

2 Conclusions

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The reference

2.1. The Secretary of State for Trade and Industry made a reference to us under the merger provisions of the Fair Trading Act 1973 (the Act) concerning a proposed joint venture between Stena and P&O. The full terms of reference are at Appendix 1.1. The Department of Trade and Industry press notice stated that the joint venture had been referred because of competition concerns in respect of the market for Channel crossings.

The companies

Stena

2.2. Stena was incorporated in Sweden in 1962. The company's largest shareholder, with 45.7 per cent of shares, is Stena AB which is one of a group of three companies wholly owned by the Sten Allan Olsson family. The world-wide business interests of the three companies include ferries, offshore contracting for the oil and gas industry, shipping, drilling, property, finance and metals.

2.3. Stena's ferry operations began between Sweden and Denmark in 1962. In the early 1980s it acquired the Scandinavian ferry companies Sessanlinjen AB and Lion Ferry AB. In 1989 it took over a Dutch ferry operator, now known as Stena Line Holland BV (Stena BV), and it acquired Sealink British Ferries Ltd (Sealink) from Sea Containers Ltd (Sea Containers) in 1990. The company now operates a fleet of around 35 ferries on 15 routes in four business areas: the Kattegat, Skagerrak, English Channel (including a Harwich-Hook of Holland service) and Irish Sea. It also wholly owns harbours at Harwich, Holyhead and Stranraer and has a 50 per cent share in the harbour at Fishguard. Services from Great Britain to the Republic of Ireland, Northern Ireland and the Continent, with the exception of the Harwich-Hook of Holland service, are operated by Stena's subsidiary Stena Line (UK) Limited.

2.4. Stena's provisional financial results for the calendar year 1996 showed an operating loss of £5 million on a turnover of £767 million. This compared with an operating profit of £45 million in 1995 on a turnover of £786 million. The ferry operations of Stena Line (UK)

Limited contributed 55 per cent of turnover in 1996 and made an operating loss of £[*] million, compared with a profit of £24.1 million in 1995. Ferry services in the English Channel business area contributed 39 per cent of Stena's turnover in both 1995 and 1996.

2.5. In the rest of this report, unless the context otherwise requires, references to Stena are to Stena and its current subsidiaries.

P&O

2.6. P&O, which was incorporated by Royal Charter in 1840, was originally developed as a pure shipping concern but has diversified, since the 1970s, into other areas of transport and also into property and services.

2.7. The company is currently organized into ten operating divisions. P&O Ferries, the ferry division, operates tourist and freight ferry services between mainland Great Britain and the Continent, Northern Ireland and the Orkney and Shetland Islands. P&O European Transport Services is concerned with road freight transport and warehousing businesses and also operates a number of roll-on/roll-off (ro/ro) vessels for the maritime leg of its international road transport services. P&O's other businesses include cruise ships, deep sea container shipping, bulk shipping, international exhibition management, housebuilding and construction, property investment and development and an Australian division with a varied range of activities.

2.8. P&O has been involved with North Sea and English Channel ferries since the 1960s. In 1985 it sold its cross-Channel activities, then limited to two routes, to European Ferries Group plc (European Ferries). But on acquisition of that company in 1987, it gained control of several cross-Channel ferry services establishing the basis of P&O's current ferry division. In addition to its services to Northern Ireland and the Scottish Islands, the division now operates mixed passenger and freight or freight-only services from Dover, Felixstowe, Portsmouth, Hull and Teesport in the UK to Calais, Zeebrugge, Le Havre, Cherbourg, Bilbao and Rotterdam on the Continent.

2.9. P&O's turnover in the calendar year 1996 was £7,090.8 million and it generated an operating profit of £509.3 million. This compared with an operating profit of £490.8 million in 1995 on a turnover of £6,571.1 million. P&O Ferries contributed around 8.5 per cent of the turnover and 8 per cent of the operating profits in 1996 with the division's profits declining to £41.0 million, from £73.5 million in 1995.

