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IN REPLY PLEASE QUOTE
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DATE
27 November 2006

DIRECT DIAL

BY E-MAIL AND COURIER

Edwin James
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

PRIVATE AND CONFIDENTIAL

Dear Edwin

SvitzerWijismuller A/S ("Svitzer") / Adsteam Marine Ltd ("Adsteam") Merger Inquiry

Further to your letter of 13 November 2006, I now enclose a non-confidential version of Svitzer's response to the Issues Statement of 6 November 2006. Please note that the annexes to Svitzer's response are confidential.

Please do not hesitate to contact me should you have any queries.

Yours sincerely



Richard Blewett

Enc.

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LIMITED LIABILITY PARTNERSHIP

NON-CONFIDENTIAL VERSION

**SVITZERWIJSMULLER A/S /ADSTEAM MARINE
LIMITED**

COMPETITION COMMISSION INQUIRY

RESPONSE TO ISSUES STATEMENT

1. INTRODUCTION

In this document, SvitzerWijismuller ("SW") responds to the Issues Statement, which the Competition Commission ("CC") circulated on 2 October 2006. Where appropriate, SW also comments on the CC's Draft Working Papers on Market Definition, Entry and the Counterfactual, although these papers also form the basis of separate SW responses. This document contains information which is confidential to SW and, where noted to that effect, confidential to Adsteam.

2. EXECUTIVE SUMMARY

2.1 Product and geographic markets

This transaction concerns the market for harbour towage, which consists of a series of geographically distinct "port by port" markets. The existence of such distinct geographic markets is demonstrated by a number of studies conducted by RBB, and described in Section 3 below. This analysis is also supported by the draft CC working paper on market definition.

2.2 No SLC in Liverpool

The proposed transaction will not lead to a substantial lessening of competition within Liverpool, because the increased efficiencies derived from the merger would allow SW's Liverpool operations [~~3~~] at existing price levels.

Moreover, there is no evidence that competition in Liverpool "spills over" into other UK ports, since customers have not been able to use the threat of switching towage suppliers within Liverpool in order to secure better terms elsewhere.

Finally, although the merged entity would be the sole operator in Liverpool post-merger, its ability post-merger to raise prices would be constrained by the same threat of entry from other operators that is described below. The constraint posed by the threat of entry will ensure that the transaction will not lead to an SLC in Liverpool.

2.3 No SLC in other UK ports

Given that the parties are active in different geographic markets, the only manner in which an SLC could hypothetically occur would be if prices were to be currently constrained by the threat of potential competition, and if the transaction were to significantly reduce the level of that threat.

So far as the ports where SW is the sole operator are concerned, SW does consider that potential competition in the form of a threat of entry acts as a competitive constraint in Tees and Avonmouth in particular. The threat of entry (and therefore the role played by potential competition) is lower in the smaller ports where SW operates. However, SW does not believe that the only (or even principal) threat of entry into Tees and Avonmouth comes from Adsteam, or that SW itself represents the only (or even

principal) threat of entry into Adsteam's ports. On the contrary, the evidence shows that:

- The merging parties are, if anything, less likely entrants into each other's ports due to their high legacy and other employment-related costs;
- Numerous other harbour towage operators have access to the main inputs and finance needed in order to enter UK ports;
- With the exception of the high cost base facing SW and Adsteam, all other entry barriers are equally high for all potential entrants (including the merging parties); and
- The parties possess no UK-specific advantages that give them a unique advantage over their rivals when seeking to enter a new UK port.

This analysis is also supported by the results of the CC's customer survey, which shows that customers view potential entry from North European operators and start-up companies as at least as credible as, if not more credible than, entry by the merging parties (In response to Question 14 and 15, 54% of all customers stated that they "agreed" or "strongly agreed" with the proposition that the threat of sponsoring entry of a towage operator other than the merging parties was an important source of bargaining power, whilst only 43% answered in the affirmative for the merging parties.)

In the light of this, SW does not believe that the transaction will result in a reduction in the level of competitive constraint posed by potential entry, and that therefore there is no basis for concluding there will be an SLC.

3. RELEVANT MARKET DEFINITION

In accordance with precedent and third-party analyst reports, SW submits that the relevant market is that of harbour towage on a port-by-port basis¹.

3.1 Relevant product market

There is clearly no demand or supply side substitution between harbour towage and salvage or ocean towage, which require entirely different tugs with much higher bollard-pull and different equipment. This appears to be in line with the CC's preliminary thinking, expressed at paragraph 13 of the draft working paper on market definition.

In terms of supply side, harbour towage can also be distinguished from owner terminal towage, as owner terminal contracts tend to be of long duration (10-25 years), are internationally tendered and generally stipulate that tugs employed at the terminal cannot be employed elsewhere for harbour towage work. An exception to this is the Shell Tranmere terminal contract at Liverpool (currently held by SW) which has a duration of [X] and which does not restrict SW's tugs to work at that terminal. In general however, there is little scope for towage operators at owner terminals to respond immediately to rises in harbour towage prices².

3.2 Relevant geographic market

Both market participants and third parties including various competition authorities view the geographic market for harbour towage as being port-by-port in nature, for example:

- The decision of the Dutch Competition Authority in *Svitzer/Wijsmuller*;
- The decision of the Federal Court of Australia in *Stirling Harbour Services Pty Ltd v Bunbury Port Authority* [2000] FCA 38:

"... all parties agreed that the relevant geographic market was that of the Port of Bunbury. There was no viable basis for substituting towage services in Fremantle or Albany for those in Bunbury."

- The position of the Australian Competition and Consumer Commission ("ACCC") in its 1995 Inquiry Into the Harbour Towage Declaration and in its submission to the 2002 Productivity Commission Inquiry:

"The market evidence in Australia points to a trend in single seller markets in harbour towage. The minimum number of tugs that service a port is largely determined by the size of the largest vessels that call at

¹ SW's tugs also provide occasional assistance to vessels by towing them from port to port in coastal waters. However, such activities are rare, accounting for less than [X] of SW's UK towage revenues.

