



## Review of PNG Coastal Shipping: Consort Express Lines Ltd

# Public Submission

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## **CONSORT EXPRESS LINES LIMITED**

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## CONSORT EXPRESS LINES LIMITED

### EXECUTIVE SUMMARY

Consort Express Lines Ltd welcomes the opportunity to assist the Independent Consumer and Competition Commission (the Commission) to undertake a comprehensive review of the shipping industry in Papua New Guinea. This submission responds to the comprehensive range of issues identified in the Commission's issues paper of the 20 March 2006. The submission provides detailed responses to many of the information requests made in the Issues Paper and raises a number of further issues that impact upon the quality of coastal shipping services in Papua New Guinea.

In the time available for receipt of submissions, Consort has not been able to adequately address all of the issues raised in the Issues Paper. It is our intention to provide follow up material to the Commission over the next week.

Consort Express and the other PNG liner shipping companies provide frequent, regular and continuous coastal shipping services to most ports in the country in a safe and environmentally sound manner. The growth prospects for the economy in the next few years are sound. A large number of projects are either under construction or committed. This will increase the need for additional investment in shipping and in port facilities. To meet the expected growth in coastal trade in Papua New Guinea, Consort has recently invested \$80 million kina in upgrading and expanding its fleet. This has reduced our need to charter manned overseas vessels and will enable us to provide employment and training opportunities for PNG workers. This investment confirms our commitment to servicing the coastal trade in PNG.

The Commission's goal is to ensure that PNG shipping is efficient. This is critical as the coastal shipping network is essential to the functioning of the PNG economy. The country is unusual in that it does not have a well developed road network and has no rail infrastructure. Given the operating conditions in PNG and the type and volumes of cargo involved, our freight rates are internationally competitive. Coastal shipping in PNG is subject to price controls that are infrequently changed to accommodate changes in market conditions. This has seen prices paid by coastal shippers fall substantially in inflation adjusted terms over the past decade. Consort has responded by increasing its efficiency. Today, all of our rates quoted to shippers are either at or *below* the price ceiling.

Consort has no monopoly in the coastal trade. While our share of the liner shipping trade is high, there are other firms that provide an alternative to our services. Moreover, there are no barriers to entry into the PNG coastal shipping market for PNG registered businesses employing PNG flagged vessels. If the price ceiling were removed, Consort would only be able to set prices at levels that justify our continued provision of liner shipping services. If we set our freight rates above the competitive level, competing firms will enter the market with shipping capacity and undercut our rates. The coastal shipping market is contestable.



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Consort provides tier one coastal liner shipping services. This means that all of our vessels and crew comply with international standards for safety and environmental care. Consort operates to a schedule, providing regular and reliable services to our customers. We operate this regular service regardless of the amount of cargo that is available at our ports of call. This has provided a high level of certainty to coastal shippers and minimised their need to invest in inventory. Tier two and three coastal ship operators do not provide regular services and they do not comply with international standards. The Study Team that wrote the Australian Department of Foreign Affairs and Trade (DFAT) funded report on page 35 observed, in relation to coastal shipping in the **Pacific Island economies**, that:

*As a consequence, many domestic shipping operators, particularly small companies, operate on very tight profit margins, making it extremely difficult - if not impossible to accumulate sufficient capital to purchase new vessels. Replacement tonnage is provided either through aid funding or is purchased second-hand (more typically third or fourth-hand). Second-hand vessels are chosen on the basis of affordability, and are frequently unsuitable for the trade in question. Typically vessels do not comply with the requirements of recent international conventions. Vessels employed in coastal and inter-island trades are characteristically old and in poor condition.*

**This generalisation applies to second and third tier coastal shippers in PNG. It does not apply to Consort and other Tier 1 operators in PNG today.**

- Consort is profitable in spite of tariffs that have been fixed since 1991 and has delivered real decreases in shipping rates over this period through productivity gains;
- In the past year, Consort has invested around K80 million in new vessels;
- Consort vessels and their crew are fully compliant with international conventions and their standards;
- Consort invests heavily in training its PNG crews to international standards at the Maritime College at Madang
- Consort has been able to manage uneven coastal demand as evidenced by its ability to supply regular, frequent and continuous liner shipping services to a large number of ports in PNG.
- Consort commenced a weekly international liner service to North Queensland in 1994 and continues to operate this service. This service competes in a competitive trade and is the only international service offered utilising PNG flagged vessels.
- Consort, as do all other coastal operators, operates without any government or international aid subsidies.



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The Commission seeks comment on the validity of the DFAT conclusions on cabotage. We note that DFAT did not write a report on PNG's cabotage regime. It provided funding to the Pacific Forum Secretariat which commissioned a study by independent consultants, the Study Team, on general transport issues in Pacific Island nations. There was a limited description of coastal shipping in PNG and about one page devoted to cabotage. The Study Team, not the Australian Government, recommended that the PNG Government consider relaxation of the coastal licensing regime. The Study Team provided no analysis of cabotage and therefore the view expressed by the Study Team that cabotage contributed to high freight rates and poor service was unfounded.

Cabotage regimes apply to coastal shipping industries in many countries around the world and, as far as we know, no government is considering liberalisation of its coastal licensing regime. The analysis presented in this submission provides good reasons for this, particularly in the case of smaller, developing economies.

Our analysis suggests that liberalising the coastal licensing regime to allow foreign flagged vessels to carry coastal cargo poses substantial risks to the quality of coastal shipping service and to the PNG economy. It also raises significant social, environmental and national security concerns.

If international shipping companies are allowed to carry coastal cargo, it will only pay them to carry convenient cargo that sits at ports along their international routes. That is, they will service high volume, containerised cargo. PNG shipping companies would be unable to match the rates of the international lines because the only additional costs they would face are the additional turnaround time and cargo handling costs and international rates are lower than coastal shipping rates reflecting the more favourable 'economies' of international shipping. International liners would not carry break bulk and small containers on the high volume coastal shipping routes (such as between Port Moresby, Lae and Rabaul) and they would not visit other ports in the country. The low return trades such as small volume loose cargoes and the lower volume ports will be left to the coastal shipping industry. The international shippers will 'skim the cream' off the market. This may provide benefits in the form of lower freight rates to large shippers on the major coastal shipping routes, but it could result in higher freight rates and reduced service to the rest of the country. The reasons follow.

Coastal shipping companies provide a universal service that covers as far as possible all cargoes and all coastal trades. However, many of these cargoes and trades are unprofitable in their own right—the cost of providing the specific service is greater than the payment. These shipping companies can only provide a 'universal service' by cross subsidising the unprofitable trades with the profits made on profitable trades. If international liners skim the cream the means to subsidise unprofitable trades evaporates.

Coastal shipping companies, such as Consort that provide scheduled liner shipping services would be unable to continue the existing service unless there was a substantial increase in shipping rates. Many customers would be unable to afford those rates, and will turn to cheaper, but lower quality second and third tier services. The result will be both an increase in the price of coastal shipping and a reduction in quality. This scenario has



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dire consequences for Papua New Guinea, especially for remote communities that rely on low cost, regular and safe coastal shipping services.

The benefits of removing cabotage are a small gain in the profitability of larger coastal shippers through lower freight rates for their cargoes along the main routes. Even these gains would be eroded by a possibility of reduced service reliability since PNG coastal trades would only be incidental to the business of international liners rather than the main focus.

The potential costs include:

- The loss of a coastal fleet with the capacity to serve the country in times of military, civil and natural disaster emergency;
- Reduced employment of PNG seafarers and land based employees and therefore reduced income to their many dependants;
- Reduced sales by businesses that supply the coastal shipping fleet and further rounds of unemployment and income losses through the community;
- Higher freight rates that will undermine the viability of businesses in many parts of the country;
- Less reliable services that will reduce security of supply of essential goods and services to much of the country and require considerable investment in inventories and storage facilities;
- A deterioration in coastal shipping safety and environmental performance;
- Reduced monitoring of shipping activity in PNG coastal waters by PNG flagged vessels and increased activity by foreign vessels, complicating the national security task; and
- Loss of government revenue derived from the earnings of coastal shipping companies and their employees.

Consort plans to lodge a further submission to the Commission that will cover a range of impediments to the efficiency of Consort and other coastal shipping companies. These impediments include:

- The determination of third party charges by PNGHL. On average 19 percent of the shipping charge is paid to third parties in wharfage, handling fees, equipment and port surcharges.
- The additional fuel cost that Consort incurs by being forced to purchase locally refined fuel; and
- Manning requirements on PNG flagged vessels.



## CONSORT EXPRESS LINES LIMITED

### 1. INTRODUCTION

Consort Express Lines LTD (Consort) welcomes the opportunity to assist the Independent Consumer and Competition Commission (the Commission) to undertake a comprehensive review of the Coastal Shipping industry in Papua New Guinea (PNG). This submission responds to the comprehensive range of issues identified in the Commission's issues paper of the 20 March 2006. The submission provides detailed responses to most of the information requests made in the Issues Paper and raises a number of further issues that impact upon the quality of coastal shipping services in Papua New Guinea.

Efficiency is a multi-faceted concept in the context of coastal shipping. An efficient coastal shipping service is one that meets the requirements of shippers for frequency, reliability, continuity and quality of service at freight rates that reflect the efficient cost of providing that service. It must also achieve local and international objectives in terms of safety and environmental performance. The industry also assists the PNG government to achieve safety, security, natural disaster and defence objectives.

Since Independence PNG governments, like many governments throughout the world, have regulated coastal shipping. This regulation has involved cabotage and price regulation. Cabotage involves the restriction of the coastal trade to PNG flagged vessels operated by companies registered in PNG. The original objective of cabotage was to allow the development of a PNG owned coastal shipping fleet. This approach was thought to be more consistent with the achievement of national objectives than an open market policy. Tariff regulation was introduced to protect shippers against the potential misuse of market power by coastal shipping companies. Since the mid-1970s, the coastal shipping industry has been further regulated for safety and environmental purposes.



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### 2. RECENT PROPOSALS FOR SHIPPING REFORM

The Commission states in the Issues Paper at page 4 that:

*The Commission seeks comments from stakeholders as to the validity of the conclusions of the Australian Department of Foreign Affairs and Trade report into the cabotage regime in PNG.<sup>1</sup>*

In the Issues Paper at Page 26, the Commission says that a Study Team from the Australian Department of Foreign Affairs and Trade (DFAT) recommended that the cabotage regime in PNG be modified and that as part of these recommendations, the restrictive entry regime be relaxed by issuing more coastal shipping permits. The Commission notes that the PNG Government has not responded formally to these recommendations, although this inquiry represents the first attempt to consider these issues from within PNG.

This is misleading. The Commission says that the Australian Government (through DFAT) studied the cabotage system in PNG and recommended to the PNG Government that it be abolished.

This is not the case. The study was not conducted by a Study Team from DFAT. It was conducted by independent consultants. There is a disclaimer on the cover page of the report that states:

*The recommendations set out in this report are those of the Technical Team alone and do not necessarily reflect the views of the Australian Government or any of the persons and agencies interviewed.*

The Australian Government has not made a public recommendation to the Government of PNG on cabotage or on any other matter covered in the Report—the Study Team has made the recommendation. Since no organisation's name appears on the cover of this report, its origin is not clear.<sup>2</sup>

The Study Team did not focus exclusively on the cabotage regime in PNG as is implied in the Commission's Statement. PNG is only covered in any detail in a brief chapter of a second volume. The Study Team covered Pacific Island regional transport, including ports, airports, aviation, international shipping and coastal shipping. The report is brief and descriptive. It covers a wide range of transport issues in a superficial manner.

The specific recommendation made by the Study Team to the PNG Government is on page 16 of Volume 2 of the Report, not in the main report. The Study Team recommended that:

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<sup>1</sup> Pacific Regional Transport Study, Final Report, Volume 1, June 2004.

<sup>2</sup> The report appears on the website of the Forum Secretariat. Volume 1 of the report presents general findings and recommendations. Contained in Volume 2 of the report is a brief discussion of the coastal shipping market in PNG.



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*The Government of Papua New Guinea should consider the benefits of modifying its cabotage regime, either through the relaxation of restrictions on foreign flag tonnage or through the regional exchange of cabotage rights. (Emphasis added)*

In neither volume does the Study Team provide any real analysis of the benefits and costs of cabotage in general or in the specific circumstances of PNG. The only support offered for its recommendation in Volume 2 is the unsubstantiated observation that:

*There is considerable dissatisfaction with the coastal shipping service as it currently operates.*

No mention is made of who is dissatisfied or the grounds for dissatisfaction and no opinion is offered about whether the dissatisfaction is informed and reasonable.

The Study Team considered Pacific Island shipping in Chapter 4. Most of the focus of this chapter is devoted to international shipping. The Study Team discussed coastal and inter island shipping in the Pacific generally on pages 34 and 35. It noted that most of the Forum Island Countries (FICs) reserve coastal and inter island shipping for locally registered vessels (cabotage). It also noted that prices charged are low and do not allow operators to put funds aside to replace vessels. It considered that prices should reflect the real costs of providing the service but in practice prices have been constrained by ability to pay and/or political factors.

As a consequence of low freight rates, profit margins are tight. Replacement tonnage is provided either through aid money or the purchase of old vessels that are in poor condition and are frequently unsuitable for the trade. "Typically vessels do not comply with the requirements of recent international conventions", according to the Study Team (page 35). It is common for local shipowners to economise on maintenance and the region lacks adequate repair facilities.

The Study Team (page 35) concluded that:

*"Managers of inter-island shipping services face major challenges, including the availability of finance for replacement vessels, the operation of old and poorly maintained replacement vessels, and seasonal and cyclical fluctuations in demand. The sector needs an injection of management skills."*

This generalisation applies to second and third tier coastal shippers in PNG. It does not apply to Consort and other Tier 1 operators in PNG. While the performance of Consort is described in more detail below, it should be noted that:

- Consort is profitable in spite of tariffs that have been fixed since 1991 and has delivered real decreases in shipping rates over this period through productivity gains;
- In the past year, Consort has invested around K80 million in new vessels;
- Consort vessels and their crew are fully compliant with international conventions and their standards;



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- Consort invests heavily in training its PNG crews to international standards at the Maritime College at Madang;
- Consort has been able to manage uneven coastal demand as evidenced by its ability to supply regular, frequent and continuous liner shipping services to a large number of ports in PNG;
- Consort commenced a weekly international liner service to North Queensland in 1994 and continues to operate this service. This service competes in a competitive trade and is the only international service offered utilising PNG flagged vessels; and
- Consort, as do all other coastal operators, operate without any government subsidy.

Cabotage receives little discussion and no analysis in the DFAT Report. In the body of the report it is first mentioned, briefly on page 34, where it is asserted that:

*Cabotage ... rules limit competition in such trades. Typically, coastal and inter-island trades are operated by a mix of publicly and privately owned vessels. Many vessels employed are old and poorly maintained. Individual trades may be subject to licensing arrangements.*

The conclusion to emerge from our analysis of cabotage arrangements is that they do not preclude entry and are therefore not an impediment to competition. The nature of the markets limits the number of operators that can efficiently offer liner shipping services. However, as entry costs are low, the market is contestable. PNG does not have individual routes that are subject to licensing arrangements.

