118979

# BY THE COMPTROLLER GENERAL

# Report To The Chairman, Committee On Merchant Marine And Fisheries U.S. House Of Representatives

# OF THE UNITED STATES

# Changes In Federal Maritime Regulation Can Increase Efficiency And Reduce Costs In The Ocean Liner Shipping Industry

The U.S. ocean liner shipping industry is subject to regulation under the Shipping Act. Critics allege that this Act has led to the decline of the U.S. flag liner fleet, has led to inefficient service, and has damaged foreign relations. In this report, GAO examines these allegations and analyzes alternatives to the current regulatory framework. The report finds that while the Act has led to inefficiencies and high costs, the U.S. flag liner fleet is not in the state of decline ascribed to it. The views of liner firms and their conference organizations as well as of shippers are presented. Although the report makes no recommendations, it sets forth a number of issues for congressional consideration.

UNITED STATES GENERAL ACCOUNTING OFFICE

118979

GAO/PAD-82-11
JULY 2, 1982

022766

2

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are $3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are $1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-198002
10CCPAD79

The Honorable Walter B. Jones
Chairman, Committee on Merchant
Marine and Fisheries
House of Representatives

Dear Mr. Chairman:

This report responds to your committee's request that GAO conduct an economic analysis of the international ocean liner shipping industry. In the report we discuss the economic rationale for revising the Shipping Act, 1916, and the economic implications of frequently discussed modifications of the Act. We provided your committee a copy of the draft report in December 1981, for use in deliberations on H.R. 4374, a bill to improve the international ocean commerce transportation system of the United States.

As arranged with your office, we are sending copies of this report to the Secretary, Department of Transportation, the Chairman, Federal Maritime Commission, and the Attorney General, Department of Justice. Copies are also being sent to other interested parties and to those who request them.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

Enclosure

COMPTROLLER GENERAL'S
REPORT TO THE CHAIRMAN,
COMMITTEE ON MERCHANT
MARINE AND FISHERIES,
U.S. HOUSE OF
REPRESENTATIVES

# CHANGES IN FEDERAL MARITIME REGULATION CAN INCREASE EFFICIENCY AND REDUCE COSTS IN THE OCEAN LINER SHIPPING INDUSTRY

## D I G E S T

Increasing concern about the viability of the United States merchant marine has led the Congress to consider substantial revisions to the Shipping Act, 1916, as amended (hereinafter referred to as the Shipping Act or the Act). While valid reasons exist for modifying the Act, GAO does not believe the current condition of the general cargo liner segment of the U.S. merchant marine is among them. Certain provisions of the Act have fostered inefficiencies and high costs in the ocean liner shipping industry and strained foreign relations, but the U.S. flag liner fleet has performed adequately and does not appear to be in the state of decline generally ascribed to it.

## OBJECTIVES, SCOPE, AND METHODOLOGY

The House Committee on Merchant Marine and Fisheries requested that GAO conduct an economic analysis of the international ocean liner shipping industry. The two principal objectives of this analysis are to determine whether there is any valid economic rationale for revising the Shipping Act, and second, to assess the economic implications of frequently discussed modifications of the Act.

GAO used several methodological approaches to meet the objectives of this report. First, GAO consulted Government officials and reviewed relevant documents and studies to ascertain the general condition of the U.S. flag liner fleet. Second, GAO relied on economic analysis to determine the effects of current regulation, and potential alternatives to it, on the international ocean liner shipping industry. Third, GAO supplemented this approach by surveying and interviewing U.S. shippers, carrier representatives, and other affected parties. Fourth, GAO used statistical techniques to analyze data collected from the Maritime Administration and the Federal Maritime Commission (FMC). (See chapter 1.)

PAD-82-11
JULY 2, 1982

## THE SHIPPING ACT, 1916, PLACES RESTRICTIONS ON SHIPPING CONFERENCES

Shipping conferences are voluntary associations of ship operators that jointly determine rates and levels of service on trade routes throughout the world. The Shipping Act allows the members of U.S.-based conferences to jointly determine rates, pool revenues, and restrict or regulate service levels between ports. Any agreements to do so, however, must be filed with and approved by the FMC, which can disapprove any agreement that it finds to be unjustly discriminatory, detrimental to commerce, contrary to the public interest, or in violation of the Shipping Act. If their agreements are approved by the FMC, conferences are granted immunity from prosecution under U.S. antitrust laws.

The Act, as amended, also requires that conference membership be open on equal terms to any carrier willing and able to provide regular liner service on a U.S. foreign trade route. It restricts the type of exclusive patronage contracts that conferences can use to foster shipper loyalty and combat competition from nonconference carriers. Conferences are allowed to use dual rate contracts, whereby shippers agreeing to ship exclusively on conference lines are charged lower rates. However, restrictions are placed on the amount of discount allowable under these contracts and on the type and amount of any penalty that can be imposed on shippers violating these agreements. A variety of other practices are also prohibited to ensure that shippers are not denied access to nonconference carriers.

In addition to these restrictions, the Shipping Act prohibits any common carrier serving the U.S. foreign trades from charging unjustly discriminatory or unreasonable rates. Carriers are also prohibited from charging less than their published tariff rates, and the FMC can disapprove any rate that it finds detrimental to U.S. commerce. (See chapter 2.)

## THE SHIPPING ACT FOSTERS WASTEFUL SERVICE COMPETITION

In the ocean liner shipping industry, the demand for services is affected by both the rates charged and the level of service offered. As a result of the Shipping Act and its enforcement by the FMC, conferences covering the U.S. foreign trades are able to restrain price competition by jointly establishing common tariffs to which their members must adhere. However, conferences have not been able to effectively control capacity in the U.S. foreign trades because of their inability to limit membership and the difficulty of obtaining FMC approval for agreements to pool revenues or restrict the number of sailings. Consequently, competition among conference members occurs primarily by augmenting the level and frequency of service offered to shippers and not by reducing prices. This process can result in higher costs due to low capacity utilization rates (a result of more frequent sailings with each carrying less cargo), and lower rates of return on invested capital.

High rates charged by conferences can also induce nonconference operators (also called independents) to enter the U.S. foreign trades. The inability of conferences to use more stringent types of exclusive patronage contracts limits their ability to deter the entry of these carriers. A substantial amount of entry by price-cutting independents would cause rates to fall and aggravate the problem of excess capacity. As a result, U.S. flag conference members could suffer financial losses. (See chapter 2.)

## THE CONDITION OF THE U.S. LINER FLEET DOES NOT JUSTIFY A MAJOR REVISION OF THE SHIPPING ACT

Taken at face value, certain statistics suggest that the general cargo liner portion of the U.S. merchant marine is in serious trouble. For example, the number of U.S. flag general cargo vessels declined from 523 in 1970 to 256 in 1980. In addition, the number of carriers composing the U.S. flag liner fleet has fallen from 19 in 1970 to 9 in 1981. Further, the U.S. fleet of general cargo vessels has fallen from second largest in the world in 1965 to eighth largest in 1979 in terms of total deadweight tons.

But recent advances in cargo handling and ship design technology suggest a different interpretation. Containerization enables fewer containerships to transport the same amount of cargo in the same amount of time as conventional vessels. Thus, rather than indicating distress, the decline in the number of U.S. flag vessels and the relative ranking of the U.S. flag liner fleet reflect significant changes in the type of ships used by U.S. flag operators to carry their cargo. By adopting containerization, a smaller number of operators and vessels can carry the available cargo. The decline in the number of U.S. flag carriers was also a result of other factors, such as diversification and changing market conditions.

Thus, major revisions of the Shipping Act are not required to assure the fleet's existence. However, because advances in technology are producing even larger, more costly vessels, U.S. flag operators may find it increasingly difficult to replace their fleets in the future. To assure the continued, successful performance of the fleet, it may be necessary for U.S. carriers to form consortia. These arrangements would let U.S. flag operators pool their resources, while maintaining the benefits of interline competition. (See chapter 3.)

## ENFORCING THE SHIPPING ACT STRAINS INTERNATIONAL RELATIONS BUT IS NOT BIASED AGAINST U.S. CARRIERS

The United States is unique among maritime nations in the way it regulates the international ocean liner shipping industry. Most countries do not impose restrictions on the practices or organizational structures of shipping conferences. Shippers are generally allowed to protect their own interests by forming groups known as shippers' councils to negotiate rates and conditions of service with conference representatives.

Because of differing international philosophies and policies regarding the maritime industry, the FMC's enforcement efforts have strained relations with a number of trading partners of the United States. As a result, the FMC has had difficulty in obtaining access to documents stored in foreign countries and U.S. flag carriers have claimed that enforcement of the Shipping Act is thus disproportionately directed toward them. GAO's analysis of 58 malpractice cases initiated by the FMC failed to show any evidence of an enforcement pattern biased against U.S. flag carriers. (See chapter 3.)

## ELIMINATING WASTEFUL SERVICE COMPETITION-- ALTERNATIVES TO THE PRESENT SYSTEM

Eliminating wasteful service competition and its onerous effects on operators could be achieved in two dramatically different ways. The first method is to subject all carriers serving the U.S. foreign trades to the full force of this country's antitrust laws. Then, price competition would supplant wasteful service competition. Rates would be lower but less stable. High cost U.S. flag operators would be adversely affected and, in the worst circumstances, could cease operation without substantial increases in the subsidies currently available. This option could also increase diplomatic tensions since it would further subject foreign flag carriers to prosecution under U.S. antitrust laws. The other method is to adopt the policy of most maritime nations and free the conferences covering U.S. trade routes from all regulatory and antitrust constraints. This approach would permit carriers greater freedom to devise and implement methods to control capacity, eliminate wasteful service competition, and deter the entry of nonconference operators. In addition, it would relax diplomatic tensions and lower the costs of providing liner service. The interests of shippers could be safeguarded by forming shippers' councils.

## REACTIONS OF CARRIERS AND SHIPPERS TO PROPOSED ALTERNATIVES

The results of GAO's interviews with shippers suggest that if the current conference system is retained, freight rates will increase at the same rate as costs incurred by carriers increase. Both the current degree of rate stability and level of service quality would be expected to remain the same. Shippers believe that eliminating the carriers' antitrust immunity would lead to lower but less stable rates. Conversely, shippers believe that extending antitrust immunity would result in higher rates than those that now exist. There was, however, no consensus among shippers regarding the level of service quality under either alternative.

GAO also posed questions to carrier and conference officials, who believed that the current problems affecting the industry could be solved by permitting conferences to limit membership and more easily rationalize service. (See chapter 4.)

## MATTERS FOR CONSIDERATION BY THE CONGRESS

Two broad options are available to the Congress in considering revisions to the Shipping Act, 1916, that can eliminate the inefficient form of service competition which presently exists on U.S. foreign trade routes. The first option is to withdraw the current level of antitrust immunity. The second option is to expand the antitrust exemption to allow carriers to control capacity more easily.

The most suitable choice depends upon the economic and diplomatic costs and benefits associated with each alternative, but GAO's evaluation of the current evidence does not clearly favor one over the other. However, if carriers are granted expanded antitrust immunity, GAO believes shippers should be provided with the opportunity to form shippers' councils to safeguard their interests.

Currently there are two bills before the Congress, S. 1593 and H.R. 4374, that would significantly expand the level of antitrust immunity. S. 1593 contains a provision establishing U.S. shippers' councils, but H.R. 4374 does not.

The Congress should also consider changing current maritime regulation to enable U.S. flag liner operators to more easily form consortia to facilitate financing new vessels. By making this alternative form of vessel acquisition readily available, U.S. flag carriers may be placed in a more favorable position compared with their foreign flag competitors.

## AGENCY COMMENTS

GAO received comments on a draft of this report from the Department of Justice (DOJ), the FMC, and the Department of Transportation (DOT). DOJ considered the report to be, overall, a "well-reasoned and factually accurate assessment." The FMC commended GAO on the report and stated its own views on several issues. DOT agreed with the conclusion that the Shipping Act fosters wasteful service competition, but felt that the report failed to consider other important measures of the U.S. fleet's performance. GAO disagrees with DOT's contention that these measures would show the fleet to be in significant enough distress to justify a major revision of the Shipping Act. All these agencies' specific comments, and GAO's responses to them, are in appendixes I-III.

CONTENTS

TABLES

# ABBREVIATIONS

| | |
|---|---|
| AIA | American Importers' Association |
| CDS | Construction Differential Subsidy |
| CENSA | Council of European and Japanese National Shipowners' Association |
| DOJ | Department of Justice |
| DOT | Department of Transportation |
| ESC | European Shippers' Council |
| FMB | Federal Maritime Board |
| FMC | Federal Maritime Commission |
| MARAD | Maritime Administration |
| NYCCI | International Traffic Committee of the New York Chamber of Commerce and Industry |
| ODS | Operating Differential Subsidy |
| SUNAMAM | Brazilian National Superintendency of Merchant Marine |
| UNCTAD | United Nations Conference on Trade and Development |

# CHAPTER 1

## INTRODUCTION

Firms providing regularly scheduled common carrier liner service on U.S. foreign trade routes are regulated by the Federal Maritime Commission (FMC) under provisions of the Shipping Act, 1916, as amended (hereinafter referred to as the Shipping Act or the Act). Although the regulatory provisions of this legislation affect carriers operating under foreign flags as well as those operating under our country's flag (known as U.S. flag carriers), increasing concern about the viability of the U.S. merchant marine has led the Congress to consider major revisions to the Act. This concern stems partly from the fact that the U.S. flag liner fleet has an important role as a naval auxiliary in time of war or national emergency.

To facilitate their review of the Act and the FMC, the House Committee on Merchant Marine and Fisheries asked us to conduct an economic analysis of the international ocean liner shipping industry. Specifically, we were requested to consider:

- the size, stability, and profitability of the U.S. flag ocean liner shipping fleet;
- the availability and prices of ocean shipping services in U.S. trades;
- the rate of technological change;
- effects on U.S. trade and the balance of payments;
- the economic effects of current, increased, or diminished regulation;
- the consequences of increased competition that U.S. carriers face from state-supported foreign flag lines; and
- the effect on the U.S. liner industry of revenue pools and equal access agreements governing the movement of some cargoes between the United States and other countries.

## OBJECTIVES, SCOPE, AND METHODOLOGY

We had two principal objectives: first, to determine whether there is any economic justification for revising the Shipping Act, and second, to analyze frequently discussed revisions. We first used economic analysis to establish the possibly harmful effects Federal maritime regulation could have upon the U.S. ocean liner industry. We then evaluated the actual performance and financial health of the U.S. flag liner fleet.

The scope of this report parallels the congressional request, although we have elaborated in discussing some areas of concern and restricted our discussion of others. We believe that, prior to undertaking any major revision of maritime legislation, it should be well established whether the U.S. flag liner fleet has been declining, and if regulation is indeed the principal cause. Thus, we examined the effects of regulation and the status of the U.S. flag liner fleet in great detail.

Our analysis of alternatives to the current regulatory system was limited by the unavailability of data on unregulated trade routes and the willingness and ability of those whom are interviewed to respond to certain questions we posed. When we examined revenue pools, data and resource availability forced us to narrow the scope of our analysis to freight rates, capacity utilization, and profit rates.

We used several methodological approaches to achieve the objectives of this report. First, we consulted with officials of several Government agencies, including the Maritime Administration and the Federal Maritime Commission, and reviewed relevant journals, Government-sponsored research, congressional hearings, reports by the Federal Maritime Commission (FMC) and the Maritime Administration (MARAD), and numerous articles published in newspapers and trade magazines.

Second, we conducted interviews with shippers, carrier representatives, and conference officials. Our interviews with shippers were preceded by a comprehensive survey questionnaire. Third, to analyze the effect of revenue pools, we used economic and statistical analysis to both specify the particular relationships to be estimated and interpret the results obtained. Our review was performed in accordance with GAO's current "Standards for Audit of Governmental Organizations, Programs, Activities and Functions."

In chapter 2, we discuss the restrictions and privileges that the Shipping Act, and amendments incorporated in P.L. 87-346, have placed on international ocean liner companies operating in the U.S. foreign trades, and analyze their economic and diplomatic effects.

In the next chapter, we assess the condition and performance of the U.S. flag liner fleet by examining (1) its dependency on Federal assistance, (2) its technological achievements, (3) its ability to carry the Nation's imports and exports, and (4) its absolute and relative size (in terms of the number and types of vessels operated, the number of companies in existence, the relative ranking of the U.S. flag general cargo carrying fleet among all nations, and its market share). Chapter 3 also contains the results of our analysis of malpractice cases brought by the FMC against liner operators from 1976 to 1980. The purpose of our analysis was to determine the validity of allegations that FMC enforcement efforts have been disproportionately directed toward U.S. flag carriers.

In chapter 4, we discuss the effects of two commonly proposed modifications of the Shipping Act: namely, reducing the antitrust immunity granted to carriers; and, to the contrary, expanding carriers' antitrust immunity. Both these would eliminate the problem of wasteful service competition, but would achieve this goal in quite different ways. We supplement this discussion with the results of our interviews with shippers concerning what the effects of certain alternatives to the current system would be on rates and service quality. We also include the results of our discussions with carrier and conference officials, who told us about the changes that they would like to see made to the Shipping Act.

In chapter 5, we discuss shippers' councils. These are organizations that could probably serve a useful purpose if carriers are granted expanded immunity from this country's antitrust laws. Included in the chapter is a review of the functions and organizational structures of shippers' councils established in other nations, and a review of attempts to establish these organizations in this country.

In chapter 6, we present the results of our analysis of the effects of revenue pooling by carriers serving several U.S.-South American trade routes. This activity is likely to increase if carriers are granted expanded antitrust immunity or if the United States accedes to the United Nations Code of Conduct for Liner Conferences. Because U.S. accession to this Code could require major changes to the Shipping Act, the Code's main provisions, historical background, and current status are also discussed in this chapter.

Our main conclusions, matters for consideration by the Congress, and agency comments on a draft of this report, are presented in chapter 7.

## CHAPTER 2

## PROVISIONS OF THE SHIPPING ACT FOSTER WASTEFUL SERVICE COMPETITION, EXCESS CAPACITY, AND HIGH COSTS, AND STRAIN INTERNATIONAL RELATIONS

This chapter reviews the restrictions and privileges that the Shipping Act, 1916, as amended, has placed upon international ocean liner companies operating in the U.S. foreign trades. We conclude that the Act encourages carriers serving these trades to engage in wasteful service competition that leads to over-capacity and raises costs. Some liner operators may be financially impaired in the long run as a result. In addition, enforcing the Act has also strained the United States' diplomatic relations with foreign governments.

### SHIPPING CONFERENCES SEEK TO INCREASE PROFITS BY LIMITING COMPETITION

Since the late 19th century, ocean liner companies have formed carrier associations known as shipping conferences. One objective of these associations is to increase the profits realized by their members as a group. While the jurisdictions of conferences vary, they generally cover the traffic moving from one group of ports to another and are organized so that their territories do not overlap. Most liner companies are members of several conferences, since they generally serve ports that are covered by more than one conference.

At the beginning of the 20th century, the Congress began to investigate the activities of conferences with jurisdiction over U.S. ports. These conferences tried to secure higher profits for their memberships as a whole by establishing higher rate schedules to which all members were to adhere. Conferences also sought to control carrying capacity. Without such control, the higher conference rates would induce carriers to increase their sailings and fleet size, increasing costs until any additional profits that could otherwise have been achieved were eliminated.