² See also paragraph 25 of the CC's draft working paper on market definition.

the port. However, the proportion of large vessels that actually call at the port may be small. This contributes to low utilisation rates and high fixed capital costs for towage. With two towage operators in a port the low utilisation rates would be exacerbated. These factors point to the conclusion that harbour towage on a port basis is a natural monopoly and that with the exception of the port of Dampier, direct competition between towage companies in any port may not be sustainable in the longer term. It may result in the eventual business failure and exit of one of the firms" (Page 4 of the ACCC Submission to the Productivity Commission Inquiry)

- The New Zealand High Court case of Port Nelson Ltd v Commerce Commission [1996] 3 NZLR 554.

The CC's initial conclusions follow this precedent. The CC indicates that *"each port area is likely to be a separate geographic market."*³ These initial conclusions are further supported by detailed economic evidence, which supports each of the following points (see further Annex 1 (*RBB Economic Analysis*)):

- Each port is subject to distinct market conditions, which are not affected by other ports
- Customers do not switch ports in response to relative price changes of harbour towage; and
- Suppliers cannot easily switch between ports and provide harbour towage services on a multiple port basis.

Each of these points is addressed below:

3.2.1 *Each port is subject to distinct market conditions*

Prices are determined on a port-by-port basis. This is supported by PD Ports, the Tees port authority, in a recent survey of port services in the UK, found that⁴:

"As far as towage is concerned the historical tariffs of the former companies taken over by Adsteam or SW seem to have been maintained. These companies have not established nationwide charging rates."

The factors which affect demand and determine the nature and price of tug jobs are very port specific. In some ports, such as the Clyde, a tug job can take up to seven hours, whereas in others, such as Tees, the average tug job

³ See paragraph 40 of the draft working paper.

⁴ *"Port Services in the UK: Survey of Costs and Service Providers"* prepared by, in 2005. A copy was submitted to the Competition Commission on 13 October 2006.

takes less than two hours. Some ports have a relatively shallow approach (for example the Humber ports) meaning that there is a relatively narrow window of time either side of high tide within which larger vessels are able to enter or leave the port; others do not.

Prices are also affected by the costs incurred by the operator - for example, reflecting the degree of investment put into the fleet in a port and the impact of labour costs, including the crew structures and rotas.

Since the factors that determine prices vary substantially between different ports, there is substantial variation in pricing between different SW ports. As is explained in more detail below, pricing is not only determined by cost but also by the composition of customers -- all things equal, customers with larger volume requirements obtain larger discounts.

Figure 1: Price and cost comparison between different SW ports

[X]

In addition to the absolute pricing being different, there is also no parallelism over time as evidenced from the following graph:

Figure 2: Indexed average net prices for each port operated by SW, 2000-2006

[X]

Price increases in a given port have no impact on pricing in other ports, demonstrating that prices are determined by port-specific conditions, including historic background, levels of demand, customer composition and competitive constraints.

Likewise, profit margins are significantly different between ports and there is no apparent pattern or correlation that can be attributed to competition among ports or to demand side substitution, as is explained further below.

Figure 3: Comparison of profit margins

[X]

If the geographic market were to be wider than a single port, profits or margins would be more similar across different ports, as they would be subject to the same competitive constraint. This is clearly not the case here.

3.2.2 Demand side substitution (customer switching)

There is no or only negligible demand side substitution for harbour towage between different UK ports, and such substitution as does exist does not provide any appreciable competitive constraint.

There is no evidence of actual switching by customers between ports in order to obtain lower harbour towage charges; and there is no evidence that customers who may have an ability to switch ports obtain higher discounts or lower prices than those customers who are unable to switch ports (due, for example, to a customer having made a major infrastructure investment at a given port).

This lack of demand side substitution is due to the fact that harbour towage represents a very small proportion of total port costs (less than 5% of total port costs for container lines, car carriers and bulk carriers, which represent the majority of customers). Customers are therefore most unlikely to switch ports on the basis of changes to a charge, which represents such a minor part of their overall costs of port usage. The minor importance of harbour towage costs to customers in comparison to other port costs is demonstrated by a number of sources.

A recent study into UK port costs⁵ found that harbour towage costs represent only 3% of total port costs for container customers, for car carriers and bulk ships. That study concluded that *"the abolition of light dues is unlikely to have any impact on the routing of cargo and is unlikely to lead to a greater proportion of direct calls by deep sea container ships in the UK"*. According to this study, light dues represent a significantly higher proportion of port costs than towage. Depending on the type of vessel, the proportion of port costs represented by light dues varied from 4% to 22%. Hence, the study's conclusion should apply equally to harbour towage fees.

Figure 4: Harbour towage costs as a proportion of total costs

[X]

This evidence is also consistent with the submission made by the merging parties to the OFT, based on ECORY's Economic Evaluation Study on the Commission Proposal for a Directive on Market Access to Port Services, which demonstrates that within container ports, harbour towage costs represent less than 5% of total calling costs. Similarly, the Australian Department of Transport and Regional Services ("ADTRS") provides statistics on port-interface charges (including ship based charges such as towing, pilotage etc together with stevedoring, harbour dues etc) across a number of Australian ports. These show that towage costs represent 2-3% of port interface charges⁶.

⁵ Source: "Study of Economic Effects of Light Dues" by MDS Transmodal Limited in association with DTZ Pineda Consulting." Commissioned by the Department of Transport March 2004.

⁶ Page 9 of the ADTRS 2006 *Waterline* maritime statistics bulletin.

As such, even a hypothetical increase in harbour towage prices of 50% would result in an increase of total port costs of only 2.5%. Therefore, only if there were an excessive level of price increases would customers contemplate switching ports on the basis of harbour towage prices. This is consistent with the customer responses that the Competition Commission has received: there were only 4 customers (out of a total of 32) who said they would consider switching and (for all but one of these) even then only if prices would increase by an excessive amount (by more than 20%)⁷. In addition, customers' decisions as to whether to switch between ports are not only dependent on total ports costs, but also on the costs that they and their customers would incur because of higher sea and inland transportation costs or new investments in port facilities.

Moreover, any attempt to increase prices significantly above current levels would be undermined by (sponsored) entry initiated by customers or by customers in conjunction with the port authority; and therefore the question as to whether customers would switch if prices would increase by significantly more than 5-10% (the SSNIP test) is strictly theoretical. Customers would use the threat of entry by a new harbour towage operator before they would consider switching ports⁸.

