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Interisland Liner Shipping Rate Rationalization Study

Volume I

Findings and Recommendations Regarding Liner Shipping Rate Rationalization and Deregulation

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FOREWORD

The Interisland Liner Shipping Rate Rationalization Study (SRRS) was conducted in the Philippines from November 1990 through August 1991 by a six-person team. This study was completed through the assistance of the U.S. Agency for International Development (A.I.D.). Throughout the study the team received full cooperation from management and staff of the Maritime Industry Authority (MARINA) and the Philippine Shippers' Council (SHIPPERCON). A.I.D. and the Conference of Interisland Shipowners and Operators (CISO), together with MARINA and SHIPPERCON, closely reviewed the work of the team and provided valuable information and comments. Several other Philippine public and private organizations also provided useful information and comments. Notwithstanding all of these important inputs from various concerned organizations and individuals, the analyses, conclusions, and recommendations in this report remain solely those of the SRRS team and do not necessarily reflect the views or policies of MARINA, SHIPPERCON, A.I.D., CISO, or any other individual or organization. Certainly any mistakes that might appear in the report are solely the responsibility of the study team.

The SRRS first phase report submitted in June 1991 and the draft final report submitted in August 1991 are incorporated into this final report, with some revisions based on comments and further analysis.

This final report is submitted in five volumes. Volume I presents the findings and recommendations of the SRRS team on liner shipping rate rationalization and deregulation; Volume II presents study shipping cost and rate analysis and incorporates most of the first phase report; Volume III discusses the economic effects of shipping rate regulation and deregulation; Volume IV discusses the design and development of MARINA and SHIPPERCON databases; and Volume V presents a broader review of the Philippine interisland shipping sector and identifies desirable actions to be taken for improvement of the sector.

ACRONYMS

ADB	Asian Development Bank
BOC	Bureau of Customs
BOI	Board of Investments
CISO	Conference of Interisland Shipowners and Operators
DOTC	Department of Transport and Communications
DTI	Department of Trade and Industry
DWT	deadweight ton
FAK	freight--all kinds (cargo shipping rates)
GRT	gross registered ton
IATS	Interisland Agro-Transport Study (recommended)
LSRS	Liner Shipping Route Study (recommended)
MARINA	Maritime Industry Authority
MICT	Manila International Container Terminal
navaids	navigational aids (lighthouses, beacons, and buoys)
NEDA	National Economic and Development Authority
NM	nautical miles
NRTSDS	Nationwide RORO Transport System Development Study
PAL	Philippine Airlines
PCCI	Philippine Chamber of Commerce and Industry
PCG	Philippine Coast Guard
PICO	Port Integrated Clearance Office
PISA	Philippine Interisland Shipping Association
PISDA	Philippine Interisland Shipping Development Act
PPA	Philippine Ports Authority
PTF	Presidential Task Force (on interisland shipping)
PTSR	Philippine Transport Sector Review
RORO	roll-on roll-off (vessels)
SHIPPERCON	Philippine Shippers' Council
SMC	San Miguel Corporation
SMSA	Southwestern Mindanao Shipowners Association
SRI	Stanford Research Institute
SRPS	Interisland Liner Shipping Rate Rationalization Study (current study)
TEU	twenty-foot equivalent unit
TOR	terms of reference
USAID	United States Agency for International Development
VAFCSO	Visayan Association of Ferryboat and Coastwise Service Operators

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Chapter 1

INTRODUCTION

Background on Liner Shipping Regulation

In 1990, the Philippine Transport Sector Review (PTSR) team prepared the terms of reference for an Interisland Liner Shipping Rate Rationalization Study (SRRS). The Maritime Industry Authority (MARINA), the National Economic and Development Authority (NEDA), the Philippine Shippers' Council (SHIPPERCON), and the United States Agency for International Development (USAID) agreed on the terms of reference, and USAID agreed to finance the study. The need for the SRRS derived from

- Distortions that had developed in the way in which appropriate liner shipping cargo and passage rates were identified since rate regulation was introduced in 1928;
- Problems in interisland shipping caused in part by inappropriate cargo and passage rates;
- Recent steps taken to alter the method of charging or to deregulate liner shipping charges for some services; and
- Other possible steps toward liner shipping rate deregulation that had been recommended by various studies of the Philippine interisland liner shipping industry, but without adequate assessment of the effects of such deregulation and without guidelines for carrying it out.

The rate distortion and the problems caused by rate regulation were identified by a Presidential Task Force (PTF) on interisland shipping in 1989. To correct the most serious rate distortions, the PTF recommended abolition of ad valorem charging for cargo. The PTF discovered that the most serious problem created by rate regulation was the reluctance of liner operators to accommodate Basic Class commodities (grains, horticultural commodities, and

livestock) because of the low official rates payable for transport of these cargo. To eliminate this problem, the PTF recommended that agricultural products be reclassified as Class C items instead of as Basic products. The PTF also recommended that greater flexibility in charging be introduced by instituting "fork" tariffs, specifically to permit charging within ± 15 percent of "indicative" reference points. Finally, for passenger services, the PTF recommended that "at least the First and Second Class rates be deregulated."

The rate regulation changes recommended by the PTF were only partially adopted in 1989. Second Class passage rates were deregulated (First Class having been deregulated earlier), and ad valorem charging for cargo was abolished. At the same time, a $\frac{3}{10}$ percent surcharge was instituted. The Basic Class cargo category was converted to a "Class C (Basic)" category, with charge levels more closely in line with charges for other cargoes. No fork tariffs were instituted in 1989, and no officially specified rates were downgraded to indicative only.

The next steps toward liner shipping rate deregulation were taken in October and November 1990, pursuant to an order by the Maritime Industry Board. The $\frac{3}{10}$ percent surcharge was abolished, thus ending ad valorem charging, and shipments of transit cargoes (Philippine imports and exports), cargoes in refrigerated containers, as well as livestock were deregulated. At the same time, a set of fork tariffs was introduced: charges for Class A, Class B, Class C, and Class C (Basic) cargoes were to be within ± 5 percent of reference points for the respective classes.

Liner shipping routes in the Philippines include primary, secondary, tertiary, and development routes. These route designations do not appear to have strict definitions, but current practice is to designate as primary those routes between Manila North Harbor and other principal ports. The majority of secondary routes have Cebu as one terminus; however, some important ferry services (Batangas-Mindoro, Iloilo-Bacolod) are also included among secondary routes. In the absence of strict definitions of route classifications, primary, secondary, and tertiary routes should be differentiated on the basis of the level of annual ton-miles and passenger-miles and should exclude all ferry operations. Development routes should be designated as those routes on which immediate prospects for viable commercial operation are not good, and some special inducement (such as a tax holiday) is required to attract liner operations. The SRRS does not attempt to differentiate between primary and secondary routes, but together the two categories include all nonferry routes on which the minimum number of franchised operations should be two.

The franchising of routes and their attendant regulation (and potential deregulation) lies beyond the scope of a strict interpretation of the terms of reference of the SRRS. Nevertheless, the study reviews the implications of the interrelationships between deregulation of rates and regulation or deregulation of routes. It was relevant, therefore, to explore the historical development of the regulation of routes in addition to that of rates.

Although rate regulation was first instituted in 1928, it was not until 1972, the year in which martial law was imposed, that franchising of vessels by route was introduced. The accepted reason for the imposition of route franchising in 1972 is that the major routes were overtonnaged (while many of the other routes were inadequately served or had no service) and this is undoubtedly true. MARINA did not take over regulation of the interisland shipping industry from the now defunct Board of Transportation until 1985.

The SRRS team has not been able to identify records or studies pertaining to the 1972 introduction of route franchising. A 1957 study by Stanford Research Institute (SRI)¹ described conditions in the interisland liner shipping industry in the 1950s, and it appears likely that the practices referred to were carried on until route franchising eventually became of critical import, by 1972.

The SRI study states that domestic water transportation was characterized by "intense chaotic competition." The study refers to the following shortcomings of the transport sector:

- Overtonnaging existed on many routes and excess competition resulted in wasteful and uneconomic practices, including bunching of sailings, leading to periodic congestion.
- Ship operators were free to institute or suspend service.
- Ship operators were not required to obtain certificates of public convenience or necessity or franchises.
- Standards of service were not established by government agencies.
- Widespread discrimination in rates existed, through rebates, discounts, and other practices.
- Rate regulation was ineffective; little relationship existed between the going rates and those prescribed by the Public Service Commission (the regulatory body at the time).
- Large shippers and consignees used the competitive situation to force rate and service concessions not available to others.

Not all of the practices listed might be regarded at the time or even now as anything other than the results of healthy competition. However, the SRI consultants were of the opinion that the lack of regulation of entry into service was impeding the introduction of new capital into the industry,

¹Stanford Research Institute, *An Economic Analysis of Philippine Domestic Transportation*, Menlo Park, California, 1957.

because investments were unprotected from uneconomic competition. One of their recommendations was that operations be properly regulated as to routes and standards of service.

This background material is primarily of historical significance because it is not the business of the SRRS team to investigate and analyze route deregulation per se. However, the events of the past are of some concern to present and future actions and in that regard they are germane to the present study and to the SRRS team's approach to liberalization of route regulation.

SRRS Objectives

The SRRS team was required to identify the desirable next step in liner shipping rate rationalization and liberalization, with the original expectation that the step could be implemented during 1990.

It was evident that the most effective way to achieve rationalization, and one that had not been fully tried recently, was to adopt a fundamental approach; that is, to determine as accurately as possible the cost of operating the service.

In conducting a detailed cost analysis of operations of the interisland liner fleet, on the basis of data in annual reports submitted to MARINA by individual ship operators, the objectives of the SRRS team were to

- Recommend a tariff structure that would accurately reflect the costs of the liner operations.
- Recommend a fork tariff for 1991 that would provide a range of freight rates giving flexibility within the industry to meet variable trading conditions and productivity levels.
- Recommend a rate-monitoring system that would facilitate the task of MARINA and SHIPPERCON in monitoring actual user charges versus authorized rates.
- Develop the mechanics for periodic adjustment of the fork tariff, in years after 1991.

These objectives are the principal focus of Volume II, "Shipping Cost and Rate Analysis."

To some extent, events have overtaken the study in that deregulation of rates is already underway, beginning with transshipment cargoes, reefer cargoes, and livestock movements, and a fork tariff has been introduced. Far from being a disadvantage, these events have provided the opportunity for an initial assessment of the effects of liberalization on rates.

Chapter 2

FINDINGS

Policy and Procedural Gaps in Rate Regulation

Before 1989, MARINA rigidly regulated all liner shipping rates. As noted in Chapter 1, the Philippine Government took steps toward rate liberalization in accord with PTF and PTSR recommendations when MARINA issued Memorandum Circular No. 57 in October 1990, which provided for the following.