To control carrying capacity (which is a function of the number and size of the ships serving a particular trade route and the number of sailings made by each ship), these conferences restricted their memberships and limited the number of sailings made by each member. In addition, conferences sought to drive nonmember companies (called independents) out of business by using predatory practices.

In addition to setting rates and controlling capacity, the conferences also had to suppress potential price competition from two sources--their own members and independents--to achieve a lasting increase in joint profits. Latent price competition among conference members was typically controlled by organizing a revenue pool. Revenues earned by individual member companies serving the same ports were pooled together and periodically distributed among the member companies according to a predetermined schedule. This eliminated the incentive for conference carriers to secretly undercut the high conference rates and increase their own individual profits at the expense of those who adhered to the established rate schedule.

Controlling price competition by nonconference members was more problematic for conferences. To prevent independents from entering a trade route and undercutting rates, conferences developed methods to guarantee that shippers would continue to patronize their members even in the presence of lower-priced carriers. One such method was the deferred rebate. During a specified period, 6 months for example, part of the charges paid by a shipper would be set aside by the conference. If the shipper continued to patronize the conference exclusively during the next 6 months, the funds accumulated during the preceding 6 months would be refunded. This served to substantially increase the cost of switching from conference to nonconference carriers, since shippers risked losing not only the funds accumulated during the previous 6 months but also those being accumulated during the current period.

Another method was to offer shippers better sailing schedules than those offered by independents. This was accomplished by coordinating their members' sailing schedules to prevent the bunching of sailings around a few peak times, thus minimizing any gaps in service. This coordinating activity, frequently termed rationalization, is considered by some to be the most desirable feature of the conference system because it allows carriers to increase capacity utilization and reduce the costs per ton of cargo carried. Instead of transporting a given quantity of cargo aboard two ships, each of which was only half-filled, conferences attempted to use only one ship. The other ship could then be rescheduled to sail at another time or transferred to another trade route. It is uncertain, however, to what extent the resulting savings were passed on to shippers in the form of lower rates or used to increase members' joint profits.

A third method used by conferences to foster shipper loyalty was to refuse service to shippers who had used nonconference vessels in the past, even when space was available. Conferences on occasion also employed "fighting ships" against independents. These vessels, subsidized by conference members, would meet or undercut the lower rates charged by independents until they either left the trade or joined the conference.

## THE SHIPPING ACT ATTEMPTS TO PROTECT SHIPPERS BY REGULATING CARRIERS

The Department of Justice brought suit against three conferences in 1911, charging them with engaging in practices and entering into agreements which restrained trade and thus violated the antitrust laws. The matter was never resolved, however, because these conferences dissolved prior to World War I. In 1912, partly because of this suit, the Congress appointed a committee, chaired by Congressman Alexander, "to determine whether or not [the Congress] should recognize the agreements existing between carriers by water or recommend that the Sherman antitrust law be enforced against them and those combinations be broken up." 1/ In its final report, issued in 1914, the Alexander Committee, as it came be to known, advocated that a balance be struck between the interests of shippers and carriers. This recommendation became the basis of the Shipping Act, 1916, legislation that is the cornerstone of American regulatory policy in international ocean shipping.

During its investigation, the Alexander Committee found that conferences offered shippers a number of advantages, including ample tonnage and efficient, frequent, and regular service. However, the committee also believed that conferences, if left unregulated, would not always act in the best interests of shippers. The problems identified with the unsupervised operation of conferences included "excessive" and discriminatory rates, the lack of published tariffs and classifications, and deferred rebates which placed shippers in a state of continual dependence on conference carriers.

Partly in response to a dramatic increase in ocean freight rates during World War I, the Congress passed the Shipping Act in 1916, incorporating most of the recommendations of the Alexander Committee. The legislation was essentially a shipper protection statute that attempted to aid shippers by enabling them to reap the benefits of conferences while avoiding their undesirable features. By permitting liner operators to form conferences and gain antitrust exemption, the Shipping Act also benefited carriers. However, explicit restrictions were placed on carrier practices and agreements as well as on the organizational structure of conferences. Section 14 of the Act, for example, prohibited carriers from using deferred rebates and fighting ships, and prevented them from retaliating against shippers for any reason by threatening to refuse service.

Section 15 gave carriers the ability to negotiate agreements that provided for the formation of conferences, pooling of revenues, rationalization of services, and joint setting of rates. Before any of these agreements could go into effect, however, they had to be submitted to and approved by the United States Shipping Board, a predecessor of the Federal Maritime Commission. Originally, the Board could disapprove any agreement it found to be unjustly discriminatory, detrimental to commerce, or illegal under the Shipping Act. Subsequently, a fourth ground, "contrary to the public interest," was added. 2/

---

1/53 Congressional Record 8077 (1916).

2/See FMC v. Aktiebolaget Svenska Amerika Linien (Swedish American Line), 390 U.S. 238 (1968).

Sections 16, 17, and 18 of the Act placed restrictions on the carriers' ability to set rates by requiring, among other things, that rates be just, reasonable, and nondiscriminatory.

## ACT REVISIONS AFFECT CONFERENCE OPERATIONS

The regulatory system established by the Shipping Act, 1916, was extensively amended in 1961, when P.L. 87-346 was passed. This legislation was enacted partly in response to a 1958 Supreme Court decision in which exclusive patronage contracts (dual rate contracts) were declared illegal. These contracts, which give shippers discounts if they agreed to ship exclusively on conference vessels, were devised by conferences as a replacement for the deferred rebate. Breach damages imposed under a dual rate contract, like those under a deferred rebate contract, were designed to impose costs on shippers who switched from conference members to independents.

Section 14 of the Act was amended to legalize dual rate contracts, but specified several conditions that carriers believed considerably reduced their effectiveness. Of primary importance was limiting the penalties that could be imposed for violating a contract and limiting the exclusive patronage discount to 15 percent.

P.L. 87-346 also amended section 15 of the Act to restrict the conferences' ability to control their memberships. Prior to being amended, the Act stated that any conference agreement could be disapproved if it was unjustly discriminatory or unfair between carriers. P.L. 87-346 explicitly permitted approval of only those conference agreements specifying that conference membership be open on equal terms to any carrier with the intention and ability to provide regular liner service in the trade. 1/

P.L. 87-346 further revised the Act to state that carrier agreements could also be disapproved if they were found to be "contrary to the public interest." To implement this new criterion the FMC formulated a principle that agreements violating this country's antitrust laws would be approved only if carriers could "bring forth such facts as would demonstrate that the...rule was required by a serious transportation need, necessary to secure

---

1/"No such agreement shall be approved...which fails to provide reasonable and equal terms and conditions for admission and readmission to conference membership of other qualified carriers in the trade, or fails to provide that any member may withdraw from membership upon reasonable notice without penalty for such withdrawal." 46 U.S.C. 814 (1976). Such conferences are commonly called "open conferences" to distinguish them from "closed conferences" which have the ability to restrict their membership.

important public benefits or in furtherance of a valid regulatory purpose of the Shipping Act." 1/ This principle, known as the Svenska test, has become a matter of major concern to carriers, who consider it to represent an unwarranted application of antitrust laws to the maritime industry, and has increased the difficulty carriers face in obtaining FMC approval of their agreements. 2/

Not all amendments to the Act have weakened the conferences operating in the U.S. foreign trades. The Ocean Shipping Act of 1978 (P.L. 95-483), for example, protects conferences from incursions by price-cutting state-controlled carriers. This legislation, which was enacted primarily in response to the Soviet Union's increasing incursion into U.S. foreign trades during the 1970s, permits the FMC to adjudicate the reasonableness of controlled carrier rates and suspend their tariffs for up to 180 days.

## ECONOMIC EFFECTS OF THE SHIPPING ACT

Conferences covering the U.S. foreign trades today are considerably less able to control competition among their members and limit competition from nonmembers than conferences did prior to the passage of the Shipping Act. Their powers were reduced even further by P.L. 87-346. Conference members must receive FMC approval to organize revenue pools, rationalize service, and limit sailings, and are not permitted to limit membership. Their inability to use deferred rebates or more effective dual rate contracts has limited their ability to deter the entry of independent operators. As a result of these restrictions, conferences covering U.S. foreign trade routes are unable to increase the profits of their members as a group.

The primary problem U.S.-based conferences have is the inability to effectively control capacity by limiting the number of members and the number of sailings made by members. The lack of any effective conference controls on capacity, in conjunction with the high rate schedules set by conferences, encourages members to seek increases in the amount of cargo they carry. Banned from competing through secretly reducing rates below posed levels 3/ to attract more traffic, members increase the level of

---

1/FMC v. Aktiebolaget Svenska Amerika Linien, 390 U.S. 238, 243 (1968).

2/One noteworthy exception is that shipping agreements negotiated between governments are automatically assumed to be in the public interest and are not subject to the Svenska test.

3/Among the revisions to the Act included in P.L. 87-436 was a provision requiring operators to adhere to posted tariffs. Conference agreements also generally require that members adhere to posted tariffs.

service they provide by increasing sailings or adding additional ships. This process leads to chronic over-capacity and increases the costs of transporting a given amount of cargo until profits are, at best, comparable to those available from other forms of investment.

The fact that conference members serving the U.S. foreign trades are unable to use deferred rebates, more effective dual rate contracts, or predatory practices, creates an additional problem. Independents operating in other trades may be attracted to the U.S. foreign trades because of the ease with which they can enter and the prevailing high conference rates, thus exacerbating the overtonnaging problem. In addition, these independents typically offer lower rates to attract cargo.

To combat the incursions of price-cutting independent operators, U.S.-based conferences may either permit their members to reduce their rates (the right of independent action) in an attempt to drive the independents from the trade, or persuade them to join the conference. Rate wars of this type can be very costly for conference members as they are forced to reduce their rates while providing a high level of service. This can cause some conference members, particularly high cost U.S. flag carriers, serious financial problems over time.

Even in the absence of incursions by independents, however, the Shipping Act would lead to a combination of high rates, high costs, high and wasteful service levels, and at best, a level of profit that adequately compensates invested capital.

## DIPLOMATIC EFFECTS OF THE SHIPPING ACT

Because the United States is unique among maritime nations in the way it regulates the international ocean liner shipping industry, there are also diplomatic effects associated with the Shipping Act and its enforcement by the FMC. Other nations generally do not regulate conference activities governmentally, but allow shippers to form associations (known as shippers' councils) to negotiate matters concerning rates and service levels directly with conference officials. Thus, international carriers operating on U.S. foreign trade routes may find themselves concurrently under the jurisdiction of two governments having substantially different legal systems and regulatory philosophies.

The potential for international difficulties present in the Act did not materialize until the early 1960s, when the FMC was established solely to regulate the industry, and the resources devoted to enforcing the Shipping Act were substantially increased. Shortly thereafter, international discord arose when the FMC ordered several foreign flag carriers and conferences that had allegedly violated the Shipping Act to produce certain documents located outside of the United States. Foreign governments vehemently protested these orders and some European governments enacted "blocking statutes" or issued decrees preventing the release of any documents requested by the FMC.

Under these conditions, foreign flag lines could acquire, in effect, partial immunity from the Shipping Act, since the FMC would not be able to obtain sufficient information to determine whether they were, in fact, violating the law. U.S. flag carriers, on the other hand, might therefore be subject to much stricter enforcement by the FMC, an allegation that we examine in the next chapter. The Congress hoped to alleviate this potential problem by passing the Shipping Act Amendments of 1979, which allowed the FMC to suspend the tariffs of foreign flag carriers failing to comply with its subpoenas or discovery orders.

## CHAPTER 3

## U.S. FLAG LINER FLEET PERFORMS ADEQUATELY DESPITE PROVISIONS OF THE SHIPPING ACT

One major reason given for revising the Shipping Act is concern about the condition of the U.S. flag liner fleet. Despite considerable Federal assistance, a number of factors indicate that the general cargo liner segment of the U.S. merchant marine may be in serious trouble: the number of U.S. flag general cargo vessels declined from 523 in 1970 to 256 in 1980; the relative size of the United States' general cargo vessel fleet (in terms of deadweight tons) fell from second in the world in 1965 to eighth in 1979, and the number of U.S. flag liner carriers declined from 19 in 1970 to 9 in 1981.

The evidence shows, however, that these developments are, in large part, attributable to the combination of a stagnant volume of U.S. liner cargoes and the rapid adoption of container handling technology by U.S. flag liner companies. Thus, it appears that the U.S. flag liner fleet is not in a state of general distress significant enough to justify a major revision of the Shipping Act.

### FEDERAL ASSISTANCE

Without question, the performance of the U.S. flag liner fleet has been greatly assisted by the Federal Government. To promote developing and maintaining an adequate and well-balanced U.S. flag fleet, the Congress passed the Merchant Marine Act in 1936.

This legislation authorized two direct subsidy programs that are currently administered by the Maritime Administration (MARAD) within the Department of Transportation. 1/ These two programs are the Construction Differential Subsidy (CDS), under which approximately $200 million was spent during the 1979 fiscal year, and the Operating Differential Subsidy (ODS), under which about $300 million was spent during the same period. Under the CDS program, U.S. flag liner companies who purchase vessels for foreign trade built in U.S. shipyards receive a portion of the difference between the ship's domestic and foreign price. The ODS program compensates U.S. flag liner companies for the differences between certain U.S. flag vessel input costs (essentially labor) and the lower input costs of competing foreign vessels serving the same trade routes. Currently, eight of the nine U.S. flag carriers participate in MARAD's ODS program. In addition to these two direct fiscal aids, the liner fleet also receives assistance through three cargo preference requirements that reserve certain cargoes for U.S. flag vessels.

---

1/MARAD was transferred from the Department of Commerce to the Department of Transportation by P.L. 97-31 on August 6, 1981.

MARAD also administers a Federal loan guarantee program for ships purchased by U.S. flag lines from U.S. shipyards that effectively lowers the interest rate that these companies must pay.

## CONTAINERIZATION REVOLUTIONIZES THE FLEET

Until the mid-1950s, liner shipments moved exclusively in small parcels. In this conventional or breakbulk system, each piece of cargo would be handled many times on its way from the manufacturer to the overseas buyer. During the late 1950s, U.S. flag carriers introduced an alternative cargo handling process that greatly reduced the number of times an individual parcel had to be handled. This new technology, containerization, consisted of stowing cargo in strongly constructed standard sized boxes or vans, either at the manufacturer's plant or at a nearby consolidating station, and then shipping the entire load of cargo as a single unit to its ultimate destination. From the time the container is locked and sealed, the cargo is untouched until it reaches the consignee or a customs inspection station.

The economic advantages of container shipping are substantial. First, extensive savings are made in packaging and claims costs. Second, from four to eight times more tonnage per hour can be loaded or unloaded from a containership than from a conventional breakbulk vessel. Third, because of faster loading and unloading times, container vessels have a much higher ratio of sea time to port time than conventional breakbulk vessels. Fewer ships, therefore, are required to transport a given amount of cargo in a specified period.

Because a containerized cargo handling operation requires a substantial support system, and conventional breakbulk vessels need to be modified to accept containers or be replaced by ships designed specifically for this purpose, containerization has made it necessary for U.S. flag liner companies to acquire large amounts of very costly equipment. But despite these high initial costs, containerization has nonetheless greatly lowered the cost per ton of cargo transported when compared with the cost per ton of conventional breakbulk shipping. This cost advantage explains, in part, the dramatic increase in the amount of containerized cargoes our country has shipped since 1970. As shown by table 1, the percentage of U.S. containerized liner cargoes has risen from 15.3 percent to 53.7 percent between 1970 and 1978. This table also shows that the total amount of U.S. commercial liner tonnage has not substantially or consistently increased since 1970.

### U.S. fleet size affected

Replacing conventional cargo handling technology with containerization allows liner companies to reduce the number of vessels required to transport a given amount of cargo in a specified period. Thus, if U.S. flag carriers anticipate that

Table 1

U.S. Containerized Liner Cargoes

| | Total commercial liner tonnage a/ (millions of tons) | Commercial container tonnage b/ (millions of tons) | Percentage containerized |
|---|---|---|---|
| 1970 | 50.4 | 7.7 | 15.3 |
| 1971 | 44.2 | 8.3 | 18.8 |
| 1972 | 44.6 | 12.1 | 27.1 |
| 1973 | 51.3 | 17.5 | 34.1 |
| 1974 | 51.4 | 20.8 | 40.5 |
| 1975 | 44.3 | 21.3 | 48.1 |
| 1976 | 49.8 | 25.7 | 51.6 |
| 1977 | 47.8 | 27.3 | 57.1 |
| 1978 | 54.8 | 29.4 | 53.7 |

a/Excludes Department of Defense cargoes.

b/These figures include containerized cargo transported aboard vessels in nonliner service and, in some cases, transported aboard tanker vessels. Consequently the percentages overestimate the extent to which liner cargoes are containerized by some small amount.

Sources: The Annual Report of the Maritime Administration for the Fiscal Year 1979, p. 33, Containerized Cargo Statistics, 1975, p. 10, and Containerized Cargo Statistics, 1978, p. 6.

their share of this country's import and export liner tonnage will remain relatively constant, they will order fewer ships when making vessel replacement plans, leading to a decline in the number of U.S. flag cargo vessels over time. Table 2 shows that this has, in fact, occurred. As the number of U.S. flag general cargo vessels fell from 523 in 1970 to 256 in 1980, the fleet has become increasingly containerized.

Because conventional breakbulk vessels have been replaced with more productive container vessels, the decline in the absolute number of U.S. flag liner ships has not adversely affected the fleet's cargo carrying capability. As table 3 shows, the average annual U.S. flag share of U.S. liner cargo (expressed either in dollar value or tonnage) actually increased from 1966-70 to 1976-78.

The rapid containerization of the U.S. general cargo fleet is also partly responsible for the decline in its relative size from second largest in the world in 1965 to eighth largest in 1979. Such rankings are made on the basis of total deadweight tons and ignore differences in the compositional nature of various fleets. By 1979, the U.S. general cargo carrying fleet had

Table 2

Percentage Distribution of Privately Owned U.S. Flag General Cargo Vessels in Excess of 1,000 Gross Tons

| Vessel type | June 30, 1970 | June 30, 1975 | June 30, 1980 |
|---|---|---|---|
| Conventional breakbulk and partial container | 83% | 55% | 43% |
| Full container a/ | 16 | 35 | 42 |
| LASH-barge carrying | 0 | 7 | 6 |
| Roll-on/Roll-off | 1 | 3 | 9 |
| | 100% | 100% | 100% |
| Total number of vessels | 523 | 310 | 256 |

a/Full containerships transport only containers. Roll-on/Roll-off (RO-RO) vessels differ from full containerships in that they can transport entire tractor trailer trucks as well as containers. In a Lighter Aboard Ship (LASH) system, cargo is intially loaded aboard barges that are then lifted onto a mother ship, which then transports them to their final destination.

