HT. 3754 – Review of the Consortia BER

The Liner Shipping Industry Supports the Commission's Proposed Extension of Commission Regulation (EC) No 906/2009

March 2014

The World Shipping Council (WSC), the European Community Shipowners' Associations (ECSA), and the International Chamber of Shipping (ICS) respectfully submit these comments in response to the Commission's public consultation notice in matter HT.3754 – Review of the Consortia BER. For the reasons set forth in more detail below, the shipping industry agrees with the assessment of the Commission that Commission Regulation (EC) No 906/2009 on the application of Article 81(3) [101(3)] of the Treaty to certain categories of agreements, decisions, and concerted practices between liner shipping companies (consortia) should be extended for an additional five years, until 25 April 2020.

Identity of the Commenters

The World Shipping Council is a non-profit trade association, with offices in Brussels and Washington, D.C., that represents the interests of the international liner shipping industry in public policy and regulatory matters. WSC's twenty-nine member companies account for more than ninety percent of the world's liner shipping capacity. ECSA is a non-profit trade association whose membership comprises the national shipowner associations of the European Union and Norway. ECSA's aim is to promote the interests of European shipping so that the industry can best serve European and international trade and commerce in a competitive free enterprise environment to the benefit of shippers and consumers. ICS is the global trade

association for shipowners with a membership comprising national shipowners' associations in 36 countries, representing all sectors and trades and over 80% of the world merchant fleet. [1]

Introduction

In its proposed regulation to extend the period of application of Regulation (EC) No 906/2009, the Commission makes two important statements. First, the Commission has stated that:

> "On the basis of the Commission's experience in applying the block exemption, it appears that the justifications for a block exemption for consortia are still valid and that the conditions on the basis of which the scope and content of Regulation (EC) No 906/2009 were determined have not substantially changed."

The second critical substantive assessment set forth in the draft Commission regulation published on 27 February 2014 is as follows:

> "Regulation (EC) No 906/2009 simplified and introduced substantial modifications to the rules applicable to consortia. Since the new legal framework has been in place and applied for only a short period of time, further changes should be avoided at this stage. This will avoid increasing the compliance costs of the operators in the industry."

The liner shipping industry concurs with both of these assessments. In the comments that follow, WSC, ECSA, and ICS discuss the legal framework in which the Commission's assessments have been made, and we provide facts and analysis that demonstrate that the Commission's assessments and proposed course of action are correct.

[1] The World Shipping Council's Transparency Register ID Number is 32416571968-71. Additional information about WSC and the liner shipping industry is available at www.worldshipping.org. The European Community Shipowners' Associations' Transparency Register ID Number is 59004966537-01. Additional information about ECSA and its member associations is available at http://www.ecsa.eu. The International Chamber of Shipping's Transparency Register ID Number is 90104608462-14. Additional information about ICS is available at www.ics-shipping.org.

1. History and Rationale of the Consortia BER

The Commission's current statement that the "justifications for a block exemption for consortia are still valid and that the conditions on the basis of which the scope and content of Regulation (EC) No 906/2009 were determined have not substantially changed" is best understood within the context of the history of the consortia BER.

Beginning with Commission Regulation (EC) No 870/95, which was adopted by the Commission pursuant to the power granted to it by Council Regulation (EEC) No 479/92, the Commission has adopted a series of consortia block exemption regulations, each effective for a period of five years. The current regulation, No 906/2009, adopted under authority of Council Regulation (EC) No 246/2009, expires in April of 2015.

