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OFFICE OF THE SECRETARY**

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October 30, 2006

Mr. Thomas Abe
Commissioner & CEO
Independent Consumer Competition and Commission
P.O Box 6394
BOROKO
National Capital District

Dear Mr. Abe

RE: Submission on ICCC Draft Report on the Coastal Shipping Industry

I refer to your letters seeking Treasury's comments on the above matters. We have attached herewith a submission outlining our views. The submission is self explanatory and if you need any clarification, do not hesitate to contact Mr. Clement Kote on telephone number **328 8829** or Mr. Winston Rodrigues on telephone number **328 8752**.

Yours sincerely,

SIMON TOSALI
Secretary

Submission on draft ICCC report on coastal shipping

Introduction

This submission is made by the Treasury in response to the invitation in the draft report of the Independent Consumer and Competition Commission (ICCC) for interested parties to do so.

Background

This submission concentrates on a few issues in which Treasury, as the central economic policy advising department, considers it is well placed to comment.

Specific issues and submissions

Terminology used

At the outset, it is useful to clarify terms used in this submission as they have the potential to be ambiguous.

The term “cargo-shippers” is intended to mean consignors of cargo.

The term “ship-operators” is intended to mean owners or operators of vessels used in the carriage of goods or passengers by sea.

These terms are used to avoid use of the term “shipper” alone, as it commonly appears to be taken to mean either the operator of the vessel (incorrect use) or the consignor of cargo (correct use).

PNG Harbours Limited

Any consideration of coastal shipping necessarily involves the role, functions and efficiency with which PNG Harbours Limited carries on its business. The discussion in the draft report of the operations of PNGHL confirms this principle.

The Treasury has had occasion, in the context of the ICCC review of the stevedoring and handling industry to make submissions about PNG Harbours Limited. Those are not repeated here but a copy of that submission forms **Attachment 1** hereto.

The Treasury further suggests that the ICCC explore the approach that we understand is used by the Western Australian Government in “contracting out” the management of one of its ports in the North West of the State and in leasing out a wharf on the basis of performance.

Pilotage and towage

In the submission in Attachment 1, some reference is made to the desirability of contracting out to operators the right to supply the services on the basis of the lowest tendered maximum weighted average prices for their supply to users. Those suggestions apply equally to pilotage and towage.

The Treasury considers there is no particular efficiency advantages in PNGHL or other Government instrumentality providing such services. Similarly, parties licensed to provide such services have no incentive in increasing efficiency and reducing costs to users.

Consequently, in the absence of price control for such services, the port manager has the responsibility of putting in place service provision contracting arrangements which secure cost reductions to users.

Cabotage

The Treasury accepts that the form of cabotage in PNG is less restrictive than in some other countries e.g. the *Jones Act* in the United States. To the extent that cabotage is justified by some other claims, however, the Treasury cautions against the unquestioning acceptance of certain assertions without sufficient evidence to substantiate them.

Claimed country-specific vessel purchases

For example, at p.13, it is claimed that coastal ship-operators have invested in vessels designed specifically for particular PNG environments and locations.

The draft report does not indicate whether this assertion has been tested. PNG is not substantially different from many other archipelagic countries. Ships are not “sunk” assets in any sense of the term. While they can only be used for carriage of cargo and/or passengers, they can be moved from one trade to another and are often bought and sold internationally. The *MV Milne Bay*, for example, is understood to have been purchased from the Philippines. In the absence of special factors, Treasury submits that ships should generally be regarded as transferable assets having alternative uses to their current use.

There is a global market for shipping and, it is understood, most PNG shipping is bought second-hand on that market.

Claimed cross-subsidisation of trades

The draft report recounts a number of ship-operator submissions asserting that they cross-subsidise unprofitable routes with the profits from profitable ones. The PNGHL also support the assertions. Some figures have been quoted by the Lutheran church, part owner of Kambang Holdings in respect of certain high cost routes and such cross-subsidisation is said to be readily acknowledged by all stakeholders.

Treasury would find it much more useful if the nature and extent of evidence to support such assertions were canvassed. While detailed cost and revenue figures can be readily accepted as being confidential and sensitive business information, it would be useful for the ICCC to examine the basis of such assertions and provide an assessment thereof.

It can be readily accepted that some routes are uneconomic. What is much more debatable and relevant is the extent of losses on such routes and the degree to which they are cross-subsidised.

Some indication would be available from the overall profitability of the ship-operators. If, after cross-subsidisation, they still return profits which are higher than can reasonably be expected, taking into account the risk-weighted cost of capital, then the cross-subsidy provided to the unprofitable routes is less than the excess profitability of the profitable ones.