Source: U.S. Department of Commerce, Maritime Administration Vessel Inventory Report as of June 30, 1980, p. 4.

the largest containership capacity and LASH vessel capacity in the world, and, by far, the lowest percentage of breakbulk capacity (24.9) of any major maritime nation. To the contrary, the seven nations that ranked ahead of the United States in 1979 had fleets that were largely composed of breakbulk vessels. Thus, the decline in the United States' relative ranking since 1965 reflects its more rapid adoption of container technology. It is not an indication of distress, because these rankings do not consider the relatively higher productivity of the U.S. flag containerships, and, as a result, severely understate the fleet's true cargo carrying capability compared with those of other nations.

## Number of firms affected

Containerization could also be partly responsible for the decline in the number of U.S. flag liner companies from 19 in 1970 to 9 in 1981. If an efficient container service requires more and larger vessels than one company can afford, the number of liner companies may decline as firms with breakbulk operations decide not to invest in container technology and eventually merge or cease operation entirely.

Table 3

Average Annual U.S. Flag Share of Ocean Liner Cargoes, 1956-78

| Years | Avg. annual value of liner cargoes | U.S. flag share value of U.S. liner cargoes | % share | Avg. annual tons of liner cargoes | U.S. flag share tons U.S. liner cargoes | % share |
|---|---|---|---|---|---|---|
| | --------(billions $)--------- | | | ---(million long tons)--- | | |
| 1956-60 | 16.5 | 5.9 | 35.8 | 47.1 | 15.6 | 33.1 |
| 1961-65 | 20.1 | 6.2 | 30.8 | 49.1 | 12.8 | 26.1 |
| 1966-70 | 27.4 | 8.0 | 29.1 | 47.2 | 10.9 | 23.1 |
| 1971-75 | 49.4 | 14.7 | 29.7 | 47.2 | 12.4 | 26.3 |
| 1976-78 | 85.9 | 25.9 | 30.1 | 50.7 | 15.1 | 29.9 |

To determine whether containerization was, in fact, an important causal factor affecting the number of U.S. flag firms, we investigated the circumstances surrounding the demise of eight subsidized U.S. flag carriers since 1965. The advent of containerization and the costs of its adoption was a major factor in three of these cases. In another case, a company's financial problems were at least partly caused by the selection of an inappropriate type of container technology for the particular trade trade routes it served. Other factors, such as diversification efforts and uncertainty about the maritime policies of certain South American nations, were of major importance in the remaining cases.

Our review certainly did not indicate that the U.S. flag fleet is in any general chronic distress attributable to the Shipping Act. Of the eight defunct companies considered, a majority offered service on only one trade route at the time they were either acquired by other liner companies or ceased operation. This suggests that, in the future, successful liner companies may be those that are larger, multi-route operations. As advances in containership technology produce even larger, more costly vessels, the continued successful operation of the fleet may require that U.S. flag companies form consortia similar to those formed by Japanese companies. These arrangements, in which capital resources are pooled, would enable U.S. operators to acquire the equipment needed to compete effectively against foreign flag consortia while still retaining the possibility of interline competition.

NO EVIDENCE OF UNFAIR ENFORCEMENT

If enforcement of the Shipping Act is disproportionately directed toward U.S. flag carriers, their competitive position relative to foreign flag lines operating on U.S. trade routes, and thus their economic performance, could be adversely affected. Because the number and magnitude of Shipping Act infractions actually committed by U.S. and foreign flag carriers is unknown, the following two assumptions were made to determine whether the FMC has been evenhanded in its enforcement of the Act. First, the fraction of all malpractices actually committed by the carriers of any country is equal to the fraction of the total liner tonnage it transports. Second, if the FMC's enforcement activities were unbiased, the malpractice cases brought against U.S. flag carriers should represent a fraction of all such cases that is equal to the fraction of the total liner tonnage they transported.

Our analysis was based on 58 rebating and malpractice cases initiated by the FMC against U.S. and foreign flag liner companies from October 1976 to June 1980. The FMC provided us with the following information on each case: (1) the carrier involved, (2) the carrier's flag, (3) the date on which the case was instituted, (4) the trade route(s) on which the malpractice was alleged to have occurred, (5) the period over which the malpractice was alleged to have occurred, and (6) its current disposition, the date on which the case was concluded, if appropriate, and the settlement, if any.

On the basis of our two assumptions we anticipated that, in the absence of any flag bias, 16 or 17 of the 58 cases would have been brought against U.S. flag carriers. However, only 14 cases were actually brought against U.S. flag carriers. Thus, the available evidence suggests that the Shipping Act is not being unevenly enforced by the FMC.

## CHAPTER 4

## ALTERNATIVES TO THE CURRENT CONFERENCE SYSTEM, AND VIEWS OF SHIPPERS AND CARRIER AND CONFERENCE OFFICIALS

Two major alternatives have been suggested for eliminating the wasteful service competition resulting from the Shipping Act. They have differing economic consequences for the U.S. liner industry as well as differing implications for this country's diplomatic relations with our maritime trading partners, and possibly the military capability of the U.S. flag liner fleet as well.

The first alternative is to subject carriers serving the U.S. foreign trades to the full force of this country's antitrust laws. This would probably result in abolishing conferences on U.S. foreign trade routes and ending joint rate setting by carriers. Wasteful service competition would be eliminated as operators adjust their prices rather than their service levels to attract additional cargo.

However, several arguments have been advanced against eliminating the industry's antitrust immunity. One argument is that severe price competition would drive rates below average total cost, resulting in financial distress for many carriers. A related argument is that if only a few companies, or perhaps only one, are able to survive a protracted rate war, they will eventually set rates at higher levels than under the current conference system. A third argument is that severe rate instability might result, making U.S. shippers worse off.

While none of these arguments is especially persuasive on economic grounds, national security and diplomatic considerations merit some attention. Primarily because of higher wages and higher staffing levels, U.S. flag liner companies are among the highest cost operators in the world. Thus, without the protection afforded by high conference rates, U.S. flag carriers may be forced out of existence. If this happens and the U.S. flag liner fleet is essential to this country's national security, then an alternative means of supporting U.S. flag operators must be found. Such options as increasing maritime subsidies or increasing cargo preference requirements might be required. In addition, this alternative could exacerbate international tensions as a result of enforcing U.S. antitrust laws against foreign flag carriers.

The second major alternative is to expand the conferences' antitrust immunity. The ability to more easily form revenue pools and limit members' sailings, in conjunction with increasing powers to combat the incursions of nonmember lines, would eliminate wasteful service competition. The cost of providing shippers with liner service would be lowered because of increased capacity utilization. Whether these lowered costs would be passed along to shippers, however, is uncertain.

But many of the abuses noted by the Alexander Committee could reappear if some regulation did not exist. Perhaps self-regulation, in the form of shippers' councils, might be employed. These councils could negotiate rate and service issues directly with conferences, and ensure that U.S. flag carriers remain viable conference members at current or even reduced subsidy levels. In addition, having vessels available as a military auxiliary would be more certain, and U.S. maritime law would be brought into closer correspondence with the rest of the world, lessening diplomatic difficulties.

## SHIPPERS' VIEWS

Because revising the Shipping Act could have a substantial impact on U.S. shippers, we surveyed and interviewed them to determine what they considered to be the likely effects of various alternatives. Although several shipper organizations have already testified before the Congress regarding legislation to revise the Act, we nevertheless thought it would be insightful to sample the attitudes and experiences of individual shippers.

We first mailed a detailed written questionnaire to 105 shippers. Of the 45 shippers who responded, we then selected 22 for indepth interviews concerning the current conference system and alternatives to it. 1/ Specifically, we were interested in determining what shippers believed the effects would be of different alternatives to the current system on the level and stability of freight rates and the level of service provided. We also asked shippers how their answers to these questions would be affected if a U.S. shippers' council were operational.

### The current conference system

To the question of what would happen to rates and service over the next few years if the current conference system remained unchanged, 14 of the 19 respondents projected rate increases due primarily to increased labor and fuel costs. Sixteen of the 21 shippers who answered the question on service quality felt that it would probably remain about the same.

---

1/This group of 22 shippers was not scientifically selected; our choices were based upon a number of factors. Limitations in our travel budget forced us to concentrate our efforts in the eastern half of the Nation. Therefore, the views of smaller shippers may not be adequately represented in our sample. In light of that restriction we focused our attention on the shippers accounting for the largest percentage of this country's import and export trade. Some consideration was also given to the mix of commodities transported and the trade routes on which those goods were shipped.

These shippers strongly supported the concept of shippers' councils. Twelve of the 19 respondents said that councils would have a beneficial effect on both rates and service quality, and 16 of the 22 shippers interviewed stated that their companies would join and support financially such an organization.

When asked to list the three most important changes needed in the U.S. conference system, 3 did not answer and 9 of the 19 respondents listed only one change. Although there was no strong consensus among these respondents, the most commonly cited change concerned the need for greater shipper involvement in rate matters. It is possible to conclude, therefore, that the shippers in our sample believe the current conference system is a perfectly viable one not in need of major change.

Alternatives

In asking shippers to determine which alternative to the present conference system would most likely lead to the highest and lowest rate levels, the most and least stable rate structure, etc., we focused on the following four alternatives:

| | |
|---|---|
| Open competition | Conference either further weakened or prohibited.<br>Carrier antitrust immunity eliminated.<br>Joint rate making no longer permitted. |
| Restricted conference | Carrier antitrust immunity increased.<br>Membership of third flag carriers limited.<br>Forming cargo pools and rationalizing service available. |
| Closed conference | Extensive antitrust immunity for conference carriers available.<br>Operators have a free hand to engage in whatever activities would enhance the joint profits of all members. |
| Other | Respondents could identify any other option, including the current system. |

The answers we obtained are summarized in table 4.

Obviously, these shippers believe that open competition and closed conferences will result in dramatically different combinations of average rate levels and rate stability. There was, however, no consensus regarding a relationship between service quality and these four alternatives. Consequently, even if shippers could reach agreement on the desired combination of average rate level, rate stability, and service quality--something our survey indicated might not be possible--it is unlikely that there would be any agreement regarding the way in which it could best be achieved.

Table 4

Effects of Alternatives to the Current Conference System

| Effect | Open competition | Restricted conference | Closed conference | Other a/ |
|---|---|---|---|---|
| Lowest liner rates | 13 | 1 | 1 | 5 (4) |
| Highest liner rates | 2 | 1 | 15 | 2 |
| Most rate stability | 2 | 6 | 3 | 8 (5) |
| Most rate instability | 13 | 0 | 4 | 1 |
| Greatest improvement in service quality | 5 | 5 | 3 | 6 (3) |
| Greatest decline in service quality | 8 | 0 | 12 | 0 |
| Most significant overall effect on trade | 10 | 1 | 2 | 6 |

a/The number in parentheses indicates the number of shippers that identified "the current system" as their specific choice.

VIEWS OF CARRIER AND CONFERENCE OFFICIALS

The carrier and conference officials with whom we spoke generally believed that the problems of carrier resignation from conferences, illegal rebating, and the entry of nonconference operators into the U.S. foreign trades could be handled by abandoning the current system and moving toward closed conferences. The revisions proposed by carrier and conference officials would typically result in substantial increases in carrier cooperation, such as revenue pools and service rationalization, a situation that could reduce price competition and result in higher rates.

Our view of congressional testimony and discussions with seven U.S. flag carrier officials indicated that while there is broad agreement that the Shipping Act should be revised, there is little consensus as to what changes should be made. We asked these carrier officials how they view the current conference system and how they think its continued operation will affect such performance measures as size of the U.S. fleet, carrier financial stability and profits, capacity utilization, introduction of new technology, and the balance of payments. Although several either could not or would not predict how the various factors would be affected, these officials often attributed many of the problems faced by the liner industry to the current conference system.

For example, they cited the ease with which foreign flag carriers can enter our trades to "dump" excess tonnage, thereby contributing to the overtonnage problem, or to "skim" the highly profitable high value cargo and then leave when the market dries up. This situation is particularly onerous to U.S. flag carriers because they have made substantial long-term commitments and large capital investments in ships and other equipment in order to adequately service the U.S. trades. In addition, representatives of one carrier stated that it is especially difficult to correct overtonnage in U.S. trades because carriers find it very difficult to obtain FMC approval of capacity sharing agreements and U.S. carriers are not always able to join conferences in foreign trades.

Although most U.S. flag carriers are dissatisfied with the current system, we also found that they do not completely agree on the most desirable alternative to it. Four of the seven carrier officials we interviewed, however, did support extensive bilateral cargo preference requirements or the establishment of more revenue pools.

We also interviewed the chairmen of three conferences serving the U.S. foreign trades. Chairmen often serve in the same capacity for several ocean liner conferences, and such was the case with these three--together, they serve as the chairmen of 17 conferences. They were generally dissatisfied with the current system, which was perceived as enabling independents to enter the U.S. foreign trades and undercut the conferences' rates on high value-high profit cargoes. This was attributed to the limited measures that U.S.-based conferences currently have available to foster shipper loyalty. They did not, however, acknowledge the possibility that independents are being attracted to the U.S. foreign trades because of the high rates charged by conferences. They also believed that incursions by independents could best be reduced by legalizing closed conferences and allowing members to more easily rationalize their services. Two of these officials thought that adopting closed conferences should be accompanied by organizing a U.S. shippers' council. None of the three suggested that a comprehensive approach, encompassing both the subsidy and regulatory systems, was necessary to correct the problems they discussed.

# CHAPTER 5

## SHIPPERS' COUNCILS CAN LIMIT THE MARKET POWER OF CONFERENCES

Shippers' councils 1/ could represent shippers' interests effectively if the antitrust immunity of conferences operating in the U.S. foreign trades is expanded. Even under the current conference system, such councils could help establish formal communications between shippers and carriers. But attempts to organize shippers' councils in the United States have not been successful, although they exist in practically every other major trading nation. This chapter reviews the development of foreign councils and issues seen as barriers to establishing councils in this country, and discusses their potential advantages and disadvantages.

### DEVELOPMENT AND STATUS OF FOREIGN COUNCILS

The shippers' council concept is not new; in Britain it was recommended as early as 1909. The early councils were usually composed of large shippers and organized along product or commodity lines. Actively supported by their governments, they were primarily concerned with fostering exports of certain major commodities. Later, these councils expanded their memberships to include a wider range of shippers using liner services.

According to a 1976 study by the United Nations Conference on Trade and Development (UNCTAD), shippers' councils or equivalent organizations were established and operating in 23 developing nations or territories and 20 developed market economy countries by mid-1976. 2/ Thirty-five of these councils were established in the private sector, although many of these have government agencies as members. Government influence has been stronger in the other eight councils. In the United States and Brazil, government agencies (FMC in the United States and SUNAMAM in Brazil), instead of shippers' councils, protect shippers' interests.

In the late 1950s, delegates from European nations met with representatives of the British Shippers' Council, and subsequently

---

1/Shippers' councils are defined as associations of shippers or their agents established to: (1) consult and exchange information or views regarding general rate levels, rules, practices, or services; and (2) agree upon positions for the purpose of consulting and negotiating with oceanborne common carriers in foreign commerce or conferences of such carriers.

2/Together, these 43 nations accounted for abut two-thirds of the cargoes usually shipped by liner in 1973.

formed the European Shippers' Council (ESC). Together with the Council of European and Japanese National Shipowners' Association (CENSA), they have produced 19 joint recommendations that reflect concern for commercial due process, and have adopted a code of practices for conferences calling for maximum freedom by shippers and carriers to resolve their problems with minimal government interference.

Other existing multi-national councils include the Central American Shippers' Council, the Intergovernmental Standing Committee on Shipping composed of 4 East African countries, a Southeast Asian Federation of 5 countries established in 1976, and the establishment that same year of a permanent secretariat and joint negotiating committee among 20 west and central African countries. In addition, both Australia and Japan have had considerable experience with shippers' councils. For example, the Australian Shippers' Council, an outgrowth of shippers' councils that had jurisdiction over individual trade routes, was established in 1972.

## COUNCIL STRUCTURE AND ACTIVITIES VARY

No single, universally accepted shippers' council format exists. Councils have evolved differently, and are shaped primarily by the interests and needs of the shippers and institutional considerations. Because of the diversity among nations, a great deal of flexibility is needed in establishing a multinational council.

Councils are usually composed of individual companies, trade associations and/or commodity boards, or a combination of the first two types. Financing also varies. Most are financed through member subscriptions, government grants, or a combination of both, while others are financed by imposing a tax on shipments. Some councils use these funds to employ relatively large, full-time permanent staffs, while others rely on members or the government to provide research and other types of assistance.

Generally, functions such as overall policymaking, management, and coordination are carried out by an executive committee, a general assembly, or a board of directors. Consultations with carriers, however, are usually conducted by a series of standing or ad hoc committees which generally are organized along functional (i.e,. legal, import, export, liner air cargo, etc.), regional, and/or commodity lines.

Council activities vary from country to country. Although there are exceptions, councils usually deal with matters of broad concern to all shippers (such as port congestion problems, surcharges, general rate levels and increases, and maritime law) rather than with specific issues regarding a particular commodity or an individual rate. These latter matters are generally pursued by individual shippers or trade associations.

## EFFECTIVENESS OF COUNCILS

While the evidence is limited, several studies have demonstrated that shippers' councils have established effective consultation procedures with conferences. One report (by UNCTAD in 1976) identified five factors essential to meaningful consultation: (1) a willingness on the part of conferences to provide councils with essential financial data, (2) councils which adequately represent all shippers, (3) the ability and willingness of councils to use data provided by conferences, (4) "compatibility" between conferences and councils, and (5) a competitive market for shipping services, i.e., the ability of shippers to use alternative services.

Another UNCTAD report 1/ recommended the establishment of shippers' councils to protect shippers' interests, while a study performed by the University of Wales in 1978 attributed much of the need for regulation of U.S. liner conferences to the absence of effective shippers' councils.

Other studies conducted in the past few years have also argued that councils can effectively prevent conference abuses and have supported the establishment of shippers' councils in the United States. In addition, some evidence exists which credits the effectiveness of foreign shippers' councils with freight rate disparities in U.S. foreign trades. In a 1978 report for the Department of Transportation, Booz-Allen and Hamilton, Inc., concluded that shippers' councils representing exports in Europe and in the Far East may be a significant factor behind the generally lower inbound rates.

## EFFORTS TO ESTABLISH A U.S. SHIPPERS' COUNCIL UNSUCCESSFUL

One of the earliest references to a U.S. shippers' council appears in a 1967 FMC report, which concluded that U.S. shippers were generally not aware how the European councils operated and were uncertain about the antitrust implications of collectively dealing with conferences. To alleviate this situation, the report recommended that the FMC consult with interested agencies to develop a program with satisfactory safeguards which would permit shippers to bargain collectively with conferences. According to FMC officials, however, no action was ever taken on this recommendation.

CENSA/ESC attempted to foster interest in U.S. shippers' councils by inviting selected American observers to its 1965 proceedings. In subsequent years other U.S. shipper groups--the

---

1/United Nations Conference on Trade and Development, Protection of Shippers' Interests--Guidelines for Developing Countries, U.N. Doc. TD/B/C.4/176 (1978).

National Industrial Traffic League, the International Traffic Committee of the New York Chamber of Commerce and Industry (NYCCI), and the American Importers' Association (AIA)--became interested in the idea of a U.S. shippers' council. The latter two groups began independent studies of the feasibility of establishing a U.S. council.