2.10. In the rest of this report, unless the context otherwise requires, references to P&O are to P&O and its current subsidiaries.

The merger situation

2.11. We are required by our terms of reference to report on whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation, as defined in the Act, in that:

- (a) enterprises carried on by or under the control of Stena will cease to be distinct from enterprises carried on by or under the control of P&O; and

*Figure omitted. See note on page iv.

- (b) either the value of the assets which will be taken over exceeds £70 million (the assets test) or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK or a substantial part of the UK (the share of supply test),

or if events so require, whether the actual results of those arrangements are the creation of a qualifying merger situation. Section 63(2) of the Act defines an 'enterprise' as the activities or part of the activities of a business. Section 65 of the Act specifies the circumstances when two enterprises are to be regarded as ceasing to be distinct. One of the circumstances is where they are brought under common ownership or control.

2.12. On 3 October 1996 P&O and Stena announced that they had signed a Memorandum of Understanding concerning a proposal to operate as a joint venture certain businesses carried on by them. The businesses concerned are broadly those that provide ferry services on the Short Sea routes (see paragraph 2.18) and the shore-based handling, administration and marketing activities relating to those services.

2.13. A framework agreement governing the overall structure of the transaction between P&O and Stena (details of which are set out in paragraphs 3.88 to 3.97) and an agreement between P&O and one of its wholly-owned subsidiaries were signed on 23 December 1996. These agreements provide for the relevant businesses to be transferred to a holding company. On completion of the agreements, P&O would hold 60 per cent of the ordinary shares of the company but would have 50 per cent of the voting rights. Stena would hold the other 50 per cent of the voting rights and 40 per cent of the ordinary shares. There are a number of conditions precedent to completion of the framework agreement including clearance from all relevant competition authorities.

2.14. It is clear that arrangements are in contemplation which, if carried into effect, will result in enterprises owned and controlled by P&O and enterprises owned and controlled by Stena being brought under the ownership and control of the joint venture holding company and, accordingly, ceasing to be distinct within the meaning of the Act.

2.15. We have to consider whether the value of assets taken over are in excess of £70 million having regard to section 67 of the Act. As we note in paragraphs 3.94 and 3.95, P&O would contribute assets worth £[*] million to the joint venture and Stena would contribute assets worth £[*] million. It is clear therefore that the assets test is satisfied. We do not need to consider the market share test because, if we find that one of the two tests for a merger qualifying for investigation has been satisfied, we are required, under our terms of reference, to exclude the other test from our consideration.

2.16. We are, therefore, satisfied that arrangements are in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation as defined in the Act.

Background to the joint venture

Regulatory history

2.17. As we describe in paragraphs 5.1 to 5.5, the provision of cross-Channel ferry services has been the subject of a number of previous inquiries by UK regulatory authorities. A 1974

*Figures omitted. See note on page iv.

report by the Monopolies Commission¹ concerning collective agreements on fares and pooling arrangements then applying to cross-Channel car ferry services recommended that increases in fares should be supervised and that there should be restrictions on participation in future pooling agreements. There followed a period during which the ferry operators sought prior approval for any increases in fares and in which the DGFT was able to influence the fare structures put in place. These arrangements were relaxed in 1979 when a pooling agreement between Sealink and European Ferries Limited came to an end and they and the two other main ferry operators gave undertakings to notify the DGFT of changes in fares and to seek prior approval before extending any existing fare or pooling arrangements or entering into new ones. In 1982, following a merger inquiry by the MMC,² Sealink and European Ferries Limited gave further undertakings that they would not merge. The 1979 and 1982 undertakings were reviewed by the MMC in their 1989 report on Cross-Channel Car Ferries³ (the 1989 report) but the Secretary of State accepted the MMC's recommendation that both sets of undertakings should remain in force. This remained the position until July 1996 when the Secretary of State released P&O (which had acquired European Ferries in 1987), Stena (which had acquired Sealink in 1990) and Hoverspeed from all existing undertakings. However, in announcing his decision, the Secretary of State emphasized that it was without prejudice to the normal application of competition law to any future transactions in the cross-Channel ferry market.