Throughout the history of the Council and Commission regulations concerning liner shipping consortia, the Parliament, the Council, and the Commission have consistently found that consortia bring economic benefits. In its most recent authorizing regulation, for example, the Council found that:

> "Joint-service agreements between liner shipping companies with the aim of rationalizing their operations by means of technical, operational and/or commercial arrangements (described in shipping circles as consortia) can help to provide the necessary means for improving the productivity of liner shipping services and promoting technical and economic progress."[2]

The various regulations have also found that consortia provide benefits to shippers, with the current regulation noting that:

> "Users of the shipping services provided by consortia may benefit from the improvements in productivity which consortia can bring about. Those benefits may also take the form of an improvement in the frequency of sailings and port calls, or an improvement in scheduling as well as better quality and personalized services through the use of more modern vessels and other equipment, including port facilities."[3]

Taken together, these efficiency and innovation gains, a fair share of which accrue to the shipper customers of carriers participating in consortia, have been found to satisfy the conditions of Article 101(3) of the Treaty with sufficient certainty that consortia may properly be exempted from Article 101(1) as provided in Article 103 of the Treaty on the Functioning of

[2] Council Regulation (EC) No 256/2009, recital 5.

[3] Commission Regulation No 906/2009, recital 6.

the European Union (TFEU). These findings, which provided the basis for adopting the version of the consortia block exemption regulation currently in effect, remain valid today. Indeed, recent developments in the liner shipping markets demonstrate why consortia – and the consortia block exemption regulation – are even more important to the efficient operation of the liner shipping industry today than they have been in the past.

2. Market Developments Since the Last Consortia BER Review: Cost Increases and Bigger Ships

The fundamental characteristics of the liner shipping industry that have been the basis of the consortia BER since 1995 remain unchanged today. Specifically, the industry is not concentrated; there are no regulatory barriers to carriers entering markets; the industry struggles with overcapacity for structural, cyclical and seasonal reasons, but such excess capacity cannot be utilized or easily idled; capital and operating costs are high; the industry is highly competitive with shippers having an array of service choices; and profits (where they exist) and returns on investment typically lag behind those of other major industries. In short, the industry is a very challenging one for vessel operators and is a favorable one for the European importers and exporters that use the services of those vessel operators.

Although the basic structure of the liner shipping market remains as it has been during earlier Commission reviews of the consortia BER, some trends that had begun to appear at the time of the Commission's last review of the consortia BER have accelerated since that most recent review. The two trends with the greatest relevance to the role of consortia are the substantial increases in the cost of fuel and the related trend towards larger vessels, especially in the trades between Asia and Europe.

According to *Alphaliner*, in January of 2007 there were two container vessels in excess of 10,000 TEUs.[4] As of December 31, 2012, there were 162 such vessels. By the end of December 2016, based on *Alphaliner's* analysis of orderbooks, there will be an estimated 281 container vessels over 10,000 TEUs. Also according to *Alphaliner*, the next largest container vessel size (7,500 to 9,999 TEUs) has grown from 145 ships in 2007 (total capacity 1,225,433 TEUs) to 326 ships at the end of 2012, with continued projected growth by the end of 2016 to 437 ships. These vessel size increases are in addition to an earlier increase that occurred between 2005 and 2006, when the size of the largest container vessel jumped from 9,500 TEUs to 15,500 TEUs in a single year. The largest container ships being delivered today have a capacity of 18,000 TEUs.

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[4] A "TEU" is a twenty-foot equivalent unit, which describes the size of the smallest standard shipping container in general use. Most containers are forty feet in length, and would therefore represent two TEUs.

