Submission to the Productivity Commission concerning the draft report reviewing Part X of the Trade Practices Act 1974: International Liner Cargo Shipping

Prepared by John Zerby, December 2004.
j.zerby@unsw.edu.au

The purpose of this submission is to clarify several aspects of the US Ocean Shipping Reform Act (OSRA) 1998 that are mentioned briefly in the Productivity Commission's Issues Paper, as well as in their Draft Report, in the main references listed in both of these and in some of the submissions that were available online at the time this was written. The need for clarification arises principally from the belief that without it the relevance of OSRA 1998 to this Review of Part X is likely to be overstated, and may therefore direct attention away from the main objectives of the Part X Review.

I provide this clarification partly from personal experience. More specifically:

- For a brief period in 1977, I was with the Merchant Marine Subcommittee of the US House of Representatives to help draft the Controlled Carrier Bill that subsequently became an amendment to the US Shipping Act of 1961 and, in modified form, part of the US Shipping Act of 1984.

- In 1982, I acted as consultant to the US Federal Maritime Commission (FMC) in conducting an internal review of liner shipping regulation within the context of regulatory reform in domestic transport in the US at that time.

- For an 18-month period beginning in July 1985, I was invited by the FMC to act as advisor in establishing the principles and procedure for the Review of the Shipping Act of 1984 that was mandated in that Act.

The submission proceeds on the basis of several inaccurate or incomplete statements concerning OSRA 1998, most of which are either visible in the literature mentioned above, or are implied by it.

The Shipping Act of 1984, with OSRA 1998 amendments, limits the anti-trust immunity that was available in the previous version of the Act. This is correct, but the limitation was the result of a technical change and is therefore trivial. While anti-trust immunity is not extended to loyalty contracts under the OSRA amendments, the definition of loyalty contracts was changed to coincide with deferred rebates. That is, a loyalty contract is now defined as one through which a shipper obtains lower rates by committing all or a fixed portion of its cargo to a carrier or agreement and the contract provides for a deferred rebate arrangement. The Shipping Act prior to 1989 specified loyalty contracts without deferred rebates, loyalty contracts with deferred rebates and service contracts. Why include all three, particularly when loyalty contracts without deferred rebates were similar to (but not identical to) service contracts? This requires a brief account of the legislative history of the original 1984 Act and this, in itself, is relevant since it explains some of the changes that occurred in 1998.

In 1961, the Bonner Act amendments to the US Shipping Act of 1916 conveyed the desire of Congress to achieve tight supervision of liner shipping activities with a primary purpose of protecting US shippers. Discriminatory practices were thoroughly investigated;[1] the legality of basic agreements was carefully examined; the influence one conference might exert on

[1] The importance of non-discrimination in US regulatory regimes is highlighted in J.A. Zerby (1984), 'Regulating Ocean Shipping in the U.S.A: Historical Perspective and Current Trends', *The Great Circle* (Journal of the Australian Maritime History Association), Vol. 6., No. 1 (April). An electronic version of the article is available at: http://www.library.unsw.edu.au/~jazerby/circle1.htm.

another conference was closely watched; and various hurdles were constructed for the purpose of informing conferences that their existence was dependent upon compliance with the new Act. Deferred rebates were illegal since they were thought to comprise a tying arrangement that was unfair to shippers. Loyalty contracts without deferred rebates were permitted, provided they did not discriminate among shippers displaying the same degree of loyalty.

When domestic transport was deregulated in the US in the 1970s and early 1980s, the large American shippers were able to obtain quantity discounts that significantly reduced their transport costs, but they could not achieve the same advantage for international shipping since any such discounts *could be construed* as discriminatory under the Shipping Act of 1916 as amended. Additionally, they sought contracts that specified port-to-port or door-to-door movements so that both cost and time-in-transit for ocean freight could be known with reasonable certainty for a stated period. This, in turn, *could be construed* as discriminating between US ports and between US domestic carriers.

Pressure on Congress for a major change in the regulatory framework for liner shipping came initially from the National Industrial Transportation League, whose membership consists entirely of the very large shippers, contrary to expectations that might follow from its unfortunate acronym – NIT League. Since greater competitiveness of US exports was held as the outcome of NIT League's objectives, it was difficult for Congress to ignore them.