There are no reported instances of SW customers switching to other UK ports because of harbour towage costs. Even though there is no evidence of actual customer switching due to changes in harbour towage prices, it could still be argued that the mere threat of switching by some customers would constrain pricing. The OFT indicated that container and car customers, who are statistically more prone to switch ports than bulk customers, appear to obtain larger discounts⁹. However, a thorough econometric analysis of extensive pricing data by customer shows that higher discounts are in fact accounted for by other factors, in particular volumes, rather than by the ability to switch. The table below shows that, dividing all of SW's customers into 10 deciles according to the volume of business, the higher the volume, the deeper the discount.

Figure 5: Discounts achieved by number of tug jobs over 2000-2006 split into deciles

[]

Moreover, if the threat of customers switching ports were to be a significant competitive constraint, one would expect to see higher profitability for

⁷ Paragraph 33 of the First Draft of the Working Paper on Market Definition (SW Version).

⁸ []

⁹ OFT decision, paragraph 36.

harbour towage operators in relatively isolated ports, from which customers could not easily switch. An analysis of SW's profitability indicates that this is not the case as can be seen from the last 3 columns that show margins by port based on different cost allocation.

Figure 6: Margin and price comparison across ports, SW 2005

[X]

This economic analysis and evidence is also consistent with the Competition Commission's preliminary views on switching; and SW's experience and recollection, as no customer has made a threat to switch ports in response to a price increase. Rather in those instances where SW sought a perceived unjustified price increase, customers threaten to sponsor entry by a new harbour towage operator into the port (see below under Section 4).

3.2.3 *Supply side substitution*

There is no or only negligible supply side substitution. For example, SW's two closest ports are Tyne and Tees (which are approximately 2 to 3 hours steaming time apart)¹⁰. Since 2004, there were only five instances of SW deploying a tug between Tyne and Tees to cover for maintenance or repairs (chartered tugs are also used for such purposes¹¹). As a general rule, harbour towage suppliers do not operate their services from multiple ports thereby sharing tugs, crew and other assets.

- Each port seeks to operate with a minimum number of tugs required to meet peak-demand (agreed with the port authority), which means that it is usually not possible to spare a tug to redeploy elsewhere since it would be missing in its port of origin;
- Demand is unpredictable in the short term, which makes it very difficult to plan operations across different ports (even if relatively closely related); and
- The average steaming time between SW and Adsteam ports means that harbour towage suppliers incur significant opportunity costs, as they would have no tugs in the port of origin for a day or more. Furthermore, bad weather (when demand increases for tug jobs) may prevent a tug sailing between ports.
- Moreover, the additional fuel and crew costs would render any such tug job unprofitable.

¹⁰ Except for Avonmouth and SE Wales which have historically formed part of the same port area (insofar as a single tariff applied across both ports).

¹¹ SW sometimes charters tugs from [X].

The analysis shows that there is no supply side substitution, which justifies a wider market than "port-by-port".

4. THE MERGING PARTIES ARE NOT THE MOST CREDIBLE POTENTIAL ENTRANTS

The existence of port-by-port markets means that there is no actual competition between the merging parties for harbour towage in the UK with the exception of Liverpool (which will be addressed separately in Section 5). This transaction this concerns primarily potential competition. In case of a merger between two potential rather than actual competitors, a substantial lessening of competition can only occur if:

- A threat of entry results in a significant competitive constraint on the merging parties; and
- There are no potential entrants, which are as credible as the merging parties.

There is evidence that demonstrates the threat of entry results in a significant competitive constraint especially in the large UK ports. Moreover, there clearly *are* existing potential entrants that will constrain the merged entity's behaviour post-merger. As is explained in detail below, the evidence available indicates that there are numerous potential entrants who are at least as credible as the merging parties. The merging parties have no advantage over other potential entrants and other potential entrants are therefore equally credible. If anything, the merging parties have a cost disadvantage, which makes them less likely potential entrants.

For this reason, the proposed merger clearly does not alter the existing threat of entry. There will therefore be no substantial lessening of competition due to an elimination of potential competition.

The existence of numerous other credible entrants (especially international operators and start-up companies) is consistent with the following:

- The main inputs *e.g.*, tugs, crew required to enter a harbour towage market are equally accessible to all potential entrants. All entrants incur the same costs except for the merging parties who have a labour cost disadvantage due to their legacy position in the UK. As such the merging parties are not better placed to enter another UK market;
- Entry barriers are the same for all potential entrants. In particular, all entrants require a sufficient scale to enter a market, which limits the number of UK ports a "cherry picking" strategy is viable; and the reaction of the incumbent operator has a similar, if not identical, impact on all entrants.
- There are no appreciable UK or region-specific competitive advantages that would confer an advantage upon the merging parties when entering UK ports. This is *inter alia* evident from the fact that entrants (or existing operators) do not require a regional presence to operate profitably, UK customers approach both UK and non-

UK operators to enter the market and do not seem to have a preference for the merging parties, as they deem other potential entrants at least equally credible.

4.1 The main requirements for entry are equally available to all potential entrants

The inputs required to enter any harbour towage market are tugs, crew, supporting assets, reputation and track record and finance. The most important inputs are tugs and crew, as these not only represent the largest proportion of total costs but also have the most significant impact on the credibility of a harbour towage service.

All potential entrants have equal access to these inputs and finance, which are required to enter any UK port. No potential entrant (including the merging parties) has special or privileged access to any of these inputs that would confer a significant competitive advantage as an entrant. If anything, the merging parties have a cost disadvantage due to their legacy position in the UK. This means that all potential entrants are equally capable of providing a credible harbour towage service, as the credibility of a service is determined by these inputs.

4.1.1 Tugs

Tugs have a long economic life, which is also evident from the average age of SW's fleet (the "youngest" tugs are a few months' old whilst the "oldest" tug in SWs fleet is 36 years). Therefore, tugs keep their relative value over a long period and hence there is a market for second-hand tugs.¹² Since tugs are usually sold in relatively low volumes there is no significant cost advantage for an established operator vis-à-vis start-up companies. The purchase price or cost of tugs does not vary significantly according to the number of tugs purchased; and in any event, since these costs are written off over a long period, any advantage becomes negligible on an annual basis. In addition, there are a number of sources of second hand tugs. As regards the time required to obtain either new or second-hand tugs, established operators do not have an advantage here either. It is also possible for new entrants to charter tugs (with or without crew, on a short or long term basis), which is facilitated by the ship brokering industry. For example, in response to an e-mail request by SW, Offshore Shipbrokers replies as follows:¹³

"...We can confirm that in our experience there are modern ASD tugs of around 40/60 tons bollard pull regularly available for time charter Northern Europe on very short notice. Currently tugs from this size can be usually sourced from Fairplay, Unterweser, Bugsier, SMS, Kotug, Stevns Ocean, Ostenjoe and JP Knight."