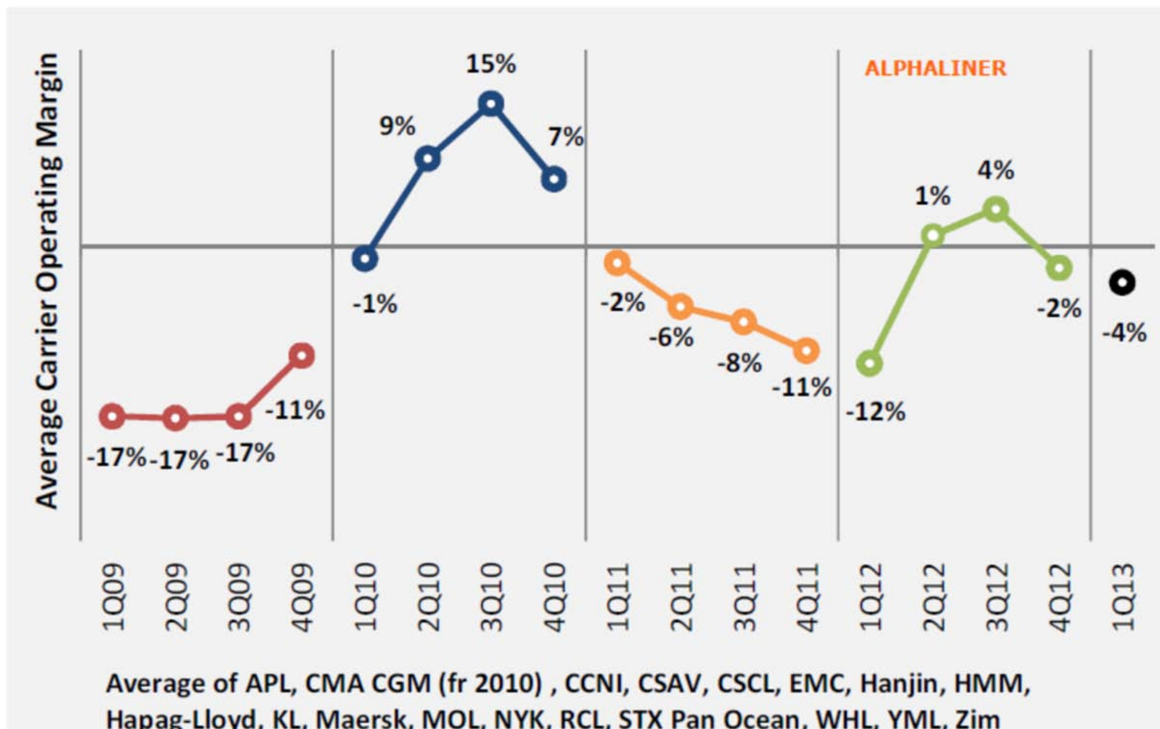
In short, beginning at about the time of the Commission's 2008-2009 review of the consortia BER, an entire new category of very large container vessels has been built and delivered. These new vessels represent a major innovation in efficiency and air emissions reduction in the ocean transportation sector, but they also represent an operational challenge for the carriers that are bringing them to the market.

The primary reason that carriers have invested heavily in these large vessels is to reduce per-unit operating costs. Bunker fuel prices, which are the single greatest variable operating cost in liner shipping, doubled between 2007 and 2013.

In addition to the steady increase in baseline bunker prices over the years, carriers have also seen increased fuel costs because of air emission control areas (ECAs) in Europe and North America. The low sulphur fuel required in these areas carries a price premium over heavy fuel oil (HFO). In 2015, the ECA sulphur limits will become stricter, which will increase costs further. The current cost differential between HFO and the distillate fuel that would meet the 2015 ECA sulphur limits is approximately 30%. The greatest increase in fuel costs will occur when, pursuant to MARPOL Annex VI, the global fuel sulphur limit drops from 3.5% to 0.5% in 2020 or 2025, essentially requiring distillate fuel for all oceangoing ships worldwide. Based on current average fuel price differentials between HFO and distillate fuels, WSC has estimated that the increased cost of the global 0.5% sulphur limit may be in the range of €55-70 billion per year on a global basis for the worldwide fleet (all sectors). Those estimated increases are in addition to the ECA costs discussed above.

Under any scenario, fuel costs will rise substantially in the coming years, and those increased costs will continue to require continuous improvements in transport efficiency.

At the same time that fuel prices have increased substantially, freight rates have remained flat, meaning that carriers have effectively absorbed the increases in fuel costs. For example, an analysis by *Alphaliner* in May of last year concluded that average global container freight rates rose only 3% in the fifteen years between 1998 and 2013. Once those rates are adjusted for fuel price increases, the real rates have declined by over 15% during that period, according to the *Alphaliner* analysis. As one would expect, the combination of rising costs and falling rates in real terms has produced historically poor overall rates of return on investment in the liner shipping sector. The *Alphaliner* chart below plotting recent operating margins for carriers with public profit and loss information is indicative of the difficult economic environment in which liner shipping operates:



Source: Alphaliner Weekly Newsletter Volume 2013 Issue 23, June 3, 2013

Under these market conditions, the only recourse for carriers is to reduce costs if they are to maintain services. One of the primary strategies that carriers are pursuing to cut per-unit costs for transporting containers is to deploy larger vessels. On a per-slot basis, these vessels use substantially less fuel than older, smaller vessels, thus lowering per-unit costs and improving the overall efficiency of the transportation.