In 1976, the AIA and the NYCCI called for a single national shippers' council with five strong regional organizations, and asked the Department of Justice, Antitrust Division, to state its enforcement intentions with respect to the proposed council. DOJ responded to the AIA request in July 1977, stating that the subject of shippers' councils was not appropriate for its business review procedure because it was currently investigating the antitrust implications of joint carrier/shipper activity in connection with ocean freight rates. However, DOJ did state its opinion that while the objectives of the proposed council were clear, the means of accomplishing these objectives presented "an almost infinite number of activities which could result in unreasonable restraint of trade." Thus, the antitrust question, we believe, continues to be a major obstacle to establishing a U.S. shippers' council.

## LEGISLATIVE ATTEMPTS TO ESTABLISH U.S. COUNCILS STALLED

Several bills calling for establishing shippers' councils have been introduced in recent years. The reaction from the executive branch has been mixed; the Department of Justice is primarily concerned that such councils may have substantial anticompetitive effects or otherwise inhibit market forces. According to the FMC, Government involvement would be essential for several years until authorizing legislation was fully implemented. The FMC is also concerned that the interests of noncouncil shippers might not be adequately protected and that a council might prove to be ineffective in the absence of strong governmental involvement. In commenting on legislation proposing shippers' councils, the Department of Commerce was concerned about the possibility that those organizations would abuse any antitrust immunity granted them.

## STRONG SUPPORT FOR U.S. COUNCILS AMONG SHIPPERS

Shippers have generally supported establishing a U.S. shippers' council. Recent polls and surveys, including our discussions with shippers (see chapter 4), indicate strong support for such councils. As reported in American Shipper, 1/ 78 percent of

---

1/"Sixty-three Percent of Shippers Oppose Mandatory Conference Membership for Lines Offering 25 Sailings Each Year," American Shipper, June 1979, p. 2.

the shippers polled favored shippers' councils, 17 percent were opposed, and 5 percent had no opinion. However, there was little consensus concerning how councils should be organized.

## ADVANTAGES AND DISADVANTAGES OF ESTABLISHING U.S. COUNCILS

Although we have the experience of some foreign shippers' councils to draw on, weighing the pros and cons of establishing U.S. councils is still quite difficult. The main argument in favor of councils is their ability to serve as a countervailing force to the organized power of conferences. Other potential benefits of councils include a more responsive conference system based on regular and frequent consultation as opposed to confrontation, better representation of shippers before the Congress and Federal agencies, and increased comity with our trading partners who rely on organized shipper/carrier consultation, rather than regulation, to control conference abuses.

Among the more commonly cited potential disadvantages or problems associated with forming U.S. councils is the concern that they may become strong cartels which might engage in anticompetitive activities, such as price fixing and boycotting. Another major concern is that councils will fail to adequately represent and protect the interest of small shippers. Also, there is some concern that councils will merely become regulatory appendages of the FMC and add another layer of bureaucracy in an already over-regulated industry.

While several issues need to be resolved prior to forming councils, we believe two are especially important. First is the uncertainty about the FMC's future role. If it is retained or enhanced, the need for strong U.S. shippers' councils is diminished, and vice versa. Second is the antitrust implications of participating in council activities. While many questions still remain as to exactly what councils will be allowed to do, it is clear that the Department of Justice, during the previous administration, supported strong antitrust controls of shippers' councils. However, we believe that if the powers of conferences are significantly enhanced by extensive antitrust immunity, then U.S. shippers should be provided the opportunity to form councils to safeguard their interests.

# CHAPTER 6

## REVENUE POOLS AND THE UNITED NATIONS CODE OF CONDUCT FOR LINER CONFERENCES

Very little reliable information is available concerning the effects existing revenue pools have upon participating U.S. flag carriers, although it is needed to evaluate several maritime policy issues. First, the Congress may decide to promote forming revenue pools as a way to improve the profitability of the U.S. flag liner fleet. Currently, carriers operating in the U.S. foreign trades have difficulty receiving FMC approval for pooling agreements because they must demonstrate that they are in the public interest. Second, such information could assist the FMC in deciding whether to approve or disapprove revenue pooling agreements. Third, the United States has to decide how it will respond to the internationally accepted United Nations Code of Conduct for Liner Conferences (the Code), portions of which bear a strong resemblance to revenue pools.

### REVENUE POOLS AND CARGO RESERVATION PROGRAMS MAY CAUSE AVERAGE RATE LEVELS TO RISE

Economic theory suggests that both revenue pools and cargo reservation programs may increase the average level of rates on affected trade routes. Cargo reservation programs could have that effect through their tendency to greatly reduce the number of companies permitted to carry what are often substantial amounts of merchandise. Carriers authorized to transport those shipments can set high rates without fear of being underbid by other companies. Revenue pools may also increase average rate levels by discouraging firms from cutting rates in an attempt to increase the amount of traffic they carry. 1/

Sometimes, governments, such as those of the United States and many South American nations, restrict the carriage of certain cargoes to their own national flag lines. When there is a significant amount of reserved cargo carried between two countries, the countries involved often enter into an equal access agreement, with each country granting the other's national flag carriers access to its own government-controlled cargoes. The national flag carriers can then generally set rates without fear of competition from other carriers, and increase their profits. However, if the governments of developing countries desire to promote their exports and obtain imports as cheaply as possible, they may regulate rates to allow these carriers only a compensatory return on investment.

---

1/Alternatively, cargo reservation programs and revenue pools could cause average rate levels to fall if they lead to significant increases in capacity utilization and resulting decreases in costs.

Another means of raising rates and profits is through revenue pools, which discourage firms from secretly cutting rates in an attempt to increase the amount of traffic they carry. Participating carriers pool the revenues earned in transporting specified cargoes and, at regular intervals, redistribute them according to a predetermined scheme. Generally, the cost structure of the liner industry makes rate cutting a real possibility. When the demand for liner services declines, carriers may suffer losses even if all firms adhere to the same rate schedule. A carrier could reduce its individual losses by cutting rates if other lines maintained theirs. If all carriers followed this same strategy, however, their losses would increase as rates fell below average cost. Revenue pools can prevent this from occurring by eliminating the incentive to cut rates. Thus, average rate levels may be higher, all other things being equal, on those trade routes where revenue pooling occurs.

## CAPACITY UTILIZATION AND PROFIT RATES SHOULD INCREASE AND COSTS SHOULD FALL

Without revenue pools, carriers must compete for a relatively fixed amount of cargo by lowering their rates or increasing their sailings. But this will eventually lead to overtonnaging, with a resulting increase in the cost per ton carried. However, revenue pools guarantee each participating carrier a share of pooled revenues; thus, there is no incentive to increase sailings to attract more cargo. 1/ So capacity utilization should improve, cost per ton should fall, and carrier profits should increase as a result of revenue pooling.

## REVENUE POOLS LINKED TO EQUAL ACCESS AGREEMENTS

In the U.S.-South American trades, revenue pools have generally been instituted in conjunction with or in the wake of governmentally negotiated equal access agreements. Pooling insures that equal access to government-controlled cargoes leads to an equal distribution of the revenues earned by the national flag carriers serving these trade routes. The cargoes covered by these pools typically include all the commercial as well as the government-controlled cargoes carried by the participating carriers.

In the U.S.-Brazilian trades, revenue pools and equal access agreements were agreed to in negotiations in 1970 between the two countries. Similar agreements were made between the United States and Argentina in 1973.

---

1/To the contrary, revenue pooling agreements generally contain a provision that requires participants to make a minimum number of sailings to be eligible to receive their allotted portion of the pooled revenues.

## ANALYSIS OF REVENUE POOLS PLAGUED BY STATISTICAL PROBLEMS

We tried to determine how the revenue pools organized in the 1970s among the United States, Brazil, and Argentina, actually affected the profit rates, freight rates, and capacity utilization of participating U.S. flag carriers. While we encountered severe statistical problems in determining the effects of pooling on profits and freight rates we found that some, but not all, of the revenue pools led to a significant improvement in capacity utilization.

## UNITED NATIONS CODE OF CONDUCT FOR LINER CONFERENCES

Many developing nations believe that liner conferences, by restricting competition and increasing freight rates, have slowed their economic development. They contend that excessive transport charges make their exports less competitive and increase the cost of their imports, depriving them of foreign exchange which could be used to finance growth. These nations argue that this situation should be remedied through the international regulation of conferences.

At the urging of these developing nations, the United Nations passed a resolution in 1962 calling for the formation of the United Nations Conference on Trade and Development (UNCTAD) to study the advantages and disadvantages of the conference system and recommend changes to it. After many years of intensive and often bitter negotiations, UNCTAD formulated the United Nations Code of Conduct for Liner Conferences, which was adopted by maritime nations on April 6, 1974, subject to ratification by individual national governments.

The main purpose of the Code is to allow developing nations to establish and develop their own shipping lines, thus ensuring reasonable rates for their cargoes. This would be achieved by admitting these carriers to full conference membership and allocating equal shares of most conference cargo carried between two participating countries to the conference liners of the trading partners.

According to its provisions, the Code will go into effect 6 months after the date on which at least 24 nations having a combined tonnage of not less than 25 percent of the world liner tonnage (as of 1973) ratify it. This is expected to occur sometime in 1982. So far, the United States has declined to ratify the Code, primarily because some of its provisions conflict with the Shipping Act and the Nation's own economic philosophy. Some maritime analysts have predicted that unless the United States ratifies it, the Code could have an unfavorable effect upon U.S. flag liner operators serving the U.S. trades, although we do not believe this will necessarily occur.

Some similarity exists between the Code and revenue pools, such as assigning cargo shares to agreement members. However, the main difference is that the South American pooling agreements reserve certain cargoes exclusively for pool members, but under the Code, nonconference carriers can still compete for the cargo. Thus, independents are more of a competitive threat under the Code than under the South American pooling agreements.

## CHAPTER 7

## SUMMARY, MATTERS FOR CONSIDERATION BY THE CONGRESS, AND AGENCY COMMENTS

Under the provisions of the Shipping Act, 1916, as amended, firms providing regularly scheduled common carrier liner service on U.S. foreign trade routes are permitted to join shipping conferences. Subject to regulatory approval by the FMC, these carrier associations are granted antitrust immunity which allows them to jointly set the rates charged by their members. Unlike conferences covering non-U.S. trades, however, they are not permitted under U.S. law to restrict their memberships and must receive FMC approval before implementing any capacity-restricting devices such as revenue pools or sailing agreements.

In the ocean liner shipping industry, the demand for service is affected by both the rates charged and the level of service offered. As a consequence of the Shipping Act and its enforcement by the FMC, conferences covering the U.S. foreign trades are only able to restrain price competition by establishing common tariffs to which their members must adhere. Competition among conference members thus occurs primarily by augmenting the level of service offered. Such service competition reduces profits by decreasing capacity utilization and increasing operators' costs and not through lowering their revenues (as would be the case if prices were cut). The current system probably does not result in excessive profits for conference members, but it has led to excess capacity, inefficient service competition (such as more frequent sailings with emptier ships), and higher costs than would be the case in either a fully competitive market or a fully rationalized cartel.

The high rates charged by conferences also induce carriers in other trades to enter the U.S. foreign trades. Because the Shipping Act prohibits using deferred rebates and limits the terms of dual rate contracts, independent operators find it easy to enter U.S. foreign trades. These nonconference companies attempt to gain a share of the market by offering lower rates than those of conferences. This competition can cause U.S. flag conference members to suffer financial losses.

In addition to eliminating wasteful service competition, we identified two other possible reasons for changing current maritime regulation: (1) to assist the U.S. flag liner fleet, allegedly in a state of decline because of the Shipping Act; and (2) to remove a strain on U.S.-foreign relations. We decided to submit the first of these to closer scrutiny because of the importance of the U.S. merchant marine as a reserve and auxiliary to the military in time of war or national emergency.

Our initial survey revealed that the general cargo liner segment of the U.S. merchant marine is apparently in serious trouble as evidenced by declines in the number of firms and ships, and in the relative status of the U.S. flag general cargo fleet among maritime nations. Upon closer study we found that the declines in the number of vessels and the relative position of the U.S. flag fleet were largely due to adopting a highly efficient containerized cargo handling technology (containerization) and did not appear to be a sign of chronic distress. The reduction in the number of firms was primarily the result of several factors including containerization, uncertainty over the maritime policies of certain South American nations, and the diversification efforts of U.S. companies. However, the rapidly rising cost of new vessels may make it increasingly difficult for U.S. flag operators to replace their fleets in the future. The ability to more easily form consortia and thereby pool resources could alleviate this situation. Although this could require slight modification of present regulation, we conclude that the current status of the U.S. flag liner fleet is not a valid rationale for a major overhaul of the Shipping Act.

Because the United States is unique in the way it regulates an essentially international industry, we found that FMC enforcement of the Shipping Act strained diplomatic relations with a number of our maritime partners. To enforce certain provisions of the Shipping Act fairly, the FMC needs to obtain documents stored in foreign countries. But some nations believe that the FMC's attempts to gain access to these documents represent a violation of their sovereignty, and have enacted blocking statutes to prevent the transfer of documents and limit the enforcement powers of the FMC. These statutes could provide foreign flag carriers with what amounts to partial immunity from the Shipping Act, and U.S. carriers have claimed that FMC's enforcement efforts, as a result, are disproportionately directed toward them. To determine the validity of this claim, we examined 58 malpractice cases initiated by the FMC from October 1976 to June 1980. Our analysis failed to show any evidence of a biased enforcement pattern.

Having found that provisions of the Shipping Act, as administered by the FMC, foster wasteful service competition and strain international relations, we examined two widely discussed modifications of the Act. The first is to initiate more price competition by reducing or eliminating the antitrust immunity currently granted to shipping conferences. The second is to expand the antitrust immunity currently granted conference members. Either of these two alternatives would reduce the amount of wasteful service competition. The first alternative would introduce more price competition into the liner shipping industry. Competition would consequently be of more value to shippers. Wasteful service competition would be supplanted by increased price competition to give shippers a more desirable combination of rates and service. But this option would have diplomatic costs associated with it that are probably greater than those associated with this country's current maritime policy. The second alternative would allow conferences to more easily adopt measures that would enable them to limit service competition by controlling capacity. This could be achieved by allowing conferences to limit membership (i.e., closed conferences) and the number of sailings made by members. If this permission is granted, we believe it will be necessary to allow U.S. shippers the opportunity to form shippers' councils so they can safeguard their interests. U.S. maritime law would be brought into conformity with that of most major maritime nations, and international tensions created by differences in maritime policies would lessen.

Thus, while the first alternative may be preferable on economic grounds, certain diplomatic costs are associated with it that are not present in the second alternative. Since it was not possible for us to weigh these economic and diplomatic costs against one another, we could not reach a conclusion as to which alternative was preferable.

In analyzing shippers' councils, we concluded that these organizations should not be established in the United States unless the conferences' antitrust immunity is expanded or the FMC's power to protect shippers is reduced. At present, the FMC is charged with protecting shippers' interests. This situation is analogous to that between the Interstate Commerce Commission and shippers who use rail and truck services. Since those shippers have not needed to form councils, we concluded that under current regulation the users of international ocean liner services do not need to organize shippers' councils.

Our study of alternatives to the current conference system concluded with a statistical study of the revenue pools organized on this country's Argentinian and Brazilian trade routes during the 1970s. These pools are of interest because an expansion of carriers' antitrust immunity and/or the United States' adoption of the United Nations Code of Conduct for Liner Conferences in its present form could lead to a proliferation of these agreements. We believed it was important to determine how revenue pools might affect U.S. flag operators and shippers.

Because of data limitations and statistical problems, we were only able to reach conclusions regarding the effect of revenue pools on the capacity utilization of participating U.S. flag carriers. We obtained some evidence that suggested capacity utilization has significantly improved. Some of the pools that were examined, however, did not have that effect upon capacity utilization.

## MATTERS FOR CONSIDERATION BY THE CONGRESS

Two broad options are available to the Congress in considering revisions to the Shipping Act, 1916, that can eliminate the inefficient form of service competition which presently exists on U.S. foreign trade routes. The first option is to withdraw the current level of antitrust immunity. The second option is to expand the antitrust exemption to allow carriers to control capacity more easily.

The most suitable choice depends upon the economic and diplomatic costs and benefits associated with each alternative, but our evaluation of the current evidence does not clearly favor one over the other. However, if carriers are granted expanded antitrust immunity, we believe shippers should be provided with the opportunity to form shippers' councils to safeguard their interests.

Currently there are two bills before the Congress, S. 1593 and H.R. 4374, that would significantly extend the level of antitrust immunity. S. 1593 contains a provision establishing U.S. shippers' councils, but H.R. 4374 does not.

The Congress should also consider changing current maritime regulation to enable U.S. flag liner operators to more easily form consortia to facilitate financing new vessels. By making this alternative form of vessel acquisition readily available, U.S. flag carriers may be placed in a more favorable position compared with their foreign flag competitors. It may be desirable to allow only those consortia that will permit the largest amount of intercarrier competition on a route. In this regard, the joint space charters used by Japanese firms appear to be the most appropriate choice. It would be possible to secure the benefits of interfirm cooperation while avoiding the anticompetitive problems that could emerge under other types of consortia.

## AGENCY COMMENTS

We requested and received written comments on a draft of this report from the Department of Justice (DOJ), the Federal Maritime Commission (FMC), and the Department of Transportation (DOT). (All three agencies' specific comments and our responses to them are contained in appendixes I-III.) DOJ considered the report to be, overall, a "well-reasoned and factually accurate assessment." The FMC commended us on the report and stated its own views on several issues. DOT agreed with the report's conclusion that the Shipping Act fosters wasteful service competition, but felt that the report failed to consider other important measures of the U.S. flag liner fleet's performance.

Specifically, DOT contended that such financial measures as the rates of return on equity and assets, the ratio of long-term debt to equity, and the ratio of current assets to current liabilities would show the fleet to be in significant enough distress to justify a major revision of the Act. We disagree with this contention for the following reasons: First, U.S. flag liner operators have become increasingly diversified since 1965, and many are now in fact subsidiaries of conglomerate enterprises. Thus, the financial measures cited by DOT, particularly those involving equity valuation, are questionable in comparing the performance of the U.S. carriers over time or with other sectors of the economy.

Second, we found that the Maritime Administration did not have the data needed to compute such financial measures for a long enough period to be indicative of any long-term trend or chronic distress within the U.S. flag fleet. Thus, our approach was based on the premise that if the return on invested capital realized by U.S. flag liner operators was chronically unremunerative, there would be clear evidence of a long-term decline in new investment and, ultimately, in the ability of the U.S. flag fleet to transport cargo. The evidence presented in the report shows that this has not occurred. As table 3 indicates, the U.S. flag fleet transported about the same amount of cargo (in terms of average annual tons) from 1956-60 as from 1976-78. Compared with the 1971-75 period, U.S. liner operators have actually increased their carriage. More impressive, U.S. flag carriers were able to undertake a substantial and rapid investment in new and costly container technology during the late 1960s and 1970s. As a result, the U.S. merchant marine had the largest containership and barge carrier vessel fleets in the world by 1979 in terms of total deadweight tons.