Cabotage in relation to shipping, as opposed to aviation, is next discussed on the third last page of the report (pages 83 and 84).

The Study Team, relying heavily on a 1997 ESCAP report, considered that the objectives of cabotage are not being achieved.<sup>3</sup> These objectives include the reservation of coastal trade for locally flagged vessels, the prevention of over tonnage and ensuring adequate services are provided. No reasons for this failure are discussed.

The authors express the opinion that (page 36):

*In so far as the interests of locally owned and registered ships are protected at the expense of foreign owned and registered vessels, cabotage is clearly discriminatory. In a world in which barriers to trade are being reduced and countries are moving towards regional trading arrangements cabotage appears increasingly anachronistic. The study team note that cabotage is a form of protectionism that is likely to lead to higher freight rates and, hence, lower levels of coastal trade than would be the case in a more competitive environment.*

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<sup>3</sup> United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) 1997, Study on Shipping and Port Capacities in the Island Developing Countries, New York, p.6.



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The cabotage laws in PNG do not prevent the entry of foreign companies. The requirements that the company is registered in PNG and that the vessels be PNG flagged are designed to meet the objectives noted by the Study Team. The requirements are also designed to achieve other economic and social objectives of the PNG Government.

Policies towards regulation of coastal shipping need to be based on a consideration of the facts and the community interest. The circumstances of coastal shipping markets in countries like PNG differ to those of most markets for goods and services where 'free trade' more often than not proves to best serve the community interest.

Whether or not open access results in lower tariffs is subject to debate. Coastal shipping is subject to economies of scale that limit the number of ship owners and operators that can viably operate even high volume routes. At the same time, the markets are contestable and this acts to limit the ability of licensed ship owners to charge monopoly prices.

In recommending that cabotage be removed, the authors of the DFAT report ignore the risks that international shipping companies will focus solely on the major routes. International companies, particularly those registered under flags of convenience, have a major competitive advantage over local operators and would be able, at least for a time, to offer significantly lower rates than Consort or other liner shipping companies could afford to offer on the main routes. However, international ships are highly unlikely to service the 'thin' trades to and from less developed parts of PNG. They are also unlikely to find it economical to service the difficult break bulk, small volume trades on the major routes. In PNG, Consort is able to subsidise these less profitable trades from revenues earned on the major routes. If the liner shipping companies are to compete on their main routes, the existing quality of service to the thin trades could not be maintained without a substantial increase in freight rates. The result is likely to be a substantial rise in freight rates with serious consequences for economic development in most areas of PNG. If the liner shipping companies are forced out of business, there is a danger that these routes will be left to second and third tier operators operating unsafe and inadequate services (the very same situation upon which the authors lament on page 34 of their report).

The scenario we have described would involve a major setback for the PNG community in terms of its economic, environmental and safety objectives. There is also the risk of compromising national security and sovereignty objectives.

The Study Team (page 36) noted that:

*... the abolition or modification of cabotage may have a negative impact on some players. For example, opening up of coastal trades to foreign competition would have a negative impact on seafaring employment in an economy whose entrepreneurs fail to take advantage of the opportunities created by the opening of shipping markets. In such cases, government may experience a loss of tax revenues.*



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The unilateral relaxation of cabotage would create no opportunities for PNG coastal shipping companies. Such opportunities may arise in a regional shipping “common market” such as exists in the EU; but such a multi-lateral framework is a very long way off in the Pacific. Employment of PNG seafarers will be directly affected by the loss of coastal trade market share for local companies. It is unlikely that the small increase in cargo carried by international ships will stimulate any increase in the demand for PNG seafarers.

The reduced revenues of the coastal shipping companies will constitute an important revenue loss. The taxes that the PNG Government can levy on international shipping companies are likely to be much less than that it receives from Consort and other coastal shipping companies. Moreover, we argue in this report that the extent of the losses and the range of ‘players’ affected could be much larger than acknowledged by the Study team.



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### 3. THE PERFORMANCE OF CONSORT

#### 3.1. CONSORT SERVICES

Consort offers scheduled liner services to 12 ports in PNG. Its scheduling objective is to maintain fixed day services whether they are twice weekly, weekly or fortnightly. Lae is the hub port.

Consort is 33 percent owned by Steamships, 33 percent owned by Kambang Holdings Limited, the Business arm of the Evangelical Lutheran Church of Papua New Guinea, and 33 percent owned by Anton Lee Transport Limited. Consort operates seven vessels at this time, of which four are chartered from shareholders and the remaining three are owned by Consort. The vessels range in age from 9 to 22 years. Details of the Consort fleet are contained in Table 1. All Vessels are GMDSS, ISM and ISPS Compliant and are able to trade internationally. All Crew hold STCW 95 Certification, which is the internationally accredited certification.

Consort has three main sectors—North Coast, Islands and South Coast. Within the main sectors are sub sectors that are provided with fortnightly services. The schedules are designed to support the manufacturing centres (Lae, Port Moresby, Alotau, Madang, Wewak, Rabaul and Kimbe) and to provide direct port calls from these centres to as many ports as practical. The schedules are also designed to provide a feeder service for agricultural exports and imports to and from the hub port of Lae.

The North Coast Sector involves a weekly service from Lae to Madang – Wewak – Madang returning to Lae. The Papuan Coast operates on this sector. The sub-sector involves a fortnightly service from Lae to Madang – Vanimo returning directly to Lae. The Sepik Coast, the Madang Coast and the Morobe Coast are rotated to provide this service.

The Islands Sector involves a weekly service from Lae to Rabaul – Kimbe back to Lae. The Gazelle Coast and the Nuigini Coast operate on rotation to provide this service. The Kavieng sub-sector has a fortnightly service provided from Lae to Kavieng via Rabaul. This service is an extension on the Nuigini Coast cycle through the Islands. On the week of the Nuigini Coast schedule to the islands there is an extension to include Kavieng (ex Lae – Rabaul – Kavieng – Kimbe and back to Lae). The Bougainville sub-sector involves a fortnightly service ex Lae to Rabaul – Buka – Kieta – Rabaul returning to Lae.

The South Coast sector involves a twice weekly service from Lae to Port Moresby (which incorporates the Alotau sub-sector). The South Coast has a mid week service and an end week service.

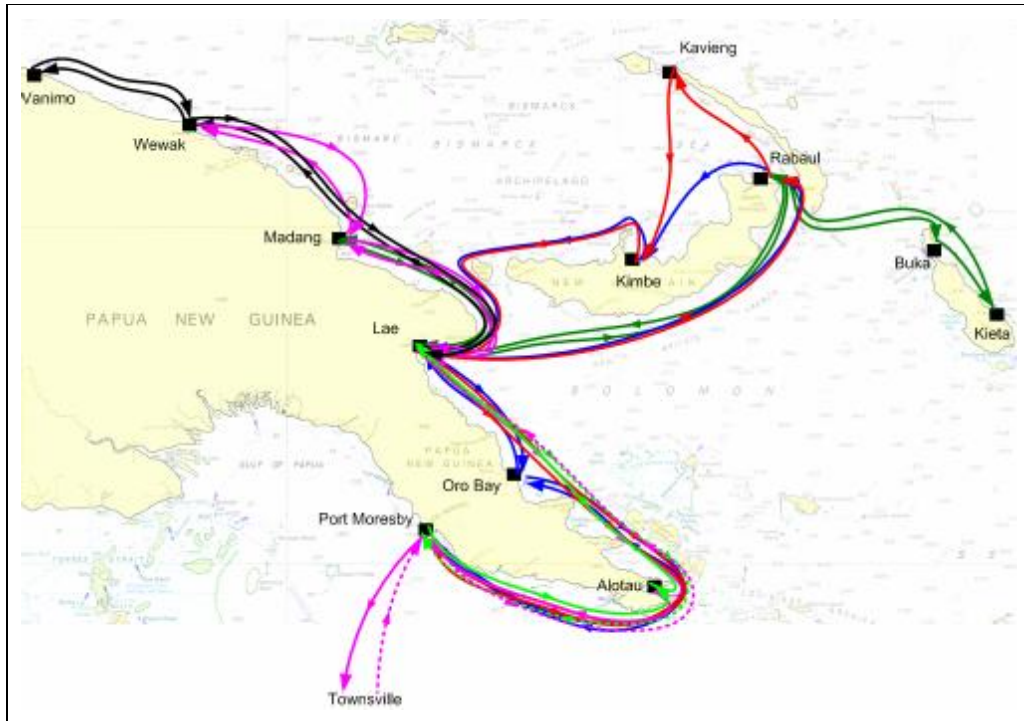
- Week 1: from Lae Tuesday direct service to Port Moresby. The operating vessel then continues on to Townsville before returning via Port Moresby – Alotau – Lae. The Sepik, the Madang Coast and the Morobe Coast are rotated on this service.
- Week 2, from Lae Tuesday to Alotau – Port Moresby – Townsville returning to Lae via Port Moresby. The Bougainville Coast operates this service.



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- The End Week service is a weekly service from Lae direct to Port Moresby and back. The operating vessels are the Gazelle Coast and the Niugini Coast.
- An Oro Bay sub- sector service involves a fortnightly service ex Lae to Oro Bay returning to Lae. The Sepik Coast, the Madang Coast and the Morobe Coast are used on rotation to provide this service.
- International Service which provides direct links between the ports of Lae, Alotau and Port Moresby with Townsville. This is a weekly service operated by the “Bougainville Coast” and the “Madang, Sepik and Morobe Coast” on rotation.
- The Schedule configuration also provides Port Moresby with direct port calls services to Alotau, Oro Bay, Lae, Kimbe, Rabaul and Kavieng. Other ports ex Port Moresby are serviced via Lae.

**Map 1: Consort Express Liners routes**





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Table 1: Consort Fleet: January to September 2006

Vessel	Built	Class	No. of Decks	Ownership	Container Capacity TEU		Derrick/ Cranes		Capacity		Service	Fuel	Fuel Cons
					M/T	14Tn	Type	Number	Tonnes	Combined	Speed	Type	MT/Day
Niugini Coast	1996	GL	1	Consort	373	220	Crane	2	36	N/A	13.5	IFO 180	16
Gazelle Coast	1984	BV	2	Consort	354	228	Crane	2	30	120	11	IFO 180	10
Bougainville Coast	1984	GL	2	Consort	256	168	Crane	2	30	50	10.5	IFO 120	7
Papuan Coast	1997	ABS	2	STC	152	110	Derrick	2	25	N/A	10	MGO/ADO	6
Morobe Coast	1988	ABS	2	STC/ATL/KHL	88	72	Derrick	2	25	N/A	9	MGO/ADO	4.5
Sepik Coast	1986	ABS	2	ATL	88	72	Derrick	2	25	N/A	9	MGO/ADO	4.5
Madang Coast	1986	ABS	2	KHL	88	72	Derrick	2	25	N/A	9	MGO/ADO	4.5



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Consort's revenues are dominated by the trade between the ports of Lae and Port Moresby. Lae accounts for 64 percent of Consort's outward freight and 27 percent of Consort's inward freight. The next most important port is Port Moresby, accounting for 15 percent of outward freight and 24 percent of inward freight. The remaining ports in PNG that are serviced by Consort collectively accounted for 21 percent of Consort's outward freight and 49 percent of Consort's inward freight movement. There is therefore a marked imbalance of trade with inward cargo movement to most ports well exceeding the volume of returning or outward cargo.

### 3.2. COMPETITION IN COASTAL SHIPPING

Consort and other liner shippers compete for the business of commercial companies that operate ships. Some of these companies operate chartered vessels to carry their own cargoes and also the cargo of other shippers. North Fly Rubber, Agmark Pacific and Rimbunan Hijau (PNG) fall into this category. While these companies largely service their own commercial operations, they supply a service that could have been provided by Consort and other liner shipping companies. These vessels are also engaged in the shipping of cargo on behalf of third parties in regions in which they operate.

In liner shipping Consort's market share on the main sectors that it services is high. It faces limited competition from other liner shipping operators for its services. At the moment there is no direct competition on the North Coast. Traditionally the North Coast was serviced by Lutheran Shipping (Luship). However uncertain economic conditions in 2000 and 2001, low margins, increasing operating costs and the need to invest significant capital into larger vessels prompted Kambang Holdings Limited as a shareholder in Consort to negotiate the time charter of the larger vessels in the Luship Fleet to Consort for a three year period (vessels "Wewak" and "Kuder") after which Consort would "own the trade". This allowed Kambang Holdings to maintain their level of involvement in the Coastal Trade and at the same time grow their investment in Consort without having to directly inject any capital. Consort was able to better utilise their smaller vessels in a mix and match configuration to uplift the cargo on offer over this period. The "Kuder" went off hire in September last and the "Wewak" in December—Consort introduced new tonnage (Niugini Coast) in early December and the sister vessel to the (Niugini Coast) will arrive in PNG at the end of June 2006. This allowed Luship to concentrate on their passenger services and their passenger / cargo services to the smaller ports on the North Coast, Siassi islands and West New Britain.

On the South Coast service, there is no direct competition for the ports of Oro Bay and Alotau. Bismarck Maritime operates a weekly scheduled service between Lae and Port Moresby utilising two 600 DWT landing craft. This service occasionally makes calls at Oro Bay and Alotau to collect equipment.

Curtain Bros operated the "Coral Trader" out of Townsville, Port Moresby, Lae, Rabaul, Kieta and Buka during the period 2001 to 2003, in competition with Consort. However this vessel suffered major main engine problems mid 2003. It was deemed uneconomical to repair, the vessel was sold for scrap and the service was discontinued.



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For scheduled break bulk and palletised services there are a few competing operators providing services from Rabaul to Kavieng – Kieta and Buka – Kieta using wet deck and dry cargo hold landing craft ranging in size from 200 DWT to 300 DWT. Tug and dumb barge operators drift into and out of the trade to service project cargoes.

Consort competes with vessels in the 200DWT to 400DWT range operated by Coastal Shipping, Rabaul Shipping, Bismark Maritime, AgMark, Rimbunan Hijau (RH) and the Manus and New Ireland Provincial Governments. These boats provide passenger and cargo services, mainly focussing on smaller ports. While the competition that Consort faces from these small boat operators may be limited at present, the presence of this fleet of boats acts as a constraint on Consort's market conduct. In setting its freight charges, Consort would need to take into account the potential for increased competition from these operators for some segments of its trade.

### 3.3. FREIGHT CHARGES

An indication of the efficiency of the PNG coastal shipping industry is provided by movements in coastal shipping charges over time and a comparison of shipping charges with similar trades in other countries. In this section, we first explain how shipping charges are determined. We then examine the movement over time of real charges paid by shippers and revenues received by the coastal shipping industry. Coastal shipping rates in PNG are then compared to coastal shipping rates in a number of other countries in Asia.

