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REPORT

Newfoundland Domestic Trade Routes and Competition Assessment

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Solutions for growing economies

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Confidential Report / Ackowledgments

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The CPCS Team would like to thank the Transport Canada project team and all of those consulted in the preparation of this report, including in particular, representatives from Marine Atlantic, Inc. and Oceanex.

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Acronyms / Abbreviations

ARG	Argentia
BR	Business Register
CPCS	CPCS Transcom Ltd.
MAI	Marine Atlantic Inc.
MER	Market exchange rate
NAICS	North American Industry Classification System
OCX	Oceanex
PAB	Port aux Basques
PPP	Purchasing power parity
RoRo	Roll-on Roll-off
TC	Transport Canada
TCOD	Trucking Commodity-Origin Destination (Survey)
TEU	Twenty-foot equivalent unit (container)

Executive Summary

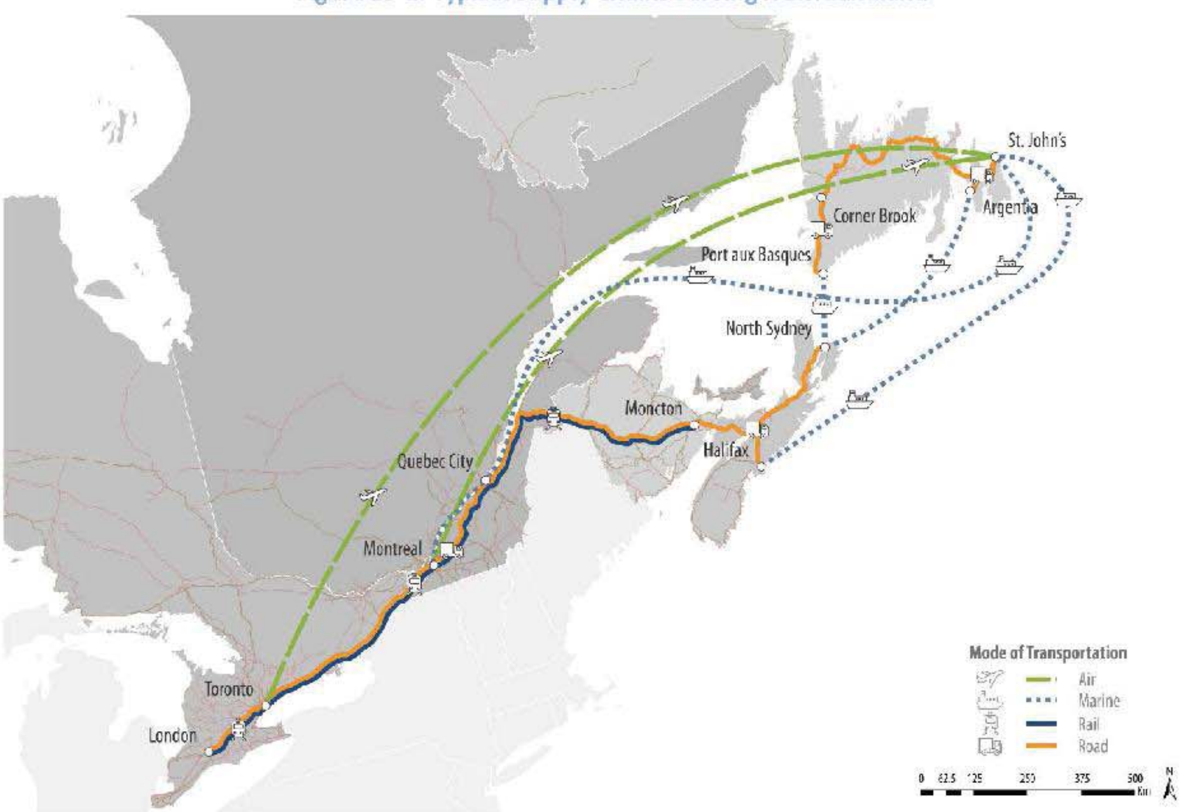
Background

Transport Canada has retained CPCS to assess the degree of distortion in the Newfoundland-Mainland freight market attributable to Government of Canada support to Marine Atlantic Inc. (MAI) and possible solutions in terms of revised fare structures.