¹² Moreover, technological developments in relation to tugs are such that tugs do not become quickly outdated. Existing tugs can also be upgraded with new features. For example, the installation of a retractable thrusters beneath the bow can significantly increase the bollard pull.

¹³ [X]

4.1.2 Crew

Crew costs represent a substantial proportion of total costs and as such any advantage in terms of crew costs has a significant impact on any entrant's competitive position. An entrant would need a crew, which typically consists of a tug master, an engineer and a third-hand. Whilst there is a large supply of third-hands and engineers -- also from non-UK countries, in particular Eastern European countries. For example, SW believes that SMS operates with a mixed Polish/British crew, qualified tug masters may be more difficult to obtain but this applies to all potential entrants; and Kotug typically enters with a crew that largely consists of Eastern European workers (see Annex 2 (*Analysis of International Entry*)), which also illustrates that the recent enlargement of the EU has also created a larger pool of available labour.

The Competition Commission suggested in its Working Paper on Entry that SW might have an advantage over other potential entrants in terms of crew availability, as it can use its existing crew to enter new ports. This, however, is incorrect: SW typically operates with a minimum number of crew and has no "idle" crew (on a more permanent basis). Moreover, SW cannot relocate employees, as it deems necessary, as its labour contracts do not cater for such permanent relocation of crew.

[X]¹⁴

The customer survey and third party statements available do not suggest that SW has any advantage in terms of access to, or cost of crew. On the contrary, none of these explicitly contradict the cost disadvantage that SW has over other potential entrants.

4.1.3 Supporting assets

The only support that a harbour towage operation would require would be an office. There is no need for extensive IT support or marketing support. For example, Ostensjo runs its Fawley terminal operation from Norway without the need for a UK office. Likewise, no significant marketing is required to support a sizeable operation, which is evident from the proportion of total costs that SW's marketing and promotion efforts represent (on average, less than 0.5% of SW's revenues in each of the last 3 years). The insignificance of these supporting assets implies that no potential entrant can achieve a significant competitive advantage over another.

4.1.4 Reputation and track-record

As regards international operators, their track record and reputation is identical to that of the merging parties. Most, if not all, UK customers conduct business with many different harbour towage operators on a worldwide basis and can therefore choose from a large number of potential entrants with established track-records.¹⁵

¹⁴ [X]

¹⁵ For example, MSC calls at over 28 major ports worldwide, of which only six are serviced by SW or Adsteam. Likewise, Hanjin calls at 51 major ports worldwide, of which only four are serviced by SW or Adsteam.

Newly established companies do not necessarily lack prior experience. Management and employees provide newly established companies with a track record and relationships in harbour towage. For example, a former employee of Adsteam set up SMS whilst the owner of AMS (a start-up company in Australia) previously owned a stevedoring company and also had extensive relationships with Chinese maritime companies. As is evident from SMS' entry in the Humber, successful entry does not require all customers to consider the new entrant to be credible; if only a small proportion of customers deem the new entrant credible, the impact on the incumbent's profitability would be substantial.

The results of the Competition Commission's customer survey also show that new start-up companies do not face any tangible disadvantage vis-à-vis established companies: only 3 out of 14 submissions draw a distinction between the two types of entrants. Respondents to the large customer questionnaire mentioned continental European operators as well as SMS as potential entrants.

4.1.5 Finance

Any entrant has access to either internal or external finance. There is no appreciable difference in terms of the cost of capital of internal or external finance. For example, SW often obtains external finance to purchase new tugs. SMS recently obtained finance from NatWest to purchase new tugs. Any entrant has a choice to either purchase or charter new tugs. For example, SMS has entered with chartered tugs. Furthermore, an entrant can charter tugs on a temporary basis *e.g.*, AMS' entry in Australia (for further details see Annex 2 (*Analysis of International Entry*)). Therefore, finance is available to all potential entrants and does not have any impact on the credibility of potential entrants.

4.2 **Entry barriers are the same for all potential entrants**

4.2.1 The impact of entry on the incumbent's profitability is substantial irrespective of the type of entrant or entry strategy

SW believes that entry barriers are relatively manageable and that there is, therefore, competition given the threat of entry:

- First, the investments or assets required are not substantial (see above) and for a large part not sunk.
- Second, the impact of entry is substantial, as even a small loss of volume would result in a substantial decrease of profitability due to the high-fixed cost nature of the harbour towage business; and

- Third, customers (and under certain circumstances port authorities) can easily support or sponsor entry due to their knowledge of the harbour towage industries and the various harbour towage operators.¹⁶

The impact that entry has is very substantial, as is further demonstrated in the table below. The table show the impact of volume loss on SW's profitability in each of the ports. It represents a best-case scenario, as prices are assumed to be the same, which is unlikely in the event of entry:

Figure 7: Effects of loss of volume on SW's profitability at current fleet size, 2005

[X]

Source: Data from SW, RBB computations

This impact on profitability due to volume loss would be the same regardless of the type of entrant, or strategy that an entrant follows. As such, from an incumbent operator's perspective, there is no difference between a newly established company (such as SMS) or an established operator. What matters is whether the entrant is capable of capturing sales from the incumbent, as this determines the likelihood of the threat of entry.

Scale economies also affect the likelihood of entry and can therefore also be viewed as an entry barrier. Other entry barriers may arise from the port-specific knowledge that an incumbent operator has and an incumbent's reaction to entry, but these possible entry barriers affect all potential entrants including, therefore, the merging parties. This may be different in relation to scale economies, as potential entrants other than the merging parties could more easily enter with a lower cost-base.