However, the possibility of abandoning the emphasis on non-discrimination gave rise to pressure from other sources and changed the normally two-way confrontation between shippers and carriers, as buyers and sellers. More specifically, small shippers (including large shippers who were not as large as NIT League's members) were concerned that the 'big boys' might substantially undercut them. These smaller shippers secured the support of many US ports that were at risk in being left out of the well-organised logistic systems being devised by the 'big boys'. A fifth stakeholder consisted of freight forwarders whose rapid growth was fanned by the deregulation of domestic transport, and by their offer to small shippers to consolidate their freight so as to achieve the economies of scale that were claimed by the 'big boys'. All of these new participants demanded equal consideration and argued that competition would be threatened if they were driven out of the market.

In order to appease these new participants, Congress agreed to the 'me-too' clauses[2] that allowed small shippers to benefit from the rates and conditions negotiated by the large shippers in their service contracts. The very large shippers were most unhappy with that, but at least they were able to begin the task of reducing their transport costs to foreign markets. Liner conferences were also unhappy since the definition of 'similarly situated shippers' was unclear. Conferences feared that regulatory rulings or court decisions would result in a downward spiral of rates following successive negotiations that were ultimately applied to an unknown number of previously negotiated contracts. Conferences argued that bankruptcies are likely to be a consequence of such a rate spiral and the first to go could be the US-flag carriers. This also was difficult for Congress to ignore, and conferences were therefore allowed to exert influence over service contracts. All of these concessions or

[2] These were referred to as 'most favoured shipper' clauses in the 1980s since they were viewed as similar, in principle, to 'most favoured nations' clauses that are contained in many government-to-government trade agreements.

compromises stemmed from uncertainty about the effect of service contracts on small shippers, carriers and ports.

OSRA 1998 resulted in significant reduction is liner freight rates, and thus brought about a convergence of freight rates toward the real cost of liner operation. This also is partly true, but arises from the elimination of constraints imposed by the US Shipping Act of 1984 as much as, and perhaps more so, than the constraints created by and imposed by liner conferences. The capacity of conferences to discourage members from signing service contracts is the only conference constraint that was removed with the 1998 amendments. How important was this? We lack detail about the number of times since 1984 that conferences succeeded in limiting the number of service contracts or even the number of times they tried to do so. We know that serious, downward rate-spirals did not occur and apparently were not even embryonic. If conferences attempted to limit the ability of their members to negotiate service contracts when a satisfactory reason for such a limitation did not exist, then they would probably either lose members or give rise to independent action on the part of those members who wanted the contracts. Intervention by conferences would therefore accomplish little or nothing.

Some conference carriers used the presumed veto power of conferences as an excuse to avoid negotiations with shippers. This was of course motivated by the desire to retain shipper loyalty at the tariff rate, rather than at a lower service contract rate, and obviously this would be possible only for conference members. It therefore could be treated as a conference constraint, but if so it is a constraint that was put into effect by the conferences when they did nothing.

Previous constraints that can be attributed to the Shipping Act of 1984 (rather than to the conference system per se):

- The 'me-too' clauses that were intended as a protection for small shippers and ports prevented meaningful discounts from being offered.

- The retention of much of the non-discrimination requirement created uncertainty in relation to fully tailorised service contracts.

- Carriers were not allowed to negotiate jointly with railroads, trucking companies or airlines for transport within the US under the previous Act. They can now do so, although for those negotiations they are subject to the US antitrust laws and their objectives must be consistent with the purposes of the Act as defined in the Act's Declaration of Policy.

Much emphasis has been placed on the advantages associated with the greater degree of confidentiality. Under the new amendments, service contracts must make public:

- the commodity or commodities included the contract,

- the volume or portion of the commodity or commodities covered by the contract;

- the duration of the service contract; and

- the US port range through which the carrier intends the service covered by the contract to be provided.

Confidentiality is therefore limited to the following:

- foreign ports included in the contract,
- precise origin and destination (geographic areas) in the case of through intermodal movements;
- line-haul rate;
- service commitments; and
- liquidated damages for non-performance, if any.

This undoubtedly contributed to a sharp rise in the number of service contracts and to an increase in the percentage of freight carried by service contracts. It is difficult, however, to see how it alone reduced operating costs for liner operators or even that it brought rates closer to those costs.