MAI, a federal Crown corporation, fulfills the constitutional obligation of Canada to provide a year-round ferry service between North Sydney, Nova Scotia and Port Aux Basques, Newfoundland. MAI also provides a seasonal non-constitutionally mandated service between North Sydney and Argentia, NL.

Oceanex, a privately-owned shipping line, operates two services to St. John's, NL for container, drop-trailer, and roll-on roll-off (ro-ro) cargo: one weekly sailing from Montreal and one from Halifax. Whereas Oceanex typically provides shippers with door-to-door service, MAI service is limited to the marine link to Newfoundland. Beyond this marine link, shippers routing traffic via MAI are dependent on third-party truck and rail service providers to move their cargo to and from Newfoundland. Air cargo focuses on niche high value and time sensitive products and represents a very small share of the regional freight transportation market.

Figure ES-1: Typical Supply Chains Serving Newfoundland



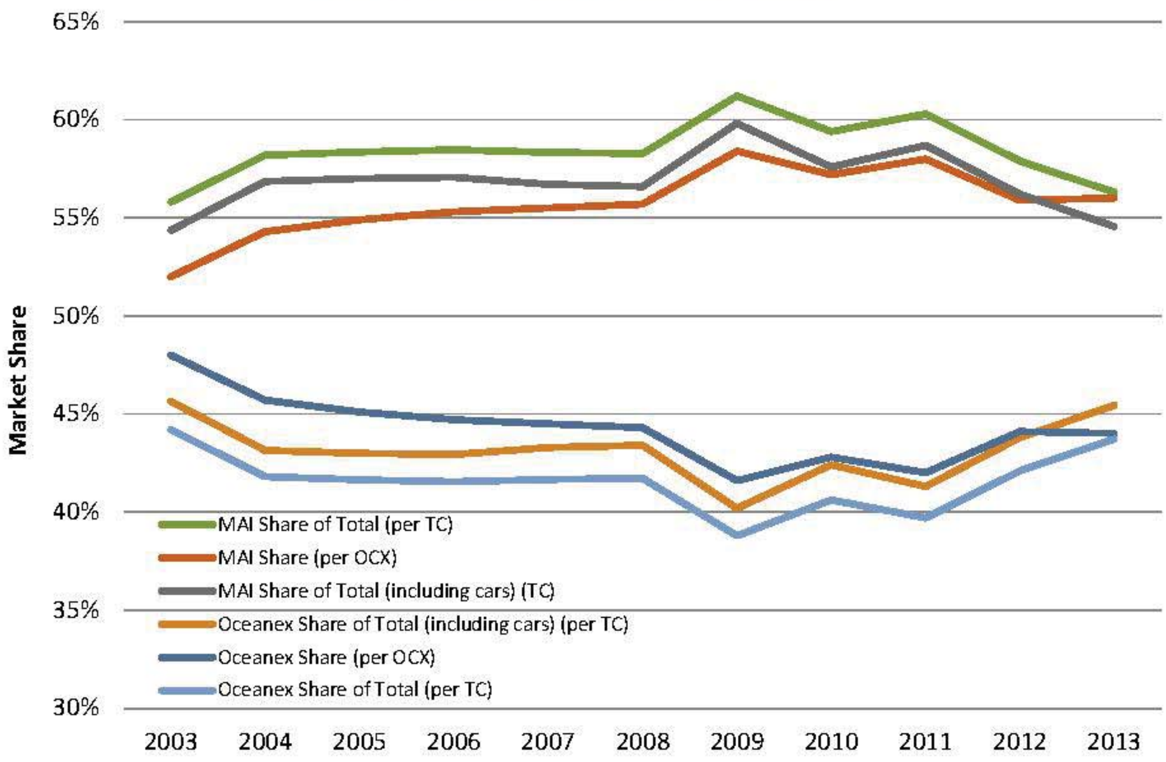
Source: CPCS

Major Freight Flows to and From Newfoundland

The flow of freight from the mainland to Newfoundland is far greater in volume and, most likely far greater in value, than the flow of freight in the other direction. Generally, food and agricultural products, machinery and transportation equipment, as well as manufactured and miscellaneous goods are largely destined for consumer markets in the Avalon Peninsula.

While estimates of market share vary by data source (Transport Canada or Oceanex), both show that between 2009 and 2013 MAI lost market share to Oceanex (Figure ES-2). MAI currently appears to have roughly 55% of the Newfoundland surface freight transportation market compared the 45% for Oceanex. This is roughly similar to 10 years ago.

Figure ES-2: Market Shares of MAI and Oceanex



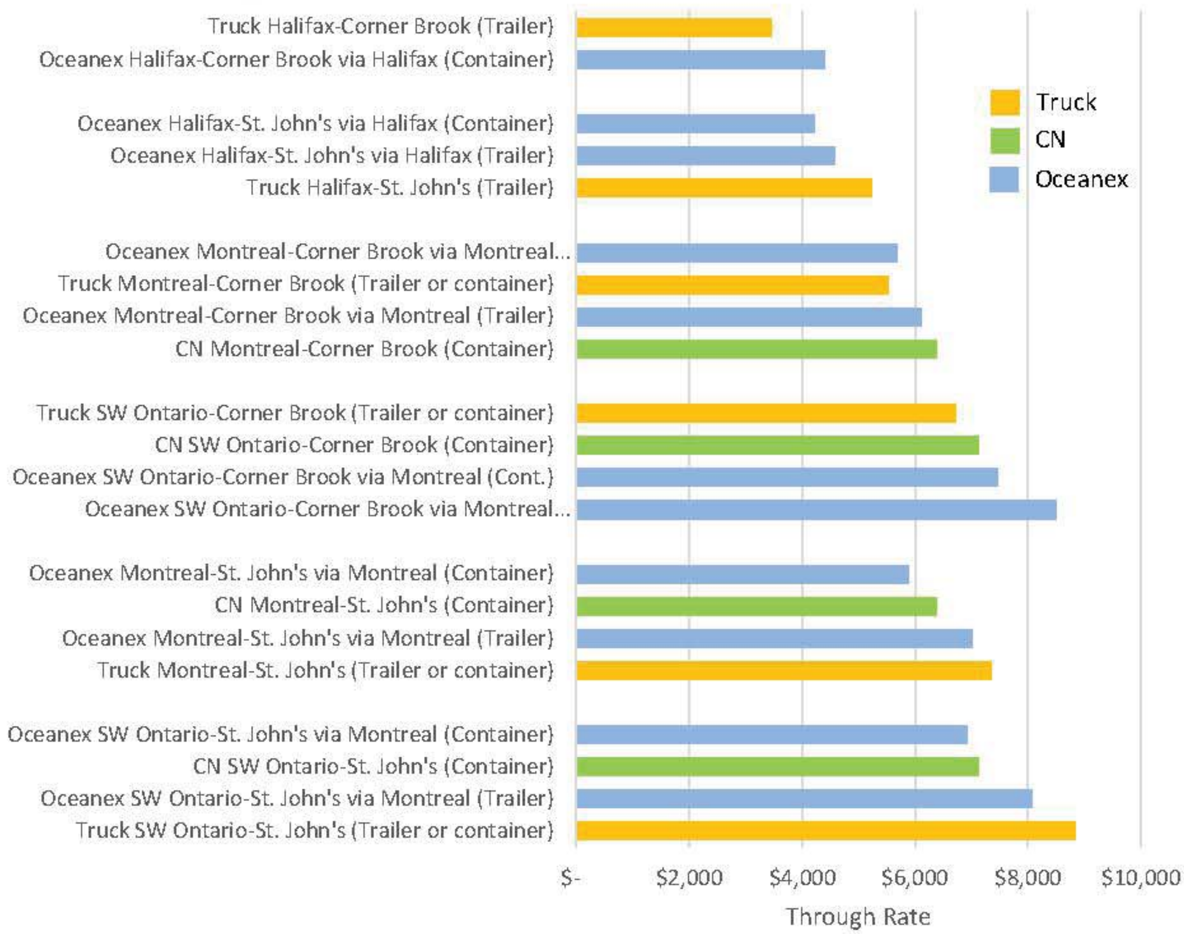
Source: CPCS analysis data from Transport Canada and Oceanex. See full explanation in Section 2.4.3.