4.2.2 Scale economies

The level of entry barriers varies by port and is determined by the size of the harbour towage business and the number of large customers. All things being equal, larger ports (with larger customers) seem to be subject to lower entry barriers than small ports (with smaller customers) where the threat of entry does not appear as significant, which is also consistent with the following evidence:

- To the extent that requests or approaches are made to potential entrants, these requests typically relate to the large UK ports; and

¹⁶ The CC indicates that some customers may be concerned about the negative reaction that sponsored entry in larger ports may cause in smaller ports where the incumbent operator is the only operator. There was no reference to this concern in the Competition Commission's customer survey; and as regards the third-party statements, only operator "A", who considers itself a credible entrant for UK ports, mentioned this point. More importantly, even if such concerns were well founded, these would equally apply to sponsored entry by either merging party in the UK e.g., if a customer invites Adsteam to enter a SW port, SW could also "punish" this customer in a port where it is the sole operator.

- Most entry examples concern entry in ports that can sustain more than one operator; and most ports cannot sustain more than one operator, as also noted by the ACCC in its Productivity Report:

*"There is some suggestion that economies of scale for a (minimum) tug fleet (and one operator) could be exhausted at around 8000 tug-jobs per year. This need not imply, however, that two operators would be efficient at this scale of operation - returns to scale may not decrease until much higher volumes are reached. The Port of Singapore, with 84 000 tug-jobs per year, has issued six licences, equivalent to 14 000 tug-jobs per licence."*¹⁷

- Moreover, operators "A" and "Z" who both made submissions to the Competition Commission indicated that they would not consider entry in smaller ports.

In larger ports, there is sufficient volume to sustain a "cherry-picking" strategy whilst in smaller ports a displacement of the incumbent is likely to be the only viable strategy. Such displacement is less likely to occur than "cherry picking" and potential competition therefore seems lower in these ports. This is not to say that entry is not feasible and that there is no threat of entry in these smaller ports, entry in smaller ports would only occur if there would be "complete" displacement, which requires coordination among all customers and the port authority.

As regards larger ports, the merging parties are not more credible than other potential entrants. If anything, the merging parties seem less credible as they are unlikely to enter on a low-cost basis.

RBB has analysed the viability of a "cherry picking" strategy on the basis of an entrant with a high-cost and low-cost model. Under both cases, RBB has determined the likely break-even point (see further details Annex 1 (*RBB Economic Analysis*)):

- The high-cost model is based on the current cost structure of SW. Therefore, SW has analysed whether entry into SW ports would be viable if the entrant had the same cost base as SW, which is similar to that of Adsteam;
- SW believes that this an unrealistic assumption since the entrant could enter with a lower cost base, as it does not incur the same legacy costs as the incumbent. Moreover, most entrants could do so without risking a negative reaction of their workforce in other ports whilst the merging parties would face such a risk, which could have a substantial impact on their operations (see further below);
- The low-cost model is based on the entry model that SW would employ under ideal circumstances if SW were not concerned by the likely repercussions that such a low-cost model may trigger in the UK ports where it is currently present.

¹⁷ See Australian Productivity Commission, Report on Economic Regulation of Harbour Towing, 2002.

Therefore, the low-cost entry model is a hypothetical and other potential entrants could either operate with a lower or higher cost base. The objective of the analysis is not to provide a precise estimate of the cost differential but to show whether a cost differential has a significant impact on the viability of entry strategies.

The results of the break-even analysis show that:

- Even with a low-cost base, a "cherry picking" strategy would only be viable in the following ports [X]; and less likely in [X]. As such, all potential entrants including Adsteam are less likely to enter [X].
- A low-cost base enables the entrant to enter on a smaller scale than an entrant with a high-cost base. Therefore, an entrant with a low-cost base would require a smaller scale and fewer customers to profitably enter a market. More importantly, a low-cost base would enable the entrant to sustain much lower prices post-entry, as is also evident from SMS' prices, which are believed to be 20%-30% lower than Adsteam's prices.

The results of this analysis also appear to be consistent with statements made by third parties to the Competition Commission. There seems consensus that entry is less likely to occur in the small UK ports and that entry is a source of significant potential competition in the large UK ports. As regards the scale that is required to enter, there are a number of factors that influence whether an entrant would require a smaller or larger scale than strictly required to break-even. In particular, the level of support or guarantee that operators obtain from customers is important:

"The failure of Kotug to enter the Antwerp market in 1996 provides additional evidence of the extent of buyer power. Whilst many customers welcomed the prospects of Kotug's market entrance and the resulting price war, they were reluctant to support the new venture once the incumbent firm, Union de Remorquage et de Sauvetage S.A. (URS) had responded by reducing its tariff rates. Kotug president, Ton Kooren, was quoted as being: "... deeply disappointed in certain shipowners who instigated our Antwerp project but who were finally not prepared to stand behind us."¹⁸

Likewise, the prospect of obtaining further volume or customers following entry e.g., presence of spot customers also affects the viability of entry.

Moreover, some entrants may be willing to accept a higher risk (or lower return). For example, Operator A indicated that it would consider entry in large UK ports if it could obtain a market share of at least 25%, which is substantially lower than the market share required to break-even (even under a low-cost model), as the following table shows:

¹⁸ Rod Atkin and Merv Rowlinson, Competition in ship handling: a study of market turbulence in North European harbour towage - Citing: Kotug stands bloodied - but unbowed, Lloyds List, 11 October 1996

Figure 8: Comparison of estimated market shares of total volume large customers (> [X]) required to break-even (at current prices¹⁹)

[X]

In sum, all potential entrants are less likely to enter the small UK ports. Any scale advantage that an entrant may have does not change the number of ports for which a "cherry picking" strategy is viable. And even though some entrants may have an advantage over others, as they may require a smaller scale (and fewer customers) to enter, the threat of entry is essentially the same, as they can all profitably enter the larger UK ports. Potential entrants other than the merging parties could more easily enter with a low-cost base, which allows them to break-even with fewer customers and lower prices.