#### 3.3.1. Freight charge determination

Maximum freight tariffs for coastal shipping have been set by the Department of Transport since the mid 1980s in accordance with Section 238 of the Merchant Shipping Act (Chapter 242). The last time that the tariff was reviewed was in 1990 and the recommended maximum tariff came into force on 1 January 1991. Since that time Consort has set its freight rates in accordance with this schedule of maximum freight tariffs.

The maximum tariff has a number of cargo classifications and distance zones. There is some cross subsidisation of trades. For example the basic village food tariff is about eighteen to 27 percent lower than the general cargo tariff, dependent on the Distance Code. While rates increase with shipping distance, this would not appear to closely reflect the increase in shipping cost with distance shipped.

The charges to shippers consist of a number of charges by coastal shipping companies and by third parties. These include:

- Freight which is set at or below the maximum tariff;
- A currency adjustment factor which is currently set at 110 percent of the freight rate;
- Wharfage and handling at both the outward and destination ports;
- A bunker adjustment factor;



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- Equipment charges; and
- Port surcharges.

In Table 2, an average of rates quoted to representative customers of Consort to various ports is presented, broken down into its components.

**Table 2: Average of representative shipping charges (1 April 2006 in Kina)**

	Port Moresby	Alotau	Oro Bay	Madang	Wewak	Vanimo
Distance (nm)	594	341	189	220	377	527
Revenue tons (TEU)	20	21	21	26	26	26
Sea freight	655	644	644	626	904	918
CAF on freight	720	708	708	689	994	1010
W&H Lae	182	189	189	233	233	233
W&H destination	226	196	196	241	241	241
BAF	539	560	560	689	689	689
Port surcharge	0	135	135	0	125	0
Total all charges (Kina)	2322	2433	2433	2478	3187	3091
<u>Distribution of the charge</u>						
Third party charges	18%	21%	21%	19%	19%	15%
Offset/recovery charges (BAF)	23%	23%	23%	28%	22%	22%
Vessel income	59%	56%	56%	53%	60%	62%

On average 19 percent of the shipping charge is paid to third parties in wharfage, handling fees, equipment and port surcharges. This percentage varies substantially across ports. Vessel income (freight plus CAF) averages 58 percent of the charge, again varying across port destinations.

With the floating of the Kina in 1994, the coastal shipping industry with the approval of the Department of Transport introduced a currency adjustment factor (CAF) designed to reduce exchange rate related losses in the industry. The CAF was last varied in 2002 when the CAF was raised from 85 percent (agreed with the Department of Transport in July 1999) to 110 percent of the freight rate. The industry therefore absorbed the impact of the downward trend in the exchange rate for three years. Exchange rate variations impose costs that are outside of the control of the coastal shipping operators. In industries where prices are not controlled, the impact of exchange rate variations can be passed on or at least shared with customers.



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In 2002, the Coastal Shipowners Association had sought to have the CAF incorporated into the maximum freight rate. This would mean that freight rates could be continuously adjusted, up or down, in response to variations in the exchange rate. Such an approach would provide a more efficient pricing mechanism for coastal shipping services. .

The bunker adjustment factor is a surcharge of freight charges designed to recover the costs of increases in fuel costs. The approved BAF formula is as follows:

BAF = (Change in fuel price X 1000 X Average consumption per revenue ton)

Specific gravity of diesel fuel X 100

At the time the BAF was introduced on 1 January 1985, the Lae Mainport Price of diesel fuel was K0.31 toea per litre. On 8 March 2006, the Lae Mainport Price of diesel had risen to K2.05 per litre.

Since the commissioning of the Napa Napa Refinery late in 2004, importation of any type of fuel produced by the refinery has been restricted. Under a formula agreed with the ICCC, the Refinery reviews fuel prices on a monthly basis and posts these prices on the 8<sup>th</sup> day of each month. The commissioning of the Refinery has substantially increased the price of fuel to the coastal shipping industry. When the Refinery was first proposed, there was an understanding that the Government would reduce the excise on coastal ships bunkers. Coastal ships which generally run on diesel fuel pay six toea per litre while the excise on heavy fuel oil is two toea per litre.

### 3.3.2. Cross subsidisation of freight rates

There is some cross subsidisation of trades. The Distance Code One rates, on measurement, are as follows.

- Basic Village Food                      K26 per revenue ton.
- Agricultural Products                      K28 per revenue ton.
- General Cargo                              K36 per revenue ton.

The cost to Consort of shipping these three cargo classifications is the same. Yet basic village food rates are at a discount of 27 percent on general cargo rates. Representatives of the manufacturing industry have for some time objected to this cross subsidisation. They have argued shippers of general cargo should not be forced to bear the cost of this subsidy through higher freight rates for general cargo. This subsidy should be paid for by the Government rather than general shippers.

Rates for the shipment of basic village foods have been a contentious issue for some time. In some instances, wholesalers were placing a few basic village food items in a 20ft container and then claiming the subsidised basic village food rate for the entire container. This matter came to a compromise wherein Consort established a "Cocktail" rate for wholesalers which ranges from between 87 percent and 93 percent of the general cargo rate.



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### 3.3.3. The Custom of the Trade

The custom of the trade is for all across-wharf charges at both the load and discharge port to be included on the one invoice along with the freight charges and paid, in most cases by the shipper. Payment is worked out on the basis that all freight and across-wharf charges are prepaid, on account of either the shipper or the consignee at time of shipment. Consort then pays out all third party charges to the respective parties involved.

This is an important point when we come to make a comparison between the cost of international and coastal shipping rates. International rates are generally liner terms, with the across-wharf charges at the load port paid for by the shipper and the across-wharf charges at port of destination paid for by the consignee. On the PNG Coast all these charges are lumped together on the one invoice.

### 3.3.4. Movements in freight charges over time

An analysis of changes in the maximum freight charge over the past decade is presented in Table 3 and summarised in Figure 1. Note that the figures do not include the BAF. The BAF represents an adjustment for freight charges due to rises in fuel prices which are beyond the control of the coasting shipping companies.

Current vessel charges by Consort are not only below the maximum tariff, but for many routes the vessel charges are substantially below the maximum tariffs. Over the past decade or so shipping charges in PNG have fallen substantially in real terms. Consort has therefore made a significant contribution to enhancing the growth of coastal trade and PNG's economic development.

In 1994, the freight charge was K40 per ton. By April 2006, the freight charge plus CAF had risen to K84 per ton. However, after adjusting this charge for inflation, the real freight charge to shippers was K21 per ton, almost 40 percent below its level in 1994. If the current BAF of K26.93 per ton were added to the freight charge, the current charge to shippers is still 20 percent lower today than in 1994 in real inflation-adjusted terms.

The return to coastal ship owners has fallen substantially since 1994. In US dollar terms, the freight rate, using distance code 2, general cargo rates as an example, fell from \$US42 per ton in 1994 to \$US26 per ton in April 2006, a fall of 38 percent. Even if we include the BAF, the revenue to coastal shipping companies per ton has fallen by 22 percent. The revenue in Australian dollar terms has fallen by a similar percentage.

Consort has been able to continue to provide regular and frequent services to a wide range of ports in Papua New Guinea in spite of this pronounced fall in revenues over the past decade. This indicates that Consort has achieved substantial efficiency gains through the introduction of improved vessels and equipment, improved worker productivity and management enhancements.



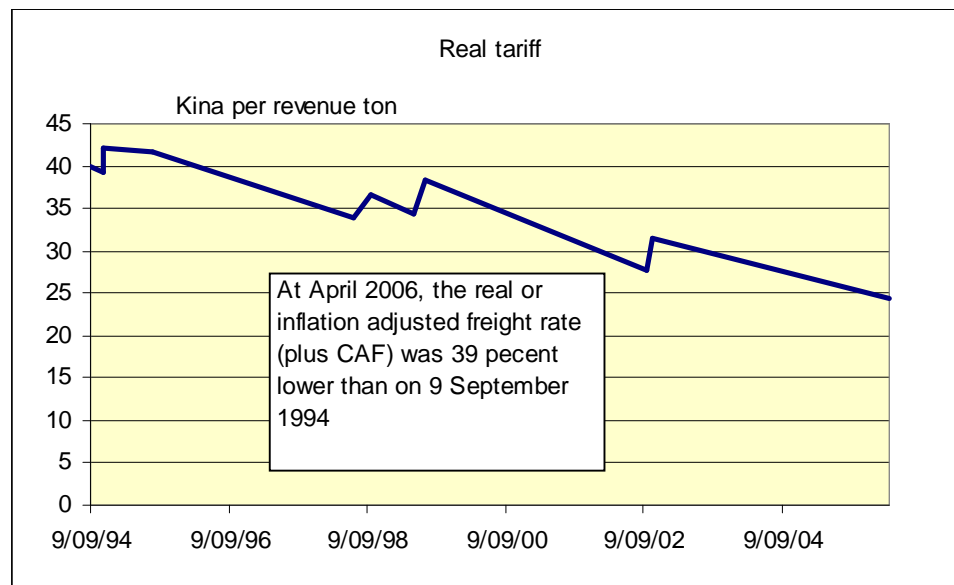
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**Table 3: Changes in freight charges 1994 to 2006**

	<u>Exchange rate</u>	<u>CAF rate</u>		<u>Tariff(a)</u>	<u>PNG CPI</u>	<u>Real tariff</u>
	US\$		Kina/ ton	US\$/ton	Index	Kina/ton
09 Sep 94	1.0494	0.0%	40.00	41.98	256	40.00
14 Nov 94	0.8435	0.0%	40.00	33.74	261.7	39.13
21 Nov 94	0.8435	15.5%	46.20	38.97	280.7	42.13
31 Jul 95	0.7390	21.5%	48.60	35.92	298.5	41.68
04 Jul 98	0.4725	30.0%	52.00	24.57	392.6	33.91
01 Oct 98	0.4368	50.0%	60.00	26.21	418.7	36.68
14 May 99	0.3820	50.0%	60.00	22.92	447.8	34.30
13 Jul 99	0.2900	85.0%	74.00	21.46	495.1	38.26
24 Sep 02	0.2390	85.0%	74.00	17.69	686.1	27.61
01 Nov 02	0.2390	110.0%	84.00	20.08	681.1	31.57
01 Apr 06	0.3100	110.0%	84.00	26.04	880	24.44
Percentage change	-70%		110%	-38%	244%	-39%

(a) General cargo distance code 2

**Figure 1: Changes in freight charges 1994 to 2006**





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### 3.3.5. International comparison of coastal freight rates

It is common for domestic shippers to compare the rates that they pay with the rates that are offered on the international services with which they are familiar. But while it is quite natural for shippers to do this, it usually provides a very flawed basis for comparison. There are a number of reasons for this, amongst the most important of which are:

- Typically coastal services operate on a smaller scale than international services; because economies of scale are important in shipping, this almost invariably leads to unit costs being higher for domestic services.
- Coastal operators must purchase their fuel in-country, whereas international operators often have the opportunity to purchase some or all of their fuel in internationally competitive bunkering centres such as Singapore. This means not only that they are able to purchase fuel at a lower base price, but also that they are able to avoid local taxes that frequently apply to domestic fuel sales (in PNG, coastal shipping companies pay 6 toea per litre for diesel fuel).
- Cargo handling facilities for domestic operations are usually significantly inferior to those that are available to international operators. This increases ship turnaround times and hence lowers capital productivity. Additionally, the absence of efficient handling equipment and shortages of skilled labour in some ports may make it necessary for ships to be equipped with on-board cranes, to carry auxiliary handling equipment or to carry additional labour to assist with stevedoring tasks. All vessels that call at PNG ports are self sustained; that is, they all have derricks or cranes. With the exception of Port Moresby, the public wharf facilities in all other ports do not have shore based cranes.

The precise magnitude of these effects will depend on the specific vessels engaged in the two operations, and the routes that they follow. However, we estimate that the cost of operating a typical 800TEU geared ship on a route between Southeast Asia and PNG is approximately US\$0.10 per nautical mile per TEU of capacity provided, For a 300TEU vessel of the same age and quality operating on domestic route between Lae and Port Moresby the cost per TEU-mile would be approximately 35 percent to 40 percent higher.<sup>4</sup>

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<sup>4</sup> These relativities were based on a comparison of a Southeast Asia route service calling into Singapore, Malaysia and Thailand to Port Moresby with a simple coastal shuttle between Lae and Port Moresby. Comparing a relatively complex international route with a simple coastal route will tend to produce lower bound estimates for the cost differences. Daily ship costs are long term equilibrium time charter rates, based on Meyrick and Associates in-house data. To enable a like-for-like comparison, and isolate the structural effect of scale and route details, it was assumed that both vessels operated with the same crew levels and terms and conditions of employment. Daily costs for an 800TEU vessel were estimated at US\$12,000 per day, and for a 300TEU vessel at US\$7,200 per day. Fuel consumption for the 800TEU vessel was assumed to be 33 tonnes per day at sea and for the 300TEU vessel assumed to be 15 tonnes per day at sea.



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There are other less readily quantified reasons why coastal shipping costs are higher:

- Coastal vessels often fulfil a complex range of economic and social needs. One consequence of this is that in many archipelagic countries coastal vessels are designed for combined passenger/cargo operations. While this may well be the most economical way to serve the full range of community requirements, such vessels do not usually provide the most efficient configuration for freight operations.
- In PNG, coastal vessels carry a high proportion of break-bulk and difficult to handle cargo whereas the international liners tend to carry containerised cargo.

Differences in the transport task, size and type of vessels used, sailing distances, taxation arrangements and wage levels also make it difficult to make meaningful cross-country comparisons of domestic freight rates. However, if we confine our attention to small-scale domestic services in the Asia-Pacific region, it is likely that comparisons of domestic freight rates in PNG with domestic rates elsewhere, while still manifestly imperfect, will provide a better indication of what is reasonable than comparing domestic with international rates. Information on such rates is sparse and not readily accessible. However, we have been able to compile Table 4 from data acquired in previous studies.



