga, NZ Airports, Auckland Airport, Christchurch Airport and Air New Zealand have been consulted on the issues in this paper.

73 The Commerce Committee called for public submissions on the proposals to transition international shipping and international civil aviation to a Commerce Act regime. Fifteen written submissions were received in response with four opting to appear before the Committee. Of the written submissions six specifically addressed aviation and ten addressed international shipping.

74 The Committee also authorised officials to seek further views from submitters on the potential impact of the proposals. Officials had thirteen meetings subsequent meetings with individual stakeholders and informed parties.

75 The Ministry of Transport, the Treasury, the Ministry for Primary Industries and the Commerce Commission were consulted. The Department of Prime Minister and Cabinet was informed.

76 The Ministry of Foreign Affairs and Trade noted that the short consultation period on this paper did not afford them sufficient time to fully consider the potential policy implications on services to and from the Pacific Islands and whether the proposals were compliant with international trade agreements.

77 Trade to and from the Pacific Islands is important to New Zealand both from a development perspective but it is also important for New Zealand's exporters and importers. As noted in this paper, the purpose of the reforms is to deter anti-competitive behaviour and encourage collaborative arrangements that increase productivity. All people that use services on routes to and from the Pacific Islands should benefit from these reforms.

78 This paper recommends that the Ministries of Business, Innovation and Employment, Transport and Foreign Affairs and Trade be directed to work with carriers on the Pacific Island routes to assist their transition to the new competition regime. If this raises further issues, officials may report back to Ministers before the end of the transitional period.

Financial Implications

79 The proposal outlined in this paper would result in the Commerce Commission being given responsibilities for oversight of international shipping under the generic Commerce Act regime. The costs of this proposal for the Commission are difficult to predict, given the discretionary and demand driven nature of the oversight function.

80 The Commission would incur some initial one-off costs in providing guidance on the application of the Commerce Act to international shipping agreements. Potentially over the transitional period, up to five agreements may be submitted to the Commission for authorisation and up to another 10 agreements for clearance. The costs to the Commission of these determinations are application dependent, and range from $50,000 to $200,000 for clearances and $150,000 to $500,000 for authorisations.

81 The Commission should be able to manage some of the costs (both in the transitional period and over the longer term) within existing baselines through reprioritisation and phasing of discretionary activities. A portion of these costs would also be met by application fees which are currently under review. The level of the fee could range from a nominal contribution to something that is closer to cost recovery. If the Commerce Commission comes under financial pressure as a result of undertaking these new activities, the need for additional funding will be assessed at that time.

Human Rights

82 The proposals in this paper appear to be consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative Implications

83 The proposals in this paper are intended to be given effect through an amendment to the Commerce (Cartels and Other Matters) Amendment Bill, currently before the Commerce Committee. The Shipping Act 1987 will require amendment to repeal the industry-specific competition regime covered by the exemption following a sufficient transitional period. The Commerce Act will also need to be amended to repeal the exemption for international shipping, with associated technical amendments to ensure a smooth transition. These amendments will be submitted to the Committee for its consideration for incorporation in the Committee's report back on the Bill.

Regulatory Impact Analysis

84 The Regulatory Impact Analysis (RIA) requirements apply to the proposal and a Regulatory Impact Statement (RIS) has been prepared and is attached. The Regulatory Impact Analysis Team has reviewed the RIS prepared by the Ministry of Business, Innovation, and Employment, and the associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Recommendations

It is recommended that the Committee:

1 **Note** that international shipping is currently exempt from the application of the Commerce Act 1986 and subject to an ineffective sector-specific regime under the Shipping Act 1987.

2 **Note** that international civil aviation trade practices can be exempt from the Commerce Act 1986 if authorised by the Minister of Transport under the Civil Aviation Act 1990.

3 **Note** that the Business Growth Agenda includes action points to strengthen rail, sea and air infrastructure, more specifically, to respond to the Productivity Commission's freight inquiry and removing the exemptions from general competition law for shipping.

4 **Note** the Government has set a goal of exports making up 40 percent of GDP by 2025 and that improving the efficiency of international freight transport services through more appropriate regulatory regimes that promote greater transparency and competition is one concrete step that the Government can take to achieve this objective.