4.3 No regional or UK specific competitive advantages

4.3.1 No regional presence required for profitable entry or presence

The viability of start-up companies in the UK and elsewhere *e.g.*, SMS in the UK, AMS in Australia, and the presence of international operators show that success (and therefore the threat of entry) is not determined by local or regional factors. Many operators can operate profitably although they do not have operations in nearby ports, which is illustrated in the analysis of International Harbour Towage Operators, attached to this document at Annex 3 (*Overview of International Operators*). The following are good examples:

- SMIT, which currently only has one harbour towage operation in South America, namely in La Plata, Argentina; and is due to begin a joint venture in Rio de Janeiro, Brazil, in 2007 using just 3 harbour towage tugs;
- PSA Marine, which operates primarily in the Far East and Australia but which has announced its intention to consider operations in the port of Antwerp, Holland, later this year;
- Hong Kong Towage and Salvage, which provides harbour towage services with three tugs in Cilegon, Indonesia, despite the fact that its nearest alternative harbour towage operation is in Hong Kong;
- Grupo Boluda which, despite having a main focus along the South coast of Spain, has expanded to Mexico, Panama and Venezuela;
- Les Abeilles which, despite focussing its harbour towage operations around the coast of France, also services several widely dispersed ports in African countries, in particular Senegal, the Ivory Coast and Cameroon;

¹⁹ Please note that the market shares required to break-even will increase if prices decrease post-entry as is likely to be the case. [X]

- The Gesmar Group, which provides harbour towage services in Venezuela, despite its main operations falling along the East coast of Italy;
- Multraship, the Netherlands operator, which recently acquired Bourgas Tugs in order to enter Bulgaria; and
- Kotug, which operates in the Netherlands and recently entered the German ports of Hamburg and Bremerhaven. Kotug also entered the port of Le Havre in the past year.

As such, if international operators can credibly enter ports in different countries or regions, what is the basis for arguing that they cannot do so in any large UK port? For example, Kotug successfully entered German ports (Hamburg and Bremerhaven) even though it had no prior presence in Germany, and Fairplay (in response) entered the port of Rotterdam where it is now an established player. Likewise, SMS entered one of the largest ports in the UK even though it had no prior presence in the UK or elsewhere.

4.3.2 Port-specific advantages in one port cannot be transferred to other UK ports

There are port-specific advantages *e.g.*, knowledge of local port conditions, local experience and track record, relationships with PAs and other port users etc. These port-specific advantages may give the merging parties as incumbent operators a slight advantage when defending against rival entry, but they do not afford the merging parties a competitive advantage when seeking to enter a new port: as potential entrants the merging parties are equally disadvantaged by these local factors.

The absence of UK-specific advantages is also confirmed by the Competition Commission's customer survey: none of the customers identified a UK specific advantage that would make the merging parties the most credible entrants. As regards other third parties, the statements so far published only include one port user group, which identified "advantages" including knowledge of English and an "understanding of how companies operate if they can see them work." Given these non-significant advantages, this port user group ultimately acknowledged that it would also consider non-UK operators.

4.3.3 No competitive advantage due to UK multi-port agreements

In relation to multi-port discounts, SW does not view the ability to provide customers with multi-port discounts as a competitive advantage. On the demand side, SW uses multi-port arrangements very rarely. [X] As such, there are no appreciable "one-stop shop" advantages, or other efficiencies for customers who deal with operators with a presence at multiple ports. Indeed, there is no systematic difference between discounts for customers using several ports and for those that call at only one port. Furthermore, international operators could easily replicate this alleged advantage. Operators such as, *i.e.*, SMIT, Kotug, or Fairplay are active in strategically important ports, which account for much larger volumes than UK ports. Arguably, it would be more difficult

for start-up companies to offer multi-port discounts, as they would be less likely to be present in more than one port, at least for an initial period. However, this potential disadvantage is by far outweighed by the increased discount that such companies are able to offer in their port of operation. [X]

4.3.4 Actual entry and approaches to enter the UK do not suggest that the merging parties are the most credible entrants

The threat of entry is a credible and constant constraint. As also acknowledged by the OFT in paragraph 76 of its decision: "*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 constrain the parties' behaviour*". Therefore, actual entry does not need to occur, as the *threat* of entry is sufficient to constrain the behaviour of the incumbent operator. This is also evident from the following instance:

*"Earlier this year, [the Antwerp incumbent] URS lowered its towage rates by an average 16%. It was under strong pressure to reduce rates after Dutch tug operator Kooren (Kotug) threatened to enter the market in Antwerp with rock-bottom rates; a move it has successfully made at Rotterdam and Hamburg."*²⁰

Therefore, the fact that there have only been four new entrants in the UK over the last 10-15 years is not informative of the threat of entry that comes from non-UK operators and start-up companies.

The threat of entry is constant. It is only when the incumbent operator seeks to secure unjustified price increases or service deteriorates markedly that the prospect of entry becomes concrete. The likelihood of any potential rival entering a UK port depends largely on the performance of the incumbent operators. Therefore, potential entrants are unlikely to consider entry in concrete terms until they have been approached by customers and have received a request that represents the basis for a viable business case.

Nonetheless, SW understands that some international operators are considering entry in the UK in the foreseeable future. This is clear from the persistent rumours regarding entry by Kotug and the statement made to the CC by operator ("A"): "*A is interested in entering into selected UK ports within the next five years.*"²¹

Not surprisingly, customers occasionally contact potential entrants including the merging parties to see if they would be willing to enter a port, and if so on what terms and what level of service they would offer. However, many approaches appear to be a form of "market testing", rather than serious attempts to sponsor entry; and in many

²⁰ Lloyd's List, October 16, 1996, Special Report on Belgium: Antwerp making the effort to lower ship costs.

²¹ Summary of hearing with harbour towage operator "A"; questions on A's interest in the UK.

instances the potential entrant concludes that there is no viable business case for entry. Often customers have unreasonable expectations as to what the potential entrant can offer to outperform the incumbent significantly.

SW has been approached to enter UK ports but none of these approaches resulted in viable business cases (see further below Section 7 The Counter-Factual). Furthermore, customers also approach other potential entrants as is evident. For example:

- Operator "A" states that some of its international customers have approached "A" to enter the UK;
- The CC's customer survey indicates that customers invited not only Adsteam and SW, but also operators from continental Europe (and possibly start-up companies). Moreover, there is nothing to suggest that the customers that have approached Adsteam or SW in the past would *not* consider other entrants *e.g.*, other European operators post-merger.