- Adoption of new freight and passage rate formulas with a fork tariff system of ± 5 percent for both Third Class passage and freight and
- Deregulation of interisland liner rates for reefer (refrigerated) boxes, livestock, and all transit traffic (any commodity carried over an interisland leg of export or import shipments).

In the same circular, MARINA also abolished the valuation surcharge equivalent of $\frac{3}{10}$ percent of the declared value. Other than the rates mentioned above, the structure of interisland liner rates, that is, the relative magnitude of the fixed and distance-related components of the rate formulas, the number of commodity classes, and the distance range categories, have remained unchanged.

The SRRS team recognizes that the government has adopted the policy to regulate interisland liner rates with the basic objectives of protecting the public from indiscriminate charging by common carriers and, at the same time, protecting investments of liner operators by preventing ruinous competition. Although these objectives are laudable, the SRRS team has identified the need to interpret the government's policy in the light of its objectives and the need to present a phased action plan for further changes in procedures in support of the policy. These needs stem from the following findings:

- Rate regulation in its present state has worked to the detriment of some shippers because the commodity classification and corresponding rates for some cargoes (e.g., Class C [Basic]) have generally been set too low, thus failing to induce liner operators to provide adequate capacity for shippers' needs on some routes.
- For social reasons, Third Class passage rates have failed to keep pace with the increasing cost of providing passenger service and thus have prevented liner operators from upgrading the standards of Third Class passenger services. In view of the compulsory allotment of 50 percent of passenger space to Third Class service, pure passenger vessel operation becomes less viable.
- Although a ± 5 percent fork tariff provides limited flexibility for liner operators, the existing rate regulation remains relatively rigid because rates cannot vary to the extent that operating costs vary with respect to routes, the ship technology provided (container service, RORO service, fast craft service, etc.), and the type or quality of packaging and cargo handling method offered to users.
- The continued application of the traditional "revenue deficiency method" for rate adjustment has resulted in rate formulas that have fixed and distance-related components that do not reflect the magnitudes of vessel-running and voyage-related costs. Furthermore, this method has failed to consider the relationship between freight and actual cost of providing cargo liner services and between passage rates and actual cost of providing passenger services. This relationship appears to be essential to ensuring adequate, safe, and reliable services under the present fleet configuration where combined passenger-cargo vessels are predominant.

The revenue deficiency method has also failed to consider the extent to which ship users may be either paying relatively higher rates because of low vessel load factors and productivity, or paying relatively lower rates as a result of exceptionally high vessel productivity (e.g., when vessels were not drydocked during the period covered by the financial evaluation or when vessels experienced exceptionally high load factors).

- When the government increases fuel prices or legislates wage increases, liner operators must undergo a lengthy process of public hearings (although not as lengthy as the process under the now defunct Board of Transportation) before additional cost burdens can be eliminated.

- Enforcement of regulated rates currently depends on a passive system of attending to complaints from shippers, usually in cases of overcharging, or from competitor lines in cases of undercharging or rebating. Currently, neither SHIPPERCON nor MARINA has adequate personnel and regional offices to assume a more active role in monitoring and enforcing rate regulations. Surveys indicate that this system of enforcement has posed problems for small shippers, who usually have no means to go through the legal process of filing and following up complaints.

Another aspect of rate regulation is the issue of prescribing rates that provide a reasonable return on investment. Based on jurisprudence, liner rates are to provide a 12 percent return on asset investment. The SRRS team has made no recommendation on what the magnitude of the allowable rate of return should be; this is beyond the terms of reference. Before a recommendation can be made, this issue will require an in-depth study of the Philippine economy's long-term opportunity cost of capital and of the feasibility of adopting this rate as a precedent for shipping (and eventually for all public utility firms whose rates are regulated by the government).

However, the SRRS team suggests that the 12 percent rate of return seems low for the liner shipping sector as a whole when compared with the returns of other industries. Because the existing rate regulation recognizes interest expenses (which, in the economic sense, is a return on borrowed capital) as part of the cost base for rate setting, the resulting return on equity of liner operators increases in relation to the debt-to-equity ratio of individual liner operators. As discussed in Chapter 5, Volume II, some vessels reported high rates of return that even allowed their operators to realize a 12 percent return on investment despite reducing composite freight and passage rates by more than 30 percent. With these findings, the adoption of any allowable rate of return higher than 12 percent does not appear critical at this time.

Availability and Quality of Data

In Volume II, the SRRS team presents an analysis of vessel costs primarily to assess the present amount and structure of shipping rates and to determine the cost of transporting cargoes compared with the cost of transporting passengers. It was noted that out of about 1,215 watercraft known to have been granted franchises, the annual reports received by MARINA from shipping companies for 1989 (the most recent reports available) only covered 271 vessels with data for basic cost analyses. However, only 127 vessels were considered to have adequate financial, operations, and traffic data that are necessary to establish the required shipping rates based on cost. Although the sample vessels comprised more than 90 percent of the total domestic liner capacity, SRRS team found the need for

- Adoption of a modified annual report form, as presented in Appendix A, Volume II, which covers all information required for a cost-based rate analysis;
- MARINA to publish notices to all domestic common carriers reminding them of the reporting requirements and to launch an information campaign for non-CISO members;
- MARINA to require the submission of annual reports before any renewal of franchise is granted, in addition to the ₱200 per day penalty for late or nonsubmission of report; and,
- Closer coordination between MARINA, the Philippine Coast Guard (PCG), and SHIPPERCON in the exchange of information and, possibly, in the maintenance and sharing of a maritime database.

Analysis of Costs and Rate Formulas

The analysis of costs in Volume II involved the classification and coding of data in order to

- Define parameters for analysis;
- Apply "meta-analysis" methods, that is, grouping data with similar parameters to minimize variances in estimates and eliminating atypical samples; and
- Maintain confidentiality of information.

The parameters adopted for analysis were vessel types, scale of operation, and average trip length, which corresponded to the distance ranges in the current tariff structure. The analysis (as shown in Volume II, Figures 4-1 to 4-3), covered

- By vessel type—68 pure cargo vessels, 49 container ships, 8 pure passenger vessels, 39 passenger-cargo vessels, 22 passenger roll-on roll-off (RORO) vessels, and 18 passenger-container ships. The 69 vessels for which types could not be classified that appeared to be in overseas trade, on temporary deployment in domestic waters, were not included in the analysis.
- By company scale of operation—111 vessels operated by companies with assets of ₱100 million or more, 42 vessels operated by companies with assets of ₱50 million to less than ₱100 million, 85 vessels operated by companies with assets of

₱10 million to less than ₱50 million, and 33 vessels operated by companies with assets of less than ₱10 million.

- By average trip length—17 vessels with average trip length of 100 mi or less, 22 vessels with average trip length of more than 100 mi but less than or equal to 300 mi, and 88 vessels with trip lengths averaging more than 300 mi. The SRRS did not include some 144 vessels that had no trip length and traffic data.

Summary of the findings from the analysis is as follows.

- Voyage cost of vessels carrying passengers account for 32 to 38 percent of total operating cost, whereas voyage cost of cargo alone or container vessels is about 30 percent of total operating cost.
- For each type of vessel, daily running and operating costs increase in relation to deadweight tons (DWT). However, these daily costs increase as a vessel is designed to accommodate more passengers. Because the DWT of a vessel of a given gross tonnage is reduced as passenger capacity is increased, it is possible that daily costs of vessels of lower DWT, but with larger passenger capacity, can be higher than for other vessels with higher DWT but with much less passenger capacity. Chapter 4, Volume II, presents estimates of daily running and operating costs of vessels by type and size to further illustrate this relationship.
- Based on the configuration of sample cargo vessels, an average of approximately 1.99 tons in deadweight are lost for every passenger capacity installed. This relationship of DWT to passenger capacity could vary from 0.49 tons (for vessels with more Third Class or non-cabin passengers) up to 2.92 tons (for luxury passenger vessels).
- Daily operating and running costs of conventional cargo vessels are estimated to increase by ₱59.13 and ₱38.45, respectively, for every increase in passenger capacity.
- Based on the configuration of sample container vessels, about 2.3 tons in deadweight are lost for every additional passenger.
- Daily operating and running costs of container ships are estimated to increase by ₱84.44 and ₱40.87, respectively, for every space provided for passengers on these vessels. This incremental cost, coupled with the relatively higher loss in deadweight for every space installed for a passenger indicate that Third Class

passengers on board passenger-container ships are more heavily subsidized by containers and by other passenger classes.

- By applying the traditional revenue deficiency method on 174 vessels operated by 38 shipping companies, it appears that prevailing freight rates could be reduced by 3.5 percent, and passage rates could be increased by 1.7 percent, or an across-the-board adjustment of -2.8 percent, to allow operators to generate a 12 percent return on assets. These relative adjustments in freight and passage took into consideration the equivalent tons forgone by carrying passengers and the incremental costs for accommodating them.
- After grouping vessels according to average trip length and applying a modified revenue deficiency method, the results indicate that to attain a 12 percent return on assets, across-the-board rate adjustments of 1 percent, 9.6 percent, and -6.5 percent are appropriate for the less than 100-mi, 101- to 300-mi, and more than 300-mi ranges.
- By applying a cost-based approach, thereby calibrating the fixed component of the formulas to reflect the running cost per ton (or per passenger) and likewise the distance-related component to reflect the voyage cost per ton-mi (or per passenger-mi), the 1991 tariff could be as shown in the following tables.

<i>Distance (NM)</i>	<i>First Class</i>	<i>Second Class</i>	<i>Third Class (-P)</i>
0-100	Unregulated	Unregulated	-P 36.19 + 0.71 x distance
101-300	Unregulated	Unregulated	-P 140.63 + 0.50 x distance
301+	Unregulated	Unregulated	-P 264.93 + 0.48 x distance

Class A freight rates per revenue ton could be as follows.

<i>Distance</i>	<i>Fixed (-P)</i>	<i>Distance related</i>
0-100	-P 136.92	+ 0.54 x distance
101-300	-P 160.72	+ 0.42 x distance
301+	-P 218.18	+ 0.36 x distance

Classes B, C, and C (Basic) could maintain their relative quantum in relation to Class A, based on the existing tariff.

"Meta-analysis" methods resulted in the elimination of some vessel cost samples. These formulas were based on a reduced sample of 11, 21, and 44 vessels for the less than 100-mi, 101- to 300-mi, and more than 300-mi distance ranges. As MARINA improves its database, future (perhaps by 1992) calculations in the course of the Liner Shipping Route Study (LSRS) will result in larger sample sizes, and finer-tuned calculations by route may be

possible. In the meantime, the preceding formulas still serve to indicate the prevailing disparities between costs and the components of the existing rate formulas.

