

SVITZERWIJSMULLER A/S / ADSTEAM MARINE LTD

COMPETITION COMMISSION INQUIRY

INITIAL SUBMISSION ON BEHALF OF SVITZERWIJSMULLER

NON-CONFIDENTIAL VERSION

1. INTRODUCTION AND OVERVIEW

SvitzerWijismuller A/S ("**SW**") welcomes this opportunity to make its initial submission to the Competition Commission on this reference.

SW made extensive submissions to the Office of Fair Trading ("**OFT**"), during the course of the OFT's first phase investigation. The Competition Commission has copies of all these submissions; hence SW does not propose to restate those submissions at length.

SW will develop its case more thoroughly during the course of the Competition Commission's inquiry. Accordingly, the focus of this paper is on the OFT's decision.

2. THE OFT DECISION

The OFT's decision found that SW and Adsteam Marine Ltd ("**Adsteam**") (together "**the parties**") had provided "*plausible arguments as to why competition concerns may not arise as a result of the merger*" (para.79). However, since the OFT did not have sufficient time to verify these plausible arguments, it concluded that it was under a duty to refer the proposed merger to the Competition Commission.

This decision was also influenced by the feedback that the OFT received from customers. Some of this feedback was negative and indicated that the proposed transaction would result in a loss of some competition. The OFT did not link this feedback to any concrete evidence of competition between the merging parties. It therefore appears that this feedback needs to be re-examined upon a more detailed investigation of the relevant facts. This is particularly relevant since many customers are also competitors of SW's parent company A.P. Moller-Maersk. These companies, predominantly container shipping lines, may oppose the transaction for reasons other than transaction-related competition concerns.

The OFT, relying heavily on third party opinion, appears to acknowledge that it lacked concrete evidence to support its case. In this regard, the OFT's case is simply a "hypothetical" which is far less plausible than the reasoning provided by the parties.

In particular, the OFT seems to suggest that, even if competition between operators active in different UK ports does exist, this competition is very limited, as is evident from the lack of demand-side and supply-side substitution between different ports. The

OFT's tentative conclusion that competition in the harbour towage industry takes place on a port-by-port level is also in accordance with relevant precedent. Invariably, other competition authorities and third party analysts refer to a "port-by-port" market definition and a limited competitive constraint that comes from the threat of entry.

In this submission, we will address the hypothetical arguments as put forward by the OFT as to why there may be some competition between the merging parties in the UK. In summary, the OFT's arguments are as follows:

- Customers are able to constrain harbour towage prices in ports where only one merging party is active, as they can either (a) use competition in Liverpool as a means to obtain lower prices in other UK ports; or (b) threaten to switch to another port ("**demand side substitution**").
- Customers are able to constrain harbour towage prices in ports where only one merging party is active, as they can threaten to sponsor entry by the other merging party ("**supply side substitution**").

3. DEMAND SIDE SUBSTITUTION

3.1 Liverpool competition: no significant "spill-over" into other UK ports

The OFT suggests that customers have been able to use the threat of switching within Liverpool to achieve better prices in ports where one of the merging parties is a sole operator. However, apart from unverified customer statements, there is no concrete evidence of price competition as between harbour towage operators in different UK ports.

In the case of SW, port managers typically conduct price negotiations at the port level, without reference to the discount structures in other UK ports. Accordingly, SW typically does not offer multi-port agreements (*i.e.*, agreements where there may be uniform discounts based on volumes across two or more ports). Therefore, as far as SW is concerned there is no appreciable "spill-over" effect.

3.2 No significant customer switching due to changes in harbour towage prices in different ports

Apparently, a very limited number of customers indicated to the OFT that if harbour towage prices increased, they may be willing to move to different ports if towage prices were lower elsewhere (para.35).

Although the OFT was plainly sceptical as to this argument - "*However, it is not clear from the evidence received by the OFT that the threat of customers switching ports in case harbour towage prices go up is credible enough to, in itself, constrain the behaviour of the parties*" (para. 38) - it concluded that such a threat "*might impose some constraint on the behaviour of the merging parties*" although "*not a particularly strong one.*" (para. 41).