It is clear that incumbents are typically not informed of such contacts or approaches and are therefore left in the dark as to which potential entrants are considering entry (in more concrete terms). Furthermore, the evidence shows that UK customers also approach potential entrants other than the merging parties on an informal or more formal basis by UK customers. Thus, the history of entry and approaches to enter in the UK do not support a finding that SW is a more likely entrant than other potential entrants.

4.3.5 Conclusion

The above analysis shows that SW is not a more credible potential entrant than other international operators or start-up companies. Moreover, SW appears to be a less likely entrant, as it is more limited in its entry strategies due to its legacy position in the UK. But even without this disadvantage, other potential entrants are at least as credible as either merging party, as is also clearly demonstrated by the Competition Commission's own market investigation:

- **Third party statements (so far published):** no third parties have indicated that there are no other potential entrants than the merging parties. Some respondents indicate that North European operators are more likely entrants but none dismiss the credibility of start-up companies. As noted, operator "A" explicitly states that it is interested in entering UK ports, and ZIM (container line) states that: *"it will do all in its power to encourage other operators to move into the UK market"*. Likewise, THPUA (port user group in Tees) would consider inviting operators based in Rotterdam and Antwerp. Likewise, ABP and MDHC, which are port authorities in the UK, confirmed that they would support customers if they wished to invite a European entrant.
- **Customer survey:** The results of the CC's Customer Survey clearly show that customers view potential entry from North European operators and start-up

companies as being at least as credible as, if not more credible than the merging parties. In response to Question 14 and 15, 54% of all customers stated that they "agreed" or "strongly agreed" with the proposition that the threat of sponsoring entry of a towage operator *other* than the merging parties was an important source of bargaining power (and only 17% disagreed) whilst only 43% answered in the affirmative for the merging parties (with 29% disagreeing). 49% viewed start-up operations as a credible threat (with 17% disagreeing). The customers identified the following international operators: SMS, Kotug, SMIT, Targe Towing, Solent Towage, and Fairplay. Moreover, those customers that had approached the merging parties in the past did not suggest that they would not consider other potential entrants post-merger (other operators or start-up companies).

5. NO SUBSTANTIAL LESSENING OF COMPETITION DUE TO REDUCTION FROM "2-TO-1" IN LIVERPOOL

The proposed transaction will not lead to a substantial lessening of competition within Liverpool because the increased efficiencies derived from the merger would allow SW's Liverpool operations [§<] at existing price levels. The merged entity's ability to raise prices would be constrained by the same threat of low cost entry that constrains SW's operations in the other UK ports in which it operates. Moreover, there is no evidence to suggest that customers have been able to use the threat of switching towage suppliers within Liverpool in order to secure better terms elsewhere - in other words, there are no spill over effects such that the loss of direct competition within Liverpool might have a material impact in any other UK ports in which SW or Adsteam are present.

5.1 [§<]

5.2 The proposed transaction will lead to increased efficiencies

Including the Shell Trammere owner terminal business, in 2005 SW and Adsteam performed similar numbers of tug jobs in Liverpool²², operating 11 tugs between them (6 Adsteam tugs and 5 SW tugs). Note that under normal circumstances, SW's Liverpool fleet is also 6 tugs (2 of which, including the escort tug Svitzer Stanlow are effectively dedicated to the Shell Trammere terminal, the rest doing harbour towage work). However, in late 2005, [§<]. This shortfall has led to SW having to charter Adsteam tugs at times of peak demand at an estimated cost of [§<]. Any decision on whether to increase the SW fleet back to 6 tugs is on hold pending the outcome of the present inquiry.

SW's and Adsteam's tugs are operated as separate fleets servicing different customer bases both inside and outside the locks. This is inefficient as it means the tugs cannot be placed to ensure maximum utilisation. [§<] This was the conclusion of SW's

²² [§<]

analysis of the Project Irish proposal²³ and is also confirmed by the following cost analysis:

[REDACTED]

5.3 The merged entity will be subject to constraint

Following the proposed transaction, SW will be subject to the same degree of constraint in Liverpool that it is currently subject to elsewhere in the UK. Indeed, the threat of entry in Liverpool will be enhanced as a result of the merger, as it is unlikely that a potential entrant would commence operations in a port the size of Liverpool where there are already two operators.

In addition, the port authority in Liverpool has already demonstrated a willingness to consider alternative towage suppliers - for example, [REDACTED]. In this context, it should also be noted that Peel Holdings, the entity which owns the Mersey Docks and Harbour Company (the Liverpool port authority), together with the Manchester Ship Canal and port authorities in Greenock and on the Medway, already has a number of tugs which operate on the Manchester ship canal. As a result, Peel Holdings would be no stranger to self-supply towage services in Liverpool if it felt that the merged entity did not provide an adequate service at a competitive level.

5.4 Customer benefits

SW has invested in new tugs in Liverpool in recent years, partly in order to secure the extension of the owner terminal contract with Shell at Tranmere and partly to attract business from Adsteam, which has a less modern tug fleet. However, insofar as it was aimed at attracting new business, this strategy has not been successful - evidenced by the fact SW has not been able to win any new business from Adsteam as a result of the introduction of new tugs into Liverpool²⁴. [REDACTED] Adsteam on the other hand have not made any significant investments in tugs in Liverpool recently.

As a result of the proposed transaction, the merged entity would be profitable and would therefore have a greater incentive to invest in new tugs.

5.5 No spill over effect

Finally, the immediate loss of direct competition in Liverpool will not have any impact in other ports elsewhere. There is no evidence to suggest that customers are currently able to secure a better deal outside Liverpool by threatening to switch any business they might have in Liverpool to Adsteam. SW is not aware of any such threat ever having been made.

²³ [REDACTED]

²⁴ [REDACTED]

This is confirmed by a comparison of the average level of discounts in ports outside Liverpool achieved by customers who also stop at Liverpool against those that do not. If customers using Liverpool were able to use the threat of switching to Adsteam in order to secure better terms elsewhere, we would expect to see that these customers would on average have higher discounts than customers who do not call at Liverpool. In fact the opposite is true - across all SW ports, the average discount negotiated by customers who do not also stop at Liverpool is [X] % higher than for those that do. This strongly suggests that customers are not able to use the threat of switching to Adsteam as leverage to secure better terms elsewhere.

Figure 10: Discount comparison of customers who do and do not use Liverpool

Comparison of discounts by contracted customers who do and do not use Liverpool: by port since 2000

[X]

Source: SW data, RBB computations.