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**Table 4: Sample Of Domestic Freight Rates: Various Asian and Pacific Island Countries**

Country	Route	Approximate round trip length (n.m.)	Typical vessel freight capacity	Typical Rates	Comment
<u>Small non-containerised general cargo services</u>					
Fiji	Viti Levu – Lau Group	500–700	50–100 tonnes	USD40/tonne	Rate schedules taken from ceiling rates set by Prices and Incomes Board at the time of a 1996 study. However, during a further study undertaken in 2003 Fiji government officials confirmed that these rates were still reasonably representative of actual paid rates on these routes/
Fiji	Viti Levu – Rotuma	820	50–100 tonne	USD50/tonne	
Fiji	Viti Levu – Kadavu	200	250 tonne	USD34/tonne	
Marshall Islands	Majuro-Enewatak	1200	250 tonne	USD180/tonne (Copra US57/tonne)	Rates obtained from survey of operators undertaken in 1999
Marshall Islands	Majuro-Jaluit	260	250 tonne	USD120/tonne (Copra USD57/tonne)	
Northern Australia	Darwin – small coastal communities	750–900	150 tonne	USD145–220/tonne	Estimates rates reviewed by operators, 2003
Tonga	Nuku'alofa-Vava'u	350–400	300 tonne	USD60/tonne (USD900/TEU)	Data provided by operator, 2006
<u>Small container services</u>					
Indonesia	Jakarta – Manado	2400	No known, but almost certainly well below 100 TEU	USD600/TEU	Data provided by shipowners during fieldwork on ASEAN Promoting Efficient and Competitive Intra-ASEAN Shipping Services project
Indonesia	Jakarta - Irian	3200		USD1200/TEU	



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Country	Route	Approximate round trip length (n.m.)	Typical vessel freight capacity	Typical Rates	Comment
Philippines	Manila – Cebu	800	150 TEU	USD318/TEU	Data presented in Drewry Shipping Consultants, Intra-Asia Container Trades: Dynamism Beyond Bounds.
Philippines	Manila – Cagayan de Oro	1000	40 TEU	USD390/TEU	
Philippines	Manila – Zamboanga	1000	100 TEU	USD395/TEU	
Philippines	Manila – General Santos	1450	100 TEU	USD531/TEU	
Philippines	Manila - Davao	1650	150 TEU	USD600/TEU	

Source: PDP Australia, Meyrick and Associates, 2005, Promoting Efficient and Competitive Intra-ASEAN Shipping Services, Report of REPSF Project No. 04/001, ASEAN-Australia Development Cooperation Program, Jakarta.



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The first set of rates is for non-containerised cargo in a number of Pacific countries. The second set of rates is for small containerised cargo. Drawing on the information in Table 7, a comparison with PNG rates is presented in Table 5. Freight rates are presented in terms of \$US per tonne and in terms of \$US per nautical mile (NM).

**Table 5: Comparison of PNG and Pacific coastal rates**

Country	Route	Freight charge		
		Distance NM	\$US/tonne	\$US/nm
<u>Small non-containerised general cargo services</u>				
Papua New Guinea	Lae Port Moresby	594	21	0.04
Papua New Guinea	Lae-Kimbe	293	19	0.06
Papua New Guinea	Lae Oro Bay	189	20	0.11
Papua New Guinea	Port Moresby-Kimbe	805	24	0.03
Papua New Guinea	Port Moresby- Kavieng	856	24	0.03
Fiji	Viti Levu – Lau Group	300	40	0.13
Fiji	Viti Levu – Rotuma	410	50	0.12
Fiji	Viti Levu – Kadavu	100	34	0.34
Marshall Islands	Majuro-Enewatak	600	180	0.30
Marshall Islands	Majuro-Jaluit	130	120	0.92
Northern Australia	Darwin – small coastal communities	413	183	0.44
Tonga	Nuku'alofa-Vava'u	175	60	0.34
<u>Small container services</u>				
Tonga	Nuku'alofa-Vava'u	175	45	0.26
Indonesia	Jakarta – Manado	1200	30	0.03
Indonesia	Jakarta - Irian	1600	60	0.04
Philippines	Manila – Cebu	400	15.9	0.04
Philippines	Manila – Cagayan de Oro	500	19.5	0.04
Philippines	Manila – Zamboanga	500	19.75	0.04
Philippines	Manila – General Santos	725	26.55	0.04
Philippines	Manila - Davao	825	30	0.04



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PNG rates compare favourably with these other countries. Rates charged for non-containerised general cargo are much lower in PNG than in these countries. However, non-containerised cargo in PNG benefits from being treated in the same way as containerised general cargo under the PNG maximum tariff. A better comparison is with containerised cargo rates. Comparing the longer PNG routes with routes in the Philippines and Indonesia indicates that Consort's rates per nautical mile are comparable if not slightly lower than rates in the Philippines or Indonesia. This is in spite of the higher compliance requirements in PNG compared to these countries.

### 3.4. PROFITABILITY

High levels of concentration in an industry can lead to higher prices than what would occur in a competitive market. Over the longer term, prices need to be high enough to allow a service provider to recover operating costs and to obtain a market rate of return to capital employed in the industry. This rate of return will vary across different industries reflecting different levels of risk. In comparing profitability of firms within and across industries, it is normal to focus on earnings before interest and company income tax (EBIT).

Consort's shareholders derive returns from their investments in two ways; through dividend income and through payments for the charter of their ships and containers to Consort. Consort currently charters four ships from shareholders: the Morobe Coast, the Madang Coast, the Papua Coast and the Sepik Coast. These vessels could be deployed in any part of the Asia Pacific Region. The market value of the vessels and their charter rates are determined on international shipping markets. In assessing the profitability of Consort, it is important to take full account of the opportunity cost of these vessels being employed in PNG coastal shipping as opposed to being employed elsewhere.

The bareboat charter rates that Consort pays have been fixed for a number of years and have not moved in line with the international market in which charter rates have risen strongly over the past few years.

All 20ft containers utilised by Consort are leased from international container leasing companies and from Consort shareholders. In the case of shareholder leased containers, the lease rates are set at rates below the rates available to Consort from the international container leasing companies.

To take into account charter payments to shareholders, the following procedure was adopted:

- Charter payments were removed from expenses;
- The current market value of the chartered vessels was added to assets;
- Depreciation on the chartered vessels is 4 percent a year, based on an economic life of 25 years for each vessel.



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The results, presented in a confidential submission to the ICCC, indicate that EBIT as a percentage of assets employed in 2005 was comparable to other industries in the PNG economy. The rate of return is not excessive, especially taking into account fluctuations in earnings across years due to the volatility of the PNG economy and the coastal trade. PNG is a relatively high risk country in which to operate and coastal shipping is a relatively high risk business.



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### 4. CABOTAGE

#### 4.1. OVERVIEW OF THE LEGISLATION

The provisions relating to cabotage are contained in Part IX – Coasting Trade of the *Merchant Shipping Act*. The following provides a brief description of these provisions, while the following section discusses the implications of these provisions for competition and economic efficiency.

Section 221 exempts ships that are of traditional build, of less than 10 metres in length and pleasure craft from the application of Part IX.

Section 222 states that the Minister may, subject to such conditions (if any) as he thinks fit, grant to a person a licence to engage a ship in the coastal trade. Two classes of licenses may be granted under Section 222, a general or a special category licence. A general category licence enables its holder to engage the ship in respect of which the licence is granted in the coasting trade. A special licence allows the holder to engage the ship in the shipping service specified in the licence.

To legally engage in the coasting trade, the ship must have an appropriate coasting licence (Section 224). The Minister may provide an exemption from the requirement to hold a coasting licence in relation to the provision of a particular shipping service or for a specified period to a particular ship or class of ship or for a specified period to trade between particular ports.

Section 226 provides for limitation on the grant of licences. A coasting trade licence in respect of a ship that is registered under the Act may only be granted to the owner of a ship or a qualified person (s) that are charterers of the ship for a period not exceeding eight years.<sup>5</sup> Subject to Subsection 4, a licence in respect of a ship not registered under the Act may only be granted to qualified persons that own or charter the ship (for a period not exceeding five years). If the Minister is satisfied that a locally registered ship is unable to offer an efficient and adequate service, he may grant a licence to a ship that is not registered under the Act (for a period not exceeding two years).

Section 227 concerns the duration of licences. In determining the duration of a coasting trade licence, the Minister has regard to the age, size and condition of a ship, whether the applicant is the owner of the ship, and the suitability of the ship for the service. Special category licences are granted for periods not exceeding one year.

Section 228 means that where a licence has been issued to a qualified person and that person ceases to be qualified, the licence must be surrendered.

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<sup>5</sup> A qualified person means a person referred to in Section 14(2) (a) of the Act or a corporation referred to in Section 14(2) (b) of the Act.



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Under Section 229, where the Minister feels that is in the public interest, the Minister may cancel a licence or vary any licence condition. If the ship ceases to be registered under the Act, the Minister can alter the duration of the licence.

Section 231 requires the holder of a licence to provide information on voyages, cargo, passengers and services performed (past and planned). This includes descriptions of the operations and financial matters connected with the services. Where information has not been provided, the Minister may obtain information through going on board, checking cargo and passengers and examine accounts, shipping documents, manifests and other documents.

Division 3 of the Act concerns coasting trade permits. Where an appropriately licenced ship is considered to be unavailable or a service is inadequate, inefficient or unreasonably costly, and it is in the public interests to do so, the Minister may issue a coasting trade permit to the master of a ship. The permit issued is in respect of a particular ship and of the provision of specified shipping services.

A coasting Trade Committee is provided for under Section 235. The Committee consists of an officer of the Maritime Division, Department of Transport and Civil Aviation (chair) and two members to represent the interests of shippers and producers, a consumer representative and three members representing the interest of coasting licence holders. The Coasting Committee may advise the Minister on any matter relating to the trade and report to the Minister on any proposed regulation relating to the coasting trade. Within 60 days of a request from the Minister, the Committee is to recommend the maximum rate that should be charged for a particular shipping service.

Maximum coastal freight tariffs were originally the responsibility of the Minister for Transportation. Division 5 relates to the maximum rate for shipping services. Where the recommended rates are not as low a level as is commercially viable or the rates are too high or consistently exceed the recommended rates, and it is in the public interest, the Minister may make an investigation of the recommended rates of the rates being charged. Section 240 allows the Minister to fix an appropriate rate for a particular shipping service, having regard to advice from the Coasting Trade Committee under section 237.

Price determination is no longer the responsibility of the Minister for Transport. In December 2001, changes to the price control arrangements were announced in the National Gazette.<sup>6</sup> In the determination, the Prime Minister declared coastal shipping rates to be Declared Goods and Services for the purposes of the *Prices Regulation Act*.

Under Section 233, the Minister, after obtaining a report from the Coasting Trade Committee, may make regulations with respect to:

- applications for coasting trading licences and permits, and the form of the licence or permit:

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<sup>6</sup> *Price Regulation Act* (Chapter 320), Price Determination on Declared Goods and Services, Papua New Guinea National Gazette, Port Moresby, 3 December 2001.



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- the publication of recommended rates for shipping services;
- the submission and verification of information;
- the determination by the Minister of areas classed as places; and
- licence and permit fees.

The Merchant Shipping (Coasting Trade) Regulation covers applications for licences and permits and the publication of recommended rates for shipping services. A licence application must contain details of the ship, the proposed shipping service and proposals for the employment and training. Where the ship is not registered under the Act, the applicant must also provide satisfactory evidence of ownership and a declaration relating to whether the applicant is a qualified person. An application for a coasting trade permit must provide details of the ship and the shipping service to be provided.

### 4.2. DISCUSSION

#### 4.2.1. Restrictions on entry under the Act

The provisions relating to cabotage do not constitute a restriction to entry into coastal shipping and therefore do not restrict competition or contestability. To begin with, a significant number of competing vessels are not required to hold a licence to engage in the coastal shipping trade—work boats and non-liner commercial companies.

There are no legislative restrictions to entry to ships that would need to be licenced under the cabotage provisions. The cabotage provisions provide no limits on the number or size of vessels entering the market. The requirement to hold a coastal trading licence only involves having a PNG registered business and a PNG registered/ flagged vessel. This means that:

- existing operators competing with Consort and other liner shipping companies can buy or charter additional ships and apply for a coasting trade license to operate these ships in the coastal trade;
- licences are generally not restricted to routes so incumbents are able to enter into competition with other incumbents on their main routes;
- PNG registered companies can purchase or charter PNG ships and apply for a coasting trade licence;
- overseas registered companies or individuals can register a business in PNG, register ships under the Act and apply for a coastal trading licence;
- the Minister has the power to permit a foreign flagged vessel to engage in coastal trade if in his opinion an existing service is inadequate, too expensive or allowing a foreign flagged vessel would otherwise be in the public interest;



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- Larger individual shippers or collections of shippers have the capacity and the right to bypass liner shipping companies and provide their own services (several companies already do this in PNG);
- New operators can enter the market through purchasing equity in or the whole of the existing liner shipping companies.

The Minister has the power to set maximum tariff rates for shipping services. Although the power of the Government to set maximum tariff rates has been questioned, until now, the coastal liner shipping operators have operated under the view that freight rates charged to customers had to be below a maximum tariff rate which was last changed on 1 January 1991. Consort has continued to work within these maximum rates. Provided rates are set at levels that a competitive market would set, shippers are protected against the abuse of market power by shipping companies.

Efficiency requires, among other things that the rights to supply liner shipping services are transferable. The holder of a coasting trade licence is an individual or a company. Equity in companies or companies as a whole can be purchased. If an individual or company outside of the trade could provide the services at lower cost than an incumbent, that company would be prepared to pay the existing incumbents a greater amount than the present value incumbents would expect to earn from future operations. The assets would change hands and the efficiency with which services were provided would increase. The cabotage arrangements therefore do not prevent improvements in efficiency with which shipping services are provided over time.

The cabotage system has no provisions relating to the quality of services provided by licence holders. While shippers are protected against non-competitive pricing, the quality of services is not protected. However, actions by incumbents to extract monopoly rents by reducing coverage and frequency of services will provide incentives for others to enter the market in competition through pricing below the rates of the incumbents an/or providing a better service. The cabotage provisions do not prevent market entry.

### 4.2.2. Barriers to entry

A barrier to entry is something that confers a permanent cost advantage on an incumbent. This might arise through new entrants having to satisfy stricter standards than incumbents. Such an advantage might originate from a number of sources:

- the incumbents might have control of access to a resource that is essential to the operating of a liner shipping service such as a non-transferable and permanent licence, a technology, a source of labour or harbour facilities and services;
- long term contracts, including government contracts that cover a high proportion of the existing trade;
- incumbents being subject to a lesser technical and safety standard than new entrants;
- the presence of substantial sunk costs.



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### *Legislative and regulatory barriers*

The Coasting Trade provisions do not discriminate in any way between incumbents and potential entrants. In fact, the provisions are not prescriptive with respect to ship and operating characteristics and do not provide exclusive rights to service specific sectors.

### *Access to facilities*

All of the ports visited by the liner shipping companies in PNG are publicly owned and operated and incumbents have no exclusive rights to port facilities. Outside of the major ports the coastal trade in PNG can be serviced by landing craft and other vessels that are not reliant on shore based facilities.

