

**Liner conferences – the money and
the box**

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Liner Shipping Agreements – Recent developments and economic issues

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Structure of presentation

- Consortium and conference agreements
- Developments in various jurisdictions
- Competition concerns
- Economic efficiency considerations
- The theory of the empty core (no stable equilibrium or agreement)
- Summing up

Consortium agreements

- Involve technical, operational or commercial coordination of services
- Can vary from slot chartering (similar to code sharing for airlines) to sharing of port and marketing activities.
- Typically operate under a discussion agreement or conference with recommended or agreed freight rates **but not necessarily so - which is a defining feature**
- Are recognised internationally to have net economic benefits apart from any price setting arrangements and depending on extent of market affected, form of agreement and entry barriers

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Conference agreements

- Traditionally a route specific agreement to charge common freight rates, pool revenue, costs and profits and engage in capacity, schedule and minimum service management.
- Entail monitoring of compliance and can include mechanisms for enforcement
- Discussion agreements are similar but non-binding
- Under threat by competition and regulatory authorities but outcome is uncertain
- Also diminishing in importance with introduction of individual service contracts, alliances and mergers

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Europe

- The European Union regime consists of two block exemptions:
 - An exemption that covers the activities of conferences (4056/86)
 - An exemption that covers the activities of consortia (Regulation 611/2005 updated from 823/2000)
- Both were recently reviewed
 - The key reform proposal is to remove the conference exemption to fix prices and set capacity
 - Consortia will still be allowed provided: objective is joint operation of services, a market share threshold is met and there is effective competition (individual confidential service contracts will qualify)

United States

- In the past high information disclosure and filing obligations
- Most recent development was the passage of the Ocean Shipping Reform Act 1998 (OSRA)
 - Allows agreements to “discuss, fix or regulate transport rates, including through rates”
 - Provided conferences are open to new members, members can withdraw without penalty and take independent and confidential action on any tariff or service item
 - Tariffs do not have to be filed but must be made public
 - Service contracts have to be filed but not individual freight rates

Singapore

- A single block exemption order applies for all liner shipping agreements (including on prices and detailed capacity decisions) that meet certain conditions, as follows:
- Agreements must not preclude independent price action nor restrict withdrawal from agreement
- Where market share of parties exceeds 50% in a market in which they operate under the agreement, the agreement will still enjoy exemption but provided some minimum filing and publication conditions are met.
- Can be cancelled or varied if there are competition or efficiency concerns

Australia

- Part X of TPA provides exemption for conferences subject to filing, disclosure and negotiation requirements
- Exemptions are also provided to Australian exporters and importers to negotiate collectively with ocean carriers
- Regime does not prohibit conference agreements that inhibit independent rate action by members of the conference or closed conferences (except where US or EU law prevails)
- Productivity Commission 1999 review recommended retention of the regime, with minor modifications
- Productivity Commission 2005 review recommended **abolition of Part X; or less preferably**
 - exempting only agreements that do not discuss or set prices and/or limit capacity on a specific route;
 - or providing for protection of individual service contracts.

Competition concerns

- Conferences are effectively a legal cartel and can have the classic effects of restricting output and raising prices and profits above competitive levels
- Whether this occurs or not depends on entry barriers
- There is evidence that an open cartel leads to excess capacity and dissipation of profits as cartel members compete
- Even if a conference is closed entry barriers may be sufficiently low for non-conference members that prices remain competitive
- In addition even if conferences raise prices relative to an “effective competition” benchmark there may be economic efficiencies that generate a net public benefit

Economic efficiency considerations

- The strongest economic rationale for conferences is the so called “theory of the core”
- The core in economics is the set of transactions which buyers and sellers acting alone or in groups have no incentive to change. A well functioning competitive market will achieve such an outcome in equilibrium.
- When there is no core there may be chaotic outcomes for prices and quantities as agreements are continually renegotiated. Sometimes referred to as “destructive competition”

