

COMPETITION AUTHORITY

**Submission to the High Level Review of the State
Commercial Ports Operating under the Harbours
Acts, 1996-2000.**

Submission No. **S/02/002**

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1 INTRODUCTION

The Department of Communications, the Marine and Natural Resources is the regulatory and development authority for the maritime transport sector as well as the governing authority for the State's commercial seaports. In relation to this area the Department's overall stated goal is to ensure the availability of efficient and competitive sea transport and port services.

Since corporatisation in March 1997, the port companies have been statutorily responsible under the Harbours Acts, 1996 to 2000, for the management, control, operation and development of their harbours as fully-fledged commercial State companies¹. The purpose of establishing the port companies was to improve, modernise and provide better port services in a commercial ethos. The Minister, together with the Minister of Finance, is ultimately responsible for the conduct of the port companies.

The current consultation follows on from the Department's decision to appoint consultants who are in the process of assessing the adequacy of the current model for the governance of the State port companies (including the advisability of appointing a regulator) and their role in contributing to the optimum development of the transport sector in Ireland in line with Government policy. The consultants must have regard for the need to have structures and approaches which ensure:

- that the ports are incentivised to deliver high quality port products to stakeholders, particularly users;
- that the ports have access to appropriate funding to provide for capacity requirements in the medium to long term;
- that appropriate competitive conditions exist within and between ports, which exert downward pressure on costs and charges for port, shipping and other port related services;
- the avoidance of inefficient monopoly situations developing, with potential upward pressure on costs and charges; and
- that the shareholder/management relationship is conducive to the development of a port sector, which is fully supportive of the needs of our rapidly developing open economy.

The consultants' report will identify, evaluate and make recommendations in relation to the appropriate options for the corporate development of the ports including strategic alliances and wider share ownership possibilities. The current consultation is being conducted with a view toward eliciting responses from public and sectoral interests in

¹ The port companies are the following: the Port of Cork Company; Drogheda Port Company; Dublin Port Company; Dun Laoghaire Harbour Company; Galway Harbour Company; New Ross Port Company; Shannon Foynes Port Company; and The Port of Waterford Company.

relation to the options available to the Minister and the potential time scale for implementation.

The Competition Authority is making this submission with a view to commenting on the competition and regulatory issues raised. The Authority would like to see a regulatory structure put in place that fosters competition and ensures that ports either do not have market power or cannot exercise it if they do.

The remainder of the submission is structured as follows. In Section 2 the strategic and economic importance of the port sector is emphasised. Section 3 looks at the case port regulation in Ireland. Section 4 looks at the importance of implementing pro-competitive structural reforms in the port sector. In Section 5 regulatory issues are examined. In Section 6 the characteristics of an appropriate regulatory system for ports is outlined and it is recommended that responsibility for the sector go to the Commission for Aviation Regulation. Section 7 contains some concluding comments.

2 STRATEGIC AND ECONOMIC IMPORTANCE OF PORT FACILITIES AND SERVICES

There is a strong public interest in ensuring that ports operate efficiently and safely, that services are provided competitively and that ports support and foster economic development locally and nationally. The public interest in ports stems from the vital role they play as gateways for economic trade and commerce. This is particularly the case in Ireland given the extremely open nature of our economy and our geographical circumstances. In 2000 the values of imports and exports for Ireland were approximately €56,000 million and €84,000 million respectively.² When expressed as percentages of gross domestic product we get 54% and 81% respectively, while the corresponding openness index³ is 135%, indicating just how trade dependent the Irish economy is.

With the globalisation of the world economy, a nation economic competitiveness is linked increasingly to its ability to ship raw materials, intermediate goods and final products efficiently and economically. Excessive port costs, bottlenecks or delays are factors that could prompt investors to locate new production facilities in other countries or regions. Again, this is particularly important for Ireland where much of our manufacturing sector is closely tied to a larger EU and world production system. In many countries, high port costs have an economic impact similar to a generalised import duty, increasing the cost of all imported goods. Further, efficient and competitively supplied port facilities and services contribute to greater competition in domestic markets by promoting greater market integration and assist the export of domestic produce.

Ultimately, transport costs impact on the price of imports and exports as well as passenger traffic flow in and out of the country. Transport costs therefore impact critically on national economic performance and, more specifically, with regard to

² Source: CSO.

³ The openness index given by the ratio of the sum of imports and exports to gross domestic product expressed as a percentage.

inflation and competitiveness. The OECD highlighted this latter point in their *Report on Regulatory Reform in Ireland* (2001):

“Because of Ireland’s peripheral location as an island within the EU there has long been concern that high transport costs were having a negative impact on the competitiveness of the economy. While firms in France or Germany have only to pay for a limited road journey to get their products to the major EU markets, Irish firms have to pay for at least one ferry or air journey.”