SW agrees with this preliminary finding and emphasises that the alleged pricing constraint is effectively non-existent. In particular:

- The OFT has not identified any customer who has switched, or threatened to switch ports because of an increase in towage costs, which is not surprising given that towage costs represent such a small proportion of overall port calling costs (including costs of in-land transportation).
- The OFT points to customers transporting cars and containers as the customers most likely to switch, citing as evidence the fact that such customers receive high discounts. Such a finding ignores the fact that these discounts may be due to other factors, particularly volume. Customers with higher volumes obtain higher discounts. Moreover, as the parties described to the OFT, the discounts achieved by these parties are largely historical. In particular, until recently, the car carriers and container carriers negotiated as buyer consortia, increasing their bargaining power against the parties. Although this practice is being reduced, once SW has awarded a discount it will rarely, if ever, be able to withdraw it again.

Thus to the very limited extent that there is a competitive pressure from outside an individual port area, this competitive pressure comes from the potential threat of entry rather than customer switching. It is not only the merging parties who do not think there is competition due to customer switching, third-party analysts refer to the threat of entry as a source of competition, but do not even mention customer switching (*e.g.* the Australian Productivity Commission's 2002 *Inquiry Report into the Economic Regulation of Harbour Towage and Related Services*).

The OFT also recognises that the threat of entry, and not the threat of switching, may constrain the behaviour of sole operators if they were to misbehave and increase prices substantially: "*it is possible that the threat from a Port User Group, Port Authority or large customer to support a new entrant into the port area would happen before a price rise significant enough to induce switching ports could occur. An example of this happening is [•]*" (para. 39)

Consequently, the OFT's theory is inherently speculative. The OFT presumes that a hypothetical reduction in potential competition (or the threat of entry) by the merging parties as opposed to a reduction in actual competition, due to customer switching, is sufficient to find a substantial lessening of competition. It is only under exceptional circumstances that a loss of potential competition would be qualified as a substantial lessening of competition: only if it can be shown with concrete evidence that the loss of potential competition would have a substantial negative effect on pricing.

4. **SUPPLY SIDE SUBSTITUTION**

On the basis of unsubstantiated customer statements, which suggested that the parties could be qualified as the most likely entrants into each other's port areas, the OFT

concluded on a preliminary basis that the proposed transaction may eliminate some competition. It is worth noting that the OFT itself questioned the reliability of these customer statements: "*there are some inconsistencies in the arguments brought forward by third parties*" (para. 57).

4.1 The merging parties have no (UK specific) advantages that make them the most likely entrants

The OFT has difficulties explaining why the merging parties are the most likely entrants, as it only refers to:

Firstly, the OFT argues that SW and Adsteam "*are the only UK players with a national presence*". There is, however, no explanation how a presence in one UK port area might give an operator an advantage when seeking to enter another port area. As SW has argued strongly in its submissions to the OFT, a presence in multiple UK ports does not provide the merging parties with any unique competitive advantage over non-UK operators. In this respect, it is worth noting that many international towage operators are already active in the UK, as they frequently bid for terminal towage contracts.

Second, the OFT argues that the parties are "*capable of offering multi-port arrangements*", which non-UK operators cannot easily provide. Notwithstanding the fact that SW does not typically offer multi-port arrangements, SW believes that the cost differences are such that an operator without legacy costs can offer a significant discount to the current operator's discounted tariffs, outweighing the totality of those discounts (see further below). In addition, international operators can also offer multi-port arrangements covering non-UK ports

Third, the OFT refers to a number of possible entry barriers including staggered contracts that would prevent non-UK operators from entering the market. The key inputs that an entrant would need are tugs and crew (both of which are readily available) a dock from which to run a tug operation (which is not dependent upon a significant IT system or other knowhow); and sponsorship from a port authority or a sufficiently large customer (or group of customers). As regards the nature of contracts, although contracts may typically be of a [•] year duration such that it may take several years for all the contracts at a port to individually come up for renewal, in many cases the contracts may be terminated on a relatively short period (on average [•] notice period).

Apart from the fact that it is unclear whether these barriers are insurmountable, these entry barriers would equally apply to the merging parties. As such, it cannot be concluded on this basis that the merging parties are the most likely entrants. If anything, these alleged entry barriers are lower for operators that do not have an established presence in the UK harbour towage ports since they do not have the legacy costs that the established UK operators have.