Competition

MAI does not compete directly with Oceanex or other providers of freight services to Newfoundland, per se. MAI does not sign transportation contracts with shippers in the way that Oceanex, CN, or trucking companies do. It is more appropriate to say that Oceanex competes with transportation providers, including CN and trucking companies, that serve Newfoundland using MAI. However, MAI is a key supplier or enabler of the competitors of Oceanex, and therefore has a direct impact on competitive dynamics in the market.

Generally, trucks have the advantage for time-sensitive products owing to higher frequency and speed. Oceanex offers less frequent and slower service than trucks. The CN-served routing seems to offer somewhat faster speed than Oceanex, but somewhat slower speed than trucks. Reliability is not possible to assess as we only possess quantitative data for MAI, and qualitative information on reliability is inconclusive. In terms of transportation cost, the relative competitiveness of MAI and Oceanex varies by route and mode of conveyance. Figure ES-3 presents current rates for the transportation of 53' containers or trailers to Newfoundland from various origins.

Figure ES-3: Summary of Current Rates, 53' Unit to Newfoundland



Source: CPCS analysis based on data and assumptions noted in Section 3.2.1

The relative advantages of Oceanex vs. MAI-routings likely differ by type of cargo, on the basis of the relative importance of transit time, reliability, level of service, and cost, which will differ by type of commodity (Figure ES-4). Cost is certainly not the only, and sometimes not the most important, factor in a routing decision.

Figure ES-4: Summary of Supply Chain Value Proposition in the Mainland-Newfoundland Transportation Market

Supply Chain	Supply Chain Value Proposition				Commodities typically aligned with supply chain strengths
	Transit Time	Reliability	Level of Service	Cost	
CN Intermodal	Less Preferred	Insufficient data to assess	Less Preferred	Preferred	Heavier, lower velocity, less perishable freight
Oceanex					Heavier, lower velocity, less perishable freight such as chemicals, non/semi-perishable food products including alcoholic beverages, heavy machinery, transportation equipment, construction materials, and general merchandise.
Truck	Preferred		Preferred	Less Preferred	Lighter, higher value-to-weight, highly perishable products, notably produce, but also general merchandise.

Are MAI's Prices Distorting the Market and Creating Entry Barriers?

When a Government supported enterprise competes against the private sector there is potentially, but not necessarily, a market distortion and entry barrier. This distortion/barrier would occur if the government-supported enterprise were to offer services at prices below what the private sector could offer, i.e. below the full cost of the delivering the service.

MAI does receives support from the Government of Canada in both financial and non-financial forms:

- the Government provides financial support in the form of appropriations to cover MAI deficits (Figure ES-5). Own-source revenues only covered 42% of total costs[1] in 2013-14.
- As a ferry, MAI is exempt from pilotage under the regulations of the Atlantic Pilotage Authority, but Oceanex, which also provides a regular, scheduled service between terminals, is not designated as a ferry service and is subject to pilotage, and must incur related csots, putting it at a competitive disadvantage.