Effects of 1989-1990 Rate Regulation Changes

Discontinuance of Cargo Ad Valorem Charging

In October 1990, the Philippine Government granted shipping operators provisional increases of 20, 25, and 30 percent in general cargo passage rates for basic commodities (rice, palay, corn, corn grits, fruits, and vegetables). At the same time, the government abolished the valuation surcharge; deregulated rates for refrigerated cargoes, livestock, and transshipment cargoes; and adopted a fork tariff within ± 5 percent of reference points for the commodity classes.

The Conference of Interisland Shipowners and Operators (CISO) pointed out that the abolition of the valuation surcharge not only greatly reduced the revenues of the interisland carriers, but also provided unscrupulous shippers with the opportunity to declare unrealistically high values for their cargoes, thus increasing the carriers' risk. The conference asked the government to allow its members to impose a $\frac{3}{10}$ of 1 percent surcharge on cargoes valued in excess of ₱500,000, ₱300,000, and ₱150,000 per twenty-foot equivalent unit (TEU) container for Class A, B, and C commodities.

This is one area in which the problem is the ship operator's and not the shipper's. Freight is based only on weight or volume. Shippers, under ad valorem, were inclined to undervalue their cargo to save on freight costs, but such restraint no longer exists and some shippers are inclined toward extravagant overvaluation, because they are not penalized and stand to gain more in recompense if freight is damaged or lost. Inflated value can be several times greater than previous undervaluation, which, coupled with the loss of the 0.3 percent surcharge, can create serious problems for the carrier.

The conclusion of the SRRS team is that limitation of liability should be claimed by the carrier. If shippers want to place a higher value on their cargo, additional liability insurance paid for by the shipper should be arranged.

Institution of Cargo Fork Tariff

The SRRS surveys of shippers revealed complaints that CISO was implementing the fork tariff but only by charging at the +5 percent upper limit. CISO readily admitted this action and indicated, as justification, that the adjusted regulated rates were insufficient to offset the increases in operating costs.

Prevailing inflation and devaluation of the peso increased operating expenses by a minimum of 15 percent. Government-mandated minimum wage increases of ₱17 and ₱12 resulted in a 22 percent increase in sea- and land-based labor costs. The December 1990 hike in fuel prices increased, by a minimum of 12 percent, fuel and lube oil expenses at a time when fuel constituted 27 percent of total operating expenses. CISO asked for relief through the introduction of an automatic fuel adjustment factor in the structure of freight and passage rates.

The SRRS team believes that an automatic adjustment for an increase or decrease in fuel prices is needed, apart from the monitoring of cost and annual adjustment for other reasons. Also, the ±5 percent fork rate now appears to be inadequate. Lags in adjusting rates that have occurred in the past should be corrected. The SRRS team believes that a fork rate of ±15 percent will provide needed flexibility and will make more effective use of the fork rate. Plus or minus application within the wider negotiable band will favor a natural progression toward deregulated rates.

Rate Deregulation

Reefer Boxes

A spokesman for a group with major interests in shipping refrigerated cargoes indicated that shipping lines dictated the rates, even before reefer cargoes were deregulated. For the larger shippers, current rates are about 30 percent higher than they were in September 1990. For example, the new rate for a 20-ft refrigerated container, previously carried from Manila to Cebu for ₱18,400, would be

$$1.3 \times 18,400 = 23,920$$

Because reefer cargoes were deregulated, the freight rates charged per TEU are equivalent to two to three times the Class A commodity rate, depending on the carrier.

Again, as an example, from Manila to Cebu, two to three times the current Class A rate would be

$$2.5 \times 347.7 \times 28 = 24,339$$

which is in agreement with the preceding figure.

This increase in reefer cargo rates is not unexpected because operators are not enthusiastic about reefer business. (It should be noted that 20-ft refrigerated containers in a "thrumove" carrying transit cargoes from Cebu to Manila for export are moved for a freight charge of ₱7,925. The charge for imports is the same. For the tariff, see Volume II, Table 9-1.)

The increase in rates has not been accompanied by any improvement in service, which was defined by one large shipper as (1) availability of boxes, (2) condition of cargo on arrival, (3) speed of delivery, and (4) coordination with the carrier.

There is consumer demand for cargo requiring stowage in refrigerated containers, mainly consumer goods such as ice cream, dressed chicken, prawns, and so forth, in addition to horticultural commodities that require ventilated containers to minimize spoilage and pilferage.

There is a shortage of reefer boxes in the domestic liner trades, especially for the small, regular, shipper. There are no refrigerated containers available in the open market. In the past, ship operators have tended to purchase secondhand boxes only at the behest of regular shippers who are in a position to sign a 6-month contract.

Some of the larger shippers have recently built branch plants in the provinces, and their requirements for reefer space are shrinking, which has created more uncertainty for carriers. However, the needs of smaller shippers are not being met, and it is hoped that the deregulated rates will encourage carriers to invest in suitable containers, the availability of which will in turn stimulate regular and increased movement of goods.

A 20-ft reefer box costs about ₱200,000 to ₱250,000 per unit (secondhand, about 5 years old). A new box, a dual-powered (diesel and electric mains) unit, which is desirable where electric power outlets are limited or nonexistent, costs about US\$30,000 (₱825,000) in North America. The most suitable type of box is one that can provide a range of temperatures, from cooled, to chilled, to frozen, with reliable automatic control and a sufficient number of air changes per hour to deliver fruit and vegetables in good condition.

Transit Traffic

The Manila International Container Terminal (MICT) and the domestic liner services derive a considerable portion of their revenue from handling and carrying exports and imports that originate at, or are destined for, Philippine ports other than Manila. When rates for export and import cargoes carried on the domestic leg (i.e., transshipment or transit cargoes) were deregulated in October 1990, it would have been logical to assume that the move was designed to permit operators to decrease such rates as necessary to eliminate direct overseas shipments to and from Philippine ports other than Manila.

This has in fact happened, and actual freight rates for transit cargoes are well below current regulated rates. At the same time, export and import cargoes in transit incur extra handling, and the auxiliary charges, as they are

referred to in the tariff, are substantial. For a 20-ft container filled with export cargo moving from Cebu to Manila, the auxiliary charges represent an addition of 64 percent to the freight. For import cargo the addition is 97 percent (see Volume II, Table 9-1).

Livestock

Even with the rates deregulated, since October 1990 shutouts have occurred as a result of a lack of livestock vans. It should be noted, however, that the SRRS surveys were carried out only about 6 months after deregulation, which was not enough time to acquire additional equipment, given the desire to do so.

Before deregulation the rate was ₱6,000 per hog van from General Santos to Manila; after deregulation the rate increased to ₱9,000, then to ₱10,000. As of July 1991, the rate was ₱14,500 per hog van (75 to 80 head), an increase of 142 percent.

As of July 1991, the General Santos shippers are no longer competitive in the Manila market, in large part because the Luzon livestock raisers do not have transport problems. The shippers' problems include not only high transport and handling costs, but also a 1 to 3 percent mortality rate and a weight loss per hog of 7 or 8 percent on the voyage. The financial loss is about ₱630 per hog van or ₱8 per hog.

Even though rates are deregulated and have increased, service is still poor, mainly because of the lack of vans, lack of drinking water, and delays in delivery. The Southern Mindanao Shipowners' Association (SMSA), Zamboanga, indicates that before the rates for transporting livestock were deregulated, the shipping companies charged Class C (Basic) rates. The current regulated Class C (Basic) rate from Zamboanga to Manila is ₱250.1. On the basis of this rate, the freight, at 28 m³ per hog van, would be ₱7,003. Again, it must be noted that increases in rates for transporting livestock were to be expected. It was obviously unfair to the vessel operators to limit them to the Class C (Basic) rate for transporting live animals.

Reports about cattle are similar to those about hogs. Rates have increased from ₱6,000 to ₱7,000 per van to ₱14,000.

The higher rates charged since deregulation should have been accompanied by the provision of an adequate number of vans to handle the traffic. However, with the current rate levels, the future of the transport of livestock on the hoof is uncertain, and investment in handling equipment at this point may be ill-advised. A 1992 study recommended by the SRRS team (Interisland Agro-Transport Study [IATS]) should reveal future transport requirements and may well show that meat will not continue to travel to market as livestock.

First and Second Class Passage

Deregulation of First and Second Class fares caused no significant movement from Second Class to Third Class. Passenger ship operators know that cabin class passengers will not move from Second to Third Class. They will either continue to travel First or Second Class or will switch to air travel. The operators know, therefore, that they must keep their First Class rates well below the Philippine Airlines (PAL) fares. According to at least one operator, Third Class travel declined as a result of the increase in Third Class fares.

CISO and other operators consider the regulated Third Class rates to be artificially low and therefore subsidized to an extent by cargo. Operators know it is easier to achieve an increase in regulated freight rates than it is to obtain an increase in regulated passenger fares.

The results of the passenger surveys at Manila North Harbor and Cebu (in April-May 1991) revealed that the most frequently quoted reason (44 percent of respondents) for choosing the class of accommodation was affordability. By descending class, the importance of this reason for choice became more of a deciding factor, as would be expected.

Among First Class passengers, 15 percent cited accommodation; Second and Third Class passengers were in agreement in 38 percent and 58 percent of their responses, respectively. Among the Third Class passengers surveyed, only a few indicated that they would switch to Second Class, and some of those indicated that they would switch only if Second Class fares were regulated. More respondents indicated that they could not afford to switch and were satisfied with Third Class, particularly on those ships on which Third Class is comparable to First Class on other ships.

The message appears to be that improvement in standards of accommodation is desirable in some vessels, but that modest Third Class fare levels are of importance to many travelers. Operators indicated that there was no decrease in numbers of First or Second Class passengers after deregulation.

Recent Actions Affecting Quality of Service and Cost

The results of the actions referred to in the paragraphs that follow are particularly significant to vessel and voyage utilization.

For example, the requirement for vessels to be in class will affect the service availability of some vessels over a limited period. Such a requirement will involve a cost, as will maintaining vessels so that they remain in class. The benefits will lie in greater safety and reliability and perhaps some

measurable savings in the consumption of fuel as some vessels are replaced by more efficient units.

Other actions described have potential for enormous savings by eliminating or reducing vessel time loss as a result of inefficient and wasteful practices. When fully implemented, these actions will be instrumental in controlling costs.

The magnitude of potential savings resulting from elimination or reduction of delays is explored in Volume II, Chapter 8.