Third, even with questions about their reliability and comparability aside, the profitability data cited by DOT fail to show any evidence of a persistent secular decline. Rather, they exhibit year-to-year variation due to cyclical changes in demand and supply conditions that are common to all sectors of the economy. The ratio of long-term debt to equity does persistently increase from 1976 to 1980, but this is not necessarily an indication of sagging financial health. To the contrary, firms often increase their amount of borrowing in times of rising demand to obtain greater leverage and a higher rate of return on invested equity. Alternatively, recent increases in this ratio could reflect an increase in borrowing by U.S. flag liner operators in order to finance the ordinary and necessary replacement of aging vessels. Furthermore, Federal loan guarantee programs, by lowering interest costs, have actually made borrowing a relatively more attractive source of funds for U.S. flag operators, thereby causing the fleet average ratio of long-term debt to equity to be higher than what it might have been in the absence of these programs.

Fourth, the financial statistics which DOT cited are simple industry averages that conceal substantial differences in the performance of individual U.S. liner operators. According to a Maritime Administration report on the financial condition of U.S. flag liner operators dated November 30, 1981, the 1980 returns on equity ranged from a high of 35.8 percent to a low of -193.9 percent; the 1980 returns on assets ranged from 13.5 percent to -23.3 percent; the 1980 ratios of long-term debt to equity ranged from 16.42 to 0.21; and the 1980 ratios of current assets to current liabilities ranged from a high of 2.2 to a low of 0.6. More important, this report reveals that some major U.S. flag liner operators have had consistently and substantially higher than average rates of return on equity and assets during the 1976-80 period, while other operators have shown consistently and substantially lower than average rates of return to assets and equity. This buttresses our conclusion that there is no evidence of any systematic, industry-wide distress and that company-specific factors such as size, ship-type, and route system are more important than the regulatory system in determining the financial performance of U.S. flag operators.

Fifth, the Maritime Administration's own recent analysis of the financial condition of U.S. flag liner companies referred to above actually supports our conclusion that the U.S. flag liner fleet is not in a state of financial decline. Although their analysis notes that some U.S. flag operators had increased financial problems in 1980, it states that the majority of operators "have shown improved earnings in 1980 over 1979" and that, overall, "1980 was a relatively good year for the industry," with industry net profit increasing 539 percent, total industry assets increasing 9.7 percent, and total liabilities decreasing both absolutely and as a percentage of total assets from 1979 to 1980. Their report's assessments of the future prospects for all but two U.S. flag carriers were also very optimistic.

DOT also stated that changes in the Shipping Act appear essential because of the prospect of future budgetary constraints on the subsidy programs available to U.S. flag operators. As this report concludes, changes in Federal maritime regulation can lead to increases in efficiency and reduce costs in the ocean liner shipping industry, but these savings should be realized by foreign flag carriers operating on U.S.-foreign trade routes as well as by U.S. flag carriers. Thus, there is no assurance that the relative competitive position of U.S. flag operators will necessarily improve as a result. What puts U.S. flag carriers at a competitive disadvantage compared with foreign flag liner operators is not so much current regulation as the fact that U.S. operators are generally among the highest cost carriers in the world. As our recent report on the subsidy programs discusses, these higher costs are primarily due to substantially higher construction, maintenance, and repair costs, higher wages, and higher staffing levels compared with foreign flag vessels. 1/ Because none of these factors will be affected by prospective revisions of the Shipping Act, we do not share DOT's optimism that potential changes in maritime regulation can conceivably offset the severe cost disadvantages faced by U.S. flag operators in the event of significant reductions in the subsidy programs.

---

1/See "Maritime Subsidy Requirements Hinder U.S.-Flag Operators' Competitive Position," U.S. General Accounting Office, CED-82-2, November 30, 1981.

U.S. Department of Justice

JAN 13 1982 Washington, D.C. 20530

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

Thank you for providing the Department of Justice (Department) an opportunity to comment on your draft report entitled, "Changes in Federal Maritime Regulation Can Increase Efficiency and Reduce Costs in the Ocean Liner Shipping Industry" (PAD-82-11).

Essentially, the draft report concludes that there are two basic alternatives to the existing regulatory policy on international ocean liner shipping. Under the first of these alternatives the antitrust exemption for liner shipping would be eliminated so that liner operators would be required to become more competitive. In contrast, under the second alternative, the existing antitrust exemption would be expanded so that companies engaged in liner shipping would be given greater freedom to engage in restrictive business practices. The Administration has recently completed a policy review in this area and in general concluded that the second alternative is preferable to the first. Overall, the draft report presents a well-reasoned and factually accurate assessment of the available alternatives. However, the following three minor factual errors in the report should be corrected.

1 1. The report repeatedly asserts that U.S. flag liner operators are competitively disadvantaged because, unlike their foreign flag competitors, they are prohibited from entering into consortia agreements (see pages viii, 3-27, 5-1, 5-2, and 8-3). According to the report, this prohibition stems from the antitrust laws (see p. 3-27). This is an assertion that has been frequently repeated even though it lacks a factual basis. The antitrust laws impose neither a blanket prohibition against consortia agreements, nor distinguish among liner operators on the basis of nationality. While it is conceivable that some consortia agreements among American flag operators might theoretically violate the antitrust laws, it is always possible for the Federal Maritime Commission (FMC) to grant antitrust immunity to such arrangements under section 15 of the Shipping Act (46 U.S.C. §814). Moreover, in considering such an application the FMC would be required to adhere to the same standard of review as it utilizes when considering consortia agreements among foreign flag operators.

-2-

2. The report is out of date insofar as it represents that the Regulated Industries Section of the Antitrust Division is responsible for antitrust enforcement in the shipping industry (see page 2-16). That section was reconstituted as the Energy Section several years ago and responsibility for the shipping industry was transferred to the Division's Transportation Section. The report should also note that the Department does not agree with the assertion by some members of the industry that the Antitrust Division's participation in FMC proceedings is intended to "cripple" the conference system by "clogging up" regulatory channels (See page 2-17). All of the Antitrust Division's activities at the FMC have been conducted in good faith and for the sole purpose of insuring that members of the shipping industry justify their agreements in a manner that is consistent with the requirements of the Shipping Act and the FMC's own precedents. 2

3. The report is technically incorrect in implying in footnote 3 on page 2-17 that, in 1979, 13 shipping executives entered pleas of nolo contendere to felony violations of the antitrust laws. In fact, these individuals were charged with misdemeanor violations, and only the corporations were charged with felony violations. 3

Should you desire any additional information pertaining to our response, please feel free to contact me.

Sincerely,

Kevin D. Rooney

Kevin D. Rooney
Assistant Attorney General
for Administration

1. The Department of Justice is technically correct, and changes have been made where appropriate. Under Section 15 of the Shipping Act, the FMC does have the authority to grant immunity to consortia agreements involving U.S. flag carriers, and is required to adhere to the same standard of review as that used when considering such agreements among foreign flag carriers. However, in interviews with us, some representatives of U.S. flag carriers expressed their belief that they were, de facto, prohibited from entering into consortia agreements because of the difficulty involved with obtaining FMC approval. Moreover, U.S. flag carriers operate predominantly on FMC-regulated U.S.-foreign trade routes, while foreign flag carriers operate primarily on foreign to foreign trade routes beyond the FMC's jurisdiction. Since more of their operations are subject to FMC regulation, U.S. flag carriers can, in this sense, still be considered relatively disadvantaged.

2. Footnotes were added to the draft report to note DOJ's organizational changes and its disagreement with the assertion made by industry members.

3. A change was made to the draft report to note the distinction between the felony and misdemeanor charges.

Federal Maritime Commission
Washington, D.C. 20573

Office of the Chairman

January 22, 1982

Mr. Henry Eschwege
Director, Community and Economic
Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

Thank you for providing us with a copy of the draft report to the Congress entitled "Changes in Federal Maritime Regulation Can Increase Efficiency and Reduce Costs in the Ocean Liner Shipping Industry." We appreciate the opportunity for review and comment on this draft.

I would like to commend the GAO on its draft report. It obviously represents many hours of research on a difficult and perplexing subject.

The enclosure to this letter contains the Commission's comments on specific sections of the draft report. These comments are intended to state our views on several controversial topics and should not be viewed in any way as a criticism of the report.

After you have had the opportunity to review our comments, we would be pleased to discuss this matter at greater length.

Again, thank you for providing us an opportunity to comment.

Sincerely,

Alan Green, Jr.
Chairman

Enclosure



**Comments of the**
**Federal Maritime Commission**

The Federal Maritime Commission has the following comments regarding the proposed draft of a U.S. General Accounting Office report entitled "Changes in Federal Maritime Regulation Can Increase Efficiency and Reduce Costs in the Ocean Liner Shipping Industry." Our specific comments are organized under headings which correspond to headings in the draft.

**Digest and Summary**

In the Digest and Summary of the draft report frequent reference is made to the two alternatives to the present system -- elimination of the antitrust exemption for steamship lines serving the U.S. foreign trades and, in the alternative, authorization of closed conferences. It has been suggested in the draft report that both of these alternatives would eliminate excessive service competition in the industry. We believe that in developing its options, the GAO has overlooked a third option: the encouragement of rationalization among steamship lines without adopting a closed conference system. This can be undertaken through such arrangements as space charter agreements, pooling agreements, and/or joint service agreements. 1

APPENDIX II

2 While the GAO report does not provide a specific recommendation with respect to the lifting of the antitrust exemption or the formation of closed conferences, we believe that removal of the antitrust exemption is not a viable alternative. The draft report contends that elimination of the antitrust exemption would result in price competition supplanting service competition. The GAO draft report, however, does not examine this contention from a long-run viewpoint. There is no question that in the short run, removal of the antitrust exemption would result in increased price competition. However, the nature of the liner shipping industry is such that nationalistic interests manifested by extensive government subsidization and control of their merchant fleets may result in prices, over the long run, being higher than would be the case under the present system.

3 Given the cost structure of the industry (i.e., a high proportion of constant to total costs, with declining average costs per unit of output), elimination of the antitrust immunity would most likely result in rate wars in the short run as carriers cut rates to attract as much cargo as possible to fill their vessels. With nationalistic interests exerting a strong influence, the result of the rate war would probably not be the survival of the most efficient liner operators as economic theory would posit; but rather, the surviving carriers would more likely be those with the strongest backing of their





national governments. Thus, short-run price competition may result in the more efficient carriers exiting a given trade. Over the long run, the combination of inefficient operations and barriers to entry created by government-supported merchant fleets may result in prices higher than they would have been in the absence of the short-run price competition. We believe that a primary goal of regulation of the international liner industry should be the encouragement of efficiency. The injection of excessive price competition through elimination of the antitrust exemption may not encourage efficiency; on the contrary, it may encourage inefficiency.

From a political standpoint, elimination of the antitrust 4
immunity would severely strain our international relations by subjecting the carriers of foreign nations to our antitrust laws. While the draft report contends that enforcement of the Shipping Act strains U.S. international relations, we believe that the degree to which international relations are presently strained would be substantially greater under a scenario that removes the antitrust exemption.

Chapter 2

The title of Chapter 2, Provisions of the Shipping Act of 5
1916 Foster Wasteful Service Competition, Excess Capacity, and High Costs, and Strain International Relations, is misleading and conclusory, and not necessarily based upon the available evidence. Therefore, much of our discussion concerns this chapter.

APPENDIX II

6 We are concerned that the draft report misplaces the blame for the problems facing the ocean shipping industry operating in the U.S. liner trades. The excessive service competition discussed on pages 2-19 through 2-22 cannot be attributed solely to the FMC's administration of the Shipping Act, 1916.

7 In the first place, while the Shipping Act requires conferences to be open to any and all entrants, there is no express restriction on conferences organizing revenue pools, limiting sailings, or otherwise rationalizing services. The report states at page 2-19 that "conferences are generally denied permission to organize revenue pools, rationalize service, limit sailings, or limit membership". At page 2-20, the report refers to conferences' inability to form pooling agreements. These statements are not accurate.

8 In practice, it is rare that conferences have sought authority to pool revenues. Most pooling agreements are submitted outside the conference framework. However, members of pooling agreements generally belong to the relevant conferences in their trades. There are presently 20 pooling agreements operating in the South American trades, the Far East trade, the Mediterranean trade, and the Calcutta/Bangladesh trade. U.S. flag carriers are members of many of these pooling agreements.

9 With respect to other forms of rationalization, the draft report suggests that the FMC has generally been unwilling to permit rationalization arrangements (particularly among U.S.



flag carriers); and consequently, the inability of carriers to rationalize their services has contributed to rate wars and ultimately a reduction in operations or even a cessation of service.

There are a number of points relevant to this argument. First, the FMC has not been unwilling to approve agreements which rationalize services. On the contrary, the Commission has approved agreements which rationalize service, and attempt to develop a more efficient international ocean transportation system.

The Commission has approved more than 20 joint service agreements. Such agreements generally provide a significant degree of rationalization by combining the operations of two or more carriers into one service.

The Commission has approved over a dozen space charter agreements which provide for more efficient utilization of space on board vessels which may be sailing at less than full capacity. These agreements are prevalent throughout the Far East trades and have recently been filed in the African trades. The FMC recently approved Agreement No. 10420, which is a space charter agreement among five U.S. flag carriers in the Far East trade. This agreement is one which attempts to rationalize service by allowing each of the five lines to charter space on one another's vessels if necessary. Previous to the approval of Agreement No. 10420, the Commission approved Agreement No. 10050-3, a discussion agreement among U.S. flag

APPENDIX II

carriers in the Far East trade. In its analysis of that agreement, the Commission staff found that among the benefits emanating from the agreement were a reduction in excess capacity and the commensurate higher utilization rates that might be encouraged <u>if the carriers could c_eate an effective rationalization program</u> (emphasis added).1/

Thus, it is not entirely correct to argue that the Shipping Act or its enforcement by the FMC has discouraged the implementation of rationalization proposals. The FMC has approved pooling agreements, space charter agreements, and the formation of consortia. U.S. flag carriers have not been deterred from engaging in rationalization arrangements by the FMC. On the contrary, the FM: has approved a space charter arrangement requested by U.S. flag carriers.

10 <u>International Tension</u>

We are further concerned that the draft report singles out the Shipping Act, 1916, as the primary cause of international tension without examining the deleterious effects which our national policy favoring competition has had on international relations. Our antitrust laws, which embody our national policy favoring competition, reach the conduct of American

1/ Economic Impact Statement, Agreement No. 10050-3, U.S. Flag Far East Discussion Agreement, Office of Economic Analysis, FMC, June 21, 1979, p. 25.



nationals wherever it occurs if the conduct has substantial anticompetitive effects on the commerce of the United States. <u>United States v. Aluminum Co. of America</u>, 148 F.2d 416 (2d Cir. 1945). The antitrust laws have also reached foreign defendants where there was an intent to restrain competition in the United States. Absent section 15 immunity, conferences in the U.S. trades would be prohibited under the antitrust laws. Concerted activity which is conducted outside an approved agreement exposes the participants not only to antitrust liability but also to liability for violations of the Shipping Act. See <u>In re Ocean Shipping Antitrust Litigation</u>, 15 S.R.R. 839 (Oct. 15, 1980) and <u>Pacific Seafarers, Inc. v. Pacific Far East Line, Inc.</u>, 404 F.2d 804 (D.C. Cir. 1968). Because the policies underlying the antitrust laws are antithetical to the economic philosophies of many of our trading partners, the extraterritorial application of the antitrust laws have strained international relations.

One of the primary purposes of Section 15 was to minimize 11
conflict with trading partners by permitting a controlled departure from strict American antitrust principles in international trade. To that extent, section 15 tends to foster better relations with our trading partners. To give life to this purpose, the moderating effects of section 15 on international maritime commerce cannot be realized unless its reach is co-extensive with that of the antitrust laws of the United States.



APPENDIX II

12 Although the extraterritorial application of the remaining sections of the Shipping Act, 1916, may occasionally cause difficulties with our trading partners, there appears to be general agreement in the international community that many of the practices which are unlawful under the Shipping Act, 1916, should be curbed. The UNCTAD Code would prohibit conferences from unfairly differentiating between similarly situated shippers. Fighting ships would be prohibited and adherence to published tariffs would be required. Thus, it cannot be said that the United States stands totally by itself in believing that such activities should be regulated.

13 Contrary to the statements in the draft report, the United States is not alone in regulating the steamship industry. For example, Canada, in explaining its reservations regarding the UNCTAD Code of Conduct for Liner Conferences, stated the following:

> The conferences have become very strong, over the years, and have tended to establish monopoly situations. Canada has found it necessary to regulate the conferences to permit their continued operation in the Canadian context.2/

Australia, a strong supporter of the conference system, retains the power to regulate the practices of conferences under the 1966 Amendment to the Trade Practices Act.

---

2/ I UNITED NATIONS CONFERENCE OF PLENIPOTENTIARIES ON A CODE OF CONDUCT FOR LINER CONFERENCES 83, UN DOC. TD/CODE/1B (1975).





We are aware of several countries which are considering measures which would increase their level of regulation of conference activities. This regulation takes a variety of forms. Nonetheless, there is a growing interest by foreign governments in the activities of conferences.

Once the UNCTAD Code for Liner Conferences goes into effect, numerous countries will be in a position to veto conference activity through government owned or controlled carriers. The source of this "veto power" is contained in Article 3 of the UNCTAD Code which states in part:

> However, a decision cannot be taken in respect of matters defined in a conference agreement relating to the trade between two countries without the consent of the national shipping lines of those two countries.

This "veto power" will provide the numerous countries having government owned or controlled carriers with a ready means to regulate the activities of conferences. We have no reason to believe that this power to regulate will not be exercised.

## Section 14

The discussion of section 14 of the Shipping Act, 1916 14
(p. 2-10) implies that section 14 applies only to conferences. This is not correct. Section 14, by its terms, applies to all carriers whether they are independents or conference members.

APPENDIX II

## Summary

15 In its summary of Chapter 2, the GAO notes that excessive service competition has led to excess capacity, higher costs, and a poor level of profitability for conference carriers, which may result in a cessation of operations by those carriers. The scenario painted by the GAO omits one important element. Academic economists may argue that such competition clears the market of inefficient, high-cost operators and the result of such price cutting would be a more efficient transportation system. The problem with the theory is that it does not take into account the nature of the liner shipping industry. Numerous carriers are subsidized or government controlled. Pricing and service decisions may not be made strictly on commercial or financial grounds but rather may be significantly influenced by political considerations. Such carriers are not solely operators of vessels from non-market economy countries, but also include operators from market economies which desire to maintain shipping lines. The attached Table 1 reflects the large number of steamship lines of market economy or mixed economy countries, which are significantly government owned and/or operated.

In addition to the large number of state-controlled carriers shown in Table 1 (which is not an all-inclusive list), many nations reserve cargoes for their national fleets and designated carriers of trading partners. Many nations exert a



strong governmental influence on their merchant fleets (such as the Government of Japan, cited in Appendix II to the draft report). As a result of these factors, exit from the liner industry is impeded not only by economic factors, but also by political factors. Open competition which results in rate wars may result in some carrier victims. However, the victims may not necessarily be the least efficient carriers (as economic theory would posit) but rather may be the carriers without financial backing of their governments. As a result, the consequences of unfettered competition may not be the most efficient transportation system but may be the encouragement of inefficiency as a result of the substantial nationalistic interests involved.