Moreover, there is only one instance of SW giving a discount in a port outside Liverpool linked to that customer's business within Liverpool and that is in the case of [X].

6. NO SUBSTANTIAL LESSENING OF COMPETITION DUE TO VERTICAL FORECLOSURE

The proposed transaction results in a vertical overlap between Adsteam's harbour towage business and the shipping business of SW's parent company, AP Moller-Maersk A/S ("APMM"). APMM has activities in container shipping and oil tankers through its subsidiaries Maersk Line, Safmarine, Maersk Oil, Maersk Tankers and P&O Nedlloyd.

Some customers (who are also rivals of Maersk) have expressed concerns that post-merger, Maersk would obtain better prices or service levels, which would put them at a disadvantage.

The reasons why the merger will not result in foreclosure of rival shipping lines through lower service levels or higher prices are the following:

First, the merged entity cannot arbitrarily refuse or delay towage service to rivals of its parent company. The reality of the situation is that the Port Authority, by means of the dock tower and the vessel traffic service, dictates the order and timing of ship tows. SW has no control over the timetable for harbour towage, which is controlled exclusively by the Port Authority. Likewise, SW cannot delay a harbour towage service or otherwise decrease the level of service to rivals of Maersk. Therefore, the allegation made by some third parties that SW could do so post-merger has no factual basis whatsoever.

Second, harbour towage costs represent less than 5% on average of total port costs and total port costs only represent an insignificant proportion of total shipping costs. The impact that a change in harbour towage prices has on the profitability of shipping lines is therefore insignificant. Even if hypothetically speaking, the merged entity were to raise prices by 50% post-merger for Maersk's rivals, the impact on these rivals' profitability would be minimal. It would be irrational for SW to increase its tariffs (which apply to all users) in order to put Maersk's container business competitors at a disadvantage. Furthermore, any attempt to increase prices substantially would be undermined by the threat of (sponsored) entry that would have a severe impact on SW's profitability. Therefore, such a hypothetical foreclosure strategy through price discrimination would not have any positive impact on either SW's or Maersk's profitability.

Third, the fact that such a price discrimination strategy is not in SW's interest is also confirmed by the absence of higher discounts (or lower prices) for Maersk in SW ports. [X]

Therefore, there is no evidence to suggest that SW favours Maersk; or that Maersk favours SW when deciding which harbour towage operator to use.

7. THE COUNTER-FACTUAL

It is SW's intention to seek to grow its global harbour towage business in order to provide a counter balance to the more cyclical container and oil related business of the wider APMM Group. As there is limited scope for organic growth (except through increases in the level of sea-borne trade), this necessarily involves SW looking at further acquisitions. These will not necessarily be UK-specific and are likely to involve consideration of established operations.

This means that absent the merger, there is, with the potential exception of Liverpool, unlikely to be any significant change in the provision of harbour towage services, in the UK as a whole. Looking specifically at each of the ports discussed in the draft CC Counterfactual Working Paper the position is as follows:

Liverpool

[X]

If the proposed transaction were to proceed, the merged entity's operations in Liverpool would be profitable at existing price levels and would therefore have greater incentive to invest in new tugs. This would not be the case absent the merger.

Felixstowe

[X]

[X]

Figure 11: Table showing at what level cherry-picking entry with low costs becomes profitable for the Port of Felixstowe

[X]

Source: SW data, RBB computations.

Humber

SW does not believe the proposed transaction would have a significant impact on the provision of harbour towage services in the Humber (other than to remove SW as a potential purchaser of SMS). Absent the merger, SW would expect the competitive situation to remain unchanged. [X]

SW expects that SMS's Humber operations will continue to expand, regardless of the outcome of the present inquiry.

8. NO SUBSTANTIAL LESSENING OF COMPETITION

8.1 No SLC in Liverpool

The proposed transaction will not lead to a substantial lessening of competition within Liverpool, because the increased efficiencies derived from the merger would allow SW's Liverpool operations [X] at existing price levels. This position was explained in more detail in SW's stand-alone paper of 5 October 2006 in relation to the impact of the proposed transaction on competition in Liverpool, as well as Sections 5.1 and 5.2, above.

Moreover, there is no evidence that competition in Liverpool "spills over" into other UK ports, since customers have not been able to use the threat of switching towage suppliers within Liverpool in order to secure better terms elsewhere. This is discussed in Section 5.5, above.

Furthermore, although the merged entity would be the sole operator in Liverpool post-merger, its ability post-merger to raise prices would be constrained by the same threat of entry from other operators that is described above. The constraint posed by the threat of entry will ensure that the transaction will not lead to an SLC in Liverpool. This point is discussed in more detail at Section 5.3, above.

8.2 No SLC in other UK ports

Given that the parties are active in different geographic markets, the only manner in which an SLC could hypothetically occur would be if prices were to be currently constrained by the threat of potential competition, and if the transaction were to significantly reduce the level of that threat.

So far as the ports where SW is the sole operator are concerned, SW considers that potential competition in the form of a threat of entry acts as a competitive constraint, [X]. The threat of entry (and therefore the role played by potential competition) is

lower in the smaller ports where SW operates. However, as discussed in Section 3 above, SW does not believe that the only (or even principal) threat of entry into [X] comes from Adsteam, or that SW itself represents the only (or even principal) threat of entry into Adsteam's ports. On the contrary, the evidence shows that:

- The merging parties are, if anything, less likely entrants into each other's ports due to their high legacy and other employment-related costs;
- Numerous other harbour towage operators have access to the main inputs and finance needed in order to enter UK ports;
- With the exception of the high cost base facing SW and Adsteam, all other entry barriers are equally high for all potential entrants (including the merging parties); and
- The parties possess no UK-specific advantages that give them a unique advantage over their rivals when seeking to enter a new UK port.

This analysis is also supported by the results of the CC's customer survey, which shows that customers view potential entry from North European operators and start-up companies as at least as credible as, if not more credible than, entry by the merging parties. A more detailed discussion was presented in Section 4.3.5, above.

In the light of these facts, SW does not believe that the transaction will result in a reduction in the level of competitive constraint posed by potential entry, and that therefore there is no basis for concluding there will be an SLC.