# TOO MANY SHIPS

## Are crisis cartels the answer?

EXCESS capacity has depressed charter and freight rates to record lows across the shipping industry, as a slump in cargo demand coincides with a huge expansion of the global fleet.

Shipowners have responded by laying up tonnage, with many more ships expected to be mothballed as the recession deepens. Even so, companies are going bankrupt, while even those that managed to hedge their positions before the crisis really hit face an uncertain future and bleak prospects for earnings as contracts are cancelled or terminated.

But could shipping companies do more to reduce tonnage through joint action without breaking the law?

Although co-ordinated efforts would normally be regarded as unlawful, especially since liner conferences were banned in Europe last year, there are some legal precedents that may enable shipowners to work together to remove structural surpluses in these exceptional circumstances

The Transpacific Stabilization Agreement recently sought permission to be able to discuss joint capacity management initiatives in addition to rate-related activities, but subsequently withdrew its request to the Federal Maritime Commission partly because of competition law concerns.

As a starting point, concerted action by competitors to reduce available capacity is likely to raise serious competition law concerns. Even in an industry struck by a crisis, each company is usually expected to assess for itself whether and at which point excess capacity becomes economically unsustainable, and to take the necessary measures to reduce it independently. Less efficient players will be forced to reduce their presence or even exit the trade as market forces gradually lead to a restoration of the balance between supply and demand.

However, if overcapacity is not merely temporary and unlikely to be corrected by normal market forces, but rather has become a structural problem, economic circumstances may not necessarily guarantee a reduction in the least profitable surplus capacity.

It may, for example, be the case that companies that have failed to make the necessary adjustments are able to offset losses within their groups to the detriment of healthy companies. Against that background, in order to combat structural problems, the European Commission has in the past exempted agreements that restrict competition if they relate to a sector as a whole (or at least a large majority thereof) and are aimed solely at achieving a co-ordinated reduction of overcapacity. These measures — popularly known as 'crisis cartels' — were particularly prominent in the early 1980s when the recession persisted in the aftermath of the oil crises. For example, in 1982 the commission looked favourably upon a "shutdown agreement" between the six major European Community zinc manufacturers, whereby they agreed to close down selected capacity and refrain from establishing new capacity.

It also approved a scheme that was agreed between the 10 biggest European companies in the synthetic fibres sector, aimed at closing down parts of their capacity which were less profitable or competitive. Further, in 1994, the same policy was applied when Brussels cleared an agreement between 16 Dutch brick manufacturers to reduce surplus capacity and stockpiles.

In each case, the background to the measures was structural overcapacity, a situation in which over a prolonged period, all the undertakings concerned had been experiencing a significant reduction in their rates of capacity utilisation, a drop in output accompanied by substantial losses, and where the information available did not indicate that any lasting improvement could be expected in this situation in the medium term through the normal operation of the market. For example, in the zinc manufacturers' case, the European zinc industry had sustained heavy financial losses. There had been a crisis in the industry since the 1970s due to a collapse in consumption followed by excessive production rates when demand picked up again, leading to large excess stocks and prices plummeting to levels well below production costs.

**As shipowners struggle with one of the worst downturns the industry has ever experienced and a huge amount of unwanted capacity, competition lawyer Niels Ersbøll (above) asks whether there are legal precedents that would permit co-ordinated action to remove structural surpluses**

In the synthetic fibres case, the imbalance between supply and demand in the European market stemmed partly from adverse market trends characterised by weak demand (although not actually declining) and increased import penetration, and partly from the existence of increasing surplus capacity in the industry. Apart from the increase in imports, the situation of surplus capacity was largely the result of technological advances which had meant that there was a need to design much larger plants to reap economies of scale.

The commission considered in such cases that market forces by themselves had failed to achieve the capacity reductions necessary to re-establish and maintain in the longer-term an effective competitive structure, and that overall the measures contributed to consumer welfare.