## Chapter 4

## Conference Alternatives

In Chapter 4, the GAO outlines the arguments for and 16
against what they perceive as the two alternative methods for eliminating "wasteful" service competition -- elimination of the antitrust immunity and expansion of the antitrust immunity. From an economic standpoint, the GAO believes that price competition resulting from elimination of antitrust immunity would not be harmful. The problems with this argument are numerous. First, as we have previously noted, domestic concepts of the effects of market forces have, at best, an imperfect application to the international maritime industry.

APPENDIX II

This in itself creates barriers to entry. Inefficiency, rather than efficiency can be encouraged by the free-play of market forces. Second, while the GAO contends that as a result of a lack of barriers to entry and the mobility of resources, monopolist prices cannot be charged, it should be noted that resources in the steamship industry are not perfectly mobile (i.e., it would be very difficult for a containership operator in the Far East trade to shift vessels from that trade if it were experiencing a rate war to the South American trade, at a time when that trade was profitable, because of a lack of containerized port facilities). Additionally, it is unlikely that many carriers would be interested in reentering a trade which had just witnessed a destructive rate war. The imperfect mobility of resources in the steamship industry means that a rate war may not clear the market of inefficient carriers. In the aftermath of a rate war, carriers would not necessarily reenter a trade with the speed required to produce a textbook case of market equilibrium pricing. Consequently, the possibility for monopolistic prices does exist.

17 We are concerned with GAO's contention that the economic arguments for maintaining the antitrust exemption are not persuasive. We believe that the GAO has not fully evaluated these arguments. The international character of the liner shipping industry together with its cost structure (i.e., a high proportion of constant costs to total costs and declining average costs per unit of output) render open competition



unworkable. Moreover, the political considerations cannot be taken as lightly as the GAO has done. The most recent publication on the economics of liner shipping entitled, <u>Liner Conferences in the Container Age</u>, by Gunnar K. Sletmo and Ernest W. Williams, Jr., 1981, provides an excellent treatise on why the benefits of competition are limited in this industry.

<u>Expand Antitrust Immunity</u>

The other alternative cited by the GAO is the expansion of 18
the antitrust immunity to what the authors describe ass "pre-1916 conditions". There was no antitrust immunity prior to 1916. Prior to 1916 the Sherman Act prohibited collective ratemaking activities by conferences serving United States commerce. GAO may have intended to suggest expansion of current antitrust immunities. The Commission has supported legislative efforts to expand current antitrust immunity in ways which eliminate overlapping liabilities for Shipping Act and antitrust violations. Closed conferences are not a necessary facet of expanded antitrust immunity and may or may not respond to GAO's concerns. While closed conferences may encourage rationalization, we do not believe that sanctioning such conferences would completely resolve the political and economic dilemma of the liner industry.

In the conclusion to Chapter 4, the GAO contends that 19
elimination of the antitrust exemption would lead to lower rates. We believe that while this may be a short run impact, it may not be a long run impact since many operators have



APPENDIX II

political as well as economic motives. The argument for antitrust exemption elimination fails to address the issue of the efficiency of the carriers surviving a period of intense price competition.

## Chapter 7

### U.N. Code of Conduct for Liner Conferences

20 In explaining why the United States has not ratified the UNCTAD Code for Liner Conferences, the following statement is made on page 7-30 of the draft:

> This [the failure to ratify] is primarily because the Code's provisions regarding the powers granted to conferences and the noncompetitive allocation of cargo conflict with the provisions of the Shipping Act of 1916. (Emphasis added).

The statement is incorrect. The United States explained its failure to ratify the Code as follows:

> This involves more than just conflict between potential treaty law and our own domestic regulatory legislation, but rather basic differences in economic philosophies. Regulatory legislation can, after all, be changed, and although difficult we are prepared to seek such changes in order to promote international harmony in shipping regulation. We had hoped, however, that others would not attempt to impose principles on us which, going beyond regulatory rules, were contrary to our own economic philosophy, particularly in relation to the role of competition.3/

The conflict concerned economic philosophies regarding competition, and not the requirements of the Shipping Act, 1916.

---

3/ I UNITED NATIONS CONFERENCE OF PLENIPOTENTIARIES ON A CODE OF CONDUCT FOR LINER CONFERENCES 90, UN DOC. TD/CODE/1B (1975).





Table 1

GOVERNMENT-OWNED/OPERATED LINER CARRIERS IN MARKET ECONOMY COUNTRIES1/

| Country | Carrier |
|---|---|
| Algeria | Compagnie National Algerienne de Navigation |
| Argentina | Empresa Lineas Maritimas Argentinas |
| Australia | Australian National Line |
| Brazil | Lloyd Brasileiro |
| Egypt | Egyptian Navigation Company |
| France | Compagnie General Maritime |
| Gabon | Societe Nationale des Transports Maritime |
| India | Shipping Corporation of India |
| | Mogul Line Ltd. |
| Indonesia | Djakarta Lloyd |
| Iran | Islamic Republic of Iran Shipping Line |
| Italy | Italia Line |
| | Lloyd Treiestino |
| Malaysia | Malaysia International Shipping Corporation |
| Morocco | Compagnie Marocain de Navigation |
| Pakistan | Pakistan Shipping Corporation |
| | National Shipping Corporation |
| Peru | Corporacion Pervana de Vapores |
| Philippines | Philippine National Lines |
| Taiwan | China Merchants Steam Navigation Company |
| Thailand | Thai Maritime Navigation Co., Ltd. |
| Turkey | Turkish Cargo Lines |
| Venezuela | C.A. Venezolana de Navegacion |

Source: Maritime Subsidies, U.S. Department of Commerce, Maritime Administration, January 1981.

1/ This list does not necessarily include all government-owned/operated liner carriers of the market economy countries, rather it is merely a sample.

APPENDIX II

1. The two major alternatives referred to in the digest and summary are (1) to eliminate the antitrust exemption to spur more price competition, and (2) to extend antitrust immunity to allow conferences and carriers greater freedom to devise and implement methods of controlling capacity. The second alternative, i.e., increased ability to rationalize capacity, may be achieved by authorizing closed conferences as well as by encouraging intercarrier agreements to pool revenues or cargoes, limit sailings, or form consortia within the open conference system. The FMC, however, has misconstrued it to mean only the former. This confusion has apparently resulted from the fact that "closed conference" was one of the four, more narrowly defined, alternatives (in addition to "restricted conference," "open competition" and "other") that we posed to shippers and carriers during structured interviews.

2. The FMC's contention that the draft report considered only the short-run price effects of eliminating the current antitrust immunity is incorrect. To the contrary, the very argument that the FMC makes was explicitly stated in the draft report as follows: "One fear is that this option would lead to severe price competition, resulting eventually in very few lines, or even a monopoly in control of a particular trade route. Critics argue that the resulting rates would be higher than those charged by conferences." As the draft report noted, we do not consider this argument very persuasive for two reasons. First, this result could only occur if the surviving lines do not face the threat of having new firms enter the trade routes on which they are operating. Second, to the extent that there are barriers deterring new entry, the surviving lines would still exercise the same restraint as existing conferences in setting rates. Thus, rates in this worst case would be no higher than under the conference system. If removal of the antitrust exemption did lead to periodic rate wars followed by increases in prices to conference levels, rates, on the average over the long run, might still be lower than those experienced under conferences.

3. The draft report also explicitly addressed this argument concerning the nature of the industry's cost, as follows: "It is feared that prices often would be driven below average total cost and operators would cease operations. Competition can drive prices below average total cost in industries such as liner shipping where the level of demand fluctuates and the direct costs of providing a service . . . are small compared to overhead cost. . ." As the draft report noted, however, it is not just the nature of costs that would induce a rate war if the antitrust exemption were removed (after all, a large number of well functioning, competitive industries, such as hotels, barber shops, motor carriers, theaters, cement producers, and petroleum producers have similar cost structures), but the fact that the existing regulatory system has caused

excessive service competition and substantial excess capacity on U.S. foreign trade routes. Unfettered price competition should eventually correct this overcapacity as the level of new investment diminishes and operators shift existing vessels to other, more profitable trade routes. It is this decrease in excess capacity that, for a given level of demand, will cause increases in the extent to which the surviving capacity is utilized and subsequent decreases in the cost per ton of cargo carried on U.S. foreign trade routes. Thus, contrary to the FMC's contention, this increase in efficiency is not predicated on the survival of the "most efficient" (i.e., lowest cost) operators, although the potential cost reductions would be greater if this did occur.

We agree with the FMC that the degree to which flag carriers are supported by their various governments could be an important factor determining which carriers exit from U.S. foreign trade routes. It is precisely for this reason, given U.S. cargo preference laws, the maritime subsidy programs, and our national commitment to maintain a merchant marine adequate for national security, that the survivability of high cost U.S. flag carriers would not be seriously jeopardized if the antitrust exemption were removed.

We also agree with the FMC that a primary goal of Federal maritime regulation should be the encouragement of efficiency. However, as the report concludes, we believe that the current regulatory system has actually had the opposite effect.

4. We agree. The draft report clearly stated that eliminating the antitrust immunity could "increase diplomatic tensions since it would further subject foreign flag carriers to prosecution under U.S. antitrust laws." In fact, it is partly because we could not weigh these increased diplomatic costs that we were unable to recommend any major revisions to the Shipping Act.

5. We disagree for the reasons stated in our replies to points #6, #7, #8, and #9.

6. Although we did not seek to place any "blame" for the problems facing the ocean liner shipping industry, we do feel that our report adequately supports the conclusion that Federal maritime regulation has led to excessive service competition, overcapacity, high rates, and increased costs on U.S. foreign trade routes.

7. The FMC is correct in saying that there is no express legal restriction on conferences, or carriers, organizing revenue pools, limiting sailings, or otherwise rationalizing services.

As the Justice Department noted in its comments on this draft report, it is always possible, under Section 15 of the Shipping

Act, for the FMC to grant antitrust immunity to such agreements that might theoretically violate the U.S. antitrust laws. As the draft report noted, however, the FMC can disapprove such agreements on four grounds: unjust discrimination, detriment to commerce, illegality under one of the specific provisions of the Shipping Act, or contrary to the public interest. The fourth ground was added in 1961 as a result of P.L. 87-346. To implement this new criterion, the FMC formulated a principle, subsequently upheld by the Supreme Court, that agreements in potential violation of the U.S. antitrust laws would be approved only if the parties to the agreements could "bring forth such facts as would demonstrate that the . . . rule was required by a serious transportation need, necessary to secure important public benefits or in furtherance of a valid regulatory purpose of the Shipping Act." It is partly because of this so-called "Svenska Test" that carriers find the current regulatory process costly, burdensome, and overly time-consuming. In interviews, some representatives of U.S. flag carriers expressed their belief that they were, in fact, prohibited from entering into many such agreements because of the difficulty involved with obtaining FMC's approval. Any references in the draft report that could have inadvertently misled one to believe that the Shipping Act or the FMC absolutely prohibited these agreements were corrected.

8. The draft report clearly stated that, "as of June 1980, there were only 17 approved pooling agreements to which U.S. flag operators were party were on file with the FMC." However, many of these pools were formed by carriers to implement the provisions of bilateral trade agreements negotiated between the United States and foreign governments. As the draft report noted, such agreements are automatically assumed to be in the public interest and, thus, are not subject to the "Svenska Test."

9. The fact that the FMC has recently approved some rationalization agreements does not contradict the fact that the FMC's approval process has been slow, costly, and uncertain. Thus, we still feel that it is both correct and fair to argue that the regulatory process has discouraged the consideration, formation, and implementation of rationalization proposals by carriers serving U.S.-foreign trade routes. As noted above in point #7, some representatives of U.S. flag carriers even believe that they are, in fact, prohibited from engaging in some agreements because of the difficulty in obtaining FMC's approval.

10. Because this report concerns the effects of Federal maritime regulation, we naturally focus some attention on the international tensions caused by the FMC's enforcement of the Shipping Act. However, the draft report did not single out

the Shipping Act, 1916, as "the primary cause of international tension." It did note that "firms, both foreign and domestic, are subject to prosecution under this country's laws if they perform actions . . . [that] are illegal and have a substantial effect within the United States." Although this "substantial effects" doctrine applies to both the U.S. antitrust laws and the Shipping Act, it was not our intention or objective to determine which has put the greater strain on international relations.

11. The fact remains that the FMC's enforcement of the Shipping Act, 1916, has led to considerable international tensions. Some foreign countries have even enacted so-called "blocking statutes" which make it illegal for their shipping lines to comply with FMC discovery orders.

12. The draft report never said or implied that "the United States stands totally by itself" in believing that some maritime practices should be regulated.

13. The draft report did not state that the United States is "alone" in regulating the steamship industry. Rather, it noted that the "United States is unique among maritime nations in the way in which it regulates" the industry. In general, foreign countries have not enacted special laws, like the Shipping Act, to extensively regulate the activities of liner conferences, or have established official bodies, like the FMC, to enforce such laws.

14. The FMC is technically correct in that Section 14 applies to all carriers, whether or not they are conference members. However, prior to the passage of the Shipping Act in 1916, many of the activities prohibited by Section 14 were used by conferences to combat and deter competition by independent operators. Thus, we feel the draft report's statement that "Section 14 apparently was designed to ensure that shippers would not be denied access to nonconference operators as a result of conference actions" is a valid one. We did make a minor revision to correct any possibly misleading implication that these prohibitions concerned only conferences.

15. See our reply to point #3.

16. Contrary to the FMC's assertion, we do not contend that there is a lack of barriers to entry or that capital resources are "perfectly mobile" in the ocean liner shipping industry. In fact, we are aware of no industry, either domestic or international, where this hypothetical condition actually exists. What we do contend is that barriers to entry are not likely to be very high since vessels can, in most cases, be shifted from one trade route to another, or leased to other operators. However, as noted in our reply to point #3, even if there are significant barriers to entry, the surviving operators would

still exercise the same restraint as conferences in setting rates. Although, as the FMC suggests, carrier risk aversion could increase after a rate war, this should be a temporary phenomenon. Thus, even in the worst case, rates should generally be no higher than those set by conferences, and are likely to be lower.

17. For the reasons cited in our replies to points #2, #3, and #16, we disagree with the FMC's contentions (1) that we did not fully evaluate the arguments for maintaining the industry's antitrust exemption and (2) that open competition is unworkable for economic reasons. We also do not believe that we have taken the political considerations "lightly." The draft report clearly stated that, although removing the antitrust exemption may be preferable on economic grounds, it will lead to increased diplomatic costs. It was actually because we could not weigh these economic benefits and diplomatic costs against one another that we could not recommend this particular course of action.

18. The draft report was revised to correct the misimpression that antitrust immunity existed prior to 1916. We agree that authorization of closed conferences is not a necessary facet of expanded antitrust immunity or that it will solve completely the political and economic problems of the liner industry. Our draft report made no such statements to this effect.

19. See our reply to points #2 and #3.

20. The draft report was revised to state that the United States has declined to ratify the Code because of conflicts with the Shipping Act and our own economic philosophy.

U.S. Department of Transportation

Assistant Secretary for Administration

400 Seventh St. S.W. Washington, D.C. 20590

FEB 4 [redacted]

Mr. Henry Eschwege
Director, Community and Economic
Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

We have enclosed two copies of the Department of Transportation's (DOT) reply to the General Accounting Office (GAO) report, "Changes in Federal Maritime Regulations Can Increase Efficiency and Reduce Costs in the Ocean Liner Shipping Industry," dated December 9, 1981.

At the time the report was issued, the Administration was involved in its own effort to assess the impact of the administration of the Shipping Act on the ocean liner industry and to develop recommendations for changes in the Act. On December 31, 1981, the Secretary of Transportation announced the President's decision favoring far-reaching regulatory reform of the international ocean liner shipping industry.

1 This Department is aware of the difficulties associated with any study of the ocean liner shipping industry. This situation is compounded by the broad nature of the request of the Merchant Marine and Fisheries Committee. As currently written, the GAO report appears to be incomplete. It is the Department's recommendation that the report be revised giving consideration to the points addressed in the enclosed statement. In this regard, we will be pleased to provide whatever technical assistance would be helpful to the GAO.

Sincerely,

Robert L. Fairman

Enclosures



DOT'S COMMENTS AND GAO'S RESPONSE

I. DEPARTMENT OF TRANSPORTATION REPLY

TO

GAO DRAFT OF A PROPOSED REPORT

ON

CHANGES IN FEDERAL MARITIME REGULATION
CAN INCREASE EFFICIENCY AND REDUCE COSTS
IN THE OCEAN LINER SHIPPING INDUSTRY

APPENDIX III

II. SUMMARY OF GAO FINDINGS AND RECOMMENDATIONS

The U.S. House Committee on Merchant Marine and Fisheries requested that the GAO conduct an economic analysis of the international ocean liner shipping industry to assist them in their oversight of the Federal Maritime Commission (FMC) and their attendant review of Federal maritime regulation. The two objectives of the draft GAO analysis are to determine whether there is any valid economic rationale for changing the current regulatory system embodied in the Shipping Act of 1916; and second, to assess the economic implications of frequently discussed modifications of the Act.

The principal findings and recommendations reflected in the GAO draft report include the following:

1. THE SHIPPING ACT FOSTERS WASTEFUL SERVICE COMPETITION (Chapter 2)

In the ocean liner shipping industry, the demand for services is affected by both the rates charged and the level of service offered. As a result of the Shipping Act and its enforcement by the FMC, conferences covering the U.S. foreign trades are able to restrain price competition by jointly establishing common tariffs to which their members must adhere. However, they have not been able to effectively control capacity and rationalize service in the U.S. foreign trades because of their inability to limit membership and the FMC's general unwillingness to approve conference agreements to pool revenues or restrict the number of sailings. Consequently, competition among conference members occurs primarily by augmenting the level and frequency of service offered to shippers and not by reducing prices. This process can result in high costs due to low capacity utilization rates (a result of more frequent sailings with each carrying less cargo), and at best, adequate rates of return on invested capital.

High rates charged by conferences can also induce nonconference operators (also called independents) to enter the U.S. foreign trades. The inability of conferences to use more stringent types of exclusive patronage contracts limits their ability to deter the entry of these carriers. A substantial amount of entry by price-cutting independents would cause rates to fall and aggravate the problem of excess capacity. As a result, U.S.-flag conference members could suffer financial losses.

2. THE CONDITION OF THE U.S. LINER FLEET DOES NOT JUSTIFY A MAJOR REVISION OF THE SHIPPING ACT (Chapter 3)

Taken at face value, certain statistics suggest that the general cargo liner portion of the U.S. merchant marine is in serious trouble. For example, the number of U.S.-flag general cargo vessels declined from 585 in 1965 to 256 in 1980. In addition, the number of operators composing the U.S.-flag liner fleet has fallen from 19 in 1965 to 9 in 1981. Further, the U.S. fleet of general cargo vessels has fallen from second largest in the world in 1965 to eighth largest in 1979 in terms of total deadweight tons.



APPENDIX III

Reconsidering these statistics in the light of recent advances in cargo handling and ship design technology, containerization, enables fewer containerships to transport the same amount of cargo in the same amount of time as conventional, breakbulk vessels by reducing the amount of time spent in port. Thus, rather than indicating distress, the decline in the number of U.S.-flag vessels and the relative ranking of the U.S.-flag liner fleet reflect significant changes in the type of ships and in the means by which U.S.-flag operators carry their cargo. With the adoption of containerization, a smaller number of operators and vessels can carry the available cargo. In fact, the evidence shows that U.S.-flag liner operators pioneered in the development of containerization, and have been able to acquire this new technology more rapidly than operators in other countries. In addition to the effects of containerization, the decline in the number of U.S.-flag operators was also a result of other factors such as poor management, changing market conditions, and uncertainty with regard to the maritime policies of certain South American nations.