5 **Note** that the final report of the New Zealand Productivity Commission on International Freight Transport Services, tabled on 24 April 2012, made a number of recommendations relating to competition regimes for international shipping and civil aviation. More particularly, the Productivity Commission:

5.1 found that the performance of freight transport services could be improved by strengthening the competition regimes in both sectors; and

5.2 recommended changes to the competition regulatory regimes that apply to international shipping and international civil aviation, including removing the exemption from the Commerce Act for international shipping rate making agreements and establishing a register for non-rate making agreements.

6 **Note** that the joint study by the Australian and New Zealand Productivity Commissions – Strengthening trans-Tasman economic relations – found that the exemption from competition law for international shipping rate making agreements in both jurisdictions is no longer necessary and removing it would generate gains.

7 **Note** that the regulation of competition in international shipping and international civil aviation is currently being considered by the Commerce Committee as part of its consideration of the *Commerce (Cartels and Other Matters) Amendment Bill.*

8 **Note** that the Commerce Committee is due to report the Bill back to Parliament by 14 May 2013.

9 **Note** that submissions to the Productivity Commission and the Commerce Committee had mixed views on the merits of transitioning the regulation of competition in international shipping and international civil aviation to a regime under the Commerce Act 1986, with exporters generally in favour and international shipping carriers generally opposed.

10 **Agree** that:

10.1 the carriage of goods by sea to and from places in New Zealand should be subject to the generic competition regime under the Commerce Act 1986 after a suitable transitional period; and

10.2 at the conclusion of the transitional period, the sector-specific regime covered by the Commerce Act exemption in the Shipping Act 1987 would be repealed.

11 **Agree** that the transitional period would be for one year from the date of enactment of the Commerce (Cartels and Other Matters) Amendment Bill.

12 **Agree** that parties to agreements between carriers may apply to the Commerce Commission within the transition period outlined above for clearance or authorisation to confer Commerce Act immunity on the agreements.

13 **Agree** that the Commerce Commission should be required to consider applications for authorisation of restrictive trade practice agreements within 120 working days, with any time extensions to be agreed with the applicant.

14 **Direct** the Ministries of Business, Innovation and Employment, Transport and Foreign Affairs and Trade to work with carriers on the Pacific Island routes to assist their transition to the new competition regime.

15 **Invite** the Commerce Commission to provide, within six months following the enactment of the amending legislation, guidance to interested parties on how the Commerce Act 1986 would apply to international shipping.

16 **Note** that a review of the Civil Aviation Act is being undertaken and this review will consider how to strengthen the regulation of competition for international civil aviation services.

17 **Direct** the Ministry of Business, Innovation and Employment to recommend to the Commerce Committee that amendments be made to the Commerce (Cartels and Other Matters) Amendment Bill to give effect to these decisions.

18 **Invite** the Minister of Commerce to instruct the Parliamentary Counsel Office to draft amendments to the relevant legislation to give effect to these decisions and any technical consequential amendments.

pp

Hon Craig Foss
Minister of Commerce
20 / 3 / 13

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 anticompetitive 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.

Karen Chant
Principal Policy Adviser, Competition and Consumer Law

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.[1]

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.[2] 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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[1] Productivity Commission, *International Freight Transport Services Inquiry*, April 2012, p iii.
[2] 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 it 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 NZPC 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.*[3]

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.[4] Despite economic, political and social changes, these formal arrangements still characterise the industry today.[5]

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[3] Productivity Commission, *International Freight Transport Services Inquiry*, April 2012, p226.
[4] 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.
[5] 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 services 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.[6]

12 The special characteristics of the liner shipping industry were noted by the International Container Lines Committee (ICLC) it is 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 It 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.[7]

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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[6] OECD, *Competition policy in liner shipping,* 2002, p18.