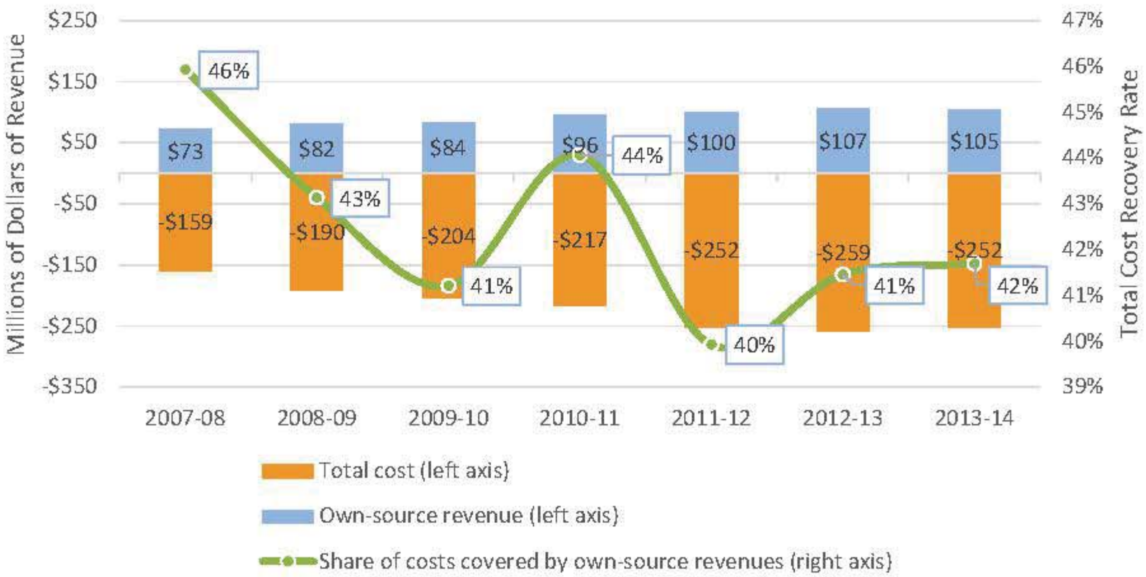
MAI uses the support it receives from Government to price both its live load (driver-accompanied trucks) and drop trailer services at less than half of the cost of these services (Figure ES-6), thereby creating a market distortion and entry barrier, and effectively putting downward pressure on the rates charged by Oceanex and discouraging other marine carriers from entering the market.[2] In dollar terms the Government of Canada provides live loads and drop trailers travelling on the Port Aux Basques routes with a subsidy of roughly $800 per direction.[3]

[1] Total costs include all amortization, charter expenses, pensions expenses, and all other expenses reported by MAI on its income statement.

[2] Information on the profitability of Oceanex was unavailable for this study.