Because there is no compelling evidence that the U.S.-flag liner fleet is in the state of decline generally ascribed to it, major revisions of the Shipping Act are not required to assure the fleet's existence. However, because advances in technology are producing even larger, more costly vessels, U.S.-flag operators may find it increasingly difficult to replace their fleets in the



future. To assure the continued, successful performance of the fleet, it may be necessary to allow U.S. carriers to more easily form consortia to pool their resources. These arrangements would place U.S.-flag operators on the same footing as foreign-flag carriers, while maintaining the benefits of interline competition.

3. ENFORCING THE SHIPPING ACT STRAINS INTERNATIONAL RELATIONS, BUT IS NOT BIASED AGAINST U.S. CARRIERS (Chapter 3)

The United States is unique among maritime nations in the way it regulates the international ocean liner shipping industry. Most countries do not impose restrictions on the practices or organizational structures of shipping conferences. Shippers are generally allowed to protect their own interests by forming groups known as shippers' councils to negotiate rates and conditions of service with conference representatives.

Because of differing international philosophies and policies regarding the maritime industry, the FMC enforcement efforts have strained relations with a number of our trading partners. As a result, the FMC has had difficulty in obtaining access to documents stored in foreign countries and U.S.-flag carriers have claimed that enforcement of the Shipping Act is thus disproportionately directed toward them. To determine the validity of this allegation, we examined the distribution of 58 malpractice cases initiated by the FMC from October 1976 to June 1980. Our analysis failed to show any evidence of an enforcement pattern biased against U.S.-flag carriers.



APPENDIX III

4. ELIMINATING WASTEFUL SERVICE COMPETITION -- ALTERNATIVES TO THE PRESENT SYSTEM (Chapter 4)

Eliminating wasteful service competition and its onerous effects on operators could be achieved in two dramatically different ways. The first method would entail submitting all U.S. and foreign-flag carriers serving the U.S. foreign trades to the provisions of this country's antitrust laws. If this were to occur, price competition would supplant service competition. Rates would be lower, but less stable. U.S.-flag operators would be adversely affected and in the worst circumstances could cease operation. Such an outcome would be unacceptable, especially taking account of the view that the U.S.-flag liner fleet serves as a military auxiliary in a time of national emergency. Under this alternative, the level of subsidy currently provided U.S. operators would need to be increased. This option could also increase diplomatic tensions since it would further subject foreign-flag carriers to prosecution under U.S. antitrust laws.

The other method would be to adopt the policy of most maritime nations and free the conferences covering U.S. trades routes from all regulatory constraints. This approach would permit carriers to devise methods to control capacity, eliminate wasteful service competition, and deter the entry of nonconference operators into certain trade routes. In addition, it would relax diplomatic tensions and lower the costs of providing liner service. The



interests of shippers could be safeguarded by forming shippers' councils with countervailing bargaining power, as has been done in other maritime nations.

A less draconian alternative could be to encourage forming revenue pools to allow carriers to rationalize service. Our analysis of the revenue pools organized on U.S.-Latin American trade routes during the 1970's showed that some pools significantly improved the capacity utilization of U.S. flag carriers. Unfortunately, we were not able to analyze the effect on rates and profits because of statistical problems and data limitations.

5. REACTIONS OF CARRIERS AND SHIPPERS TO PROPOSED ALTERNATIVES (Chapters 5 & 6)

The results of our interviews with shippers suggest that if the current system is retained, freight rates will increase at the same rate as costs incurred by carriers increase. Both the current degree of rate stability and level of service quality would be expected to remain the same. Shippers believe that under the alternative of increased competition, rates would be lower and more volatile than under the present open conference system or the closed conference alternative. Conversely, shippers believe that closed conferences would result in higher rates than those that now exist. There was, however, no consensus among shippers regarding level of service quality under either alternative.

We also posed questions to carrier and conference officials. It was their view that the current problems of carrier resignation



APPENDIX III

from conferences, illegal rebating, and the entry of nonconference operators into the U.S. foreign trades could be eliminated by permitting closed conferences as an alternative to the present system.

6. MATTERS FOR CONSIDERATION BY THE CONGRESS (Chapter 8)

Two broad options are available to the Congress in considering revisions to the Shipping Act of 1916. Both would alter the nature of the antitrust exemption which has been granted to shipping conferences covering the U.S. foreign trades. The first option would allow conferences to adopt measures enabling them to control capacity and limit wasteful service competition. If this permission were granted, we believe shippers should be provided with the opportunity to form shippers' councils to safeguard their interests. U.S. maritime law would be brought into conformity with that of most major maritime nations, and international tensions created by differences in maritime policies would be mitigated. The second option is to withdraw the antitrust immunity currently granted to conferences. This would introduce more price competition into the liner shipping industry. Consequently, competition would be of more value to shippers. Wasteful service competition would be supplanted by an increase in rate competition to give shippers a more desirable combination of rates and service. This policy would have diplomatic costs associated with it that are probably greater than those associated with this country's current maritime policy.



The most suitable choice depends upon the economic and diplomatic costs and benefits associated with each alternative, but GAO's evaluation of the current evidence does not clearly favor one over the other.

III. SUMMARY OF DEPARTMENT OF TRANSPORTATION POSITION:

By letter dated December 9, 1981, a copy of the subject draft GAO report entitled, "Changes in Federal Maritime Regulation Can Increase Efficiency and Reduce Costs in the Ocean Liner Shipping Industry," was forwarded to the Secretary of Transportation for comment. At that time, the Administration was involved in its own effort to assess the impact of the administration of the Shipping Act on the ocean liner industry and to develop recommendations for changes in the Act. On December 31, 1981, Secretary of Transportation Drew Lewis announced President Reagan's decision favoring far-reaching regulatory reform of the international ocean liner shipping industry. A copy of this announcement is attached.

The Administration's recommendations are guided by three major objectives. First, we are committed to minimizing government intervention in the affairs of the maritime industry. Second, we want to bring U.S. policy and the footing of our carriers into line with that of the rest of the world. Third, we want to maintain a strong U.S. merchant marine.

Our program would make it easier for organizations of ocean carriers to enter into agreements to determine capacity, set rates




APPENDIX III

and organize their activites without unnecessary regulatory restrictions. Intermodal rates could be established. Revenues could be apportioned and joint service arrangements would be possible. Antitrust immunity for shipping activities of ocean carriers would be extended and clarified. Specific practices such as those intended to drive independent carriers from our trades would continue to be prohibited but would be subject to penalties under the Shipping Act rather than the antitrust laws. Vague and discretionary standards for the regulatory approval of ocean carrier agreements which cause unnecessary delay and expense would be eliminated.

2 The Department concurs with the draft report's conclusions that the Shipping Act fosters wasteful service competiton. We agree that existing regulatory restraints on the activities of conferences result in high costs and low capacity utilization. As the report indicates, the high rates that result from these conditions induce excess non-conference capacity in our trades. Conference members, including U.S. flag carriers, suffer financial losses as a result.

We also concur with the draft report's conclusions that it will be necessary in the future to put the U.S. flag fleet on an equal footing with its foreign competitors. Specifically, we agree that it is necessary to allow U.S. carriers greater freedom to organize their resources and modernize their fleet. This will also require revisions to the Shipping Act.



Given the above conclusions, we are unable to understand the 3
draft report's conclusion that the condition of the U.S. liner fleet does not justify a major revision of the Shipping Act. Even though the report correctly assesses the stability of U.S.-flag liner tonnage over the period 1970 to 1978, the report fails to analyze other important measures of industry performance. The U.S.-flag share of liner cargoes has declined steadily since 1976. Financial performance of the liner industry, relative to other sectors of the U.S.-economy, has been unstable and below average. At the present time, three of the nine remaining U.S.-flag liner operators are in serious financial trouble. These conditions exist despite substantial direct and indirect Federal subsidies, a factor
ignored by the report. With the prospect of future budgetary 4
constraints on the subsidy programs, the viability of a U.S. liner fleet requires that means be found to promote industry productivity and reduce industry costs. Under these circumstances, changes in the Shipping Act to facilitate those improvements would appear essential. We are concerned that the GAO's conclusion rests upon a somewhat limited perspective and a narrow analysis of past performance of the U.S. liner industry. It is the responsiblity of this Department and its Maritime Administration to foster the development of the U.S. merchant marine. Consistent with that responsbility, we have concluded that the industry's prospects for the future require that we eliminate the increased costs and





APPENDIX III

inefficiencies attributable to the Shipping Act in order to revitalize this important industry.

5 The Department also takes exception to the report's finding that the enforcement of the Shipping Act is not biased against U.S. carriers. We believe this finding may be misleading. There is no dispute that the Federal Maritime Commission has greater enforcement capability over U.S. flag carriers than foreign flag carriers operating in our trades. It is this disparity in enforcement capability that constitutes the bias against U.S. flag carriers to the benefit of their foreign flag competitors. The statistical analysis employed in the report simplistically assumes that a FMC case is a standard unit of measure for enforcement. No attempt is made to assess the frequency or magnitude of violations nor to correlate the same with the frequency of prosecution and magnitude of punishment.

6 Further, the Department is concerned that the report's analysis of the relative construction costs of break bulk and containerships of comparable characteristics may be inaccurate. That analysis concludes that in 1979 a standard containership cost approximately five times as much as a conventional break bulk ship. The Maritime Administration's experience with construction costs of break bulk and containerships with comparable characteristics indicates that the cost differential may be substantially less.

7 This Department is aware of the difficulties associated with any study of the ocean liner shipping industry. This situation is



compounded by the broad nature of the request of the Merchant Marine and Fisheries Committee. As currently written, the draft report appears to be incomplete. It is the Department's recommendation that the report be revised giving consideration to the points addressed here. In this regard, we will be pleased to provide whatever technical assistance would be helpful to the GAO.

IV. <u>POSITION STATEMENT</u>

A. <u>Chapter 3</u>

Chapter 3 of the GAO draft report is devoted to refuting 8
evidence of the apparent decline in the U.S.-flag liner fleet, measured in terms of number of firms, vessels, and deadweight. Concern about the condition of the fleet is cited as the primary impetus for revising the regulation of U.S. foreign waterborne commerce. By observation and some statistics, the decline in these measures from 1970-1978 is attributed to be a consequence of containerization and incidental conditions - not due to conditions of industry-wide distress. Further, measured in terms of cargo carried by value and tonnage, "the U.S.-flag general cargo fleet's ability to transport this Nation's liner imports and exports had not deteriorated during the 1970's."

Narrowly interpreted, this conclusion is accurate. The U.S. fleet carried about the same amount of cargo, measured by value and tonnage, in 1978 as it did in 1970. However, the U.S.-flag share reached a peak in 1976 and has been declining ever since in terms of both measures.



APPENDIX III

9 The major Federal interest in the U.S.-flag liner fleet concerns the fleet's value as a military auxiliary in times of war or national emergency. The analysis fails to address this requirement. It does clearly point out the fleet's compositional shift from break bulk to container vessels. However, in terms of military sealift capability, the containership is the least useful of all general cargo vessel types. The decline in numbers of break bulk vessels is particularly worrisome to Department of Defense planners.

10 Financial performance is a key measure of an industry's condition. In comparison to other industrial groups the ocean liner industry is one of the poorest and most inconsistent in terms of return on equity, as shown below.

Return on Equity
U.S. Flag Liner Industry
vs Other Industrial Groups

| INDUSTRY GROUP | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|
| Manufacturing | 15.0 | 14.9 | 15.9 | 16.8 | 14.9 |
| Mining | 16.5 | 8.5 | 8.2 | 19.8 | 23.2 |
| Retail Trade | 14.7 | 15.0 | 15.3 | 15.7 | 14.1 |
| Class I Railroads | 1.9 | 2.4 | 2.0 | 5.2 | 6.3 |
| Trucking | 20.0 | 18.3 | 14.8 | 15.6 | 11.8 |
| Air Transport | 11.7 | 14.3 | 20.9 | 11.7 | 5.0 |
| Public Utilities | 11.5 | 12.1 | 12.1 | 13.0 | 12.8 |
| Services | 18.1 | 17.8 | 21.2 | 20.4 | 20.4 |
| Financial | 10.1 | 15.1 | 15.7 | 16.8 | 14.9 |
| US Flag Liner Cos. | 13.2 | 5.9 | 10.4 | 3.2 | 10.4 |

NOTE: Source of other Industrial Groups: Citibank Monthly Economic Letter, 4/78, 4/79, 4/80, 4/81



During this same period, the industry has only generated a return on assets of between .9 and 6.1%, hardly healthy. As additional indicators of sagging financial health, long-term debt increased from .76 of equity to 3.83 times the equity, and the ratio of current assets to current liabilities fell from 1.7 to 1.3 during this same period. Such financial information would not appear to have been considered by the GAO. Additionally, at the present time three U.S.-flag liner firms are plagued with financial difficulties. These difficulties are due in part to a decline in Government-sponsored preference cargoes - an important facet of U.S. support to the fleet. These preference cargoes have provided U.S. liner operators with the marginal revenues that have made the difference between profit and loss.

In addition to the potential loss of these firms, maintenance 11
of the entire fleet is in jeopardy. As the analysis points out, one-third of the current fleet was built before 1967. Replacements are highly unlikely in an environment where profitability is low, financing costs high, and construction subsidy funds curtailed. The authority to replace subsidized vessels overseas is presently limited to 1982, and will be available in 1983 only under statutory conditions which are unlikely to occur. This offers no option for the majority of replacements needed beyond 1983.

The latter part of Chapter 3 attempts to determine the 12
validity of U.S.-flag liner operator contentions that FMC enforcement of the malpractice provisions of the Shipping Act of



APPENDIX III

1916 has been disproportionately directed against them. This claim is concluded by the GAO to be unfounded on the basis of a simplistic and convoluted analysis.

The analysis is predicated on the assumption that: (1) actual malpractices committed by carriers of each flag are in direct proportion to the cargo tonnage they transport; and, (2) if FMC enforcement activities are unbiased, the proportion of total cases brought against U.S.-flag carriers should equal the portion of total tonnage carried by U.S.-flag carriers. Following this line of logic, the analysis computes that given the 58 cases brought by the FMC from October 1976 to June 1980, an unbiased distribution would have brought 16 of these cases against U.S.-flag carriers. Since in fact only 14 of the cases were brought against U.S.-flag carriers, the conclusion is derived that charges of bias are unfounded.

The assumptions employed in this analysis arbitrarily ignore the substance of the charge and lead to nothing more than a statistical computation. At issue is the charge that foreign-flag carriers have been able to engage in more illegal activities under the Shipping Act of 1916 in part because the FMC has greater enforcement capability over U.S.-flag carriers. It is this disparity in enforcement capability that constitutes a bias against U.S.-flag carriers to the benefit of their foreign-flag competitors. If indeed foreign-flag carriers do engage in more illegal activities, the apparent proportional distribution of FMC cases



suggests that a bias does exist. Following the logic employed, unbiased enforcement would require a case distribution proportional to the frequency of illegal activity.

With respect to the statistical information in Chapter 3, page 13
3-17 of the GAO report includes a chart based on <u>Fairplay International Shipping Weekly</u> (Fairplay) data and concludes that in 1979 a standard containership cost approximately 5 times as much as a conventional break bulk ship. This conclusion does not agree with our shipbuilding cost information.

The Fairplay data identifies three distinct types of ships with estimated construction costs provided for succeeding years from 1969. Each of these standard ship types provides a different service such that the classes of ships may not be used interchangeably. Comparing construction costs of such types would have as little meaning as comparing costs of a pick-up truck and a trailer-tractor rig. Our experience with the U.S. building costs of break bulk and containerships of comparable characteristics is that the costs are approximately equal.

It is inferred from information abstracted from Fairplay's July 17, 1980, issue that containership prices have risen much more rapidly than break bulk ship selling prices, thereby contributing to the high cost of providing modern marine transportation service. The Fairplay data states that in 1973 the standard containership costs approximately 3.6 times as much as a conventional break bulk vessel, but by the end of 1979 that ratio has risen to 5.2.



APPENDIX III

Closer examination of the Fairplay data reveals what may be a flaw in the data base. Between 1973 (annual average price) and June 1974, approximately a one year period, the reported price of a standard containership doubled from £ 10,000,000 to £ 20,000,000. In the following five years, from June 1974 through December 1979, the containership prices increased a total of 43.5 percent while the Fairplay standard break bulk ship increased in price by 57 percent from £ 3,500,000 to £ 5,500,000.

The questionable change in relative prices of different type cargo ships appears to center around what pricing changes actually occurred from 1973 to 1974. From June 1973 to June 1974, the price of the Fairplay break bulk ship increased 55.5 percent from £ 2,250,000 to £ 3,500,000, contrasted to a doubling of the containership estimated selling price. It should be noted, however, that an improper comparison may be drawn since the containership price is on an annual basis for 1973 and then shifts to a six-month pricing time period with two prices quoted for 1974 (June and December). It is unfortunate that this difference in baseline period occurs at a time when ship prices and shipbuilding costs were rising so rapidly as a result of shortages that were developing in material supplies (steel and other basic raw materials) and growing backlogs in international shipbuilding orderbooks.

The Fairplay article does state that the prices are estimates based on three hypothetical cargo vessels, a 11,000/13,000 dwt dry cargo carrier, a 25,000 dwt bulk carrier and a 25,000 dwt



containership. The prices are computed considering four variables: hull steelwork, main and auxiliary machinery, outfit and painting and yard overhead plus depreciation, insurance classification charges and a 5 percent profits mark-up. Since market conditions are not included in the calculation, the prices reported are in fact not really shipping selling prices, but rather builder's estimated costs of construction. Examination of the Fairplay data for each one of the three standard vessels indicates that the price always increased with time, never decreasing, which was the case in the real marketplace.

On page 3-17 of the GAO report the graphical display indicates price decreases in 1975 and 1976. This occurs, however, because the GAO authors converted the ship price expressed in British pound to U.S. dollars using year-end currency exchange rates rather than retaining the original currency, used in compiling the statistical data. In converting currency the GAO has introduced another very important variable.

In the real marketplace the selling prices of ships declined sharply in the second half of the 1970's. The drop in prices, a reaction to marketplace activities, is not included in the Fairplay pricing structure. After the 1978 oil crisis, the market for tankers, which dominated world shipbuilding tonnage demand, collapsed and ship prices declined, reaching levels in 1978 that were below building costs. In 1979 after adjustments were made to reduce shipbuilding berths ship prices rose. Increasing price



APPENDIX III

trends continued into the first half of 1981. In the second half of 1981 ship orders have declined and the market has become sluggish.

Our office records of Japanese contract prices for standard ships do not support the conclusion reached by the GAO that a standard containership design has become substantially more expensive relative to a standard break bulk ship. The Japanese shipbuilder IHI's "Fortune" breakbulk ship design that was built in 1975 for ¥ 1,800 million was constructed in 1980 for ¥ 3,000 million, whereas a large containership having a capacity of 1,450 containers, priced at ¥ 6,900 million late in 1973, would be priced in the ¥ 9,000 to 10,000 million price range in 1980 dollars. It is our observation that actual contract prices fail to lend support to the GAO statement that containership prices have increased more rapidly than break bulk ship prices. Furthermore, it should be recognized that the magnitude of ship price is a reflection of the size (capacity in cubic measure) and the degree of outfit included in a ship designed to provide a certain service. For the ship designs reviewed above and the Fairplay standard ships, the containership designs are considerably larger, having higher horsepower machinery which is reflected in the contract price.