Bringing Vessels Into Class

The MARINA dictum that all vessels that exceed 500 gross registered tons (GRT) shall be in class with a recognized classification society by September 1991 is a step toward safety and reliability in service. This action will serve to weed out those ships that are unable to achieve the required standard and will upgrade other ships that are not now in class but that, with some structural and equipment modifications, can qualify.

This goal cannot be achieved without some temporary interference with the quality of service and without the cost of attaining and maintaining the required standard. The SRRS team suggests extending the deadline for compliance with the MARINA directive to avoid many of the disruptions of service that would result from a concerted attempt to meet the deadline and the inevitable failure of many operators to do so. Vessels cannot as a rule be brought into class without a detailed condition survey and considerable work in a repair yard.

The Philippine ship repair industry is already overloaded at times when the shipping business is off-peak, and can only handle vessel surveys and repairs over a given time period. The class requirement should be spread over a period of 4 or 5 years, on a predetermined program, taking ships in turn by the nature of their service, that is, whether they carry passengers and their age and condition. The cost of upgrading and maintaining the higher standard must be borne by the owners of the vessels and will be passed on to shippers.

Reduction of Vessel Time and Costs in Ports

Port Integrated Clearance Offices

The establishment of port integrated clearance offices (PICO) called for by presidential decree in 1990 was intended to reduce vessel delays incurred by the plethora of clearances required on arrival and departure (even for ferry services making several trips each day). Representatives of the various agencies (up to nine) were supposed to be available in one office in a port

to receive or provide the necessary documents and issue clearance in return for the standard official fee. Some ports now have PICOs, others do not. For example, there is no PICO in the port of General Santos, and significant costs are incurred in obtaining clearances (for livestock for instance) because some of the agencies authorized to grant vessel clearances are 14 km apart.

Where PICOs have been established, agency representatives are not always present when needed and the situation is no better than before. The PPA representative in the office was to act as the officer in charge, and the SRRS team concurs with the view that, in the absence of any agent, authority should be delegated to the PPA representative. The PPA is trying to implement this procedure but is encountering opposition from some of the other agencies.

Clearance of a vessel is a legal requirement and can only be changed by legislation. However, changing the requirement is not the objective; successful delegation of authority to the PPA is all that is required and whatever steps that are necessary to achieve this end should be taken. Elimination of unnecessary and time-consuming practices will result in significant savings in vessel running costs. (The magnitude of potential savings resulting from eliminating or reducing delays is explored in Volume II, Chapter 8.)

Bureau of Customs

Under Section 602 of the Philippines Tariff and Customs Code, the main function of the Bureau of Customs (BOC) is to ensure the payment of taxes due the government on the importation or exportation of goods. This function should not normally require the inspection or clearance of vessels engaged in domestic trading. Yet the BOC is one of the agencies referenced in the establishment of PICOs and until now has been very much involved in the business of interisland vessel movements and the collection of entrance and clearance fees.

Nevertheless, in June 1991 it was announced in Customs Memorandum Circular No. 53-91 that henceforth the BOC would cease collecting entrance and clearance fees on vessels engaged in domestic trade nationwide. This memorandum was the result of complaints from many affected parties, culminating in a position paper to the PPA in 1990 by the Cebu-based Visayan Association of Ferryboat and Coastwise Service Operators (VAFCSO), which claimed that the collection of fees had become counterproductive because of delays in departures of vessel and added costs.

The SRRS team endorses the BOC's decision to cease collecting entrance and clearance fees and suggests that it become effective without delay. The presence of customs in a purely domestic port, or section of a port, on a regular basis serves no useful purpose.

Cargo-Handling Contracts

In the later months of 1990, the PPA announced that it was granting longer contract terms of 5, 8, or 10 years to cargo handling operators in place of "the previous 3, 5, and 8 years." Reference to the lengths of previous contracts may have had some PPA policy basis but, in practical terms, the SRRS team previously discussed the significance of adequate contract lengths with cargo-handling operators and was informed that contracts were renewed annually, giving the companies no basis for long-term investment in equipment.

The new policy was designed to encourage cargo handlers to invest in equipment, hence improving their services and the speed of cargo delivery. The longer contract terms were to enable operators to recoup capital investments in equipment and to guarantee them security of tenure. Longer terms should encourage contractors to avail themselves of the provisions in the Philippine Interisland Shipping Development Act (PISDA) relating to the availability of foreign exchange for importing containers and ancillary cargo-handling equipment. (See Volume II, Chapter 8 for details of PISDA.)

The longer contract terms will also qualify cargo handlers to avail themselves of incentives granted by the Board of Investments (BOI) to acquire or replace cargo-handling equipment under the Investment Priorities Plan.

Apart from extension of contract terms, authority was given to the PPA General Manager to increase the number of ports at which contract terms may be extended, subject to the following criteria: volume and type of cargo, kind of trade, whether domestic or foreign, manner of handling, and physical development of the port.

Where other criteria are not applicable, the volume of cargo may be used as the sole basis for extending the term, as follows.

<i>Cargo volume (tons)</i>	<i>Length of contract (Years)</i>
400,000+	10
100,001-400,000	8
20,000-100,000	5

Contractors at the following ports have been given 10-year terms under the revised policy: in Manila, South Harbor, North Harbor, and Pasig; Batangas; Calapan; San Fernando; Cebu; Iloilo; Cagayan de Oro; Ozamiz; Davao; General Santos; Zamboanga; and Polloc.

Liner Shipping Rate Deregulation

Cargo

Rate Deregulation Concerns

The SRRS team's surveys of shippers in various ports revealed some trepidation among them about rate deregulation, mainly because of an awareness that some routes are undertonnaged, even in off-peak months, and where the supply of vessels is tight, upward pressure on rates is bound to occur. Under these conditions, and in the absence of ameliorating factors, the effects of deregulation would appear to be an inevitable increase in rates. In spite of these reservations, many, but not all, shippers favored deregulation. Spokesmen for large shippers, such as San Miguel Corporation (SMC), favor deregulation because, with their volumes, they can negotiate better rates with shipping lines.

The Davao fruit growers indicated that they favor deregulation of rates if freer route entry is allowed in order to encourage competition and thus, rates may decrease.

In general, the sentiment among shippers is that deregulation should be tempered by some factor that would enable the smaller lines to compete against the more powerful operators.

The SRRS team agrees that deregulation of rates should be accompanied by a liberalization of route franchising. The objective should be to reduce the upward pressure on rates created by what might otherwise become a sellers' market.

Rate Deregulation Approach

For a number of reasons, the SRRS team believes that eventual deregulation of rates can best be achieved by using a phased approach over a period of years. There is concern among shippers, vessel operators, and the government that rapid introduction of rate deregulation could jeopardize the equilibrium of the interisland liner shipping industry. This is a legitimate consideration in view of the fundamental nature of the policy change and the possibility of cutthroat competition developing if the change is too abrupt.

At the same time, the SRRS surveys indicated a lack of capacity on some routes, and the upward pressure on rates caused by rapid deregulation could also be disruptive.

Legislative considerations are also involved in the policy change and in some of the SRRS team's recommendations. Changes in legislation cannot and should not be made without allowing sufficient time for due process.

The deregulation process actually began in 1989, pursuant to the PTF, when deregulation of First and Second Class passage rates was confirmed and the ad valorem rate option was abolished. Deregulation of selected commodities, namely, reefer, transit, and livestock cargoes, followed in 1990 along with liberalization of all cargo tariffs by application of a fork rate to the four commodity classes. SRRS team's recommendations for step-by-step deregulation of rates are presented in Chapter 3.

To forestall any tendency toward a quantum leap in rates as a result of deregulation, the SRRS team recommends the simultaneous liberalization of liner shipping services.

To implement the changes described earlier, institutional development of both MARINA and SHIPPERCON is required. The process has begun with the SRRS team's recommendations for the development and maintenance of data banks at MARINA and SHIPPERCON (see Volume IV) and will continue, with the help of a MARINA and SHIPPERCON organizational study recommended for 1992 and the implementation of its conclusions.

With the institutional development of MARINA and SHIPPERCON, these organizations will be in a position to monitor closely each stage of the phased approach to deregulation of rates. SHIPPERCON, in particular, must be in a position to certify, after the implementation of each stage, that in the overall picture the negotiated rates tend to maximize total traffic and that the process of deregulation has, in general, been found satisfactory to Philippine shippers.

Effects of Rate Deregulation

The observed effects of deregulation, late in 1990, on freight rates for reefer boxes, transit traffic, and livestock were discussed earlier in this chapter and are addressed in greater detail in Volume II, Chapter 9.

As of July 1991, the rates for reefer boxes (except transit cargoes) are about 30 percent higher than actual prederegulation rates, which appear to have been dictated by some carriers. Depending on the carrier, the box rates are actually two or three times the Class A rates.

Livestock rates are currently between two and three times what they were before deregulation, with no discernible improvement in service. In fact, as far as livestock is concerned, the increase in rate, if maintained, may eventually bring about a desirable change by eliminating the transport of hogs and cattle as livestock and promoting the establishment of a new local

industry for meat-processing in the livestock-raising areas of southern Mindanao.

Transit cargo container rates have decreased to a point where they are below the current Class C (Basic) rate, no doubt in an effort to eliminate direct shipments of exports and imports.

The expected effects of steps toward rate deregulation on the Philippine interisland shipping industry can be visualized.

Without Liberalization of Services. On the primary routes, the companies now serving the routes will initially have the best chance to compete, because they already know the transport requirements of the routes, their vessels have experience in serving the routes, and they have already established their relationships with shippers.

The companies currently serving the routes will have the opportunity to modernize their fleets by acquiring larger (within certain limits imposed by the ports they serve) and more up-to-date vessels to accommodate the increasing traffic, especially on the primary routes.

On secondary routes, improvement of the available shipping capacity will proceed at a slower pace, except on routes that might be considered potential primary routes. It will be up to the shipping industry, especially the larger operators, to lead in these developments.

In the short term, assuming the vessel capacity on a route is sufficient to generate competitive rates, shippers and passengers could benefit from services provided at lower cost than before.

With the shift to outright competition, companies that are not efficient or that have higher operating costs compared with other companies will be unable to sustain indefinitely the losses imposed by the reduced rate structure (and probably reduced load factor). They will be forced to

- Develop more cost-efficient operations or
- Increase their rates, in which case they will cease to be competitive and may be required to realign with other companies or to abandon the route. This could include some of the existing operators or some of the newcomers to the route.

In any event, the results should continue to benefit the users in the medium term.