The establishment of the port companies in the Harbours Act 1996 (amended in 2000), marked the first step toward greater transparency and accountability with respect to investment, operation and management of port facilities in Ireland. With major public investment currently in the pipeline, the effectiveness of port governance will play an increasingly critical role in determining ability to deliver:

- effective, competitive and cost efficient commercial ports;
- port infrastructure and investment that can meet the demand of a growing traffic, including in terms of integration in the total transport chain.

In 2000 maritime transport costs through the Irish commercial ports affected more than 41.5 million tonnes of goods and 4.2 million passengers. With a public investment worth €58 million planned through the National Development Plan 2000-2006, the quality of the commercial seaport governance will, in large part, determine what kind of value-for-money is delivered.⁴

Finally, ports must operate safely and with minimal environmental impact. An oil spill within a port’s harbour can damage the coastal environment and devastate local fishing and tourism sectors for several years. Port operations involve the use of heavy machinery and handling of dangerous cargo that, without proper systems and safeguards, can result in serious and sometimes fatal injury to port labourers or third persons present in the port. In general, the externalities involved in the provision and consumption of port facilities and services must be internalised.

3 THE RATIONALE FOR PORT REGULATION IN IRELAND

For infrastructure like ports, regulation is often believed necessary where competition is weak. The rationale for port regulation is therefore determined by the degree of market power in the relevant markets and the ability of one operator to engage in anti-competitive behaviour.

3.1 Market Power Issues

Since their corporatisation in 1997, the State-owned commercial ports in the Republic have had strict commercial mandates. In principle, they compete with one another as well

⁴ Source: Department of the Marine and Natural Resources Annual Report 2000.

as with ports in Northern Ireland. Competition in the provision of port facilities and services is determined, *inter alia*, by:

- the existence of certain facilities;
- the existence of spare capacity;
- their location; and
- the tariff charged.

Ireland's geographical circumstances naturally limit the set of alternatives to shipping cargo by sea, with shipping by air being the only potential substitute. Air transport is inherently more costly than is sea transport so that substitutability is limited. It is to be expected therefore that ports in Ireland have a greater degree of market power than their counterparts on continental Europe where rail or road transport are often viable alternatives. Further, under-investment in infrastructure relative to the needs of a rapidly growing economy and perceived capacity constraints currently determine the industry dynamic.

Competition within a port can and does play an important role with respect to certain port services. However, the scope for intra-port competition is often restricted by the need for access to specialized capital intensive handling or storage facilities, the existence of significant economies of scope or scale, and physical and environmental constraints on the duplication of facilities. Channel services are generally accepted to be a natural monopoly, such that the issue of within-port competition does not arise. Berths and storage areas within the port may be provided either by the port corporation or by a third party. In the first instance, the port corporation will directly set the prices. In the second, the corporation may control the land rights to the development site, and will normally exercise considerable indirect influence on the charges levied through the conditions of the land lease or development agreement. In either of these cases, the port corporation is in a position to exercise considerable influence over the determination of infrastructure service prices at all sites within the port.⁵

Without a rigorous competition assessment of the ports sector, it is impossible for the Authority to make definitive recommendations. As a first step the Authority recommends that such an assessment be undertaken. A number of points however, are worth keeping in mind. A one-size-fits-all approach toward port reform is unlikely to be successful. In particular, competitive conditions in the provision of port facilities and services are likely to be dependent on the size and location of the ports concerned and on the kind of activity carried on there, i.e. passenger or freight. Given that the industry is characterised by high barriers to entry, particular attention should be paid to the ability of small ports to expand in order to compete more actively.

⁵ In 1999 the Office of the Regulator-General, Victoria, carried out a Review of Port Services Pricing which dealt directly with many of the issues discussed here.

In this context, the extent of competition in the provision of any particular port facility or service will impact on the kind of regulation that is appropriate. If a competition assessment reveals that competition, in the provision of passenger services for instance, is strong, then little or no regulatory intervention may be called for. As a general rule, regulation is only necessary where competition is weak. Even then, however, it may not be appropriate.⁶

3.2 *Anti-competitive Behaviour in the Port Sector*

It is important to take into consideration the fact that port operators with a monopoly or a dominant position may engage in anti-competitive practices, driving out potential competitors and increasing prices to port users. Practically, this means that in addition to charging excessive prices one operator can, for instance, be in the position to:

- raise entry barriers – an operator may be able to erect hurdles and inhibit the entry of potential competitors;
- tie services – an operator can extend its monopoly power from port operations to other areas of activity where competition might develop;
- organise exclusive dealing – an operator may require the supplier of one service to sell only to them, preventing a potential competitor to access the service; or
- price discriminate among clients on non-objective grounds – an operator may lower prices for one or several clients on non-objective grounds to maintain its commercial advantage against its main competitors.