### *Sunk costs and the cost of exit*

The costs of entry into the coastal shipping industry are not prohibitive as there is a world market for the charter of ships and the hiring of containers. Large capital outlays are therefore not required to enter the market. In establishing a presence in the market, there are limited sunk costs. Sunk costs are market development and capital costs that cannot be recouped after the firm exits the market. If sunk costs are high, the risk of failure and the extent of exit costs may be sufficiently high as to prevent entry. According to Consort, there were significant costs in establishing its operations in smaller ports as facilities did not exist at those ports and had to be established. This is less relevant these days as new entrants would have access to established facilities or could service the trade with ships that are less reliant on onshore facilities. The presence of high sunk costs is therefore not likely to be a deterrent to entry in the case of coastal shipping in PNG. This has been established by the entry and exit of a number of operators over the past two years. The major asset of a coastal shipping operator can be sailed away and readily deployed in another trade throughout the world.

### **4.2.3. Economies of scope and scale**

Economies of scale arise where marginal cost falls up to or beyond the scale of market demand. These economies may result in one or two firms being able to supply the market at lower cost than more firms. Economies of scope relate to the cost of co-ordinating activities in a supply chain or to the joint provision of more than one service. Economies of scope arise when it is cheaper to provide products or services jointly than independently. Where one firm is able to supply the entire market at a cost below that of two or more firms, a natural monopoly can result. It is useful to briefly explore the concept of natural monopoly and its implications for economic efficiency

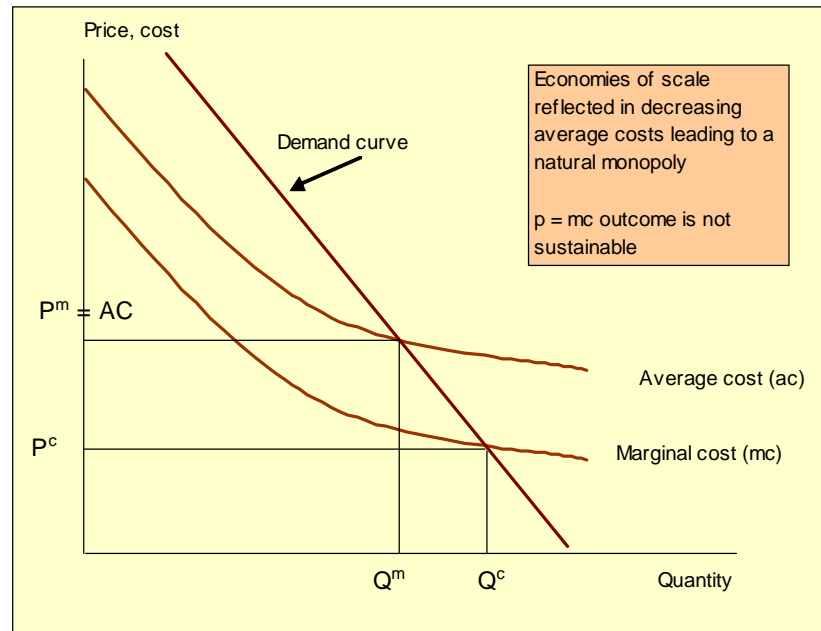
A natural monopoly occurs where a single firm is the lowest cost producer of total industry output. In the context of coastal shipping in PNG there are likely to be numerous routes where the present volume of cargo means that there is room for only one or in some cases two liner shipping firms to operate efficiently.



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Figure 2 depicts the situation of a natural monopoly for a single product firm. The key technical feature that leads to a natural monopoly is that average cost falls continuously as output increases. Note that if average cost was eventually constant, which would be depicted by a horizontal section of the cost curve, and if demand was large enough then there would not necessarily be a natural monopoly. In the situation depicted in Figure 2 pricing at marginal cost (which would be consistent with the outcome in highly competitive markets) will entail losses. This situation is depicted as the competitive price  $P^c$  and competitive quantity supplied of  $Q^c$ . If initially there are several firms and they price at marginal cost consistent with behaviour in a competitive market they will all make losses. In addition, because marginal cost declines as output increases individual firms that perceive that their behaviour does not influence the market price will expand output since this will mean a lower marginal cost relative to the price they expect to receive. The final outcome will be either a single firm producing at a price  $P^m$  and a quantity of  $Q^m$  or an oligopolistic equilibrium where price is above marginal and average cost.

**Figure 2: Natural monopoly**



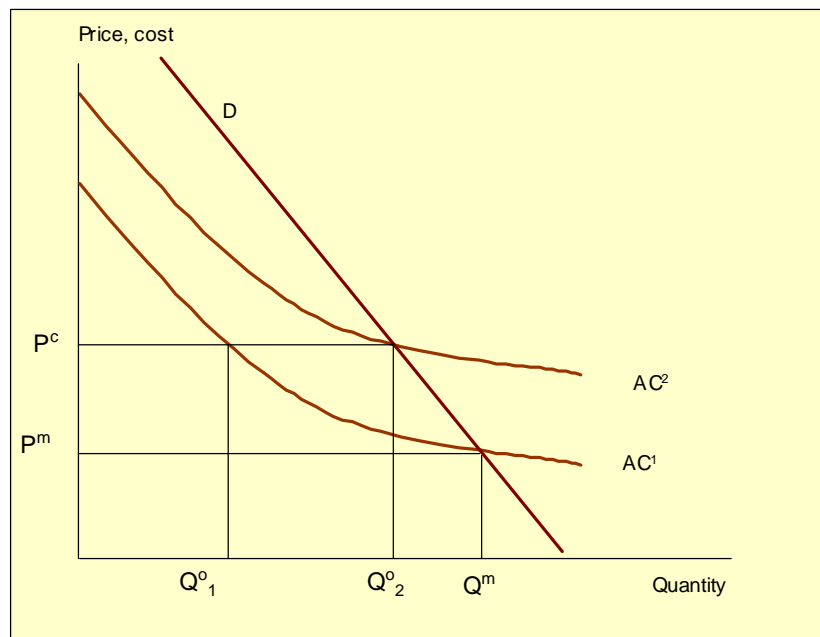
At some point demand may increase to such a level that the market can support more than one firm. However, whether or not the firms are able to produce at the lowest possible costs depends on the nature of their cost curves and the level of market demand.



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Figure 3 depicts a situation where there are two firms characterised by economies of scale but the level of market demand is not high enough to ensure that they both produce at the lowest possible cost. When there are two firms, a price of  $P^O$  is determined with firm 1 producing  $Q^O_1$  and firm 2 producing  $Q^O_2$ . Prices are sufficient to cover average costs (which include a normal return to capital). However, scale economies are such that either firm could produce all of the output at a lower price and in fact could produce a higher level of output and still earn normal profits. If firm 1 produced all of the industry output and earned a normal profit it would sell  $Q^M$  at a price of  $P^M$ . If the threat of entry from another firm was effective it would deter the firm from raising prices but if entry did occur by a similar firm, average costs would rise and normal profits could only be realised at a higher price and lower level of output. Imperfect information about demand and cost conditions and the nature of oligopolistic rivalry could mean that two firms operate in the market, rather than a single firm, but at a higher cost level and with a higher price and lower overall level of output sold than would occur if there was a single firm.

**Figure 3: The impact on costs when demand is not high enough to support the efficient operation of two firms**

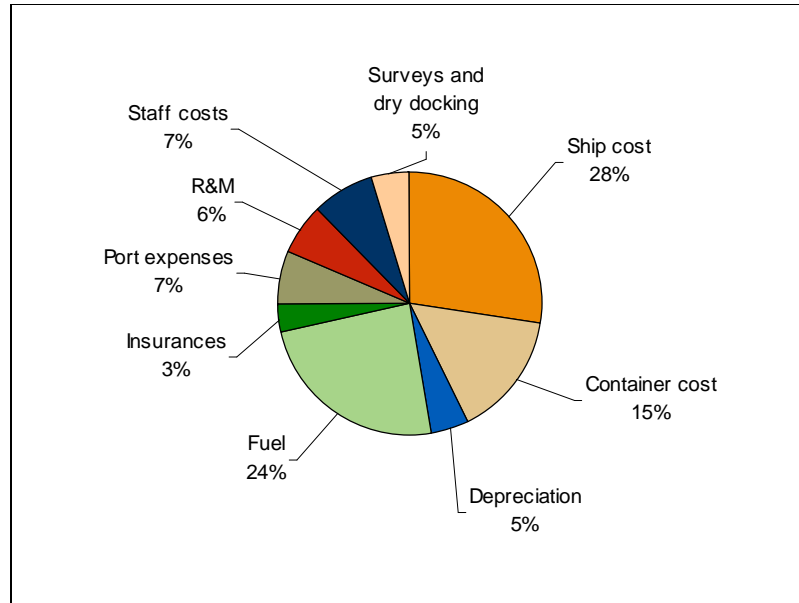


There are significant economies of scale in coastal shipping. A high proportion of ship costs (overheads, containers, equipment, containers, fuel, crew and provisions, maintenance, survey, insurance, berthage, towage and pilotage) are incurred regardless of the amount of that the ship is carrying. Cargo costs (stevedoring) vary with the amount of cargo shipped, but constitute a relatively small amount of the total cost of providing the service. To illustrate this point, Consort's ship costs are summarised in the figure below. Fixed costs amount to at least 90 percent of total ships costs. As a result, marginal costs fall sharply as the tonnage carried increases.



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Figure 4: Shipping cost structure



The small volume of cargo shipped between PNG's major ports may only allow one or two liner shipping companies to recover the cost of providing the service. For example, Consort alone provides sufficient liner service capacity to service the Lae - Port Moresby demand for tier one capacity. Smaller, unregulated vessels offering lower cost non-scheduled services in less expensive ships are able to compete for the business of shippers that do not require a regular service and are prepared to accept the higher risks associated with Tier 2 and Tier 3 services.

Dividing the Lae – Moresby cargo between several liner shipping companies would significantly increase the cost of providing the service compared to a single liner shipping company. Operating one large vessel on a route will generally cost considerably less than operating two smaller vessels: for example, we estimate that operating two 150 TEU vessels on a simple route between Lae and Port Moresby would, all other things being equal, cost approximately 25–30% more than operating a single 300-TEU vessel.<sup>7</sup>

A cartel or market sharing arrangement could evolve, with prices set at levels sufficient for operators to cover costs of supply. Another possibility is the joint operation of a single vessel with the two companies competing for cargo slots. This would be a more efficient outcome.

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Based on an estimated equivalent long-term charter rate for a 300TEU vessel of \$US7,200 per day and \$US4,800 per day for a 150 TEU vessel. Fuel consumption for the 300TEU vessel was estimated at 15 tonnes per day, for the 150 TEU per day at 8 tonnes per day. Both vessels were assumed to use IFO, and an indicative future bunker price of \$US400 per tonne was assumed.



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The fact that the market only supports one liner shipping company does not mean that the market is not contestable. Because sunk costs are small, a company could move in and out of the trade. If Consort were to raise its freight rates, this would make entry more attractive. An entrant could undercut Consort, forcing Consort to reduce its rates so as to maintain market share.

### 4.3. INTERNATIONAL EXPERIENCE WITH CABOTAGE

This section provides an overview of the current state of cabotage restrictions in a range of developed and developing countries. A brief overview of the situation in 15 countries plus the European Union (EU) is provided at Attachment 1.

The global trend towards trade liberalisation has been reflected in the abandonment of many of the measures that governments have traditionally used to provide support to national shipping industries. However, cabotage has been to a significant extent an exception to this trend. While there is evidence of partial relaxation of cabotage restrictions in some countries, others have recently reinforced and tightened cabotage restrictions. Only a handful of economies—all of them high income countries—allow free access for foreign ship operators to coastal cargoes. All of the developing countries examined, and most of the developed countries, continue to regulate the carriage of cabotage cargoes.

This appears to be largely because of the high political—and arguably social—cost that is associated with the abandonment of cabotage. As the Productivity Commission pointed out in its Discussion Draft of its Review of National Competition Policy, the current Australian Government, which has long opposed cabotage restrictions in principle, has yet to satisfy its National Competition Policy obligations to review cabotage restrictions.<sup>8</sup> There are no signs that this is likely to occur in the near future.

In the countries reviewed, as far as we are aware there are no current plans to change cabotage arrangements.

The basic principle on maritime cabotage adopted by the **European Union** is one of a 'club' with freedom of access to EU domestic maritime trades for EU registered shipowners with ships flying a EU member-state flag. Foreign or non-EU flagged vessels are generally not allowed to participate in the EU's maritime cabotage trades. Offshore registers of ships of member states are not beneficiaries of the cabotage regulation.

A number of EU member states provide waivers for foreign flag (non-EU) vessels to participate in EU maritime cabotage, albeit on strict conditions covered by permits.<sup>9</sup> In most cases, the waivers are only granted in situations whereby no EU-flag vessels are available to carry the cabotage business or only on very unfavourable terms. The EU agree-

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<sup>8</sup> Productivity Commission, 2005, Review of national competition policy reforms, Report No 33, Productivity Commission, Canberra.

<sup>9</sup> These member states are Finland, France, Germany, Greece, Italy, Portugal, Spain, and Sweden.



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ment does not prevent individual member states from adopting a more liberal approach to cabotage. The following EU member states permit unrestricted access for foreign-flagged vessels to their coastal trades.<sup>10</sup>

The **United Kingdom** is at one end of the liberalisation spectrum with 'free/unrestricted' coastal trading. Although a member state of the European Union (EU), the UK goes further than the freeing of EU member state domestic maritime trades (cabotage) to flag vessels of all EU member states.

The **United States of America** has adopted an extremely restrictive approach on access to maritime cabotage. The Jones Act of 1920 requires that domestic waterborne commerce of the United States to be carried on US-built, US-owned and US-registered vessels. There is no provision in the US regime to waive cabotage restrictions on economic grounds (for instance, because no US carrier is available to carry the cargo at reasonable cost). National security considerations provide the only legal basis for a waiver. Attempts to relax the existing Jones Act rules have been strongly resisted.

**Canada** allows access to its domestic trades to Canadian-flag vessels only. However, its position is not as extreme as the US. The Coasting Trade Act of 1992 states that foreign (meaning non-Canadian) flagged vessels are, in principle, not allowed access to maritime cabotage (or 'coasting' as it is locally termed). However, there are no foreign-ownership restrictions on Canadian-flagged vessels. The Coasting Trade Act does provide for a waiver system in the form of a license which can allow a foreign-flagged vessel to operate in specific cabotage business for a maximum license term of twelve months on the basis that no Canadian-flagged vessels are suitable and available.

**Japan** is strongly committed to the reservation of its maritime trade to Japanese flag vessels. Cabotage restrictions allow only Japanese-flag carriers to carry cargo and passengers between Japanese ports. Japan generally opposes the inclusion of the relaxation of cabotage restrictions in the discussion of trade liberalisation in international forums. We are unaware of any waiver system in Japan.

**New Zealand** has no restrictions on coastal trade, adopting a policy of 'open' waters since the early 1990s. There have been proposals to introduce a tax on domestic containers being moved around the coast by foreign-flag vessels but this was recently rejected by the NZ Government. While there is free access, immigration requirements have the effect of limiting the amount of continuous time that foreign nationality crews can spend on the New Zealand coast. Partly as a result of this, the main impact of foreign-flagged foreign-crewed vessels on the New Zealand trade has been in the incidental carriage of coastal container cargoes as part of an international voyage.