There is no discussion, however, of the evidence provided to the ICCC of the extent of the cross-subsidisation.

There is evidence of some services on some routes being discontinued. Presumably, the cross-subsidy required on those routes fell outside the limits set by the ship-operators.

One would expect that some quantification of overall profitability of coastal shipping should be provided by the ship-operators.

Inter-company shareholdings

The draft report points to inter-company shareholdings in coastal shipping. For example, Consort is said to be a joint venture in which two of its “competitors” own two-thirds of its shares. This structure is said to have come about because of the need for rationalization to give acceptable returns on investment.

There is no discussion of what constitutes an acceptable return on investment. Clearly, this market structure is not conducive to competition.

The tier one ship-operators can be expected to be market price leaders which the tier two and tier three operators follow. Given the less than competitive market structure of the tier one level, the level of competition in the lower tiers can be expected to be less than competitive, unless special factors exist.

Treasury considers these issues merit discussion and analysis to facilitate positive results.

At the very least, any change in ownership of the remaining third of shares in Consort should be subject to rigorous examination by the ICCC under its merger control powers.

The current tier one inter-company share-holding arrangements reduce the incentive to compete and it is not surprising, therefore, that each of the three companies service effectively “mutually exclusive” areas which, in a de facto sense, exhibit features of geographic market sharing.

These arrangements have the potential to give rise to explicitly anti-competitive conduct.

Productive, allocative and dynamic efficiency

The draft report suggests that the design of ships for a particular trade, in terms of size, type, capability etc is a result of allocative efficiency at work (p 53 and others). While the ‘allocation’ of ships most suited to a particular trade produces efficiencies, those are,

in the view of Treasury, more in the nature of productive efficiencies than allocative efficiencies. This arises from higher utilization of vessels.

In the view of Treasury, allocative efficiency is best demonstrated, not only in the size of vessels, but in the optimum allocation of resources, not only in shipping, but throughout the economy. This will include, but not be limited to, the number and size of vessels. It will extend to the allocation of other resources arising from productive and dynamic efficiency exhibited by the shipping industry. It is in this wider sense that allocative efficiency is significant.

Of course, allocative efficiency is one of the most important consequences of competition, dynamic efficiency being the other. While productive efficiencies can be dissipated among the factors of production by uncompetitive structures, the other two forms of efficiency are durable and self-reinforcing.

International Liner Shipping Conferences

In the Issues Paper, the ICCA canvassed the matter of international liner shipping conference arrangements. Unfortunately, the draft report does not appear to do so.

The Treasury considers that such arrangements, on their face, are likely to be illegal under the *Independent Consumer and Competition Act 2002* (the Act).

Such illegality is considered to be likely as those agreements usually provide for price-fixing arrangements.

Even if they do not provide for fixing of prices, scheduling and cargo-sharing arrangements in the form of slot-chartering, could well lessen competition substantially.

At the very least, those conference arrangements should be subject to examination under the Act.

From a national economic perspective, competitive international shipping would maximise the volumes of imports and exports, thus maximising the available volume of goods for the coastal shipping industry, with beneficial effects on the national economy.

At p 64, the draft report draws attention to the reduction in international shipping services to PNG ports. It is reasonable to conclude, therefore, that some level of demand remains unmet on the international routes or is 'hubbed' to the main ports.

One other inference capable of being drawn is that conference arrangements maintain prices higher than they otherwise would have been and restrict volumes. Such restrictions reduce the pool of available international cargoes for carriage by coastal shipping, exacerbating existing volume limitations of coastal cargoes.

Conflict of interest in composition of CTC

Treasury agrees that ship-operator involvement in this regulatory body gives rise to conflict of interest issues.

Submission on ICCC Issues Paper on its Stevedoring and Handling Services Review

Introduction

The Independent Consumer and Competition Commission (“ICCC”) released an *Issues Paper* on its review of pricing approaches to Stevedoring and Handling services on 3 July 2006. This submission is made in response to the invitation contained therein for comments.

While this review is concerned with the stevedoring sector and the Regulatory Contract with PNG Harbours Ltd (“PNGHL”) is outside the scope of the review, the Treasury considers that consideration needs to be given to the policies and commercial approaches of PNGHL which have an economic impact on the stevedoring sector.

PNGHL has a significant safety regulation role and, it is emphasised at the outset, that this submission does not relate to that aspect of its operation, which is largely non-commercial.