B. Chapter 7

14 The GAO draft report also presented (in Chapter 7) a simplistic and questionable analysis of the merits of the U.N. Liner Code of Conduct. The GAO believes U.S. adoption of the Code



could lead to proliferation of pooling agreements. The GAO analyzed the pools operating in U.S. trades with Argentina and Brazil. Of three measures used in the analysis, only changes in capacity utilization yielded some results. In the review of the GAO, there is still some doubt that establishing revenue pools will always lead to an improvement in the capacity utilization of U.S.-flag operators. Relating the Latin American pools to Codist pools infers U.S. carriers' capacity utilization might improve within the U.N. regulatory system also. That an improvement in load factors may not occur in all trades with pooling and rationalization is not even considered by the GAO.

As an alternative, GAO could have assessed the potential economic implications of code-sanctioned cargo sharing on U.S. carriers. One technique would provide an analysis of freight revenue earnings. MarAd analyses show some deterioration for U.S. operators on certain trades, and lead to the conclusion that bilateral agreements might better serve U.S. maritime interests. The GAO did not consider bilateralism as a policy alternative.

The report states there are considerable similarities between the Code's cargo allocation provisions and U.S.-Latin American pooling agreements. The conceptual similarity has yet to be proven through implementation. There are major differences between U.S. pooling practices and the regulatory regime outlined in the U.N. system. The pools to which the U.S. belongs are authorized and administered in a framework of Government-to-Government agreements, and maritime authorities communicate on the execution of the



APPENDIX III

agreements. The Code appears to be more restrictive of direct Government participation in liner regulation and it is questionable whether the unique economic and political factors and flexibility which have gone into development of U.S.-sponsored bilateral agreements could be achieved within a multinational treaty such as the proposed liner code. The U.S. pools have not required closing liner conferences, an integral provision of the Code. There is no evidence presented in the report that closed conferences would improve the profits of U.S. carriers and shippers, or expedite the regulatory process.

The GAO also comments on the possibility that displaced tonnage will move into U.S trades if the Code goes into effect without U.S. participation The GAO accepts the position that LDC's would need to acquire or charter otherwise surplus vessels to meet their cargo allocations permitted by the Code. However, no economic analysis is given to support this position.

The GAO does not evaluate the economic or regulatory implications of significant provisions of the Code. Many of these, in addition to being fundamentally different from U.S. principles, are questionable in terms of economic benefits for carriers. For example, some analysis could be included of the economic effects of Codist closed conferences, the implications of expanded conference authority, and the results of code-sanctioned intervals for conference freight rate increases on carriers and shippers.

Additional elements included in this section of the report, along these same lines, could be made more specific with



statistical evidence or data regarding the implications of maintaining or altering the U.S. position on the code. Clearly this report is engaged in an effort toward addressing this concern, and additional analyses would be helpful here to bring the study closer to its objective.





APPENDIX III

1. We disagree with the assertion that the draft report appeared to be incomplete, and have made no changes to the report's major findings and conclusions based on these comments. While we appreciate the offer to supply us with technical assistance and have received helpful assistance from Maritime Administration (MARAD) officials during the course of our review, we found that they were unable to give us much of the data and information that we requested.

2. We feel that this paraphase of the draft report's conclusions is incomplete. It notes that high costs can lead to subsequent rate increases, but fails to mention the report's finding that a crucial stimulus to high costs and excessive service competition is the high rate levels resulting from the conferences' ability to set rates and suppress price competition. Further, the draft report clearly stated that high rate levels act as an incentive for <u>both</u> conference and nonconference carriers to excessively increase capacity.

3. There are several reasons why we strongly disagree with the contention that "the report fails to analyze other important measures of industry performance" that would indicate any chronic distress significant enough to justify a major revision of the Shipping Act.

   First, DOT's implication that the draft report failed to consider changes in the U.S. flag share of liner cargoes is simply incorrect. Despite year-to-year cyclical fluctuations, there has not been any persistent, long-run secular decline in U.S. flag share (expressed as a percentage of either dollar value or tonnage carried) from 1956 to 1978, the latest year data were available for this study (see table 3). Although U.S. flag share has recently been declining from a peak reached in 1976, the average annual U.S. flag share of liner tonnage for the period 1976-78 is higher than for the earlier periods: 1971-75; 1966-70; and 1961-65.

   Second, U.S. flag liner companies have become increasingly diversified since 1965, and many are now in fact subsidiaries of conglomerate enterprises. Thus, financial statistics cited by DOT, particularly those involving equity valuation, are questionable when comparing the performance of the U.S. liner operators over time or with other sectors of the economy. Furthermore, we found that MARAD did not have the data needed to compute such financial measures for a long enough period to be indicative of any long-term trend or chronic distress within the U.S. flag fleet. Thus, our approach was based on the premise that if the return on invested capital realized by U.S. flag liner operators was chronically unremunerative, there would be clear evidence of a long-term decline in new investment and, ultimately, in the ability of the U.S. flag fleet to transport cargo. The evidence presented in the draft report showed that this has not occurred.

As table 5 indicates, the U.S. flag fleet transported about the same amount of cargo (in terms of average annual tons) in the 1956-60 period as in the 1976-78 period. Compared with the 1971-75 period, U.S. liner operators have actually increased their carriage. More impressive, U.S. flag operators were able to undertake a substantial and rapid investment in new and costly container technology during the late 1960s and 1970s. As a result, the U.S. merchant marine had the largest containership and barge carrier vessel fleets in the world by 1979 in terms of total deadweight tons.

Third, even with questions about their reliability and comparability aside, the profitability data cited by DOT fail to show any evidence of a persistent secular decline. Rather, they exhibit year-to-year variation due to cyclical changes in demand and supply conditions that are common to all sectors of the economy. Furthermore, we find it questionable how one can attribute such short-run fluctuations to the Shipping Act, 1916, or expect revisions of the Act to significantly affect the cyclical behavior of rates of returns.

Fourth, DOT mentions changes from 1976 to 1980 in the return on assets, long-term debt to equity ratio, and the ratio of current assets to current liabilities as other indicators of sagging financial health. In a followup interview with cognizant DOT officials, they supplied us with the annual values for the following statistics:

Table 5

Annual Financial Statistics for U.S. Flag Liner Companies

| | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|
| Return on assets | 6.1% | 2.2% | 3.3% | 0.9% | 4.3% |
| Ratio of long-term debt to equity | .76 | .84 | 1.70 | 2.03 | 3.83 |
| Ratio of current assets to current liabilities | 1.7 | 1.6 | 1.3 | 1.3 | 1.3 |

Source: Maritime Administration.

Like the return on equity, neither the return on assets nor the ratio of current assets to current liabilities shows any evidence of a trend. The ratio of long-term debt to equity does persistently increase over this period, but this is not necessarily an indication of "sagging financial health." To the contrary, firms often increase their amount of borrowing in times of rising demand to obtain greater leverage and a higher rate of return on invested equity. Alternatively, recent increases in this ratio could reflect an increase in borrowing by U.S. flag liner operators in order to finance the ordinary and necessary replacement of aging vessels. Furthermore, Federal loan guarantee programs, by lowering interest costs, have actually made borrowing a relatively more attractive source of funds for U.S. flag operators, thereby causing the fleet average ratio of long-term debt to equity to be higher than what it might have been in the absence of these programs.

Fifth, as noted above, we do not believe that a 5-year period is sufficient to indicate any long-run secular changes in the financial health of the U.S. flag liner fleet. During the followup interview, we asked DOT officials if they could supply us with the values of these financial statistics for a considerably longer period, i.e., 1960-80. They responded that the data necessary to compute these statistics prior to 1976 did not exist.

Sixth, the financial statistics which DOT cites for the period 1976-80 are simple averages that conceal substantial differences in the performances of individual U.S. liner operators. According to a MARAD report on the financial condition of U.S. flag liner operators dated November 30, 1981, the 1980 returns on equity ranged from 35.8 percent to -193.9 percent; the 1980 returns on assets ranged from 13.5 percent to -23.3 percent; the 1980 ratios of long-term debt to equity ranged from 16.42 percent to 0.21 percent; and the 1980 ratios of current assets to current liabilities ranged from 2.2 percent to 0.6 percent. More important, this report reveals that some major U.S. flag liner operators have had consistently and substantially <u>higher</u> than average rates of return on equity and assets during the 1976-80 period, while other operators have shown consistently and substantially <u>lower</u> than average rates of return to assets and equity. This buttresses our conclusion that there is no evidence of any systematic, chronic distress and that company-specific factors such as size, ship type, and route system, are more important than the regulatory system in determining the financial performance of U.S. flag operators.

Seventh, the Maritime Administration's own recent analysis of the financial condition of U.S. flag liner companies referred to above actually supports our conclusion that the U.S. flag liner fleet is not in a state of financial decline. Although their analysis notes that some U.S. flag operators had increased financial problems in 1980, it states that the majority of operators "have shown improved earnings in 1980 over 1979" and that, overall, "1980 was a relatively good year for the industry," with aggregate net profit increasing 539 percent, total assets increasing 9.7 percent, and total liabilities decreasing both absolutely and as a percentage of total assets from 1979 to 1980. Their report's assessments of the future prospects for all but two U.S. flag carriers were also very optimistic, as evidenced by the following excerpted characterizations of eight U.S. flag operators: "...outlook for the future is bright"; "...is having an excellent year...outlook...appears favorable"; "...outlook for the short-term appears sound"; "...short-term results should continue to be profitable"; "...prospects...appear bright"; "...should continue to be profitable"; "...stands a good chance of operating profitably"; "...results are extremely promising." Of the two operators for which MARAD expressed concern regarding future profitability, one is a very small carrier which has had problems for several years, while the other has been adversely affected by an event beyond its control. Furthermore, the study notes that several carriers are currently undertaking substantial new investment programs to replace and modernize their fleets, which have led to significant and rapid increases in their ratios of long-term debt to equity. Another carrier is said to have experienced a substantial decrease in its return on equity because of growth in retained earnings.

Eighth, the current financial difficulties of three of the nine U.S. flag liner operators referred to by DOT occurred after our review and analysis were completed. Even so, there is little reason to believe these developments are directly related to, or caused by, provisions of the Shipping Act. DOT notes only that "these financial difficulties are due in part to a decline in government-sponsored preference cargoes." Similar difficulties, however, have not been experienced by the two largest carriers of reserved cargo. In our follow-up interview, DOT officials noted that these difficulties were actually due more to the types of ships these three carriers were operating, a factor that is also unrelated to maritime regulation.

Ninth, DOT is incorrect in stating that our evaluation "ignored" Federal subsidy programs. In fact, chapter 3, on the performance and status of the U.S. flag liner fleet, begins with a discussion of both the direct and indirect assistance received by U.S. flag operators.

4. We believe that DOT is overly sanguine about potential changes in maritime regulation being able to offset future budgetary constraints on the subsidy programs available to U.S. flag operators. As this report concludes, changes in Federal maritime regulation can lead to increases in efficiency and reduce costs in the ocean liner shipping industry,

but these savings should be realized by foreign flag carriers operating on U.S.-foreign trade routes as well as by U.S. flag carriers. Thus, there is no assurance that the relative competitive position of U.S. flag operators will necessarily improve as a result. What puts U.S. flag carriers at a competitive disadvantage compared with foreign flag liner operators is not so much current regulation as the fact that U.S. operators are generally among the highest cost carriers in the world. As our recent report on the subsidy programs discusses, these higher costs are primarily due to substantially higher construction, maintenance, and repair costs; higher wages; and higher manning levels compared with foreign flag vessels. 1/ Because none of these factors will be affected by prospective revisions of the Shipping Act, we do not share DOT's optimism that potential changes in maritime regulation can conceivably offset the severe cost disadvantages faced by U.S. flag operators in the event of significant reductions in the subsidy programs.

5. We agree with DOT that a better analysis of FMC's enforcement efforts could be performed if one could "assess the frequency or magnitude of violations" of the Shipping Act. Unfortunately, however, this information is not available. Because the actual incidence of malpractices committed by U.S. and foreign flag carriers is in fact unknown, our analysis was based on the clearly stated assumption that the proportion of malpractices committed by these carriers equaled the proportion of total liner tonnage they carried from 1972 to 1978. If, as DOT implies, this assumption is not correct, our finding that the FMC has not been biased in its enforcement efforts could indeed be considered misleading. However, DOT presents no evidence or data to show that foreign flag carriers commit proportionately more malpractices than do U.S. flag carriers. Thus, while DOT may consider our analysis to be "simplistic and convoluted," we still consider it to be a straightforward, clearly stated analysis that uses the best approach possible given the limited information available.

6. In our draft report we cited information on the price trends of a 1,200 TEU containership, a conventional 11,000-13,000 DWT breakbulk cargo vessel, and 2,400 containers. Our purpose was to use a readily available source to graphically illustrate the increases in the cost of this equipment from 1969 to 1979. The draft report clearly stated that the source of this information was a trade publication, noted the basic assumptions and methodology used by this publication to derive these estimates, and referred the reader to this source

---

1/ U.S. General Accounting Office, "Maritime Subsidy Requirements Hinder U.S.-Flag Operators' Competitive Position," (CED-82-2), November 30, 1981.

for further details. We neither intended nor claimed to have done our own analysis.

In addition to illustrating the increases in the prices of this equipment, the information from this trade publication also indicated a growing divergence over time between the cost of a containership and the cost of a conventional breakbulk vessel. Based on the Maritime Administration's own experience, DOT believes the cost difference between a breakbulk and containership may actually be substantially less. Given the fact that millions of dollars of construction subsidies are based on MARAD's estimates of foreign construction costs, we certainly hope that their ship building cost information is accurate. However, whether the actual cost difference is 5 times, 3.3 times, or 1.2 times is immaterial, since the draft report drew no conclusions or inferences from it. DOT is simply incorrect in stating that "It is inferred from information abstracted from Fairplay's July 17, 1980, issue that containership prices have risen much more rapidly than breakbulk ship selling prices, thereby contributing to the high cost of providing modern marine transportation service." To the contrary, the draft report clearly stated that "Despite the relatively high and increasing prices of containerships, containers, terminals, and other supporting equipment, containerization technology has nonetheless greatly lowered the cost per ton of cargo transported when compared with the cost per ton of conventional breakbulk shipping."

7. See our reply to point #1.

8. See our reply to point #3.

9. There is certainly no dispute that the U.S. flag liner fleet has a vital role to play as a naval auxiliary in time of war or national emergency. It is also true that the fleet's shift from breakbulk to container vessels could have significant implications concerning its military sealift capability under certain scenarios. However, for several reasons, we did not feel it was appropriate to address this issue during our analysis of maritime regulation. First, it is unrelated to the basic mission of the Federal Maritime Commission or the goals of the Shipping Act, 1916. Rather, it is the mission of MARAD, under the authority of the Merchant Marine Act, 1936, to promote the development of a U.S. merchant marine capable of serving as a naval and military auxiliary and composed of the best-equipped and most suitable types of vessels. Second, it is doubtful whether current maritime regulation, or any of the proposed major changes to it, could have any discernible causal effect on the composition of the U.S. flag liner fleet. Third, if there are an inadequate number of breakbulk vessels for national defense purposes, the most effective way to correct the imbalance is to alter the subsidy programs to make the construction and operation of these vessels relatively more attractive to U.S. flag

operators, rather than to alter the regulatory system which affects all carriers, both U.S. and foreign flag, operating on U.S.-foreign trade routes. Fourth, in order to address this issue, one would have to consider not only the size and composition of the U.S. flag liner fleet, but also the size and composition of the effective U.S. controlled fleet, which consists of American-owned and controlled vessels registered under other flags that can be requisitioned by the President under section 902 of the Merchant Marine Act for national defense or national emergencies. This would have been far beyond the scope and objectives of our study.

10. See our reply to point #3.

11. We find it difficult to understand DOT's assertion that "the maintenance of the entire fleet is in jeopardy," when several major U.S. flag liner operators, one of whom has received no operating or construction subsidies at all, have recently undertaken substantial new investment programs to replace their fleets with modern, efficient vessels. If, in spite of this new investment, the Administration believes that the authority for subsidized operators to acquire foreign built or reconstructed vessels needs to be extended to 1983 in order to assure the continued maintenance of the U.S. flag fleet, it already has the ability to do so under certain circumstances. The Omnibus Budget Reconciliation Act of 1981, Public Law 97-35, allows subsidized operators to construct, reconstruct, or acquire vessels overseas if the Secretary of Transportation finds and certifies in writing that construction subsidy funds are not available. The law further provides that:

> The provisions of this section shall be effective for fiscal year 1983 only if the President in his annual budget message for that year requests at least $100,000,000 in construction differential subsidy or proposes an alternative program that would create equivalent merchant shipbuilding activity in privately owned United States shipyards and the Secretary reports to Congress on the effect such action will have on the shipyard mobilization base at least thirty days prior to making the certification . . . .

With regard to the availability of this option beyond 1983, we have recently recommended that the Congress amend the Merchant Marine Act, 1936, to extend and clarify the Secretary of Transportation's authority to allow subsidized operators to build vessels overseas and have even suggested legislative language to that effect. (See "Maritime Subsidy Requirements Hinder U.S.-Flag Operators' Competitive Position," CED-82-2.)

12. See our reply to point #5.

13. See our reply to point #6.

14. Contrary to DOT's assertion, the draft report did not attempt to analyze the merits of the U.N. Code of Conduct for Liner Conferences. Because U.S. accession to the Code could require major changes to current regulation, the draft report did discuss the Code's historical background, main provisions, and current status. We also noted that some maritime analysts have argued that there could be an unfavorable effect on U.S. flag liner operators if the United States does not accede to the Code. We just add that this expected effect may not necessarily occur under certain circumstances. We do concur with the commonly held belief that the Code's cargo sharing provisions could cause a proliferation of revenue pooling activity. However, both the similarity and the major difference between the Code's cargo allocation provisions and the major elements of the equal access and revenue pooling agreements currently in effect on several U.S.-South American trade routes are clearly stated. Despite this, DOT misconstrued our analysis of these U.S.-South American revenue pools to be an analysis of the Code's potential effects on U.S. foreign trade routes. It is not. In concluding this section of the draft report, we stated that "if the Code does come into force without the U.S. acceding to it, it is unclear whether U.S. flag operators will be adversely affected" and that "any decision that is made should consider the issues of international comity, defense capability of our liner fleet, and the welfare of U.S. shippers." We agree with DOT on the need for these issues to be analyzed. However, it was never the intention nor the objective of this report to do so.

(972110)

*U.S. GOVERNMENT PRINTING OFFICE : 1982 0-361-843/2163

~~22427~~
22527

AN EQUAL OPPORTUNITY EMPLOYER

UNITED STATES
GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE,$300

POSTAGE AND FEES PAID
U. S. GENERAL ACCOUNTING OFFICE

U.S.MAIL

THIRD CLASS