Economic efficiency considerations

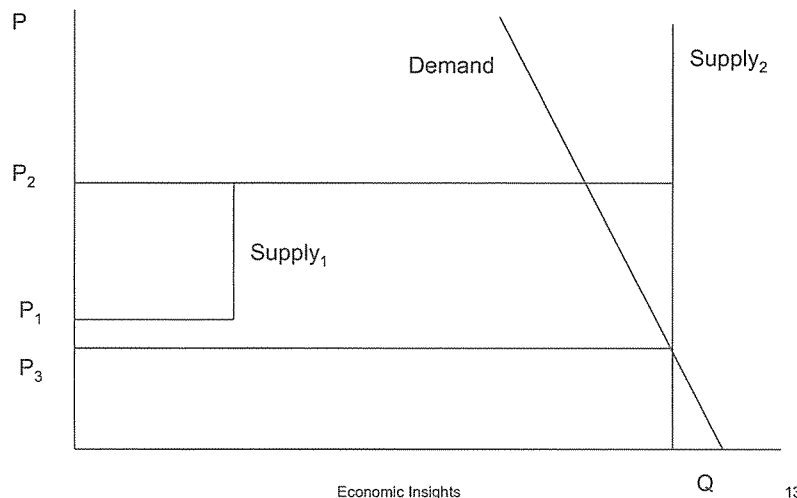
- Key conditions under which there may be no core are:
 - Relatively indivisible and homogeneous supply, high fixed costs relative to operating costs; and
 - Highly divisible, unpredictable and price inelastic demand
- With these conditions demand and supply curves may not intersect – the intuition is that supply cannot come in fractions and demand may not be of a scale that it matches supply capacity for a price that will induce sufficient supply
- In the absence of coordination, liners carrying mixed cargo will inevitably have excess capacity because the nature of supply and because of high divisibility, unpredictability and price inelasticity of demand

Economic efficiency considerations

- The following chart depicts the theory of the empty core
- Assumes supply is provided in large, discrete increments and all costs are avoidable but fixed for a given capacity decision
- Prices below P1 (e.g. P3) will mean there is no incentive to supply
- Prices above P2 will induce supply from a second firm
- For this market to have a core, demand curve must intersect supply curve on a vertical segment
- In the absence of coordination, price and quantity are indeterminate
- With coordination price could be some level above P2 and first firm is fully utilised while second firm is willing to supply but is not fully utilised. However, if prices are sufficiently high it may still be willing to supply even if it operates with some excess capacity because profits may be sufficiently high.

Economic efficiency considerations

Industry supply and demand in a market with an empty core



Economic efficiency considerations

- With high operating costs relative to fixed costs supply is likely to be flatter
- With small capacity increments gaps between segments are likely to be small
- With differentiation in the nature of the supply service, firms can compete on basis of service not just price - less likely for destructive price competition to arise
- With price elastic demand more likely to have demand intersect supply

Economic efficiency considerations

- PC (2005) suggests there are other means of achieving better utilisation of capacity, competitive discipline and market stability.
 - Co-operative sharing of assets and networks can occur without fixing prices or unduly restricting capacity.
 - Global ship operators can change capacity across trades and regions.
 - Ship speeds and turnaround times can be increased.
 - Peak load pricing can be used.
 - Shippers can package cargo into smaller volumes.
 - Service contracts can be used.
- Are these mechanisms sufficient to achieve efficiencies and stability?

Economic efficiency considerations

- PC (2005) also notes other industries with similar characteristics to liner shipping
- For example, airlines maintain scheduled services but face high fixed costs, uncertain, highly divisible and relatively price inelastic demand and can benefit from economies of scale and scope.
- Responses are:
 - Codesharing
 - Alliances
- But codesharing facilitates coordination of prices and do market access restrictions limit the scope for destructive competition for airlines?

Economic efficiency considerations

- If barriers to entry and other market conditions preclude the realisation of excess profits, the existence of conferences as cartels may be an effective market based mechanism to achieve economic efficiency and market stability.
- Note they are a market response – not a regulated response, whereas prohibiting them would be a regulated response.
- Price agreements, including price discrimination, are not necessarily adverse from an economic efficiency perspective, as they may be an efficient means of recovering fixed costs - the key competition concern should be whether output is restricted and the extent of such restriction.
- Net public benefits can still be realised even if conferences mean higher prices than in their absence and above normal profits.
- The extent to which there is a net (economic efficiency) public benefit will depend on the extent to which output is restricted relative to an ideal social optimum and the efficiency gains, not the price effects per se.

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Summing up

- Recent changes have a common theme of allowing liner shipping agreements to cover a wide range of behaviour, provided in particular that independent action of members is not precluded and more generally (and more loosely) that there appears to be scope for effective competition.
- It is yet to be seen whether price agreements will still be allowed in most jurisdictions but this continues to be the case in the US under OSRA and no changes have been proposed recently.
- The case for conferences from an economic perspective depends on showing that the industry does have the conditions that make it vulnerable to “destructive competition” based on the economic theory of the core.

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