Such situations are more likely to arise when operators are vertically integrated. Such abuses of dominant positions can be dealt with within the framework of competition law, both EU and National. In the case of ports however, this may not be the optimal way to address such transgressions. Competition proceedings tend to be time consuming, costly and can be uncertain. Therefore, for sectors in which the structure is unusually monopolistic, *ex ante* regulation may be preferable to *ex post* regulation via the application of competition law.

The EU case law illustrating the potential of anti-competitive behaviour in relation to access to port facilities can be illustrated with the following two examples: Sealink/B&I – Holyhead and Porto di Genova.

In Sealink/B&I – Holyhead: Interim Measures⁷, the Commission was prepared to grant interim measures to prevent Sealink, which controlled the port of Holyhead, from organising its ferry schedules in a way which favoured its own ships and placed B&I, the other ferry company using the port of Holyhead, at a competitive disadvantage. In its decision the Commission referred explicitly to the ‘essential facilities’ nature of the port. The essential facilities doctrine refers to a situation where a dominant undertaking which both owns and controls a facility or infrastructure to which competitors need access in

⁶ See Section 5 on the rôle of structural reforms in encouraging competition.

⁷ Sealing/B and I – Holyhead: Interim Measures [1992] 5 CMLR 255.

order to provide services to customers, cannot refuse access to such competitors or grant them access only on less favourable terms than for their own operators.⁸

In the Porto di Genova (piloting tariffs) case⁹, the Commission decided that a tariff scheme, introduced by the Italian Ministry of Transport and Shipping in September 1996, whereby certain users were granted reduced piloting tariffs, was an abuse of dominance. Depending on service frequency, the system could afford certain users reductions of up to 65%. The Commission was of the opinion that the difference in customer treatment was not justified on objective grounds. The Commission felt that Port of Genoa had abused its natural monopoly position for a large part of its traffic which it was afforded because of its geographic position and the communications network surrounding the port. The system of reduction was considered to place a burden on the transport of prices of carriers unable to benefit from the system.

This suggests that, the need for regulation is determined by the industry structure i.e. the ability of some port operators to exercise market power as well as reducing access to the market. Therefore, the need for regulation will depend on the extent and the nature of the potential structural reforms of the sector.

4 STRUCTURAL REFORM FIRST

The process of institutional reform is complex. Most countries undertake fundamental institutional reform less than once in each generation. The implication is that the knowledge necessary to carry the reform process forward needs to be built up in most countries from a near zero base. The World Bank has put together the *World Bank Port Reform Tool Kit*. The port reform tool kit is designed to lower the learning curve for institutional renewal by providing background information, concrete examples and methods which policy makers and reformers require to proceed with the confidence that genuine knowledge affords.¹⁰

Decisions about reform strategy, industry structure and regulatory frameworks are closely linked. Therefore, regulatory issues, options and their consequences should be considered at the early stages of the reform process, and not left until other key decisions about reform strategy have been made. As demonstrated by the reform experience in port and other sectors, to do so can increase the regulatory burden and cost, restrict the range of options that may be available to the regulator, and risk incongruity between regulatory requirements and institutional capacity.

Port sector reformers have two, not mutually exclusive, general strategies to choose from in order to enhance port sector competition including structural remedies and regulatory

⁸ It is interesting to note that the same point was noted in *Sea Containers v. Stena Sealing – Interim Measures* in relation to facilities in the same port.

⁹ Commission Decision of 21 October 1997 relating to a proceeding pursuant to Article 90 (3) of the EC Treaty regarding the tariffs for piloting in the Port of Genoa

¹⁰ The World Bank Port Reform Tool kit is available for download at the World Bank website – www.worldbank.org/transport/ports/toolkit.htm. The remainder of this subsection is, in large part, taken from module 6 of the tool kit.

remedies. Clearly, the preferred strategy is the one that results in more competitors. Therefore, port sector reformers should strive towards structural enhancements that increase the number of competitors before resorting to regulatory enhancements. Regulatory enhancements (particularly economic regulation) are intended to enhance efficiency by correcting various market imperfections; essentially, they are aimed at forcing ports to behave as if they were competing in a perfect market.