For example, in the synthetic fibres case, the commission found that the shake-out of capacity the agreement entailed would eliminate the least efficient and non-viable capacity which could only have survived at the expense of the profitable plant through external subsidies or loss financing within a group. It was also satisfied that the agreement would not lead to any reduction in output as utilisation rates would increase. Overall, the agreement would allow the parties to become more profitable, specialise in the areas where they respectively had the best capacity and improve efficiency through the operation of larger and more technologically advanced plants, and ultimately develop better-quality products. The agreement was also found to contribute to cushioning the social effects of the restructuring in the industry.

Some parallels could be drawn between these cases and the shipping industry today which is suffering from a collapse in demand, excess capacity and imminent delivery of significant additional supply, and the introduction of ever larger vessels to reap economies of scale.

So could something similar be envisaged for those sectors of the maritime transport industry that are particularly badly hit?

The answer would depend on a detailed analysis of the economic situation in the particular market, but the industry would have to demonstrate that excess capacity was a structural problem which market forces would not correct and which would therefore ultimately harm consumers because the market would not function efficiently.

A merely temporary downturn in a cyclical market would therefore clearly not justify a "crisis cartel". Moreover, any envisaged measure would have to include the majority of participants and contemplate actual structural capacity reductions, not just temporary solutions such as lay-up of vessels until rates have again improved. Ongoing investment plans probably would also be affected. Importantly, "crisis cartels" are not deemed to fall outside the scope of Article 81(1) EC Treaty altogether — they are agreements that restrict competition and can only be allowed if their benefits outweigh the restrictions. The fact that the commission has in the past approved such measures does not mean that it would necessarily do so again and each case needs to be assessed on its own merits. Also, it is no longer possible to notify agreements to Brussels and request an analysis of whether the conditions for exemption are met. Instead, the parties to any joint action on capacity must self-assess their agreement.

In addition to being able to demonstrate a structural issue, they would need to satisfy themselves that their behaviour meets the individual conditions for exemption at European level set out in Article 81(3) of the EC Treaty.

Parties would also need to satisfy themselves that the agreement does not rely on inappropriate means such as price fixing or quota agreements; and that the reduction in capacity will lead to improved production. Customers must also enjoy a fair share of the benefits such as a more competitive and healthy structure of supply. Further, the agreement must neither go beyond what is strictly necessary, nor substantially eliminate competition.

In other words, showing that industry-wide joint measures on capacity are acceptable from a competition law perspective will be a challenge.

Another, more attractive, alternative to rationalise operations may therefore be action taken by a smaller number of companies to use capacity more efficiently, including the reduction of redundant capacity.

Mergers, joint ventures and acquisitions may allow parties to integrate their activities in a crisis-hit market and remove excess capacity. The commission looked favourably upon a number of such agreements in the petro-chemical sector following the oil crisis in the 1970s. Examples of consolidation and other joint measures such as pools can also already be observed in the shipping markets. Depending on the extent of the co-operation, such agreements may require approval under merger regulations, at national or European level. That provides the opportunity to obtain regulatory clearance.

Significant and structural overcapacity in the market would be a factor taken into account in assessing the agreement.

Some of the principles from the 'crisis cartel' cases also should be possible to recycle in relation to more limited co-operation agreements. However, capacity agreements between competitors which do not contribute to efficiencies, or risk eliminating effective competition, are likely to raise serious concerns.

A final point to bear in mind when considering possible ways to address the crisis is the competition law concerns that may arise if competitors exchange commercially sensitive information. A company's strategy as regards its capacity is an important competitive parameter, in particular in shipping markets. Exchanging information with competitors on the future strategy as regards capacity investments, the laying up or scrapping of vessels may allow the parties to collude without reaching any formal agreement.

Therefore, to the extent that companies have capacity-related discussions bilaterally or for example in the context of trade association meetings, care should be taken in order not to exchange information that would compromise each company's independent decision-making as to its competitive behaviour. Where gathering sensitive information is necessary, such as when exploring the possibilities for a co-operation agreement or for a trade association to produce policy papers, the flow of information should be managed with the help of external counsel.

•*Niels Ersbøll is counsel in the Brussels office of law firm Arnold & Porter LLP. He specialises in competition law and has particular experience in dealing with matters relating to the maritime industry.*