Background

This submission is confined to two matters which are relevant to a number of industries (including shipping, commercial aviation and tourism) which rely on infrastructure operators in the transport sector generally and, of particular relevance to this submission, on port infrastructure operators.

By initiating discussion on these two matters now, it is hoped that interested parties could contribute ideas for consideration in the context of future assessment by the ICCC of the performance of PNGHL and initiatives to improve its performance.

The viability of downstream industries depend on the efficient operation of ports. Agricultural and rural industries are especially dependent on the costs, efficiency and reliability of shipping and port services for their viability.

PNGHL controls a number of ports and related facilities and its operations and commercial strategies influence the costs and efficiencies of downstream industries.

It charges fees to users of its “commercial” facilities. For example PNGHL charges shipowners for berthing and stevedores for using its facilities. Where its real property is occupied by businesses, rental is charged. There are likely to be other such commercial charges it makes on users of its facilities.

It is in this context that the Treasury makes this submission. The submission relates to the commercial dealings between PNGHL and stevedoring companies and the transparency of the financial and operational performance of PNGHL.

Economic significance of port management

The reason for the focus of this submission on PNGHL is that its policies, efficiency and performance are inextricably interlinked with the operations of the stevedoring companies and their customers, the shipping lines. The costs, efficiency and pricing policies of those sectors in the vertical chain influence the charges they impose on their customers, who are the shippers of freight and passengers using shipping services. Hence, such costs flow on to the prices for end services such as passenger fares and freight. Passenger fares, of course, are a cost factor in tourism. Freight is significant for a range of industries including those involved in the import and export of industrial and consumer goods. Agriculture and rural industries are especially sensitive to freight rates.

While regulating the prices charged by stevedoring companies for their services imposes a constraint on their exercise of market power to raise prices, the process takes the charges of port managers as a cost input to the charges. The charges imposed by PNGHL, however, fall for consideration under its Regulatory Contract which forms a discrete process.

There is a risk that examining the costs of different elements of the vertical chain as separate processes may not highlight their economic interdependence sufficiently to demonstrate the need for consideration of end-to-end efficiency of the waterfront sector and to explore options to improve its operation.

Under various programmes, the Government funds capital works to upgrade seaports to increase their capacity; improve efficiency and enhance throughput, with the objective of generating benefits to the national economy. If the charges and management approaches of ports do not promote efficiency, that Government objective would be frustrated. The performance of port management in relation to particular ports, therefore, provides a feedback loop to inform Government decision-making on funding their development.

The issues and suggested approaches

(a) Insufficient Accounting Transparency of Port Operations

PNGHL publishes aggregate accounts which do not give an accurate picture of the operational and financial performance of individual seaports in relation to their “commercial activities”.

Consequently, no informed assessment can be made on the efficiency of individual ports. Users of port services, therefore, are unable to exert market pressure on port charges due to information asymmetry.

This gap in performance data reduces the incentive for improvement in performance by individual ports as well as PNGHL in its strategy for them.

Proposal – Horizontal Accounting Separation

It is submitted that PNGHL be requested to publish disaggregated financial information on the commercial operations of individual seaports. This will serve a number of purposes.

First, the transparency will act as an incentive for the local managers of individual seaports to improve their performance.

Secondly, it will enhance accountability, both of individual seaport managers and of PNGHBL, in terms of their resource allocation policies and practices – whether the benefits from expenditures on particular facilities are accruing as forecast or intended.

Thirdly, it will

- increase awareness of the performance of individual seaports by PNGHL and by the communities in which the individual seaports are located;
- encourage proposals to increase traffic throughput and enhance performance of the local seaport; and
- increase dialogue between the local communities and PNGHL to optimise resource allocation and efficiency of operation of the particular seaport.

Fourthly, the Government's decisions on its own funding allocation for ports will be better informed by the track record of results from earlier expenditures on individual seaports.

(b) Pro-competitive leasing and licensing approaches

The focus of the *Issues Paper* is on price control or price monitoring approaches for stevedoring and handling. Such approaches are understandable in the context of historical circumstances and, for the short term, continuation of price regulation of that sector is appropriate.

Price regulation, however, requires detailed and ongoing regulatory oversight, with costs for all parties. Information asymmetry adds to the regulator's difficulties. Furthermore, while price glide paths offer certainty for their duration, in the longer term, stevedoring operators have little incentive to increase efficiency as they would expect that the benefits of any efficiency gains would, ultimately, be largely lost through the regulatory process (i.e. new price regimes replacing previous ones).