The equation of larger vessels delivering efficiency gains, however, only produces the desired result if those vessels' capacity is efficiently utilized to carry cargo. A 14,000 TEU ship burns less fuel on a per-unit basis than a 7,000 TEU ship, but it still burns more fuel overall. Thus, a 14,000 TEU ship that is half full is less efficient than a 7,000 TEU ship that is full. The utilization rate is critical to realizing the designed efficiency of the larger vessels, and consortia are an important tool in attaining efficient utilization rates. In many cases carriers simply do not have enough cargo to fill ships of this size on their own. Vessel sharing allows carriers to use these expensive large assets more efficiently than they otherwise could.

The usefulness of consortia in improving operational efficiency is amplified by the "lumpy" nature of liner shipping capacity (i.e., that the smallest economically viable unit of

supply is a "string" of enough vessels to provide weekly calls at each port in a service rotation), a point that is discussed in more detail in the remainder of this section.

The operational case for sharing vessel assets through consortia is a simple one. As the industry has developed, there are many liner shipping companies that provide service on multiple trade lanes around the world. That many carriers operate in multiple trade lanes is the result of several factors. First, industry participants naturally seek to grow their businesses by entering markets in which they see opportunity. Second, large international shipper customers often demand transportation on multiple routes. Third, participating in multiple trades provides market diversification for carriers, who can re-deploy assets from markets with low demand to markets with relatively higher demand as commercial conditions dictate. Fourth, the ability to re-deploy vessels across various trades provides further options for matching vessels to their most efficient use.

If every liner operator needed to provide vessel capacity by itself on every trade in which it participated, there would either be a gross oversupply of capacity, thus making the services economically unsustainable, or a shortage of investment and fewer service providers. In short, in the absence of consortia, there would be fewer services and fewer competitors.

One of the reasons that it can be less efficient for carriers to provide individual services in major trade lanes is that the smallest economically viable unit of supply is a vessel "string" – typically defined in the industry as the number of vessels necessary to provide a weekly service on a given route. In the Trans-Atlantic, for example, vessel strings tend to consist of five or six vessels. On the North Asia to North Europe route, in comparison, typical strings run between 10 and 12 vessels. The number of vessels necessary to provide such a single, weekly service is the minimum number that must be deployed in order to enter a market. More realistically, a service provider in a major trade will have to deploy multiple strings in order to provide the multi-port, fixed-day-of-the-week schedules required by many shippers.[5] Thus, with prices for large, efficient vessels ranging from US$125 million to US$175 million each, the capital investment required for a substantial Asia-Europe service is between 5 and 8 billion U.S. dollars, an undertaking that relatively few carriers could sustain individually. Absent the ability of

[5] In addition to having a sufficient number of vessels to provide the type of service that shippers require, it is necessary that the vessels deployed on a given service be as close in size to one another as is feasible. That is the case because a given service will not be able to reliably handle cargo space demands if it calls a port one week with a 15,000 TEU vessel, and then calls the next week with a 5,000 TEU vessel. This need for a homogenous composition of vessel strings also complicates the investment and deployment challenges that carriers face. That complication has been exacerbated by the increased size disparity in the global fleet that has been caused by the relatively sudden introduction of very large ships, while at the same time there are many smaller ships in existence that will be commercially serviceable for many years to come.

carriers to share vessel space through consortia arrangements and thus to spread these investment loads, there would be fewer competitors in each market, inefficiently utilized ship capacity, or both. Both outcomes would result in higher prices and reduced services.