In the longer term, the surviving companies will need to provide improved service to both shippers and passengers by investing in replacements for obsolete ships. Amortization of the investment will call for a new increase in rates but one that will be matched by a fleet of modern and cost-efficient ships providing a higher quality of service.

With Liberalization of Services. This scenario will differ from the first scenario in providing liberalization of route franchising, resulting in flexibility of service because of improved efficiency and adjustment of schedules to seasonal demand.

Companies serving the franchised routes will be allowed to introduce service frequency adjustments to suit peak and off-peak periods, thus permitting services to be more closely tailored to demand. The more flexible schedules will provide the vessel operators with incentive to take advantage of the improved turnaround time, which the SRRS team suggests can be achieved with the implementation of its recommendations for ship and port operations.

Franchising will continue in response to applications for new or expanded services, but MARINA will also be active in identifying needs for services and will publicly invite operators to provide the services, specifying the vessels to be employed and the intended service schedules and rates. The objective will be to provide or improve services on potentially desirable liner routes that are not being serviced by the liner industry or that are provided with only passenger or cargo service.

The criteria for selecting operators for expansion of the services will continue to include favorable consideration of the "prior operator" and "prior applicant," but weight will also be given to the quality and efficiency of previous services. In the final analysis, the overall health and competitiveness of the liner industry will be important.

Full Deregulation. Liberalization does not necessarily involve deregulation. Chapter 1 incorporated some excerpts from a 1957 report on interisland shipping in the Philippines, which indicated some of the problems that had developed when rates were regulated, at least officially, by the Public Service Commission, but there was no control over routes or schedules. A major problem was overtonnaging on many routes and competition was chaotic. The SRRS team does not recommend a return to deregulation of routes.

The SRRS team recommends moving by carefully monitored stages and assessing the results before proceeding to the next stage—complete deregulation of freight rates. In the process, it suggests introducing a degree of liberalization of route franchising, which will stimulate healthy competition.

Third Class Passage

Rate Deregulation Concerns

Deregulation of Third Class passage rates was not included in the SRRS terms of reference and it was not intended that the study examine this concept, even as a possibility. However, the majority of interisland passengers (excluding ferries) are carried aboard combination liner vessels that also carry cargo. It was considered necessary to examine the costs involved in accommodating passengers to determine whether cargo revenue is subsidizing the transport of passengers. If so, this would place a passenger and cargo vessel at a disadvantage against a pure cargo vessel after deregulation of cargo rates.

On the basis of the available figures, it appears that passengers are being subsidized on some routes, particularly the shorter runs, where the fare does not cover the additional daily running cost plus the loss of cargo-carrying capacity attributable to the provision of passenger accommodation and service.

The SRRS passenger surveys revealed the reason that passengers choose the accommodation class by which they travel. The surveys also revealed that, for a majority of Third Class passengers, the price of the ticket is the most important factor. Although the low rates have meant, in many cases, very poor and often squalid service levels, passengers have been willing to put up with the low service levels because of the low fares.

Under the regulations, Third Class passenger rates have been strictly controlled at what are generally considered to be artificially low levels. Any change in policy involving deregulation of Third Class fares would bring with it concern about whether they would increase and to what extent.

It would be up to the vessel operators, monitored by MARINA, to set Third Class passenger rates at an affordable level, or face the loss of passengers who would either limit themselves to only essential travel or find alternative means of transport.

Rate Deregulation Approach

Deregulation of Third Class passenger rates was not part of the SRRS. The SRRS team's recommendations include a phased adjustment of the tariff and application of fork rates.

Effects of Rate Deregulation

No deregulation of rates is contemplated

User Protection

MARINA

Liner ship deregulation, along with other actions recommended by the SRRS team, will require upgrading of the capabilities of several organizations, especially MARINA and SHIPPERCON.

MARINA has two major functions: to help the shipping industry to develop and to regulate it. In the past the organization's regulatory function has assumed the major role. MARINA's 5-year development plan for the domestic shipping sector suggests a change in emphasis from regulation to development.

Translating this shift in emphasis into effective assistance to the shipping industry and its users will involve expanding MARINA's planning capability.

At the same time, the phased approach to rate deregulation will require MARINA's involvement in shipping problem analysis with the objective of eliminating, or at least minimizing, unnecessary operating costs in domestic shipping, and thus helping to control users' cost. An organizational study is planned for MARINA and SHIPPERCON in 1992.

SHIPPERCON

SHIPPERCON should play an important role in liner shipping cargo rate deregulation. Each phase of the deregulation process requires monitoring to identify the effects of deregulation on overall rate levels, on service standards and availability, and on shippers generally, and to identify specifically the extent to which shipping operator- and shipper-negotiated terms reflect consideration for what the market will bear.

Private Sector Associations

The PTSR concluded, and the SRRS team agrees, that many of the problems concerning interisland cargo movements in the past could have been avoided if small shippers had been better organized. Major shippers have not had problems. Individual shipping lines want the business of major shippers, and shipping service arrangements are negotiated between the two. As identified by the PTF, the Philippine Chamber of Commerce and Industry (PCCI), and others, problems of transport unavailability have largely been limited to the transport needs of some agricultural commodities. This is particularly true of grains and horticultural crops produced in southern Mindanao, but also some perishable agricultural commodities produced in the Visayan islands and elsewhere. MARINA's rate regulation was partly responsible for the shortcomings of transport services, but the inadequacies

could have been largely corrected by the shippers if they had been organized and had taken appropriate action.

Actions to Improve Quality of Service and Reduce Costs

Liberalization of Route Franchising

The objective of liberalization of liner shipping route franchising and increased flexibility in the schedule of service is to improve the structure of the liner shipping industry, as well as to better serve the public, which will, perhaps, lead to full deregulation of liner services.

As indicated previously, liberalization of route franchising will benefit the user by introducing flexibility of service as a result of improved efficiency and adjustment of schedules to suit demand.

Flexibility of Service

The companies serving the franchised routes will be permitted to introduce adjustments to service frequency that correspond to peak and off-peak periods, allowing services to be more closely tailored to user demand.

Port Improvements

Quality of service could be improved and costs reduced by adopting the SRRS teams's recommendations on (1) rationalization of port cargo-handling arrangements; (2) operations and charges at ports to ensure that potential efficiencies of facilities are realized, port costs are lowered per unit of traffic, security is improved, services are more reliably provided, and charges are closely related to work performed; and (3) rationalization of other port policies, regulations, and charges with regard to shipping to eliminate unnecessary administrative and other delays and unwarranted costs in ports.

Chapter 3

RECOMMENDATIONS

Rate Identification Methodology

In view of the drawbacks of the revenue deficiency method, the SRRS team recommends that the cost-based approach presented in Volume II, be adopted by MARINA in subsequent rate identification exercises.

Figure 2-2, Volume II, illustrates the general methodology recommended; the computer software programs for executing the procedures are provided in Appendixes B through I in Volume II. The methodology involves processing annual reports to generate vessel files (i.e., files on vessel traffic, vessel operations, and vessel income statement); a company balance sheet file; a company income statement file; and a file on the schedule of property and equipment.

The computer software allocates the terminal expenses and general administrative expenses from the company income statement to individual vessels of the company on the basis of their respective share in the total company expenses (i.e., vessels, terminals, and administrative expenses). The software also derives the "invested capital by vessel" from the company balance sheet file and the schedule of property and equipment and subsequently computes the allowable return on investment by vessel.

A consolidated record is created on the financial performance of each vessel during the reported year (1989 for SRRS analysis). These data are projected to current financial values by applying adjustment factors to cost items in order to account for fuel price and salary adjustments and other inflation. To this point the procedure coincides with the revenue deficiency method, except that the database contains vessel records instead of company records.

The cost-based approach proceeds further by applying another software that analyzes the vessel operating statistics and the current financial values to estimate the daily operating and running costs per vessel. These daily costs are then allocated to passengers and to cargoes by using the analysis of incremental DWT to passenger capacity and incremental cost per passenger capacity as discussed in Chapter 2. By cross reference to the traffic file, the voyage cost per ton-mi (and per passenger mi) and running cost per ton (and per passenger) for the given distance range are estimated to yield the distance-related component and fixed component of the rate formulas.

In contrast to the revenue deficiency method, the cost-based approach removes the arbitrariness in determining what rate adjustment is required for passenger and for freight. Furthermore, the cost-based approach, although working on the basis of averages, calibrates the relative magnitudes of fixed-component and distance-related component of the rate formulas in order to cover running costs and voyage costs.

When the database of MARINA improves after shipping companies comply with reporting requirements, the SRRS team recommends that the rate identification methodology take design parameters, (i.e., vessel commissionable days and load factors) into consideration so that the recommended rates will not be unduly low as a result of high vessel productivity, nor too high as a result of low load factors or operating inefficiencies. The SRRS team also recommends that rates, whether prescribed or merely indicative, be computed by route in order to minimize the distortive effects of "averaging" costs and to ensure that the rates on each route maintain the viability of safe, reliable, and convenient liner services.

Rate Adjustments for 1991

On the basis of the SRRS team's findings, the prevailing rate formulas need to be adjusted in order to remove, if not reduce, the disparities between costs and the components of the existing rates. Because the rate formulas, as derived from the vessel cost analysis, imply drastic increases and reductions in rates, depending on the voyage distance and further considering that the level of confidence in estimates is constrained by the number of sample vessels remaining after the elimination of dubious records, the SRRS team recommends that the rate adjustments resulting from the adoption of the SRRS-derived formulas be limited to an increase or decrease of 10 percent from the prevailing rate. Such a limit to rate adjustments, for the purpose of calibrating the prevailing rate formulas, will reduce the likelihood of industry or sectoral dislocation.

In tandem with the aforementioned scheme for rate adjustment, SRRS further recommends that the prevailing fork tariff of ± 5 percent of reference point be increased to the PTF-recommended ± 15 percent, thereby affording greater flexibility for both shippers and liner operators to adopt the full rate adjustment in accordance with the SRRS-recommended formulas whenever the market can bear such adjustments. As discussed earlier, SRRS does not anticipate that the wider band of ± 15 percent will have detrimental effects. Assuming the upper limit of the fork rate is charged, the incremental freight to be paid by shippers of high-value goods will be minimal when compared with their landed cost. SRRS cost analyses indicate that several efficient vessels can still attain a return of at least 12 percent even if the lower limit of the fork becomes prevalent.

The recommended rate adjustments should be exclusive of any other adjustments resulting from changes in operating costs, considering the rollback in fuel prices in mid-August 1991 and other consequential cost changes. In view of such incidents, the SRRS team further recommends that MARINA institute a fuel surcharge in its next memorandum circular for rate adjustment so that liner operators will have immediate relief whenever fuel prices change, similar to the fuel surcharge international liner conferences incorporate into their tariffs.