4.2 The most likely entrants are those who do not have the legacy costs of the established UK operators

The parties have argued that non-UK operators or newly established towage companies, as opposed to the parties, are the most likely entrants:

It is SW's view that SW and Adsteam are closest in terms of cost structure and that that fact is precisely why they cannot be regarded even as likely entrants, let alone the most likely. In fact they would be the most unlikely entrants. In short, each has higher unit costs due to legacy costs, which entail higher labour costs (higher salaries, inflexible working hours, pension costs). Labour costs represent more than [●] of total unit costs. Therefore, a non-UK entrant or a newly established company by virtue of its significantly lower unit costs would be able to be profitable on a lower number of tug jobs and with lower revenues than an established UK operator.

In addition, if either merging party were to seek to enter the port of another it would have to significantly reduce prices in order to attract business. The original operator would immediately respond resulting in losses for each. As the only opportunity for one to win would be to drive out the other in a relatively short period thereby allowing prices to rise to at least their previous level, this is not a likely scenario.

The consequences for the current operator of potentially successful entry are very severe, as recognised by the OFT in para. 76 - "[it may be that] *although the likelihood of a threat of entry into a port materialising is not very high, the impact it would have in case it does happen is so high that it is sufficient to constraint [sic] the parties' behaviour.*" Moreover, it may not be necessary for a new entrant to secure all the business of a port. It may be able to secure sufficient business to be profitable and this would inevitably render the remaining (i.e. the original operator's) business of that port unprofitable.

In response to these arguments, the OFT indicated in its decision that there was not sufficient evidence to reach a definitive conclusion. In particular, the OFT pointed out that there were not many examples of such entry in the UK, that customers did not refer to non-UK operators as likely entrants, and that there was no reference to such threat of entry in the parties' internal documents.

SW has shown, however, that the only recent examples of entry in the UK were from other operators than the merging parties.¹ Moreover, we have also referred to examples of entry outside the UK e.g., Kotug's successful entry in Hamburg and AMS' entry in Australia. In contrast, there is no example of entry by the merging parties.

¹ These entries were from low-cost operators in the Humber (SMS) and Port Talbot (West Coast Towing). For further details see the 21 June Briefing Paper, ss 6.18-6.19 and Annex 18.

Also the absence of actual entry does not preclude a credible threat of entry, let alone one that is more significant than that allegedly exercised by the parties. Moreover, such threats of entry invariably require (either explicitly or implicitly) the ability of the entrant to create cost savings over the current operator. For example, the [•] Port Authority's threat to SW in 1995, turned on its ability to bring in Bugsier, a low-cost German tug firm. Equally, when the car carriers previously threatened to displace SW, they used the threat of setting up their own operator. Such a new start-up would have none of the same legacy-cost problems as SW. The same conclusions can be drawn in [•], where the port users' group threatened to invite in another operator to displace SW. By definition, for the port users' group to have any incentive to carry out such a threat, it would have to achieve substantial cost savings. The parties could not provide such savings. Indeed, almost half the harbour customers that responded to the OFT said they would "*consider supporting a new entrant*" but only "*if they thought it would be financially viable*" (para. 44).

The threat of entry by non-UK operators or newly established towage companies is so widely accepted by the merging parties and other market participants, that in the ordinary course of business SW does not document this threat in any further detail. To the extent possible, SW has provided the OFT with examples.²

Finally, as regards the customers who identified the merging parties as the most likely entrants, as explained, most customers are in fact fully aware of the range and identity of potential entrants, as they also work with other operators outside the UK. As such, there is a range of potential entrants that customers can choose from. In previous instances of new entry, the entrant was not yet in operation, but was effectively created by customers. Moreover, until the actual decision is made to sponsor entry, there is no reason why customers or port authorities would undertake any selective analysis of this range of potential entrants.

5. CONCLUSION

In summary, SW believes that to the extent that there is some pricing competition, the parties are constrained by the threat of entry from new entrants without legacy costs and not from each other. This threat of entry will remain post-merger and as such the proposed merger does not result in a substantial lessening of competition.

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² See, in particular, the parties submission to the OFT of 22 August, Annexes 1-3.