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<sup>10</sup> Belgium, Denmark, Ireland, Netherlands, and the UK.



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In **Australia**, under Navigation Act 1912 ships engaged in coastal trading must either be licensed, or operating under permit. There is no legislative prohibition to foreign-flagged vessels participating in the Australian coastal trades. However, conditions that attach to the issuance of coastal trading licences and permits have had the effect of limiting the operation of foreign vessels on the Australian coast. Operators of licensed ships have priority over the carriage of coastal cargo. Unlicensed vessels may carry cargo under permits when licensed ships are unavailable or determined to be inadequate. Where licensed ships cannot meet all coastal shipping demands, the Minister can issue single or continuous (lasting up to 3 months) voyage permits, which allow foreign ships to operate without having to satisfy cabotage requirements. The recent re-introduction of an East-West scheduled service by a licensed coastal shipping operator has led to the enforcement of the privileges of the licensed operator, and international lines that have been operating under permits for many years have been required to withdraw their offer to carry coastal cargoes on this route.

**India** operates a comprehensive system of reservation of cabotage cargoes, with all coastal traffic being reserved for Indian-flagged ships, manned by Indian crews. To the best of our knowledge no formal waiver system exists. However, in January 2005, the Government decided to temporarily relax, for an initial period of six months, the Merchant Shipping Act section relating to cabotage by foreign carriers in order to ease congestion at the container ports of Jawaharlal Nehru and Mumbai Ports.

Historically **Indonesia** has tightly controlled access to its coastal trades, reserving them for nationals. The Government also provides operating subsidies for vessels used on selected inter-island routes, construction subsidies for vessels used for domestic trades, and requires that crews be Indonesian citizens. Shipping lines are allowed to use foreign flag vessels with certain limitations when local flag tonnage is not available. Indonesian law allows foreign companies to participate in local trade, providing they do so in joint ventures with Indonesian partners. Up to 95 percent overseas equity in shipping ventures is allowed. As a result of these waiver provisions, and reported practical difficulties the government has had in applying and enforcing cabotage provisions, Indonesia's cabotage policy does not appear to have been effective in reserving domestic cargoes for Indonesian owned and flagged vessels.

**Myanmar** has a large coastal trade, and cabotage is an important issue. This is controlled by the Ministry of Transport, which also regulates matters such as the minimum pay scale for crew, recruits seamen (approximately 2500 per year), and controls the registration of vessels and registers foreign vessels under the terms for bare boat chartering. The cabotage policy is effective, and virtually all of Myanmar's coastal cargoes are carried on domestically registered vessels.

**Nigeria** has recently strengthened its cabotage regulation. The Cabotage Act of 2003 came into effect May 1, 2004. The Act essentially copies the principles of the US Jones Act with full cabotage protection but with the possibility of waivers in exceptional circumstances.



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**Argentina** has a cabotage policy. In August 2004, the Argentine Government passed legislation which requires foreign ships to use Argentine crew when using a waiver that exempts their operations from national cabotage over a period of 30 days or more. This formed part of new regulations to increase the national fleet by forcing national shipowners to flag back from flags of convenience to the Argentine flag.

**Philippines** maritime policy reserves cabotage cargoes to domestic shipping operators. In recent years, there has been some loosening up of the previous extremely restrictive policy, with overseas vessels allowed to carry empties between ports as long as this is for positioning and not carried as cargo. If it can be shown that no local owned vessel is available, domestic cargo can be carried under a single voyage permit issued by Marina. This has been happening frequently in recently years, but mostly for tankers and gas carriers.

Within **Vietnam's** waters, there is full cabotage: 100 percent by Vietnamese flag vessels, except where no alternatives exist. The use of foreign vessels on the coast requires the Minister's approval, issued after consultation with the national maritime administration and national shipping company respectively. Vietnam is keen to retain cabotage but, unlike others, it does not have a problem with domestic shipping capacity. This is partly because Vietnam's regulations permit partly-foreign owned joint venture companies to operate their own ships.

In **Malaysia**, to participate in the cabotage trade a license per vessel is required by a Malaysian citizen or company. Temporary licences, upon exemption given by the Minister, are granted to Malaysian companies that are required to operate foreign flagged vessels due to the non-availability of suitable Malaysian flagged vessels. The Merchant Shipping (Extension and Amendments) Act 1994 contained exemption provisions that have led to a relaxation of cabotage restrictions. These provisions were invoked in 1994 to allow foreign-flagged vessels to carry transshipment boxes between the Malaysian ports of Penang and Port Klang, and were extended to transshipment cargo between Penang, Johor and Port Klang in 1997. In mid 2000, Malaysia was said to be considering a further relaxation of cabotage to allow foreign lines to carry transshipment cargo between designated ports in East Malaysia (Sabah, Sarawak) and Port Klang. The various exemptions are designed to enhance Port Klang's position as a hub port. Under the Eighth National Development Plan (2001–05), we understand that relaxation of cabotage has been extended to support the emerging hub port of Tanjung Pelepas (PTP).

#### 4.4. THE IMPLICATIONS OF ABOLISHING CABOTAGE

The profitability of Consort's coastal trade varies substantially across its sectors. Consort derives the major part of its income from trade between Lae and Port Moresby and between Lae and Rabaul and Kimbe. To viably service the smaller ports, Consort has to combine the smaller port services with its more profitable routes. The profitability of servicing any given sector depends on the volume and type of cargo shipped as well as the ability to charge rates to cover the cost of servicing those routes.



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The freeing up of the licensing system to allow foreign vessels to carry coastal cargo would have significant implications for PNG coastal shipping and for the viability of the liner shipping companies. The changes could involve allowing international ships to transport cargo between the main ports or they could involve a more general abolition of cabotage and the adoption of an open market policy. The overview of coastal shipping regulations presented in the previous section indicates that should PNG adopt such a policy, it would be one of the few countries to do so.

Our analysis assumes that the abolition of cabotage would allow foreign vessels to service the entire PNG coastal trade. An initial question relates to the manner in which foreign flagged vessels would engage in the trade.

PNG is currently served by a number of foreign shipping companies that provide scheduled services to the major ports such as Port Moresby, Lae, Kimbe, Rabaul and Madang.<sup>11</sup> Exports from and imports to other ports are dependent on transshipment by coastal shipping companies to support these international services.

International shipping companies, either directly or indirectly through shipping agents, have a strong presence in PNG. Each year a large number of international ships undertake voyages between Australia's east coast and Asian ports. The international ships that visit PNG are not dedicated to PNG trade. Their purpose is to provide shipping services to the international trade between Australia, South East Asia and North Asia and between South East Asia and the East Coast of the US. An examination of the international liner shipping schedules indicate that most of these lines call at a large number of international ports in South East Asia, North Asia, the Pacific, Europe and North America. These voyages are driven by the large volume trades along their routes. Their share of this trade depends on their ability to meet complex delivery schedules in spite of the vagaries of weather, equipment and port entry and exit. The volume of PNG international trade is a small proportion of the cargo that most of these ships carry. The volumes of coastal trade would constitute an even smaller proportion.

### 4.4.1. The implications for major coastal trade sectors

The pattern of international trade in PNG is one in which the northern ports handle an excess of exports over imports and the southern and PNG island ports have an excess of imports over exports. The direction of flow of international shipping tends to be to Lae from Port Moresby. The pattern of coastal trade therefore does not closely mesh with the pattern of international trade. Immediately this introduces a logistical problem for international shippers concerning the placement of containers. The pattern of international shipping would see a migration of containers from Port Moresby to Lae and the island ports. Unless international shippers alter their routes, there would be a need to place

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<sup>11</sup> International shipping services to PNG are provided by Chief Container Service, (Swire), the New Guinea Pacific Line (Swire), the Australian National Line, Sofrana Unilines, Consort Express Line, Australia Asia Line, Pacific Forum Line, Pacific Container Lines and Bankline (Swire). Crocodile Line ( Swires) Pacific Forum Line ( Swires) Kyowa Shipping Co. IndoTrans Asia(Swire)



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additional containers into the service to make up for the delayed return of the containers that are utilised in making coastal movements.

International ships currently only call at the main ports of Lae and Port Moresby, Madang, Rabaul and Kimbe. If international ships were allowed to carry coastal cargo, they would try to accommodate that cargo within their existing schedules. It is unlikely that they would divert to collect and deliver cargo to ports that are off their routes. Existing routes and schedules would allow international ships to carry coastal cargo from Port Moresby to Lae and to a lesser extent from Lae to Port Moresby. The volume of exports and ports from smaller PNG ports does not justify exports from these ports unless there is a significant volume of project exports (for example palm oil exports from the West New Britain).

### *The attractiveness of the main coastal sector*

The attractiveness to international shipping companies of the coastal trade between Port Moresby and Lae is likely to be diminished by a number of factors including the small volume of cargo, the nature of the cargo, inadequacies in PNG port infrastructure and PNG shipping regulations.

While the two way coastal trade between Port Moresby and Lae is large by PNG standards, it is still small by international standards. Last year the total two way trade carried by Consort, Bismarck and others amounted to around 300,000 tons, with 75 percent of that tonnage being in the opposite direction to the flow of international shipping (that is from Lae to Port Moresby).

A relatively high proportion of the coastal trade in PNG, especially on the 'thinner' routes involves loose or break bulk cargo rather than containerised cargo. Most of Consort's customers are shipping small quantities of goods on a regular basis. To accommodate this small lot containerised trade, Consort provides coastal shippers with 4 cubic meter and 9 cubic metre containers. International shippers are largely equipped to carry bulk cargo and containerised cargo—using ISO standard sized containers. They are not well equipped to carry the small volume, loose cargo that the coastal shipping companies currently service.

Time is also a critical consideration to international shipping companies. As discussed above, the purpose of these ships is to deliver and collect cargoes from major ports working to a complex and tight schedule. Small volume and loose cargo take much longer to load and unload than the large containers for which international ships are equipped. The nature of the coastal trade exposes a shipping company to a greater risk of unforeseen delays associated with difficult-to-handle cargoes. Moreover, PNG port operations can involve unexpected delays due to congestion, particularly at Kimbe and Lae. As discussed earlier, coastal shippers also face delays due to the actions of port service providers. These delays impose a significant cost on Consort in the form of time spent in port and missed time 'slots' at forward ports. The cost imposed on international shippers is much greater.



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These costs take the form of longer voyage time (and ship operating costs). Since the scope to catch up is limited by tight schedules and because of onward port entry and exit slots, the initial time delay can cascade through the voyage. Because of limited shipping capacity, the restricted turnaround time at the end of the voyage may delay subsequent voyages. Engaging in PNG coastal shipping, except for the easier cargoes, would expose international shipping schedules to greater risk and increase ship costs. Moreover, there is the risk that delays in PNG ports associated with coastal cargoes could expose international companies to the risk of lost business in other ports.

International shipping companies would be exposed to regulations that apply to coastal shipping. In the absence of cabotage, some form of registration or licensing system would need to be in place to facilitate the safety and environmental regulation of coastal shipping. International shipping companies would also need to comply with occupational health and safety regulations, labour regulations and immigration regulations.

Labour laws might require that international shipping companies need to comply with PNG manning and other regulations whilst servicing the coastal trade. Work permits for foreign nationals might mean that ships may have to periodically exit PNG waters for compliance purposes. These regulations will raise ship costs and this additional cost will be passed on to coastal shippers.

Regardless of the compliance costs involved, these local laws and regulations impose another layer of bureaucracy on international voyages. Perhaps more importantly, international shipping companies might have some concerns if price control arrangements are maintained, either in current or amended form, after the abolition of cabotage. The efficient operation of international shipping, like any other business, requires flexibility to change prices in response to changes in the cost of providing a service. Pricing is regulated by market competition rather than by Government regulation. The rigidity of the PNG price control regime (the maximum tariff was last set in 1991 and the CAF has been infrequently changed) has meant that PNG coastal shippers have had to wear cost increases for long periods. International shipping companies are not anchored to PNG shores to the same extent as the coastal shipping companies and will therefore be less tolerant of regulatory weaknesses than local companies.

### ***Expected benefits***

Some shippers in PNG have expressed the view that coastal shipping would become considerably cheaper if foreign vessels were allowed to service the coastal trade. This is based on the view that the ships are sailing between the ports in any case and the only additional costs they would face would be extra time in port and cargo handling costs. It is claimed that the marginal cost of serving the coastal trade, if ships have the spare capacity, is therefore much lower than the costs of supplying the service by coastal shipping companies. Accordingly, it is claimed that shippers of goods between coastal ports would stand to gain from significantly reduced shipping costs, adding to their profitability and the competitiveness of PNG businesses against imports.



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### *The reality: expected costs*

There are a number of problems with this view.

*The majority of shippers will more likely pay higher freight rates for an inferior service.*

It is unlikely that international shipping companies will find it profitable to transport break bulk or small volume cargo. They will focus on large containerised cargo—the ‘cream’. Only some shippers will be serviced by international ships, even on the heavier volume sectors. Smaller volume shippers will not benefit from lower freight rates. In fact, if price controls were lifted they may face higher freight charges.

Coastal shipping companies will have to respond to competition for the cream by reducing their prices to larger shippers. Their revenues will fall because of loss of volume and lower prices. However, if they maintain their current services, their ship cost per revenue ton will rise sharply because of the loss of scale economies. To remain viable, Consort would need to increase rates charged to smaller customers. If international shippers are focussed on the cream, higher rates to small customers could be sustained without inducing a competitive response from international shippers. However, Consort faces competition for this market segment from second and third tier operators.

In choosing a shipping service, shippers will balance the cost of the service against the quality of the service. Quality considerations relate to the risk to the cargo, frequency, continuity and reliability of the service. The use of a lower quality service (using cheaper, non compliant vessels) will save shippers on freight rates. However, it will expose their businesses to greater risk and greater inventory cost. If Consort were to raise its charges to smaller customers, it would lose business to second and third tier operators. Consort would be unable to match the prices offered by the second and third tier operators because it is configured to provide liner shipping services and because it operates vessels and crew in accordance with international standards.

The Study Team for the DFAT report (on page 35) observed that:

*As a consequence, many domestic shipping operators, particularly small companies, operate on very tight profit margins, making it extremely difficult—if not impossible to accumulate sufficient capital to purchase new vessels. Replacement tonnage is provided either through aid funding or is purchased second-hand (more typically third or fourth-hand). Second-hand vessels are chosen on the basis of affordability, and are frequently unsuitable for the trade in question. Typically vessels do not comply with the requirements of recent international conventions. Vessels employed in coastal and inter-island trades are characteristically old and in poor condition.*

This observation is not true of coastal shipping services provided by Consort and other liner shipping operators in PNG. However, the entry of international vessels into the coastal shipping trade in PNG presents a substantial risk to the maintenance of tier one shipping services in PNG.