Cost and Rate Monitoring

The SRRS team recommends that SHIPPERCON take a more active role in protecting domestic shippers from unscrupulous ship operators, who either deviate from the prevailing rate regulations or refuse or delay shipments for no valid reason. As discussed in Volume V of this report, SHIPPERCON should develop its institutional capability by establishing regional presence, by adopting an information and rate monitoring system as described in Volume IV, and by developing the proper perspectives for the long-term mutual benefit of both shippers and ship operators. Such action would involve monitoring not only cases of overcharging, but also cases of excessive rebating (SHIPPERCON should note that it is also in the interest of shippers that the liner shipping sector remain healthy).

By recommending that SHIPPERCON assume a role in rate monitoring, the SRRS team does not imply that MARINA should relinquish its role in responding to complaints of shippers about violations of rate regulations. Nevertheless, closer cooperation and coordination between MARINA and SHIPPERCON should be fostered. For example, MARINA could refer complainants to SHIPPERCON to enable it to prepare the groundwork investigation of cases before legal disposition by MARINA, unless of course there is prima facie evidence against the erring liner operator.

The SRRS team further recommends that MARINA access the database of the rate monitoring system to be set up at SHIPPERCON and periodically monitor shipping costs for rate evaluation purposes.

Liberalization of Liner Shipping Rate Regulation and Deregulation of Cargo Rates

Cargo

Although the cargo rate adjustments and revised industrywide cargo rate formulas recommended in the preceding sections of this chapter will more accurately reflect the average costs of providing liner cargo services, other adjustments and actions to liberalize cargo rate regulation are desirable for the following reasons.

- However accurate estimates of industrywide shipping cost mean averages might become, wide dispersions of costs exist above and below the means so that rates based on the means are not appropriate for many operators, because they produce high returns for some and make it difficult or impossible for other operators to break even. If the only variable creating these dispersions of shipping costs was efficiency of operation, then it could be argued that the rates need not be appropriate for most operators, and the failure of inefficient operators to cover costs would gradually lead to upgrading of industry efficiency and service, with average shipping costs rising less rapidly than the rate of shipping unit cost inflation.

There are, however, variables other than efficiency levels that are partly responsible for the dispersion of shipping costs per traffic unit (cargo revenue ton). For example, an efficient operator on a route with mostly containerized cargo and a large imbalance in flows in two directions is likely to have considerably higher costs per cargo ton than an operator on a route with mainly break-bulk cargoes and good balance of flows in two directions.

- Cargo rate adjustment is currently based on shipping operator revenue deficiency. Specifically, the average operator is expected to realize a 12 percent return on assets, and when industrywide revenues no longer provide the industry with a 12 percent return, then upward adjustment of rates is approved.

Liner shipping industry efficiency levels are not taken into consideration in this procedure, nor are cargo load factors, so that rates might be adjusted upward even when poor operator returns are the result of inefficiency and excess shipping capacity.

Not only does the rate adjustment procedure protect industry inefficiency and excess capacity, but it also tends to discourage efforts by the industry to become efficient. Improvements in efficiency would be rewarded by denial of rate increases, because cost savings would prevent revenue deficiencies.

- Some agricultural commodities are classified in such a way that they do not receive sufficient and appropriate services. These commodities are milled and unmilled grains and fruits and vegetables included in Class C (Basic). Bananas, included in Class C, are also not being accommodated appropriately (in ventilated containers).

To correct the foregoing problems, the SRRS team recommends the following:

- Expand fork tariffs from ± 5 percent to ± 15 percent from reference points for each commodity class. Industrywide cargo rates would then be appropriate for a larger number of shipping operators.
- Identify cargo rates (and Third Class passage rates) by route instead of throughout the industry. Such a change will improve the appropriateness of cargo rates, because most or all operators would be operating under similar conditions so that cost dispersion from the route mean average cost would generally be narrower than industrywide dispersion, and level of efficiency would be the principal factor causing cost dispersion among operators on the same route.
- Shift from a rate adjustment procedure that disregards load factors and levels of efficiency to one that includes design load factors and target efficiency levels. Design load factors would be arrived at for each route by considering cargo imbalances in two directions and cargo seasonality, and, on new routes, perhaps allowing for a degree of financial risk. Efficiency levels would be in terms of annual voyages per vessel and would be expected to gradually improve as a result of reductions in port time.
- Abolish the commodity Class C (Basic) classification and institute "dual rates" for the commodities currently in that class. Under dual rates, operators would be charged Class C rates (approximately 13 percent higher than current rates) if commodities are shipped as break-bulk or bulk and Class B rates (approximately 39 percent higher than currently) if they are shipped by container (conventional or ventilated).
- Institute the same dual-rate approach for bananas to induce operators to provide the necessary ventilated containers.

Some of the foregoing recommendations were made by the PTF in 1989 and have been partially implemented. PTF was the first to recommend a fork tariff of ± 15 percent from route-specific reference points. PTF also recommended that the so-called "basic" commodities be shifted to Class C. Thus, the SRRS team has merely confirmed from surveys and analysis that these PTF recommendations were appropriate and should be fully implemented.

The PTF also recommended that cargo rates be indicative, that is, they should no longer be official rates that the interisland liner industry needs to adhere to. The SRRS team agrees with this PTF recommendation, with the following comments and caveats:

- Most of the potential benefits of moving from the rigid rate regulation that existed before November 1990 might be realized from the deregulation and liberalization that has occurred and that is recommended in the preceding paragraphs. Such realization of benefits is predicated, however, on MARINA continuing to accurately identify appropriate rates by route, taking into account anticipated improvements in port efficiency that should make improvements in vessel efficiency possible. No matter how much care MARINA takes in identifying appropriate rates by route, it is virtually certain that whatever the official rates, even with fork tariffs, they will not be appropriate at all times and all places for individual cargo consignments.
- Perhaps the best argument for ending cargo rate regulation is that it simply is not needed. Because the PTF recommended adopting indicative rates, the apparent view was that the liner shipping industry is sufficiently competitive and rational as not to require close control. The PTSR concluded in 1990 that there is considerable evidence that Philippine interisland liner shipping has been competitive for more than a decade. The SRRS team concurs with both views and believes that the liner shipping conferences, of which there are three in the Philippines, are cognizant of the desirability of maximizing total interisland cargo traffic and, therefore, of taking "what the market will bear" into consideration when negotiating rates for individual consignments.
- Although unlikely, two scenarios are possible with full cargo rate deregulation: (1) effective liner shipping industry collusion could result in sharply higher cargo rates; and (2) ruinous industry rate competition could lead to greater concentration of the industry and subsequently to high rates.
- From its surveys, the SRRS team found that shipping capacity appears to be "tight" on some principal routes. If this is the case, when cargo rate deregulation could place upward pressure on rates, which therefore might rise significantly, even in the absence of collusion on the part of the liner industry.

To avoid the possibility of significant rate increases, the SRRS team recommends that liner shipping service regulation be liberalized concomitantly with cargo rate deregulation. To effectively liberalize liner shipping service regulation and deregulate cargo rates concomitantly, SRRS recommends that a Liner Shipping Route Study (LSRS) be conducted in 1992. The study will identify route-by-route cargo rates, current load factors, and service standards by route and will recommend actions to be taken toward service regulation liberalization to ensure that cargo rate deregulation can proceed without the upward pressure on rates that would occur with shipping capacity constraints.

The SRRS team recommends that cargo rate regulation adjustment and liberalization, followed by full rate deregulation, proceed over the 1991 to 1996 period, as described in the paragraphs that follow.

1991

In preparing to conduct the LSRS in 1992 and adopting route-by-route rates in 1993, MARINA should immediately begin to upgrade the quality and comprehensiveness of its database. Ideally, the LSRS should begin in January 1992, but startup should be deferred beyond that date if the MARINA database is not significantly improved.

As recommended in the first section of this chapter, MARINA should make some immediate adjustments in cargo rates for all commodity classes, over four distance ranges, because current official rates are either significantly above or below average costs for those ranges. Because the fixed components of rates have been kept low in the past, operators with short routes (50 NM or less) have not been adequately compensated. Also, as a result of anomalies in the cargo rate formulas that were used until 1991, no cargo rate increments were permitted from 100 to 132 NM and from 300 to 349 NM. The relatively large distance components of current formulas cause rates for shipments of more than 600 NM to be high.

The new cargo rate formulas that the SRRS team recommends that MARINA adopt during the interim before route-by-route rates are adopted indicate that rate adjustments of more than 10 percent (up or down) would be justified purely on the basis of average shipping costs. However, the SRRS team recommends that the adjustments be phased in to reduce the shock to shippers and shipping operators and to avoid any dislocations that could result from changing the rules overnight.

Official rates should be increased in September 1991 by 10 percent for distances of less than 50, 105 to 132, and 305 to 349 NM, respectively, and rates for shipments of more than 600 NM should be reduced by 10 percent.

Class C (Basic) should be abolished, and dual rates should be instituted for all commodities currently in Class C (Basic). The dual rates will mean that these commodities are to be charged as Class C commodities when shipped as break-bulk or bulk cargo, but are to be charged as Class B commodities when containerized. This change will end the anomaly whereby the liner industry has been required to impose lower charges for containerized transport than trampers impose for bulk transport in barges. This relationship is contrary to the relative costs of providing container transport as compared with bulk transport and is contrary, also, to shipping charge practices outside the Philippines.

It is not at all surprising that liner operators, forced to undercharge for superior services, have had little incentive to provide sufficient and appropriate capacity to meet total demand.

At the same time that Class C (Basic) is abolished, the fork tariff for the remaining three commodity classes should be expanded to ± 15 percent of reference points for each class. Using index numbers rather than monetary values, the combined effect of abolishing Class C (Basic) and expanding the fork tariffs for the remaining three classes would be to permit the changes in rate range given in Table 3-1.

Table 3-1. Changes in Rate Ranges for Commodity Classes

	Index Numbers	
	July 1991 (actual)	September 1991 (recommended)
Class A		
Upper limit	105	115
Reference point	100	100
Lower limit	95	85
Class B		
Upper limit	84	92
Reference point	80	80
Lower limit	76	68
Class C		
Upper limit	68.25	74.75
Reference point	65	65
Lower limit	61.75	55.25
Class C (Basic)		
Upper limit	60.5	A
Reference point	57.6	A
Lower limit	54.7	A

Note: Class A reference points = 100; A = abolished.