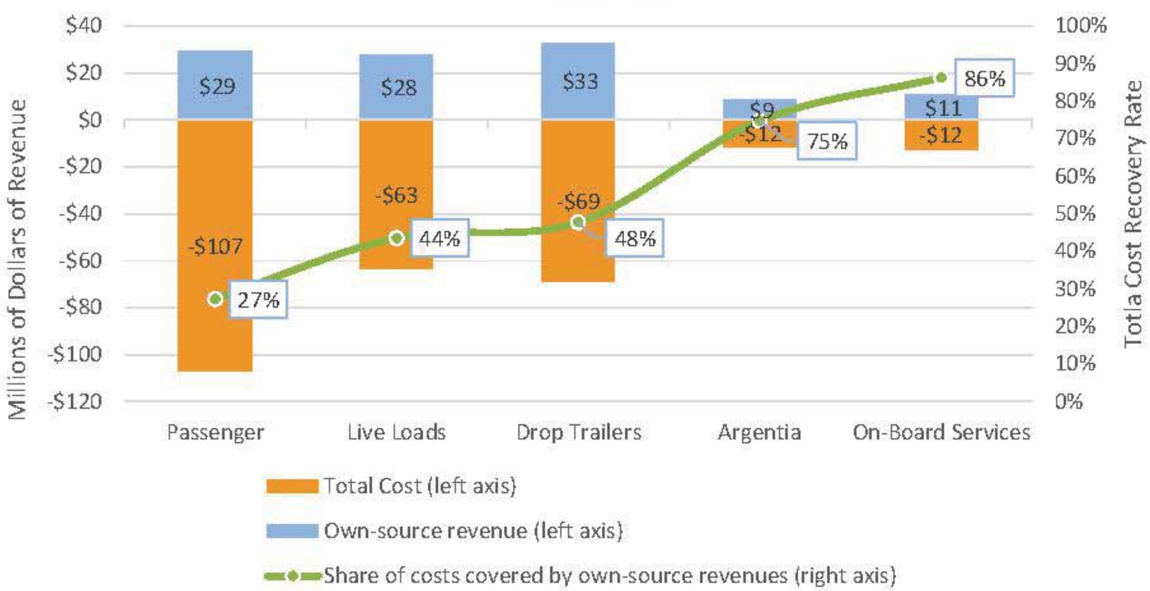
[3] Calculated as the cost of providing the service (based on cost recovery of 44% for live loads and 48% for drop trailers) less price charged by MAI ($652.89 for live loads and $762.77 for drop trailers).

Figure ES-5: Marine Atlantic Own-Source Revenues and Costs, and Cost Recovery, 2007-08 to 2013-14, Budgetary (Accrual) Basis



Source: CPCS analysis of MAI financial statements

Figure ES-6: Marine Atlantic Own-Source Revenues, Costs, and Cost Recovery, by Segment, 2011-12, Budgetary (Accrual) Basis



Source: CPCS analysis of MAI financial statements; Deloitte (2012) "On Board Services at Marine Atlantic," p. 24; Deloitte (2012) "Drop Trailer Business at Marine Atlantic," p. 26; and Deloitte (2012) "Report on Marine Atlantic's Argentia Service," p. 27 and p. 14.
Note: Argentia is not additive with other segments.

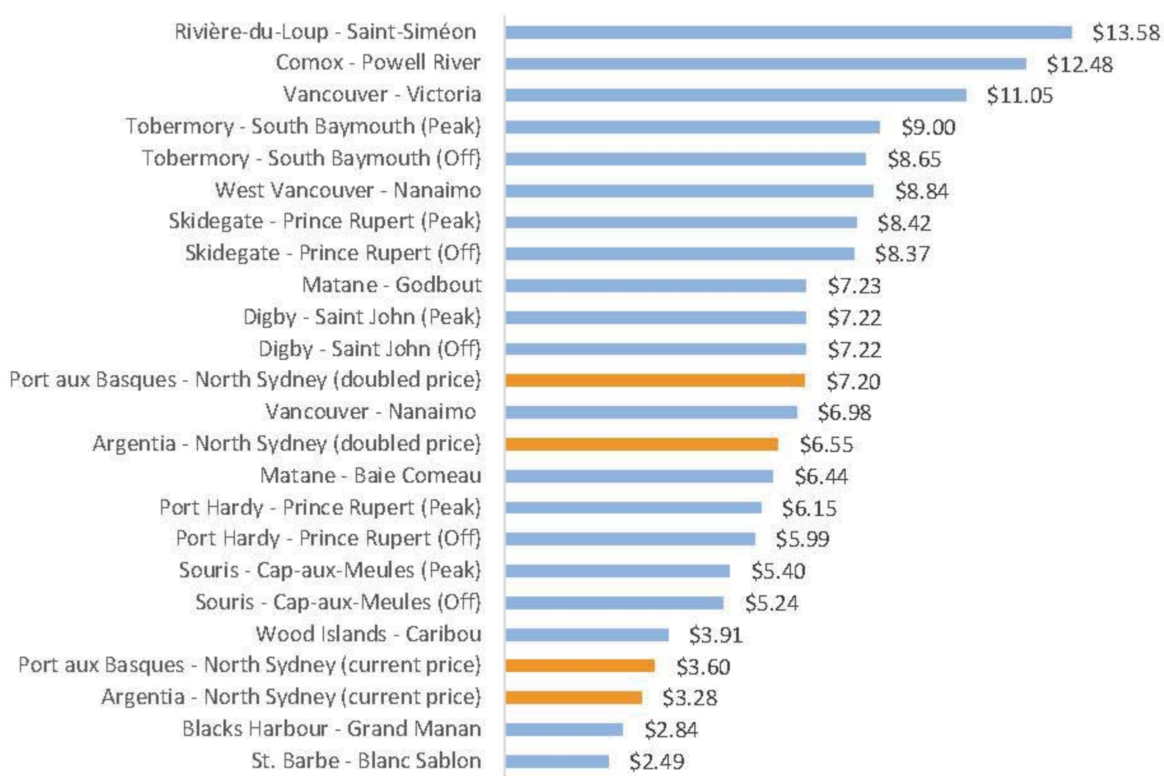
What Should be Done to Level the Playing Field?