The market prior to the opening of the Channel Tunnel

2.18. The market for ferry services from the UK falls broadly into five sectors: the Short French Sea; the Belgian Straits; the Western Channel; the North Sea; and the Irish Sea. We refer in addition to the 'Short Sea routes' in which we include both the Short French Sea and Belgian Straits sectors. All the sectors and sub-sectors to which we shall refer are described in paragraphs 5.28 to 5.30 and 5.126 and individual designations are defined in the glossary.

2.19. As we note in paragraph 5.6, there were three competing groupings of ferry operators on the Short Sea routes at the time of the MMC's 1989 report. In 1990 P&O and a grouping comprising Sealink and Hoverspeed (both then owned by Sea Containers) and Sealink's pooling partner, the French state-owned railway company SNCF, carried, between them, some 92 per cent of passenger vehicles transported on the Short French Sea routes and around 45 per cent of freight carried on the Anglo-Continental routes.

2.20. In 1990 SNCF set up a separate company, Société Nouvelle d'Armement Transmanche (SNAT), to take over its ferry operations and SNAT entered into a new pooling arrangement with Sealink in July of that year. Later in the same year Stena acquired Sealink from Sea Containers and, as Hoverspeed remained in the ownership of Sea Containers, this effectively added a fourth competitive grouping to the routes concerned.

2.21. Following a period of relatively low growth during the 1980s, the passenger market expanded rapidly during the period leading up to the opening of the Channel Tunnel in 1994. The number of passenger vehicles carried on the Short French Sea routes grew by 64 per cent between 1990 and 1994 (see Table 5.8). P&O and Stena have suggested that there were a

¹ *Cross-Channel Car Ferry Services: a report on the supply of certain cross-channel car ferry services*, HMSO, HC 14, April 1974.

² *European Ferries Limited and Sealink Limited: a report on the proposed merger*, HMSO, HC 65, December 1981.

³ *Cross-Channel Car Ferries: a report on the existence or possible existence of a monopoly situation in relation to the supply in the United Kingdom of cross-Channel car ferry services and on a proposal to enter into agreements for the joint or co-ordinated supply of such services*, HMSO, Cm 903, December 1989.

number of reasons for this growth. People's holiday habits were changing from packaged holidays at the main resorts to motoring holidays on the Continent and from a single long holiday to a number of shorter breaks. The ferry operators were also using a variety of promotional fares to expand the market before the Tunnel opened. Most of the growth, however, was accounted for by people taking day trips or other short holidays benefiting from discounted fares.

2.22. By contrast, the Anglo-Continental freight market grew by only 9 per cent between 1990 and 1994 (see Table 5.6) reflecting a period of recession in the economies of the UK and its European trading partners.

2.23. P&O and Stena told us that, in spite of the growth in the passenger market, both fares and freight rates were already beginning to fall by the time the Tunnel came into operation. This was partly as a result of increasing ferry capacity. P&O introduced a fifth multi-purpose ferry on its Dover-Calais route in 1993 to increase the frequency of its sailings and another P&O ferry was substantially modified to increase its capacity. P&O regarded this as a necessary response to the imminent opening of the Tunnel's 'turn-up-and-go' service. In the same period, Stena had been raising capacity by increasing the number of crossings undertaken by its ferries. These developments were driven particularly by trends in the passenger market, but the increasing capacity of multi-purpose vessels led to reduced prices in both the passenger and freight markets. Nevertheless, P&O's and Stena's ferry operations on the Short Sea routes were highly profitable at the time the Tunnel opened. On its Dover-Calais and Dover-Zeebrugge services, P&O made a return on capital employed of 22.6 per cent in 1993 and 39.4 per cent in 1994 (see Table 3.7). On its Dover-Calais and Newhaven-Dieppe services, Stena's return on capital employed was 18.1 per cent in 1993 and 23.7 per cent in 1994 (see Table 3.15).