Because Class C (Basic) rates are too low and do not reflect the costs of shipping services, commodities in that class are generally charged the upper limit, which is currently approximately 60 percent of the Class A reference point. By expanding the fork tariff to ± 15 percent of commodity class reference points, the 60 percent value falls well within the new rate range for Class C commodities, and thus the change does not preclude shippers and shipping operators from arriving at negotiated rates that are at the prevailing levels of July 1991. This change also does not preclude shippers and shipping operators from agreeing on rates that are approximately 75 percent of Class A reference points for noncontainerized shipments. The charges for noncontainerized shipments would be on the order of those imposed by trampers for bulk shipment of grains.

According to the SRRS dual-rate recommendation, the rate range for containerizing any of the current Class C (Basic) commodities would be the Class B range and would be 12 to 52 percent higher than the current Class C (Basic) maximum. The upper end of that range is necessary to induce shipping operators to acquire the ventilated containers needed for shipping many of the fruits and vegetables now included in the C (Basic) group. Some of these commodities, to the extent that they currently have transport service, rely largely on air transport, so that even at the high end of the containerization range recommended by the SRRS, shippers would realize a substantial transport cost savings by shifting from reliance on air transport to reliance on sea transport.

As with Class C (Basic) fruit, bananas (currently classified as a Class C commodity) could benefit from the dual-rate system. Bananas are frequently loaded into passenger cabins because there are no ventilated containers available. The dual-rate system would permit them to continue to be loaded into passenger cabins, if shippers prefer, at charges ranging from 55 to 75 percent of Class A reference points (with the recommended fork tariff—currently the allowable charge range for bananas is 62 to 68 percent of Class A range midpoints), or to be loaded, more appropriately and with less handling damage, in ventilated containers at rates that would be 68 to 92 percent of Class A midpoints.

As stated previously, shipping rate adjustment should become automatic. One aspect of rate adjustment might desirably be a fuel surcharge and discount mechanism. The SRRS team recommends that such a mechanism be adopted by MARINA in 1991 and that it be applied whenever a fuel price change will alter total shipping costs for all or some sector of the liner shipping industry by more than 2 percent. Smaller changes would be within the margin for error in estimating appropriate liner cargo rates, and would be insignificant if fork tariffs of ± 15 percent of cargo class reference points are adopted.

With the 2 percent minimum cost change criterion, the fuel surcharge and discount mechanism might be applied more frequently to one sector of the interisland industry than to another. For example, members of the Southwestern Mindanao Shipowners Association (SMSA) operate on marine diesel fuel, which is more costly per unit than the bunker oil used by operators of larger vessels. Thus SMSA members are significantly affected by even relatively small changes in fuel price.

1992

In April 1992, the SRRS-recommended cargo rate formulas should be used to obtain 1991 rates for all distances and three commodity classes. These formulas should then be adjusted by using the cost adjustment mechanism discussed earlier. Even with the recommendations for 1991 adjustments, rates for some distance ranges will not accurately reflect costs by the end of the year, so that the April 1992 adjustments will mean increases greater than the rate of 1991-1992 shipping cost inflation for the shipment ranges of 50 NM and less, 101-132 NM, and 301-349 NM. There may be little or no 1992 rate adjustment for shipments of 600 NM and over, because rates for this distance range are currently high in relation to cost.

Expansion of the dual-rate system to include all Class C commodities would be desirable in 1992. It is widely recognized by shippers and shipping operators that containerization protects cargo from damage, spillage, loss or theft, and, therefore, containerized shipping is of greater value to shippers than break-bulk or bulk cargo shipping. It has never been recognized that the superior service of container operations deserved charge increments, probably because of the difficulty of disaggregating traffic and financial data at MARINA to separately compute cargo rates appropriate to containerized and noncontainerized cargo services. The SRRS team recommends that, as a prelude to freight-all kinds (f.a.k.) charging for containerized service in a later year, MARINA permit (in 1992) shipping operators to impose Class B charges for any Class C cargoes that, according to shipper preference, are containerized.

The change may result in some windfall profits for the shipping industry if a number of shippers of Class C commodities choose containerized services at higher rates. It is also likely that the shipping industry, geared to provide containerized service, will attempt to keep currently containerized cargoes in that packaging mode by offering low rates within the official containerized cargo rate range. If this SRRS recommendation is adopted by 1992, no containerized cargo would bear less than a Class B charge, but the recommended September 1991 Class B lower limit (see Table 3-1) is almost the same as the current Class C upper limit, so that negotiated rates might rise only moderately from 1991 to 1992.

The LSRS will be conducted in 1992, and will monitor what has occurred by that time as a result of the 1990 and 1991 cargo rate adjustments, liberalization, and partial deregulation. If the above SRRS-recommended adjustments for 1992 are made early in the year, some results of these adjustments may also be identified by the LSRS. The principal objectives of the LSRS, however, will be to permit MARINA to adopt (in 1993) route-by-route identification of cargo (and Third Class passage) rates and to set the stage for 1993-1996 full deregulation of cargo rates, with concomitant liberalization of service regulation.

1993

Beginning in 1993, SHIPPERCON must be set up to monitor service availability, appropriateness, and standards, as well as cargo service charges, at several important locations.

MARINA should introduce route-by-route cargo rates based on the revenue required to produce a combined 12 percent return on assets employed on the route at design load factors and target efficiency levels (in terms of round-trip voyages per vessel per year). The rates will be based on rates identified in 1992 by LSRS but adjusted by MARINA for 1992-1993 shipping cost inflation using the SRRS rate adjustment mechanism discussed in this chapter. Rates identified will include the following:

- For routes with 10 percent or more of cargo containerized.
 - f.a.k. container rates, with fork tariffs of ± 20 percent.
 - Class A rates for noncontainerized cargo, with fork tariffs of ± 15 percent.
 - Class B rates for noncontainerized cargo, with fork tariffs of ± 15 percent.
 - Class C rates for noncontainerized cargo, with fork tariffs of ± 15 percent.
- For routes with less than 10 percent of cargo containerized.
 - Class A rates applicable to all Class A cargo (whether containerized or noncontainerized), with fork tariffs of ± 15 percent.
 - Class B rates applicable to all Class B cargo and to containerized Class C cargo, with fork tariffs of ± 15 percent.

- Class C rates applicable only to noncontainerized Class C cargo, with fork tariffs of ± 15 percent.

It is not possible to state how large some of the cargo rate adjustments might be from 1992 industrywide rates to 1993 route rates, but the LSRS is expected to recommend 2-year phase-ins of any large rate adjustments. The container f.a.k. rate ranges are expected to be somewhat higher than the average of Class A and Class B ranges that would apply in 1992, but any such containerized cargo rate increases would be largely counterbalanced by reductions (before considering 1992-1993 inflation) in charges for shipment of noncontainerized cargo.

Because shipping operators are geared to accommodate a certain volume of containerized cargo traffic, they can be expected to agree on containerized shipment rates in the lower half of the f.a.k. ranges up to the point where high container occupancy is achieved in the backhaul directions. Thus, in the short term, some inclination by shippers to from containerized to noncontainerized shipment in order that lower official cargo rates would apply is likely to result in only slowly rising negotiated rates for container shipping.

MARINA should implement the route franchise adjustments identified by the LSRS as high priority to expand service schedules or to introduce schedule flexibility between peak and off-peak seasons. MARINA should also, to the extent the LSRS recommends as necessary for 1993, issue new route franchises on existing and new routes to ensure that shipping capacity is sufficient on all routes for most periods of the year.

In December 1993, SHIPPERCON must produce a report for the first three quarters of 1993, identifying (1) any changes in liner cargo service availability, appropriateness, and standards by route from the findings of the LSRS in 1992; (2) ranges and average charges by route for containers (routes on which f.a.k. rates are applicable) and for Class A, Class B, and Class C commodities; and (3) whether any correlation exists, within any f.a.k. container rate range, between charge levels and cargo values.

On the basis of its findings, SHIPPERCON must determine whether or not the next phase of cargo rate liberalization can proceed immediately on some or on all routes. A SHIPPERCON recommendation against proceeding with liberalization on any route must be based on findings that (1) within a f.a.k. container rate range little correlation existed between charge level and cargo value (i.e., the shipping industry was not taking into account what the traffic would bear); (2) rates generally averaged near the upper limits of their respective ranges, and there was little or no corresponding improvement in the availability, appropriateness, or standards of service; or (3) capacity of one type or another was very "tight" and should be expanded if rate liberalization is to proceed. For example, there must be sufficient capacity to accommodate noncontainerized cargo so that shippers have a choice whether

to pay more to have their cargo containerized or to ship cargo as break-bulk or bulk cargo and pay lower rates.

1994

For any routes that SHIPPERCON found to be suitable for the next phase of rate deregulation, the Class A and Class B commodity classes should be combined in 1994 and the fork tariff expanded to ± 20 percent of the combined class reference point. For routes where 10 percent or more of cargo is containerized, and f.a.k. container rates are therefore applicable, combining Classes A and B will be of noncontainerized cargo only, whereas for routes with relatively little containerization, containerized cargo will remain in Classes A and B. The effects of combining two commodity classes while expanding the fork tariff are shown in Table 3-2.

Class C rates, which will be applicable only to noncontainerized Class C commodities on all routes, will need to be adjusted only for inflation in 1994. MARINA should continue to implement the liner service liberalization program recommended by the LSRS. Also, in its December 1993 report, SHIPPERCON might identify needs for new or expanded services in 1994, which MARINA should confirm; if confirmed, operators should be invited to provide the services.

**Table 3-2. Effects of Combining
Classes A and B Commodities**

	Index Number		
	1993	1994	
		Without Inflation	With 10 percent Inflation
Class A			
Upper limit	115	A	A
Reference point	100	A	A
Lower limit	85	A	A
Class B			
Upper limit	92	A	A
Reference point	80	A	A
Lower limit	68	A	A
Class AB			
Upper limit	NF	108	119
Reference point	NF	90	99
Lower limit	NF	72	79

Note: Class A 1993 reference points = 100; A = abolished; and NF = index numbers not formed.

In December 1994, SHIPPERCON must prepare a report covering the final quarter of 1993 and the first three quarters of 1994. The report must cover the same scope as the 1993 report, except that SHIPPERCON must also evaluate the combining of Classes A and B for general level of rates within the official range by route and the correlation of rates and cargo value. SHIPPERCON's recommendations must address, route by route, whether operators are ready to proceed (in early 1995) from rate liberalization to rate deregulation of all cargo except Class C noncontainerized cargo.

1995

For the routes for which SHIPPERCON's 1994 report indicates that rate deregulation may proceed, MARINA will specify (in 1995) official rates only for noncontainerized Class C cargoes and will identify indicative rates for containers and noncontainerized Class AB cargoes, assuming that these classes are combined, cargoes on routes with 10 percent or more containerized cargo. For routes with less than 10 percent containerized cargo, MARINA will provide a single indicative rate to cover all cargo for which the Class C official rate range is not applicable. Because the indicative rates are only for shipper and shipping operator reference, no fork tariffs need be indicated by MARINA in conjunction with these rates.