Carriers of all sizes can benefit from vessel sharing consortia. A larger carrier in a trade can order and deploy larger, more efficient ships with confidence that it can share the vessel assets in order to achieve superior capacity utilization. Smaller carriers that may not be able individually to afford multiple strings of the largest, most efficient assets may obtain the economic efficiencies of large vessels via vessel sharing consortia. New entrants will find it easier to begin a new service by sharing vessels rather than having to finance a stand-alone service.[6] The fact that consortia allow the maintenance of more competitors on more routes through the efficient use of vessel capacity and shared services has consistently been recognized by the Commission in enacting its prior and current consortia BERs, and shippers similarly understand and support the existence of these arrangements as providing more choices and more competition than would exist in the absence of consortia.

With the recent and continuing introduction of very large container vessels into the liner trades, the benefits of consortia discussed above are amplified in today's market. In the current situation, rising fuel prices and the search for greater efficiencies through the use of larger vessels make consortia an even more important tool for the support of reliable and frequent transportation services than was the case when the Commission last reviewed the consortia block exemption. Thus, as a factual matter, the Commission is plainly correct (and perhaps understates the case) in its current assessment when it says that "the justifications for a block exemption for consortia are still valid and that the conditions on the basis of which the scope and content of Regulation (EC) No 906/2009 were determined have not substantially changed."

3. The Consortia Block Exemption Regulation Simplifies and Reduces the Cost of Compliance, and Makes the Use of Consortia More Economically Efficient.

The discussion above deals with the factual context in which the Commission has made its determination that the conditions supporting the BER remain in place today. In this section we address the Commission's second assessment, which is that "[s]ince the new regulatory framework has been in place and applied for only a short period of time, further changes should be avoided at this stage."

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[6] While there are no regulatory barriers to entry in liner shipping, consortia reduce the risk that ships' capital and operating costs become barriers to entry.

This second Commission assessment has its legal roots in the Treaty on the Functioning of the European Union (TFEU). Recognizing that appropriate application of the law sometimes requires that the Commission provide specific guidance to individual sectors in order to ensure clarity and compliance without undue administrative complexity, TFEU Article 103(2) states in relevant part that:

"(2) The regulations or directives referred to in paragraph 1 shall be designed in particular:

. . .

> (b) to lay down detailed rules for the application of Article 101(3), taking into account the need to <u>ensure effective supervision on the one hand, and to simplify administration to the greatest extent possible</u> on the other; [and]
>
> (c) to define, if need be, <u>in the various branches of the economy</u>, the scope of the provisions of Articles 101 and 102 . . . ." (emphasis added)

As the Commission noted in the proposed regulation released on 27 February 2014, the Commission substantially amended and streamlined the consortia BER in 2009. Among other changes, the 2009 amendments removed outdated provisions and clarified important practical issues. By the terms of the consortia BER itself, those consortia that benefit from the BER are "limited to those agreements for which it can be assumed with a sufficient degree of certainty that they satisfy the conditions of Article 81(3) [101(3)] of the Treaty."[7]

In part as a result of the changes adopted in 2009, the current consortia BER is a very useful compliance tool – one that is reasonably free from ambiguity and that can be understood by commercial and management personnel without the need for extensive legal interpretation. In short, the current BER is "fit for purpose," and its clarity supports high compliance rates and low compliance costs. Those results benefit the Commission, the shipping public, and the covered shipping lines.

In addition to the fact that the conditions supporting the consortia BER remain in place (and indeed have become more compelling in recent years), and in addition to the fact that the BER simplifies and lowers the cost of compliance, it is worth noting that the BER is also justified by the fact that there is a set of core common attributes of liner shipping consortia that make this particular form of cooperation especially appropriate for regulation under a block exemption. In 1990, the Commission recognized that the common features of consortia and

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[7] Commission Regulation No 906/2009, recital 4.

the frequency with which changes are made to consortium agreements make this type of cooperation well-suited to regulation through the block exemption mechanism:

> "Consortia in liner shipping are a specialised and complex type of joint venture. Unlike most commercial and industrial joint ventures the scope, parties, activities and terms of consortia agreements are frequently altered. A block exemption for consortia should therefore concentrate on clarifying the requirements under which consortia can be exempted from the prohibition of cartels pursuant Article 85(3) of the Treaty, rather than differentiating between consortia."