Under *The Newfoundland Act* (Term 32) Canada has a constitutional obligation to provide a year-round ferry service between North Sydney, Nova Scotia and Port Aux Basques, NL.

Research indicates that the obligation of Canada is to provide ferry service between North Sydney and Port aux Basques that is priced fairly and reasonably.[4] Among Canadian ferry operators MAI currently charges among the lowest prices for live loads on a per km basis.[5]

A competition-neutral price structure, i.e. a level playing field, means MAI must fully recover all costs, just as a private sector provider would.[6] MAI's own-source revenues covered 47.8% of its costs for drop trailers and 43.6% of its costs for live loads (Figure ES-6). To recover 100% of the costs associated with providing these services, all else being equal, either prices would have to double or costs would have to be halved. Price increases alone would be unlikely to achieve full cost recovery for live loads and drop trailers, as traffic would likely be driven away. Cost reductions would also be required, though MAI cost reduction options are beyond the scope of the present study. If prices for live loads were doubled, MAI would still have moderate prices relative to other Canadian ferry operators (Figure ES-7).

Figure ES-7: Canadian Ferry Prices per km for a Live Load, with Doubled MAI Prices, 2015



[4] Transport Canada

[5] Data on drop trailer competitors are not available.

[6] Strictly speaking to operate on a commercial basis MAI would cover all costs and generate a return on equity, but for the purposes of illustration and because MAI is so far from full cost recovery, we have focused on the achievement of full cost recovery. Private operators may also have lower cost structure, but we have not undertaken such an analysis.

Source: CPCS analysis of rate data from the websites of the ferry operators and distances estimated with Google Maps.
Note: Comprehensive prices including any surcharges for a standard Canadian tractor-trailer accompanied by a driver. 2015 rate not available for Wood Islands - Pictou and Tobermory -S. Baymouth, so 2014 rate is used.

Freight price increases at MAI would be unlikely to have a large impact on prices in Newfoundland owing to traffic shifts to Oceanex, the relatively small share of total product cost attributable to MAI (or supply chain cost more broadly), and the ability of shippers to absorb price increases. We estimate that if MAI freight prices were increased by 50%, average prices for all commodities imported by truck to Newfoundland would rise by 1.4%. This is less than one year of normal inflationary price increases. Put in simple terms, if an apple cost $1.00 before a 50% increase in MAI prices, it would cost on average $1.01 after. The large difference between 50% and 1.4% is attributable to the relatively small share of cost attributable to MAI prices in the average supply chain, and the fact that many goods consumed in Newfoundland do not come via MAI or are produced locally. At the same time this impact would likely be unevenly distributed with certain products seeing higher price increases and other products seeing little to no price increase.