MARINA should continue to liberalize service regulation in line with LSRS, SHIPPERCON, and its own findings on the need for such liberalization.

SHIPPERCON's December 1995 report will cover four quarters, but it will be particularly concerned with the period after deregulation of rates for all but noncontainerized Class C commodities. Principally, SHIPPERCON will be concerned with identifying whether actual negotiated charges for all cargoes other than noncontainerized Class C cargoes remained within ranges of ± 20 percent of MARINA indicative rates, and whether there continues to be a correlation between cargo value and level of charges imposed by route. Where general rate increases are identified that would appear to significantly exceed 1994-1995 inflation, SHIPPERCON will assess whether a corresponding improvement in service occurred.

For each route, SHIPPERCON will identify for MARINA whether it is ready for the final phase of rate deregulation, or whether rate deregulation should be investigated by MARINA for possible new services (to relieve "tightness" of the market) or for other actions.

1996

For the routes (identified by SHIPPERCON in December 1995) for which rate deregulation is proceeding satisfactorily, MARINA will issue, in early 1996, updates of indicative rates identified in 1995 and will also provide indicative rates for noncontainerized Class C commodities. Thus, for each

route with more than 10 percent containerized cargo, MARINA will issue only three cargo rate figures in 1996: (1) f.a.k. container, (2) noncontainerized Class AB commodities, and (3) noncontainerized Class C commodities. For routes with low container traffic, MARINA will issue only two figures: noncontainerized Class C commodities and all others. MARINA should continue service liberalization as required.

SHIPPERCON should produce a report in December 1996 covering the same issues covered in earlier reports. The report should also cover any routes for which full rate deregulation was not recommended in 1995. SHIPPERCON should reassess the desirability of moving to full deregulation in 1997.

Third Class Passage

The terms of reference for the SRRS do not extend to consideration of the desirability of Third Class passage rate deregulation. Nevertheless, the scope of work of the SRRS has to extend to passenger services because virtually all of those services are provided by the liner shipping industry with vessels that are jointly used for cargo and passenger services. Therefore, any need to subsidize passenger services with cargo services would affect the competitiveness of these vessels vis-a-vis full cargo vessels under conditions of full cargo rate deregulation.

In 1990 the PTSR had in fact been informed by CISO that cargo services were subsidizing passenger services. If the SRRS team found this to be the case (in 1991) it would then have to identify and assess possible strategies for ending such subsidization, thereby precluding any adverse effects of passenger operations on cargo operations under deregulated cargo rate conditions.

As discussed in Chapter 2 of this volume and in greater detail in Volume II, the SRRS team found passenger services to be profitable on some routes and unprofitable on others, but overall there appears to have been some slight subsidization in 1989 (the year of the data used for SRRS analysis) of passenger services by cargo services. Certainly revenues from passenger services had to cover less than 5 percent of the costs of cargo services. Rates for Second Class passage were deregulated during 1989, thereby making it likely that the limited subsidization, over the full year of 1989, was further limited, and perhaps even eliminated in 1990.

In 1990 and 1991, PAL increased its domestic air transport fares in real terms, making liner shipping First Class and Second Class passenger services more competitive with transport services. The possibility that a continuing need of liner operators to subsidize passenger services could make passenger and cargo vessels uncompetitive with full cargo vessels under conditions of

deregulated cargo rates need not be of much concern, because passenger services are at or near the point, in general, that they are profitable.

Nevertheless, some enhancement of passenger service profitability through Third Class passage rate liberalization would be generally desirable and, from the SRRS team's analysis of 1989 costs and revenues, some adjustments of rates are also needed to reduce profitability disparities among distance ranges. Besides these 1991 and 1992 adjustments to improve the accuracy of Third Class passage rates on the basis of costs of providing services over various distance ranges, the SRRS team recommends two actions for Third Class passage rate liberalization that should help to enhance the profitability of liner shipping passenger services.

1. Undertake a pilot project to determine the desirability of instituting seasonal rates that would be higher than standard rates to induce travelers with discretionary travel schedules to travel during off-peak periods.
2. Institute a service standards rating system, permitting operators that provide good standard services to charge Third Class fare increments for their services (operators already are free to charge whatever they believe their First and Second Class services are worth).

These actions should also benefit passengers by helping to reduce peak demand (Action 1) and by helping to improve passenger service standards (Action 2).

The pilot project (to be undertaken during April-June 1992) is to be included in the LSRS scope of work. The LSRS will also assist MARINA in developing a service standards rating system. Because the principal purpose of instituting seasonal rates is to divert travel from peak periods, an essential part of the pilot project is to publicize the project more than one month before the peak travel period begins. In so doing, travelers with discretionary travel time can make their trips before the peak period and thereby pay the lower standard rate. Because students have neither discretionary travel time nor much money, the SRRS team recommends no change in the discounted rates that students pay.

On establishing a service standards rating system, MARINA has developed possible minimum standards for all classes of passenger service, and the SRRS team recommends that the same criteria for acceptable First, Second, and Third Class passenger services be used to develop a rating system. The system should also include speed, reliability, and safety of service as factors in the service ratings. Third Class passage rates currently are specified with a fork tariff of ± 5 percent. The SRRS team recommends that this rate liberalization action be rescinded in 1992 in favor of a wider rate range that would be related to service rating.

Thus, improvement of service standards would be encouraged by offering rewards, in the form of rate increments, rather than by imposing penalties in the form of actions or threatened actions against shipping lines that fail to meet regulated service standards.

The recommended schedule for carrying out Third Class passage rate liberalization is presented next.

1991

The SRRS team recommends that the work MARINA has done in anticipation of setting minimum standards be converted to a service standards rating system and that this system take into account the service characteristics and record of speed, reliability, and safety. The SRRS team recognizes that many different service standard classifications exist that might be adopted by MARINA. One possibility, not necessarily the best but perhaps useful, would be to classify service standards as "superior," "standard," "basic," and "probational." Official Third Class rates would apply to basic and probational classifications, and shipping operators who were providing superior or standard services would be permitted to charge Third Class fare increments of, for example, 20 to 30 percent and 10 to 15 percent, respectively. As a service to the public, MARINA should rate First and Second Class services as well, but in these cases MARINA will have no control over the rates charged.

It is uncertain exactly when the LSRS will begin in 1992; therefore, to ensure that the seasonal rates pilot project be carried out from April through June, preceded by a public information program in February and March, MARINA needs to make some preparations during 1991. Two liner passenger routes will be sufficient for the pilot project, and they should be routes where there is considerable peak travel during April-June, compared with the periods immediately preceding and following this period. SRRS surveys (carried out in May-June, 1991) were also conducted during a peak travel period and showed that students, who do not have discretionary timing for their travel, represent less than 10 percent of each of the three passenger classes. Thus, significant potential may exist for inducing, through higher seasonal rates for nonstudents, shifts of passenger traffic to earlier and later periods.

Adjustment of Third Class passage rates should be made for some distance ranges, as discussed in an earlier section of this chapter.

1992

A public information program on the seasonal rates pilot project must be carried out in February and March, whether or not the LSRS is under way at that time.

SRRS-recommended formulas for Third Class passage rates will be used in April 1992 for adjusting industrywide rates, as identified in an earlier section of this chapter.

The seasonal rates pilot project will be carried out as part of the LSRS April-June. The LSRS will also assist MARINA in rating all liner passenger services and in setting up monitoring procedures for MARINA to assess the effects of service standards ratings. The LSRS will also assess the extent to which operators of good standard services actually impose permitted fare increments and the effects of such increments on traffic and operator profitability.

1993

The SRRS team recommends that MARINA identify Third Class passage rates route by route in 1993. The LSRS will have identified route-by-route Third Class passage rates for 1992, and MARINA will adjust these rates for 1992-1993 shipping cost inflation using an adjustment mechanism recommended by the SRRS.

Provided that the seasonal rates pilot project is successful in 1992 and that it has helped to reduce peaking of demand, MARINA should permit seasonal rates on a number of routes with April-June peaking of demand. As with the pilot project, the public must be informed well in advance in order that travelers with discretionary travel time might schedule their travel before or after the peak period and thereby avoid the higher seasonal passage rate. (Success of seasonal rates during the April-June peak would not necessarily mean success during the Christmas travel period. Before any seasonal rates are widely approved for the Christmas peak travel period, a second pilot project should be implemented, because it is possible that fewer travelers would have discretionary travel time during this period.)

MARINA should carry out its first annual monitoring of service standards to determine whether standards ratings require adjustment for any services that might have improved or deteriorated since the ratings were instituted in 1992.

Also, MARINA should carry out LSRS recommendations for liner passenger service liberalization. These recommendations will include adjustments to existing route franchises to permit an increase in the frequency of service and issuance of new route franchises.

1994

MARINA should continue in 1994 and subsequent years to liberalize liner passenger services, keeping in mind that although costs should be minimized, service availability is of greater importance and average load factors should not be permitted to rise to such levels that demand cannot be adequately accommodated during much of the year. MARINA should also continue to monitor and adjust, as necessary, passenger service standards ratings.

Ferry Services

In the Philippines no clear definition of ferry services exists to differentiate them from liner shipping services. Both ferries and liner ships operate on fixed schedules. Liner services sometimes operate between only two ports with no intermediate ports of call; ferry services always operate between two ports. For its purposes, the SRRS team has adopted the following definition of ferry services: services provided between adjacent islands, with vessels that make a minimum of one round trip per day. MARINA includes services between Batangas and Calapan and between Iloilo and Bacolod as secondary route liner services, but according to the SRRS definition these short-distance services between adjacent islands constitute ferry services, not liner services.

None of the SRRS recommendations for liner cargo and passenger service rates in the preceding sections in this chapter is meant to apply to ferry services, as defined in this section. Another study, the ongoing Nationwide RORO Transport System Development Study (NRTSDS) will make recommendations (in 1992) for RORO service development and service rates; therefore, the SRRS has not investigated desirable rates for ship transport of road vehicles. However, the SRRS team believes that there should be substantial flexibility in rates and service schedules for ferry services (whether provided by RORO vessels, passenger and cargo vessels, or passenger vessels) if in fact these services should be regulated at all. An alternative to regulation would be for port operators (PPA or other owner-operator) to enter into contracts with ferry operators. The ferry operators would pay annual or quarterly rentals for port facilities (and no other port fees), and ferry services, standards, and charges (with an adjustment mechanism) would also be specified.