Structural remedies include:

- introduction of new berths/terminals;
- division of the existing port into terminals;
- division of port operations within the terminal by:
 - assigning areas within the terminal to each stevedoring company;
or
 - allowing stevedoring companies to control both the vessel stevedoring and yard/storage operation without any assigned areas;
and
- entering into short-term operating agreement/lease/management contract.

Thus, in order to minimise regulatory burden, other options, such as the structural reforms mentioned here, should be explored. In general, the greater the extent of competition that can be injected into the provision port facilities and services through structural reforms, the less need there will be for heavy handed regulation – particularly in the longer term. Recent experience in the electricity sector, where no significant structural reforms were undertaken prior to liberalization, is prescient in this regard.

Finally, the Authority takes no view on the issue of the privatisation of the port companies. However, should the privatisation route be chosen, then it is desirable that ownership be diverse. Competition is more likely to be effective in circumstances where ownership is not concentrated.

5 HOW TO REGULATE

The forthcoming changes in the port legal environment set the basis for competition between facilities within ports, among ports and between alternative transport means through the application of two sets of guidelines: full cost recovery and financial transparency to identify potential state aid. In addition, developments at EU level will increase the need to ensure that tariffs are cost reflective, non-discriminatory and transparent.

5.1 *Financial Transparency*

The identification of the financial flows between public authorities, the port authorities, the port operators and the users of port facilities and services will help ensure competition. Clear identification of flows is especially important if the owners of the ports also use some of the services, i.e. where there is vertical integration. This principle is developed in the Transparency Directive (Directive 80/723/EEC¹¹) and is reiterated in the Project Directive on Market Access to Port Services. In the project Directive the Commission proposes:

“ ... that where the managing body of a port provides port services, it must separate the accounts of its ports services activities from the accounts of its other activities, in accordance with current commercial practice and generally recognised accounting principles.”

The Commission add that these measures:

“ ... should ensure that:

- the internal accounts corresponding to different activities are separate;
- all costs and revenues are correctly assigned or allocated on the basis of consistently applied and objectively justifiable cost accounting principles;
- the cost accounting principles according to which separate accounts are maintained are clearly established.”

The implementation of the Directive will ensure clearer financial accounts and allow the identification of potential state financial support to undertakings carrying on commercial activities in ports. It is expected that guidelines will be issued in relation to state aid for port infrastructure.

5.2 *Cost Recovery*

The implementation of the cost recovery of new investment, operation and external costs (environmental, accidents and congestion costs) guarantees that maritime transport will be treated on a equal footing with alternative transport means such as aviation for instance. According to the European Commission:

“ ... port infrastructure should be priced in such a way that users should bear the real costs of the port services and facilities they consume¹²”.

This point has been highlighted in numerous Commission documents including the White Paper on Fair Payment of Infrastructure Use¹³ and also by the High Level Group on Transport Infrastructure Charging (organised by the European Commission¹⁴).

¹¹ OJ L 193, 297. 2000.

¹² Commission of the European Communities (1997) Green Paper on Sea Ports and Maritime Infrastructure. COM (1997) 678 finals.

Full cost recovery is conditional upon the identification of the costs associated with infrastructure use, service or supplies rendered, and also upon the choice of the accounting measures. This is a major issue, as port services require significant investment, for instance, on jetties, embarkation, stevedoring and warehousing. Moreover, these kinds of investments tend to be sunk and of a long-term nature.

5.3 *Tariff Setting*

In considering the appropriate *form* of regulation which may be appropriate for a future price control, there are three main options: incentive regulation, rate of return regulation, and profit-sharing.

The CPI - X price cap is an example of *incentive regulation*, so called because the regulated company keeps the benefits of efficiency gains it makes within the period of a price cap and so has an incentive to reduce its costs. Customers benefit from cost reductions in two ways: by the reduction in prices required by the price controls, and by receiving the benefit of any further cost reductions in future periods.

Other than incentive regulation, the main form of economic regulation is *rate of return regulation*, where a limit is placed on the returns a company can earn. Regulating the rate of return on capital assets limits a company's profitability - and so prevent any gains to shareholders (public or private) that might be considered excessive - but would provide less of an incentive for continuing major efficiency gains (e.g. cost reductions) or for redesigning the ways services are delivered. Rate of return regulation may also lead to excessive fixed investment to boost the base from which returns are calculated (so-called "gold-plating").

Profit-sharing works by allowing the regulated company to keep a specified share of profits above a certain level, with the rest returned in some way to consumers through a requirement for lower bills. Incentives for efficiency gains and delivering profitable new services would be limited compared to a CPI-X arrangement where the regulated company retains all the gains from efficiency or service improvements.