OSRA 1998 dramatically reduced the power conferences had over rate setting since only a small amount of freight is shipped at conference tariffs. There has been a reduction in conference ratemaking power, but it has little to do the percentage of freight using common tariffs. Shortly after the Shipping Act of 1984 went into effect, the percentage of freight under service contracts began to increase. This growth faltered in the 1990s, until the 1998 amendments were added. The power of liner conferences should be measured on the basis of the extent to which they succeed in rationalising liner capacity between specific trading centres in both the short-run and the long run. The history of liner conferences indicates that this was the principle objective of conferences since 1875.[3] Common tariffs made it easier by limiting the amount of internal dispute and by simplifying the inter-carrier transactions for shared space or container slots. Neither of these is of great importance now, but rationalisation of available capacity is and will continue to be important. *Any regulation that interferes with such rationalisation will add to the cost of providing the service.*

This leads to two considerations that are not directly part of the US Shipping Act of 1984, but nevertheless became more apparent through observation and experience related to the Shipping Act.

Ideology is an important factor in the way the statements above in bold Italics are presented and interpreted. Those people whose ideology maintains that (1) liner conferences exist for the purpose of controlling or limiting supply, and (2) any such control of or limit to supply will necessarily be used to achieve higher freight rates, can be easily recognised since they almost invariably use phrases such as ‘cartel-like behaviour’ and ‘collusive price fixing’. Those whose ideology holds that co-operation and exchange of information among liner operators is necessary in order to avoid (1) undesirably high levels

[3] B. M. Deakin and T. Seward (1973), *Shipping Conferences: A Study of Their Origins, Development and Economic Practices,* Cambridge University Press.

of excess capacity, and (2) accompanying service instability, use phrases such as 'contestability' and 'ample capacity to handle normal trade flows'.

That neither of these two views is an acceptable representation of reality could, perhaps, be demonstrated by the simple fact that if either were widely accepted, then the other would disappear as a rival argument. Like many other economists, I began with the first ideology and found it difficult to accept the notion that the appropriate prices in liner shipping are necessarily based upon what the market will bear. I proceeded to construct an economic model to show what prices *ought to be*, based upon the specific objective of economic efficiency. Applying this model to the Australia-to-Europe liner trade, I, and those working with me, discovered that our thought-to-be-objective freight rates did not differ substantially from the actual ones. This caused much gnashing of teeth since it contradicted our initial hypothesis and would probably alienate the organisation that sponsored the research. What to do? Should we change the model in the hope of getting a different result? That occurred to us, but getting the 'wrong' result in the first run took much of the wind out of our sails, so to speak. Since then I encountered other people who began with the same ideological premise and experienced great difficulty when it did not comport with reality.

Some thoughts are consequent to this:

Since 1875, liner shipping freight rates have been based upon what the market will bear so that history is the best guide to rate setting. Nothing this Review of Part X says or does is likely to change that.

When a government agency initiates a change in regulation it is almost always more re-regulation than deregulation. Its purpose is either to streamline government procedures or to support an ideological position. Economic efficiency and national interest are not ignored, but remain secondary despite loud pronouncements to the contrary.

One last personal experience seems relevant at this point. When I returned to Australia after helping to draft the US Controlled Carrier Bill (see above), I was invited to Canberra to discuss the outcome. I soon discovered, however, that the real objective was to solicit my support in changing Part X of the Trade Practices Act 1974. My response was to state:

> I devoted a fair amount of time in Washington to the task of convincing both Democrats and Republicans that Part X of the Australian Trade Practices Act represents a good framework for balancing the conflicting interests in liner shipping. Now you tell me that you want to change Part X. What's more, you want to change it as a 'me-too' with the Americans, and what they have is clearly inferior since they started on the wrong foot in 1911.[4] Therefore, I must consider you to be crazy and I cannot in clear conscience work with someone who is crazy.

Since then I encountered a few other crazy people, in Canberra and elsewhere, who do things for reasons other than those to which they openly profess, but I now consider that to be 'a fact of life' with almost as much certainty as the continuation of liner conferences. Perhaps we need to eliminate the former before we can eliminate the latter.

[4] This is the date of *United States v. Standard Oil*, 221 U.S. 1 and *United States v. American Tobacco* 221 U.S. 106, both of which added fuel to the presumption that there is a 'higher' authority above the public, and not directly answerable to the public, that can determine the interests of the public.