Commission Report on the possibility of a group exemption for consortia agreements in liner shipping, COM (90) 260 final of 18.6.1990.

Put differently, at the very least for those consortia that fall within the boundaries of the BER, consortia are more alike than they are different, and the workings of such consortia are well understood by carriers, shippers, and the Commission. At the same time that the basic features of consortia are well-known, however, the details of individual consortia may change frequently in response to operational demands. Having the flexibility to make such changes is critical to realizing the efficiency-enhancing potential of consortia. Under these circumstances, having a clear, uniform set of rules makes sense both as a matter of competition policy and as a matter of transportation policy.

The Commission's draft regulation cites the avoidance of unnecessary compliance costs as one of the reasons for extending the period of application of the consortia BER, and that is indeed an important factor. In addition to reducing the cost of compliance, however, extension of the consortia BER also makes the consortia mechanism more flexible and efficient as an operational tool.

Having legal certainty for those arrangements that fall within the terms of the BER means that potential consortia arrangements, or amendments to those arrangements (including terminating those arrangements and entering into different ones) can be evaluated solely on their operational merits. Instead of wondering whether the potential cooperation may be subject to legal risk, the parties can focus on whether the proposed arrangement maximizes productive use of assets, reduces costs, and better serves customers.

From an economic perspective, therefore, removing legal risk reduces transaction costs beyond the lower compliance costs noted by the Commission in its proposed regulation. Specifically, the existence of the BER removes the otherwise applicable economic cost associated with foregoing efficiency-enhancing operational opportunities because of legal risk or uncertainty. In the absence of the BER, for example, consortia carriers might forego

available opportunities in the European trades, perhaps by choosing not to make a Mediterranean port call on a service between Asia and the U.S. via the Suez Canal. Similarly, if not for the BER, increased legal risk could discourage amendments to existing consortia. Such increased legal risk could also encourage carriers to remain in an existing consortium rather than form a new consortium, even when changing consortia would make operational and economic sense and would better meet customers' needs. Minimizing the chilling effects that legal uncertainty can have on efficiency-enhancing consortia is thus another benefit that is derived from extending the application of the BER.

4. Conclusion

By the time the current version of the consortia BER expires in 2015, the BER will have provided clear, practical, and efficient guidance to the liner shipping industry, its customers, and regulators for twenty years. Especially with the modernization of the BER in 2009, the regulation provides useful legal certainty for the industry while at the same time eliminating concern that a consortium operating within the boundaries of the BER could pose a credible threat to competition. As such, the consortia BER well fulfills the Article 103(2) TFEU instruction that competition regulations are to be crafted so as "to ensure effective supervision on the one hand, and to simplify administration to the greatest extent possible on the other...."

It is widely agreed that liner shipping consortia increase competition, expand service offerings, and encourage technical innovation. Those benefits of consortia are especially important today in the face of rising fuel prices, stagnant trade growth, the mandate to reduce air emissions, and economic pressures on carriers to cut costs and maximize the efficient utilization of vessel assets while maintaining quality service.

The consortia BER, by removing legal risk from the mix of factors that must be evaluated by carriers considering consortia, allows those carriers to enter into, amend, and leave consortia based on grounds of economic efficiency, not legal risk avoidance. That in turn, makes consortia more fluid, more efficient, and more responsive to market forces. Consortia are an integral part of the liner shipping industry, and they best serve the interests of all interested parties – shippers, carriers, regulators and the public – when the rules that govern them are plain and transparent. The consortia BER provides that clarity and transparency, and the shipping industry therefore strongly supports the Commission's proposal to extend the applicable date of the consortia BER until 25 April 2020.

The World Shipping Council, the European Community Shipowners' Associations, and the International Chamber of Shipping appreciate the opportunity to share their views with the Commission.