*The reduction in freight rates to larger shippers will be less than expected and the quality of service may decline.*



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As we have seen, the situation is more complex than assumed by many PNG shippers. International shipping companies can expect to incur costs that are much greater than the marginal ship costs associated with servicing the coastal trade, even with large volume containerised trade. These costs, arising from delays, expected and unexpected, and compliance with local regulations are likely to substantially exceed the direct costs of servicing the coastal trade. International shipping companies will set freight rates at levels sufficient to compensate them for these costs. As a result, the reduction in freight rates to larger shippers is likely to be limited.

### *The outcome*

If Consort and other liner shipping companies were forced to withdraw from the market, the following market structure is likely:

- Large volume shippers served by international liner companies at lower freight rates than they currently pay;
- Small volume customers paying higher freight rates for a lower quality service; and
- Reduced compliance with PNG environmental and marine safety standards and regulations because second and third tier operators are servicing the bulk of the smaller customer market segment.

The implications for the competitiveness of shippers from access to cheaper shipping rates need to be placed into perspective. Except for low value commodities, shipping costs are only a minor component of the delivered cost of manufactured goods. Compared to the costs of disrupted supply chains and the costs of holding inventory, shipping costs are relatively unimportant. Large shippers will gain if international shipping companies maintain the same quality service as Consort. But this is not guaranteed. As discussed above, the large shipping companies are driven by other business. If the cost of servicing the PNG coastal trade threatened their main business, they would have every incentive to cut back on exposure to PNG.

#### **4.4.2. Implications for the minor routes**

International liners do not currently service the smaller PNG ports. It is unlikely that they will service these ports. In the case of some ports, international ships are too large to enter. Other ports have limited infrastructure and need to be serviced by landing craft or ships with self loading and unloading equipment. International ships that service PNG are not suited to this trade.

In any case, the costs of servicing these ports would be prohibitive given the small volumes of cargoes involved. The risks to schedules are far greater in the case of smaller ports. Further, these ports are not on the existing routes and so the marginal cost of the larger international ships servicing these ports would be likely to be larger than the costs of the coastal shipping companies.



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Consort would not expect competition from international ships on its North Coast and Island routes. Shippers along these routes would receive no direct benefits from the entry of foreign ships into the coastal trade. In the long term the freight rates would most likely rise and the quality of service deteriorate.

As noted earlier, Consort and other coastal shipping companies are only able to service minor routes on a viable basis because of the profit they make on the major routes. If denied the profit on these routes, they would be forced to fully cost the provision of services to these ports. This would see a sharp rise in freight rates. Consort would likely lose customers to second and third tier operators and would need to reduce the quality and frequency of its services to these ports.

### 4.4.3. Summary of implications for coastal shipping

In summary the removal of cabotage is not likely to lead to the benefits claimed by proponents of such a change. As explained above, generally PNG domestic cargoes are not all that attractive from an international shipping company point of view. This might suggest that if cabotage were to be removed there would be very little impact and so there would be no harm in removing it. In addition it might be argued that it would be preferable to let market forces determine the industry structure rather than restricting entry of international ships into coastal routes. However, there are two issues to consider in response to such a perspective.

The first is that there can be genuine economic efficiency losses if there is too much entry into a market. The efficiency losses reflect the additional costs that are incurred when an activity is characterised by substantial economies of scale and scope but firms cannot fully exploit these economies because the market is not large enough. In such situations it is possible for too many firms to operate for quite long periods of time entailing higher costs for operators and higher prices for customers. Too many firms enter the market and continue to operate because of imperfections in the market. For example, there may be imperfect information about demand and cost conditions. In addition, such a situation can lead to instability and uncertainty with respect to services and prices if operators compete vigorously but then subsequently withdraw capacity because of the impact of competition on profitability. This in turn can lead to considerable disruption and uncertainty about service and instability of freight rates for customers. This situation is particularly difficult for businesses that rely on regular shipping services to remain competitive.

The second and more important concern relates to the extent of 'cream skimming' that would be likely to occur if cabotage were to be removed. International shipping companies would most likely only be attracted to a few high volume routes and would not be interested in the lower volume more isolated services. As the result of a loss of income on the high volume routes and the loss of economies of scale and scope from providing a comprehensive service, the coastal shipping industry would face a significant profit squeeze. This would mean a significant risk of rising prices and reduced frequency and quality of services on the less profitable coastal shipping routes in PNG. This in turn would entail a substantial overall loss to the community of PNG given the importance coastal shipping plays in providing essential goods and services to many village communities.



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### 5. PNG HARBOURS LIMITED

PNG Harbours Limited (PNGHL) is a government owned company that is responsible for the regulation, management, operation and control of declared ports and the movement of shipping in declared ports. PNGHL is also responsible for the provision and maintenance of lightships, buoys, piers, jetties, landing stages, landing ramps and platforms in declared ports as well as the provision and maintenance of machinery, equipment and installations used in connection with the operations of declared ports. PNGHL operates almost all of the public ports in Papua New Guinea.

PNGHL is regulated by the Commission which is responsible for the issue of licences for the conduct of various port services. PNGHL has a license to provide wharfage and berthage services in the declared ports and is also responsible for the provision of pilotage services. PNGHL is required under its regulatory arrangements supervised by the Commission to maintain certain minimum standards at the ports it owns and operates.

Consort notes that this review is not intended to embrace a review of the operations of port services. However, since the efficiency and the cost at which these services are supplied are vital to the cost of coastal shipping, a number of points need to be made.

PNGHL has recently raised a number of its charges. Wharfage and berthage charges were raised by 15 percent in May 2004 and by 17 percent in January 2005. In January 2006, pilotage charges were increased by approximately 500 percent as the calculation of fees was changed from a length to a gross registered tonnage basis. It should also be noted that these increases have been taken without improvement to infrastructure as is provided for in the PNGH Regulatory Contract.

The coastal shipping industry faces actual and potential competition in its market (its market is contestable) whereas PNGHL does not. Freight rates for coastal shipping are regulated by a schedule of maximum tariffs that has not been changed since 1991. PNGHL provide a range of services and levy a range of charges that contribute significantly to the direct charges paid by coastal shippers. Yet, PNGHL is able to vary its charges for wharfage, berthage and pilotage under the oversight of the Commission. Consort notes that last year PNGHL was able to increase the amounts it charges to coastal and international shippers, in most cases by substantial amounts. Furthermore, the reasons for the substantial increase were not transparent.

PNGHL is responsible for providing minimum standards of service at its ports. Consort recommends that the Commission review the issue of congestion at Lae and other ports due to inadequate port facilities and poor service delivery.

The port facilities at Lae have changed little since 1989. Yet since that time, growth in the Papua New Guinea economy has contributed to substantial growth in both coastal and international cargo movement through the port. There has also been a substantial increase in the size of vessels visiting the port, an increase in the use of containers and an increase in the size of containers used (reducing berthage and yard space).



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In the period 2000 to 2004 alone, international revenue tons into Lae rose at an average annual rate of 9.8 percent while international revenue tons out of Lae rose at an average annual rate of 8 percent. The corresponding rates of growth for coastal trade in and out of Lae were 15.1 percent and 9.5 percent. The economic outlook for the Papua New Guinea economy is strong, with much development activity in the hinterland of the Lae port. Industry is currently experiencing a boom which demands the import of equipment and structural materials essential for its development. Coastal and overseas ship owners have recognised the need for bigger, faster ships serviced by efficient modern port infrastructure and management. The efficiency of the Lae port must improve or economic development will be stifled.

There are a number of large scale development projects that will place considerable pressure on the Lae port over the next few years. These developments include:

- The Frabelle fish cannery involving the export of containers of canned fish;
- The Hides/Kutubu PNG Gas Project which will involve substantial imports of steel pipe and other materials;
- The Highlands Highway upgrade involving the importation of heavy highway construction machinery and equipment, steel and bitumen;
- Following ISPS Code facilitations, there is likely to be an increase in the number of cruise ships visiting the port;
- The Morobe Gold Mine, the Ramu Nickel Project and the Ramu Palm Oil Mill will all involve substantial imports of steel, other raw materials, machinery and equipment;
- The new No.3 wharf will be shared with increasing number of tankers;
- Planned rehabilitation of the port will involve a reduction in yard area as well as the import of steel, piles, fill, paving and power generating equipment;
- Trukai Rice is switching the bulk of its imports to containers, taking up additional space at the port; and
- There will be continued growth in the import of rain sensitive commodities, such as wheat.

All of these projects and factors will see a growth in demand for the available berths and yard space, while at the same time a contraction in the available yard space.

- The Lae port is inadequate in a number of aspects, including:
- The sharing of limited berth space between coastal and overseas vessels;
- Pilotage restrictions due to insufficient resources, lack of wharf lighting and compulsory pilotage for all but coastal vessels;



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- Yard condition – Lack of maintenance and repair of paving, undulation of surface, poor drainage;
- Container flow – one entry and exit point, poor yard organisation;
- Lack of yard space –too many sheds, insufficient reefer points and DG area;
- Poor terminal management – including management of berth reservation, R&D, stevedoring liaison, passenger vessels; and
- Weather – grain, rice, fish and steel cargo sensitivities plus container working limitations.

Inadequate facilities at Lae and other PNG ports under the control of PNGHL impose major costs on both coastal and international ship operators and their customers. In 2005, 210 days were spent by all classes of vessel waiting for a berth on the overseas wharf for more than 2 hours of these 144 days were clocked up by 128 of the 249 overseas vessels calling at the port. Under the present circumstances, ship operators are likely to impose a congestion surcharge in the range of US\$200 – 250 / teu until port facilities have been upgraded. The impacts detailed in Box 1 attest to the importance of the issue.

### Box 1: The costs of port congestion

- Vessel charter hire while delayed
- Fuel while at Anchor
- Deviation – time and fuel.
- Delays at subsequent ports – time and fuel
- Extra steaming due ETA adjustment – fuel.
- Shutting out of cargo to achieve earlier sailings – additional operating cost.
- Reduction in number of sailings – revenue.
- Overtime at subsequent ports to catch-up – operating costs.
- Loss of custom and trade due unreliability of service schedule – revenue.
- Port omissions to restore schedule – relay costs for over carried cargo and transshipment costs for cargo that was not loaded at the omitted port.
- Increased storage costs for goods awaiting export.
- Delays in exports being shipped, increased transit times to market, increased risks of spoilage, and impaired reputation of PNG exports due shipping delays.



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The costs of delays include the direct costs associated with the initial time lost - additional fuel, wages and other operating costs as well as the cost of capital not being utilised. The initial delays have cascading effects because ships have limited capacity to make up time to meet the remainder of their schedules. This can result in further delays in forward ports. The indirect costs are also significant. This can involve the loss of customers due to unreliability in the service schedule. International shipping is particularly sensitive to delays at PNG ports since the bulk of the cargo (and the associated revenues) they are carrying are destined for ports in other countries. A continuation of congestion problems at Lae threatens the continued availability of international liner services to Papua New Guinea at affordable rates.



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### 6. LABOUR AND TRAINING ISSUES

In the past year, Consort purchased two vessels, the Bougainville Coast and the Niugini Coast which are larger than the existing Consort vessels. Consort is currently taking delivery of a sister vessel to the Niugini Coast which will arrive in country at the end of June 2006. These purchases have allowed Consort to dispense with time charter vessels from overseas with overseas manning. This in turn has increased our need to recruit more PNG officers, seamen and cadets for training.

Consort mans its vessels in excess of the minimum safe manning requirements stipulated by the Department of Transport. The main purpose of the extra manning is to provide sufficient suitable training experience for future officers and seamen, at and to all levels, to adequately man Consort vessels.<sup>12</sup> Consort places a high priority on training all its PNG seafarers to the highest standard of certification and to provide essential guided experience so they can maximise the utilisation of these qualifications.

It has been Consorts intention over the past years to select, train and employ Papua New Guineans in all roles within ship manning requirements. To date we have been very successful in achieving this by recruiting no less than eight cadets each year and commence their training over a four year period. We have been achieving a very high success rate with final year examinations for cadets and new recruitments for seamen, but despite this drive there is still a shortage of adequately qualified personnel to man the vessels, as current sea farers retire or return to their villages for various reasons, and the demand for qualified sea farers increases.

Not everybody employed by one company will remain with the same company throughout their career. The physically demanding nature of the work means that the maritime industry has a high rate of attrition of skilled seafarers. Therefore, Consort has to compensate for the loss of recruits during the training phases by employing a larger number of seafarers than we require. Otherwise we will face a situation of not having enough correctly certified personnel to meet the minimum safe manning requirements of our vessels. This would then force the company to recruit suitably qualified seafarers overseas.

Consort's investment in training seafarers will provide a larger, better trained maritime work force, not only for Consort, but for the PNG shipping industry as a whole. This is also important to the Government, as today's trainees provide a source of future recruits for the Department of Transport, the National Maritime Safety Authority and PNG Harbours Limited. The Authority is currently trying to fill positions with trained maritime surveyors and related qualified staff, positions for which there is a shortage of qualified nationals.

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<sup>12</sup> Consort employs an excess of staff required, trains and accommodates them, knowing that approximately 30 percent will not remain due to offers from other companies, or other similar circumstances.



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In past years training of seafarers in PNG has been inadequate, both in terms of the number of trainees and the quality of training. The introduction of STCW '95, International Safety Management (ISM) and the International Ship and Port Facility Security Code (ISPS), in addition to the establishment of the National Maritime Safety Authority, has led to an increase in the demand for qualified seafarers in PNG. PNG Harbours Limited has recruited some of our more senior staff in recent months further contributing to a shortage experienced marine personnel for Consort. The National Maritime Safety Authority is also recruiting senior personnel. There is an international shortage of qualified seafarers and foreign shipping companies are seeking to recruit scarce, qualified PNG seafarers to work on foreign flagged vessels.

The result is that the coastal shipping industry is finding it difficult to satisfy its need for qualified seamen. Consort is making every effort to alleviate this situation by employing as many cadets as we can accommodate, which at any one time is at least 32 cadets in training. However, the replacement of retired seafarers is a long process, given the high standard of qualifications required and many years of training.<sup>13</sup> Internationally, fewer young people are choosing seafaring as a career. Consequently very few adequately trained or experienced personnel are available to the shipping industry.

Papua New Guinea has only recently been accepted as an internationally recognized Maritime Country meeting the standards required for training. It is in both Consort's and the PNG interest to maintain this new standard to allow us to continue trading overseas. However, this means that many of our senior positions will need further training to gain the certificates of competency required, for example to be Master or Chief Engineer of certain sized vessels on either coastal or unlimited trading voyages.

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<sup>13</sup> As it takes approximately four years to train and qualify a cadet to a position of junior officer, the shortfall can not be rectified quickly or easily, and there is only limited space on board the vessels to place trainees.