[7] 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 outwards 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 to initiation 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 anticompetitive 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.*[8]

[8] 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. [9]

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.[10]

[9] Australian Productivity Commission, *Review of Part X of the Trade Practices Act 1974: International Liner Cargo Shipping*, February 2005, p83.
[10] 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 that 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 Fruits 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 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 it 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.[11]

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[11] 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 Malalysia), 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.[12] 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.[13]

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.[14]

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[12] European Union, Commission Regulation (EC) No 906/2009, Official Journal of the European Union.
[13] European Commission, Directorate-General for Competition, Letter to Murray Sherwin, 24 February 2012.
[14] 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 anticompetitive risk.
- Agreements which fix prices and control the supply of shipping to a trade route pose the greatest anticompetitive 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.[15]

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 and 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.[16]

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

[16] 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 an 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 howcollaborative 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.

Options	Criteria	
	Minimises risk strative competitive de	**Regime minimises business compliance costs**
Option 1: Status Quo	The regime in t does not protects are competitive bel ould it provide effectnd	✓✓✓ Regime is not used so no costs are incurred. However, if invoked, carriers may be subject to ministerial directions in providing services.
Option 2: Productivity Commission recommendations Rate-making agreements subject to the Commerce Act. Operational agreements (or consortia) would be exempt if registered.	Assumes that nd agreements are competitive. Opts. agreements cai to anti-competit including highe reduced freque and innovation.	✓ Agreements will need to be assessed to see whether they met the criteria for registration.
Option 3: Apply the competition regime in the Commerce Act to international shipping	✓ Established frai seeks to distings, collaborative adered pro and anti-co so	✓ Agreements will need to be assessed to see whether they raise competition issues. Sector-specific guidelines are proposed to minimise increase.
Option 4: Strengthen the Shipping Act Minister's ability to investigate suspected unfair practices strengthened, penalties introduced, regime extended to imports .	✓ Sector specific amended to mi anti-competitive would seek the outcomes as ur competition law	✓ Costs will depend on the design of the regime.

Level of contribution to objectives ✓ low; ✓

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.[17]

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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[17] 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,[18] 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 (eg 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 where 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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[18] 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 Cartels 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 would not 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 Cartels 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 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 Select 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 meetings 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 Cartels 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 anticompetitive 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 anticompetitive 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 Minsters 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 Cartels Bill.

Consultation on Cabinet and Cabinet Committee Submissions

Certification by Department:

Guidance on consultation requirements for Cabinet/Cabinet committee papers is provided in the CabGuide (see Procedures: Consultation): http://www.cabguide.cabinetoffice.govt.nz/procedures/consultation

Departments/agencies consulted: The attached submission has implications for the following departments/agencies whose views have been sought and are accurately reflected in the submission:

The Treasury, the Ministry of Transport, the Ministry for Primary Industries

Departments/agencies informed: In addition to those listed above, the following departments/agencies have an interest in the submission and have been informed:

Ministry of Foreign Affairs and Trade, the Department of Prime Minister and Cabinet

Others consulted: Other interested groups have been consulted as follows:

Commerce Commission. Public consultation also occurred though the Commerce Committee releasing its interim report on the Commerce (Cartels and Other Matters) Amendment Bill.

Name, Title, Department: Abbe Hutchins, Senior Advisor, Ministry of Business, Innovation and Employment

Date: 20/03/2013	**Signature** Abbe Hutchins

Certification by Minister:

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet/Cabinet committee.

The attached proposal:

Consultation at Ministerial level	☑ **has been** consulted with the Minister of Finance *[required for all submissions seeking new funding]* ☑ **has been** consulted with the following portfolio Ministers: Transport, Economic Development ☐ **did not need** consultation with other Ministers
Discussion with National caucus	☐ **has been** or ☐ **will be** discussed with the government caucus ☑ **does not need** discussion with the government caucus
Discussion with other parties	☐ **has been** discussed with the following other parties represented in Parliament: ☐ Act Party ☐ Maori Party ☐ United Future Party ☐ Other [specify] ☐ **will be** discussed with the following other parties represented in Parliament: ☐ Act Party ☐ Maori Party ☐ United Future Party ☐ Other [specify] ☑ **does not need** discussion with other parties represented in Parliament

Portfolio	**Date**	**Signature**
COMMERCE	20/3/13	