To facilitate continuing improvements in efficiency, something more is needed. The Treasury suggests that in tandem with price control or price monitoring of stevedoring and handling services (whichever is decided upon), an innovative approach be adopted that would create the dynamics for continuing long term efficiency improvements and prepare for the replacement of price regulation or monitoring, in the long term, by a market-oriented process.

Proposal

The approach involves PNGHL leasing a stevedoring terminal or similar cargo-handling facility on a predetermined, advertised rental (set to recover costs plus a reasonable return) by competitive bidding based on the lowest average charges for a basket of services to be provided, using that terminal or facility.

The simple example of a port containing two or more terminals or cargo-handling facilities, which adjoin shipping berths, illustrates the proposal. If such a terminal or facility is, or becomes, available for leasing, a rental is set based on a reasonable return on the asset (plus any expenses incurred by the port management in relation to it).

That rental is then nominated as the basis for competitive bids from arms-length tenderers for leasing the terminal or facility. The length of the lease would depend on the extent of any sunk costs required to be expended by the successful bidder. If no significant sunk costs are required, the lease can be a short one, say up to 2 years.

The key to the approach is the basis upon which the right to lease the facility is awarded. The successful bidder is decided on the basis of the lowest weighted average charges to be made for a basket of services to be supplied to users by the lessee for the duration of the lease of the relevant facility – in this case, a cargo-handling facility adjoining a shipping berth. This approach contrasts with the more common one of awarding leases based on the highest rent offered – thereby *raising* costs through the chain.

If the lease is to be a longer one, say more than 2 years, (where there is a requirement for significant sunk investment by the successful lessee) then a mechanism for adjustment of the tendered charges, would need to be considered as well. It is unnecessary to consider long leases, however, if no significant sunk investment is sought from the lessee.

In inviting bids, care needs to be taken to prevent collusion or information flows between bidders. Hence, it is desirable that bidders with intercorporate shareholdings or board representation be prevented from making separate bids for the same facility. Furthermore, the successful bidder for the lease of a particular facility should be prevented from bidding for a competing facility e.g. a cargo-handling facility adjoining another berth in the same port.

The benefit to users is that charges to them are set competitively and inter-temporal increases are avoided. Low charges encourage throughput with benefits to the national economy, as explained earlier in this submission.

The benefit for operators is the certainty that for a fixed rental and agreed user charges, they can focus on efficiency improvements to increase throughput and maximise profit through growth. Considerable resources would be saved by all parties involved in the regulatory process if such an approach could replace price regulation for such services.

Further, if implementation is successful, licenses for service providers such as tugboat and lineboat operators could be granted on the same basis i.e. the lowest average prices to be charged to users for the relevant services.

This process need not be limited to ports with more than one competing facility. Even single facility ports could encourage throughput by such an approach.

There is a substantial body of economic literature on this approach, often referred to as ‘franchise bidding’.

Implementation costs and benefits

The implementation costs of the two proposals are likely to be minimal. PNGHL prepares accounts which are aggregated from inputs generated by the individual seaports. It should not be either difficult or time-consuming to publish additional accounting information relating to the individual commercial activities of seaports.

Inviting bids for leases is a normal commercial activity of port managers. Amending the process to secure from bidders the lowest end-charges for users requires formulating a basket of services, appropriately weighted, as a basis for bidding. This can be done in consultation with users and stevedoring companies.

The rental for the facility could be set by the ICCC based on information supplied by PNGHL and assessed by the ICCC.

While the significance of individual port-related charges to end prices for downstream goods and services would vary, reductions in the former would be likely to flow on to the latter and, over time, lead to small, but not insignificant, end-price reductions. Such price reductions could make some marginal users viable and lead to disproportionately large increases in throughput for other users who are more sensitive on price. More broadly, increased efficiency, lower costs and lower charges can be expected to result. This would flow on to the downstream business sectors, which, in turn, would be able to reduce their charges to customers whose demand for services (and related goods) is more price responsive.

These two initiatives are likely to stimulate demand which, in turn, would encourage increased supply of services, in a “virtuous circle” with benefits to the national economy.

Downstream industries which can be expected to benefit are the passenger cruise sector; export and import industries; those dependent on coastal shipping; and those sectors which link into them. Examples are tourism-related industries; land transport; agriculture; handicrafts; and general retailing.

Recommendation

The Department of Treasury recommends that the ICCC initiate consultation among the representatives of parties involved in the chain of waterfront functions with a view to exploring options for implementation of these proposals by PNGHL, following the review of stevedoring and handling services.

Treasury staff are available to discuss these proposals with your staff.