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### APPENDIX A: OVERVIEW OF CABOTAGE ARRANGEMENTS IN SELECTED COUNTRIES

#### A.1 EUROPEAN UNION (EU)

The EU's position on maritime cabotage can be traced back to the origins of the EU (formerly the European Economic Community) as enshrined in the 1957 Treaty of Rome which prohibited discrimination based on nationality within the EU, granted constituent member countries the freedom to provide services in other member countries, and established rules for competition in the provision of these services. These general principles were also applied to the transport sector in the form of a common transport policy.

Simply put, the EU's basic principle on maritime cabotage is one of a 'club' with freedom of access to EU domestic maritime trades for EU registered shipowners with ships flying a EU member-state flag.

More specifically, the EU's principle on maritime cabotage is set out in Council Regulation Number 3577/92/EEC of 7th December, 1992—"applying the principle of freedom to provide services to maritime transport within member states (maritime cabotage)"—with the objective of eliminating restrictions on this freedom.

Foreign (meaning non-EU) flagged vessels are generally not allowed to participate in the EU's maritime cabotage trades. Since the removal of cabotage restrictions on member-state flagged ships in 1993 (with some limited exceptions, concerning Greek islands cabotage, remaining until 2004), the emergence of member state second or internationally open vessel registries (offering economic and fiscal incentives to shipowners) has been clarified by the Commission in subsequent reports on regulation 3577/92.

#### **Box: 1**

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#### **Council Regulation Number 3577/92/EEC**

The first registers of member states all have access to cabotage. In the matter of access to the second registers of member states to Community cabotage, the situation is covered by the Regulation. The Regulation provides that, for a ship of a member state to be admitted into cabotage in another member state, it must first of all fulfil all of the conditions required for admission to cabotage in the member state in which it finds itself. This applies to the following ships, which fulfil all the conditions required to participate fully in cabotage in the member states of the EU: ships registered in the Spanish REC register, ships registered in the Portuguese MAR Register, and cargo ships registered in the Danish DIS register. Ships registered in the German ISR and Finnish vessels entered on the "List of cargo ships in international trade" have only a limited access to cabotage. They may only offer regular services throughout the year. Ships registered in the Italian second register and passenger ships registered in the Danish second register do not have access to Community cabotage.

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The Commission also gave a further reminder in their reports that the “offshore” registers of ships of member states are not beneficiaries of the cabotage regulation, namely the Kerguelen Register, the French Southern and Antarctic Territories’ Register (TAAF Register), the Dutch Antilles’ Register, the Isle of Man Register, the Bermuda and Cayman Islands Registers.

A number of EU member states provide waivers for foreign flag (non-EU) vessels to participate in EU maritime cabotage, albeit on strict conditions covered by permits. These member states are Finland, France, Germany, Greece, Italy, Portugal, Spain, and Sweden. In most cases, the waivers are only granted in situations whereby no EU-flag vessels are available to carry the cabotage business or only on very unfavourable terms.

The EU agreement does not prevent individual member states from adopting a more liberal approach to cabotage. The following EU member states permit unrestricted access for foreign-flagged vessels to their coastal trades: Belgium, Denmark, Ireland, Netherlands, and the UK.

There appear to be no current plans to change cabotage arrangements in the EU.

### A.2 UNITED KINGDOM (UK)

The UK is at one end of the liberalisation spectrum with ‘free/unrestricted’ coastal trading. Although a member state of the European Union (EU), the UK goes further than the freeing of EU member state domestic maritime trades (cabotage) to flag vessels of all EU member states.

The commitment to free access to the UK coastal trades has a long history in the UK. The UK government, and its Department for Transport, have always been at the forefront of promoting and operating a policy of ‘open’ seas. There would appear to be no current plans to change cabotage arrangements in the UK.

#### **Box: 2**

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#### **Department for Transport Policy Statement**

The UK has also worked to secure open markets for international shipping services, and has a long tradition of allowing free access to foreign vessels engaging in UK domestic services (cabotage). Despite a large measure of success over recent years in securing improved access to markets, restrictions remain in various parts of the world. The Government will continue to seek to remove such restrictions, both multilaterally and through bilateral negotiations with the other countries concerned.

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### A.3 UNITED STATES OF AMERICA (USA)

The USA has adopted an extremely restrictive approach on access to maritime cabotage. The principle is enshrined in the Jones Act of 1920 which requires the domestic waterborne commerce of the United States to be carried on US-built, US-owned and US-registered vessels. The exclusive right conferred by the Jones Act extends to all shipping services between US ports, including services between the US mainland and Puerto Rico, Hawaii, Guam and Alaska. This has led to the existence of a number of exclusive US domestic carriers, so-called Jones Act carriers (notably Horizon Lines – formerly CSX/Sea-Land's domestic operations, Matson Navigation, and Trailer Bridge). Cabotage regulations are administered by the Maritime Administration (MarAd).

Unlike Canada and certain EU member states, there is no provision in the US regime to waive cabotage restrictions on economic grounds (for instance, because no US carrier is available to carry the cargo at reasonable cost). National security considerations provide the only legal basis for a waiver.

Attempts to relax the existing Jones Act rules have been strongly resisted. The issues of protection of national security and the domestic economy ensure that the lobby groups, under the umbrella of the Maritime Cabotage Task Force (MCTF), have been able to maintain the existence of the Jones Act during a series of challenges, the latest of which took place in the late 1990s in the context of the (then) proposed USA/Panama free trade agreement.

The high cost of meeting the requirement to build a vessel in a US shipyard would make it extremely difficult for a carrier complying with the Jones Act to compete with foreign-flagged vessels to participate under a waiver system.

There are no plans for change, and increased concerns about security will buttress the position of the MCTF.

### A.4 CANADA

Canada allows access to its domestic trades to Canadian-flag vessels only. However, its position is not as extreme as that of its neighbour, the US.

The Coasting Trade Act of 1992 states that foreign (meaning non-Canadian) flagged vessels are, in principle, not allowed access to maritime cabotage (or 'coasting' as it is locally termed). However, there are no foreign-ownership restrictions on Canadian-flagged vessels.

The Coasting Trade Act does provide for a waiver system in the form of a license, issued by the Minister of National Revenue, which can allow a foreign-flagged vessel to operate in specific cabotage business for a maximum license term of twelve months on the basis that no Canadian-flagged vessels are suitable and available to carry out the business. The legislation provides discretion to the Minister to include any additional terms and conditions in the license which he considers appropriate.



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Canada's position on cabotage is likely to remain 'as is' since there appears to be no plans for change.

### A.5 JAPAN

Japan is strongly committed to the reservation of its maritime trade to Japanese flag vessels:

Cabotage restrictions allow only Japanese-flag carriers to carry cargo and passengers between Japanese ports.

There has been little or no change to this policy over the years, and Japan generally opposes the inclusion of the relaxation of cabotage restrictions in the discussion of trade liberalisation in international forums.

We are unaware of any waiver system in Japan. However, if one exists, the size and diversity of the Japanese fleet and the strong commitment of Japan to the development of its coastal fleet suggests that it would be very rarely used.

There appears little likelihood of a relaxation of cabotage restrictions in the foreseeable future.

### A.6 NEW ZEALAND (NZ)

New Zealand has no restrictions on coastal cabotage with a policy of 'open' waters / free access. The principle of protecting domestic trades was abandoned by the NZ Government (Ministry of Transport) in the early 1990s. There have been proposals to introduce a tax on domestic containers being moved around the coast by foreign-flag vessels but this has been recently rejected by the NZ Government.

There are no restrictions on foreign-flagged vessels involved in New Zealand's coastal trades. However, immigration requirements have the effect of limiting the amount of continuous time that foreign nationality crews can spend on the New Zealand coast. Partly as a result of this, the main impact of foreign-flagged foreign-crewed vessels on the New Zealand trade has been in the incidental carriage of coastal container cargoes as part of an international voyage.

The NZ Government is unlikely to change their current policy. However, there is a move towards obtaining a better awareness by industry and Government of the level and composition of coastal trading involving more detailed collection and analysis of coastal movement statistics by ports and other parties.

### A.7 AUSTRALIA

Under the Navigation Act 1912 ships engaged in coastal trading must either be licensed, or operating under permit. Both licences and permits are issued by the Commonwealth Government.



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There is no legislative prohibition to foreign-flagged vessels participating in the Australian coastal trades. However, conditions that attach to the issuance of coastal trading licences and permits have had the effect of limiting the operation of foreign vessels on the Australian coast.

Operators of licensed ships have priority over the carriage of coastal cargo. Unlicensed vessels may carry cargo under permits when licensed ships are unavailable or when services provided by licensed ships are determined to be inadequate.

In cases where licensed ships cannot meet all coastal shipping demands, the Minister can issue single or continuous (lasting up to 3 months) voyage permits, which allow foreign ships to operate without having to satisfy cabotage requirements.

Ships holding permits are not required to meet the conditions applying to licensed vessels. Unlicensed vessels may legally carry coastal cargoes under either Single Voyage Permits (SVP) or under Continuing Voyage Permits (CVPs). As the name suggests, a vessel operating under a Single Voyage Permit can carry coastal cargoes only during the single voyage for which the permit is issued. Continuing Voyage Permits (CVPs) cover a six-month period that may otherwise have required several SVPs.

The recent re-introduction of an East-West scheduled service by a licensed coastal shipping operator has led to the enforcement of the privileges of the licensed operator, and international lines that have been operating under permits for many years have been required to withdraw their offer to carry coastal cargoes on this route.

### A.8 INDIA

India operates a comprehensive system of reservation of cabotage cargoes, with all coastal traffic being reserved for Indian-flagged ships, which must be manned by Indian crews,

To the best of our knowledge no formal waiver system exists. However, in January 2005, the Government and Director-General of Shipping (DGS) decided to temporarily relax, for an initial period of six months, the Merchant Shipping Act section relating to cabotage by foreign carriers in order to ease congestion at the container ports of Jawaharlal Nehru and Mumbai Ports.

### A.9 INDONESIA

Historically Indonesia has tightly controlled access to its coastal trades, reserving them for nationals.

Regulation PP17 (1988) reserves coastal trades for Indonesian-flag vessels, provides operating subsidies for vessels used on selected inter-island routes, construction subsidies for vessels used for domestic trades, and requires that crews be Indonesian citizens.



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However, the Industrial Shipping Law 1988 allows shipping lines to use foreign flag vessels with certain limitations when local flag tonnage is not available. The legislation stipulates that when time charters extend beyond six months, 50% of the chartered vessel's crew must be Indonesian nationals.

Indonesian law allows foreign companies to participate in local trade, providing they do so in joint ventures with Indonesian partners. Government Regulation No. 20 (1994) allows up to 95% overseas investment in shipping ventures.

In addition, the Industrial Shipping Law 1988 allows shipping lines to use foreign flag vessels with certain limitations when local flag tonnage is not available. The legislation stipulates that when time charters extend beyond six months, 50% of the chartered vessel's crew must be Indonesian nationals. However, local contacts suggested that the rules are not always consistently applied.

As a result of these waiver provisions, and reported practical difficulties the government has had in applying and enforcing cabotage provisions, Indonesia's cabotage policy does not appear to have been effective in reserving domestic cargoes for Indonesian owned and flagged vessels. In interviews conducted during 2005, the Indonesian National Shipowners Association reported that its members now achieve only 50% of the 117 million tons moved yearly.

### **A.10 MYANMAR**

Myanmar has a large coastal trade, and cabotage is an important issue. This is controlled by the Ministry of Transport, which also regulates matters such as the minimum pay scale for crew, recruits seamen (approximately 2500 per year), and controls the registration of vessels and registers foreign vessels under the terms for bare boat chartering.

We understand that this cabotage policy is effective, and virtually all of Myanmar's coastal cargoes are carried on domestically registered vessels.

### **A.11 NIGERIA**

Nigeria has recently strengthened its cabotage regulation.

The Cabotage Act of 2003 came into effect May 1, 2004. The Act essentially copies the principles of the US Jones Act with full cabotage protection but with the possibility of waivers in exceptional circumstances.

### **A.12 ARGENTINA**

In August 2004, the Argentine Government passed legislation which requires foreign ships to use Argentine crew when using a waiver that exempts their operations from national cabotage over a period of 30 days or more. This formed part of new regulations to increase the national fleet by forcing national shipowners to flag back from flags of convenience to the Argentine flag.



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### A.13 PHILIPPINES

Reservation of cabotage cargoes to domestic shipping operators has long been a feature of Philippines maritime policy. In recent years, there has been some loosening up of the previous extremely restrictive policy, with overseas vessels allowed to carry empties between ports as long as this is for positioning and not carried as cargo. If it can be shown that no local owned vessel is available, domestic cargo can be carried under a single voyage permit issued by Marina. This has been happening frequently in recently years, but mostly for tankers and gas carriers.

### A.14 VIETNAM

Within Vietnamese waters, there is full cabotage: 100% by Vietnamese flag vessels, except where no alternatives exist. The use of foreign vessels on the coast requires the Minister's approval, issued after consultation with Vinamarine and Vinalines (the national maritime administration and national shipping company respectively).

Like other ASEAN countries, Vietnam is keen to retain cabotage but, unlike others, it does not have a problem with domestic shipping capacity. This is partly because Vietnam's regulations permit partly-foreign owned joint venture companies to operate their own ships (subject to approval of the Minister of Transport).

### A.15 MALAYSIA

In Malaysia, the cabotage trade is administered by the Domestic Shipping and Licensing Board (DLSB). The Board was set up in 1980, part of the Maritime Division of the Ministry of Transport. In order to participate in the cabotage trade a license per vessel is required by a Malaysian citizen or company. The DSLB grants three types of licences:

Unconditional licence is granted to a Malaysian entity in respect of a Malaysian flagged vessel on the condition that it:

1. is qualified to own a Malaysian flagged vessel according to the law stipulated for owning a Malaysian ship;
2. has 30 percent Bumiputra participation in terms of equity, directorship and office staff; and
3. employs Malaysian citizens as ratings on the vessel in question to the tune of 75 percent.

Conditional licenses are granted to vessels meeting some, but not all, of the above conditions.

Temporary licences, upon exemption given by the Minister of Transport, are granted to Malaysian companies that are required to operate foreign flagged vessels due to the non-availability of suitable Malaysian flagged vessels



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The Merchant Shipping (Extension and Amendments) Act 1994 contained exemption provisions that have led to a relaxation of cabotage restrictions. These provisions were invoked in 1994 to allow foreign-flagged vessels to carry transshipment boxes between the Malaysian ports of Penang and Port Klang, and were extended to transshipment cargo between Penang, Johor and Port Klang in 1997. In mid 2000, Malaysia was said to be considering a further relaxation of cabotage to allow foreign lines to carry transshipment cargo between designated ports in East Malaysia (Sabah, Sarawak) and Port Klang. The various exemptions are designed to enhance Port Klang's position as a hub port. Under the Eighth National Development Plan (2001–05), we understand that relaxation of cabotage has been extended to support the emerging hub port of Tanjung Pelepas (PTP).



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