In practice, the key distinction between the incentive and rate of return regulation can be seen as the time period within which a company can keep additional profits it gains from cutting costs. Rate of return regulation usually implies a shorter review period, with annual or biannual reviews of the allowable rate of return taking account of any unexpected efficiency gains, while incentive regulation rules are usually set for 3, 4 or 5 years. The efficiency gains under the profit sharing arrangement would be limited compared to the incentive regulation.

¹³ Commission of the European Communities (1998) Fair Payment for Infrastructure Use: A Phased Approach to a Common Transport Infrastructure Charging Framework in the EU. COM (1998) 488 final).

¹⁴ High Level Group on Transport Infrastructure Charging (9 September, 1999) Final Report on Option for Charging Users Directly for Transport Infrastructure Operating Cost

6 TOWARD A NEW REGULATORY FRAMEWORK

6.1 *Characteristics of an Effective Regulatory System*

To help design a regulatory and reform policy for the port sector, the following principles should be borne in mind:

- At the outset of the reform process, the feasibility of implementing structural reforms that will encourage competition should be investigated. Further, regulation should only be considered when appropriate structural reforms are not available. In general, the greater the use of effective structural reforms, the smaller the post reform regulatory burden.
- The objectives of an independent ports regulator should be clearly defined. Such a regulator should be endowed with full enforcement powers.
- A ports regulator should be responsible for cost recovery, financial transparency, and tariff setting. Use of yardstick regulation may be appropriate.

6.2 *Responsibility*

The current regulatory regime in Ireland is fragmented. In recent years there has been a degree regulatory proliferation. There are now independent regulators for the communications sector, the energy sector, the aviation sector and so on. Where economies of scale and scope exist in regulation it would be appropriate to avail of them. This would help reduce the long run costs of regulation, which are inevitably higher in smaller economies, and allow information and knowledge synergies between regulators to be exploited. In addition, the OECD has highlighted the impact that moving to multi-sector regulators would have on helping to curb the incentives and opportunity for regulatory capture.

While this would appear to be a worthwhile aim in the long run, there would be merit in the interim in continuing with the current policy of adding new sectors onto current regulators (e.g. post to the ODTR and gas to the CER) rather than setting up new regulatory offices. With respect to the regulation of ports and port services, it may be appropriate that the responsibility go to the Commission for Aviation Regulation. Indeed, there is much overlap of issues surrounding port and airport regulation so that there are likely to be large economies of scope available. In particular, there will be similarities in the manner in which capacity utilisation and future investment and development plans are assessed.

6.3 *Sunsetting and Exit Strategies*

If the rationale for regulation is to allow competition to develop in a sector, it follows that there is a need to remove the regulatory burdens on sectors if and when effective competition emerges. Of course, in each sector there may remain key areas where effective competition can never be expected to emerge – some aspects of the provision of port facilities and services may fall into this category. In such areas, continued price regulation may be the best outcome. The speed with which regulatory burdens can be removed depends on market entry, technology choice, regulatory capture and the impact on capital costs of regulatory uncertainty (and the impossibility of making credible long term policy commitments). Outside this, there is a growing resistance amongst the business community to bear the cost of regulation, particularly compliance costs. In a small economy these concerns are more pronounced due to the fixed costs of maintaining numerous regulators.

Most regulators agree that, once sufficient competition has developed in a particular market, regulatory constraints on that market should be rolled back and only general competition rules should remain to police any potential abuses, i.e. *ex post* regulation becomes more appropriate than *ex ante* regulation. There are, however, many barriers to regulators withdrawing from markets. It may be in the interest of less efficient players to maintain regulation so as to protect their vulnerable market position. In addition, the regulator may have a concern that the normal competitive process will result in a reduction in the number of licensed operators. Finally, it has long been recognised that any office will be reluctant to take measures that would see it at once lose influence and resources.

In the interests of all parties, it is desirable that a clear and unequivocal statement of when regulation will be rolled back be published in advance and subject to periodical independent review. Regulators should set out a programme in their annual work plans to review market sectors and, where appropriate, lift price controls or remove outdated licence conditions.

7 CONCLUDING COMMENTS

Given the extremely open nature of the Irish economy and our geographical circumstances, an efficient and competitive system of ports and port services is crucial to our national competitiveness. On the face of it there seems to be a good case for the regulation of port activities on an *ex ante* basis. The Authority recommends however, that a full competitive assessment of the port sector be undertaken. The Authority is available to assist in this regard. The possibility of implementing pro-competitive structural reforms should then be investigated. In the long-term regulation will only be appropriate where competition does not exist and where the possibility of attaining it through structural reform is not available.