The market since the opening of the Channel Tunnel

2.24. The first revenue-earning freight train ran through the Tunnel on 1 June 1994. The rail shuttle service for freight vehicles (Le Shuttle-Freight) began operating on 25 July 1994. The Eurostar rail passenger service from London through the Tunnel to Paris or Brussels (Eurostar) began on 14 November 1994. The rail shuttle for passenger vehicles (Le Shuttle-Tourist) commenced commercial operation on 22 December 1994. The Tunnel and Le Shuttle are operated by the Eurotunnel Group (Eurotunnel). Eurostar is operated by Eurostar (UK) Ltd and rail freight services running through the Tunnel and beyond ('through-freight services') are operated, at present, by Railfreight Distribution Ltd in conjunction with certain rail freight companies on the Continent.

2.25. We describe the services, strategy and financing of Eurotunnel in Chapter 4. To put the scale of the Tunnel operation in perspective, it employs assets costing over £9 billion compared with assets of some £410 million to be employed by the proposed joint venture. Eurotunnel's rolling stock alone has a net book value of over £1.2 billion (see Table 4.7).

2.26. As we explain in paragraphs 4.24 to 4.31, calculating the Tunnel's maximum capacity is not straightforward. However, taking account only of the capacity of the services actually operated by Le Shuttle and of the capacity of the ferries, total passenger and freight vehicle carrying capacity on the Short French Sea routes increased by some 69 per cent between 1994 and the end of October 1996.¹ Eurostar and through-freight services added further capacity for the carriage of foot passengers and unaccompanied freight (defined in the glossary). Most of

¹Ten months' figures are used for 1996 to avoid abnormalities in the pattern of traffic arising from the suspension of services through the Tunnel after a fire on 18 November 1996.

the growth was attributable to Le Shuttle but a decision by Stena and SNAT to terminate their pooling arrangement at the end of 1995 led to further increases in capacity as the two operators sought to establish credible independent schedules. SNAT, which had previously relied on Stena to market the pooled service in the UK, set up a new marketing organization in the UK and rebranded itself as 'SeaFrance'.

2.27. Demand also grew strongly between 1994 and 1996 with increases of 46 per cent in passenger vehicle traffic and 34 per cent in freight traffic on the Short French Sea routes (see Table 5.13). However, this growth in traffic was insufficient to take up the new capacity and overall capacity utilization on the Short French Sea routes fell from around 50 per cent to 40 per cent during the period (see Table 5.14).

2.28. The combination of Eurotunnel's entry to the market and Stena's and SeaFrance's efforts to establish themselves as independent operators have led to significant changes in market share since 1993. The position on passenger vehicles and freight is shown in Tables 2.1 and 2.2.

TABLE 2.1 Shares of passenger vehicles carried on Short French Sea routes

	<i>per cent of passenger vehicles</i>			
	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>Jan-Oct 1996*</i>
P&O#	45.5	49.3	35.7	26.5
Stena/SNAT	34.8	34.9	26.6	-
Stena alone#	-	-	-	19.5
SeaFrance alone	-	-	-	5.5
Other ferries	19.7	15.8	11.8	9.2
Eurotunnel	-	-	25.9	39.3

Source: Drawn from Table 5.7.

*Figures provided by P&O and Stena.

#The P&O and Stena operations which would form the proposed joint venture.

TABLE 2.2 Shares of freight carried on Anglo-Continental routes

	<i>per cent of freight units</i>			
	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>Jan-Oct 1996*</i>
P&O (Dover)#	18.0	20.0	17.0	16.0
Other P&O	12.0	12.0	10.0	11.0
Stena/SNAT	14.0	13.0	11.0	-
Stena alone#	-	-	-	8.0
Stena BV	3.0	3.0	3.0	3.0
SeaFrance alone	-	-	-	4.0
North Sea Ferries~	7.0	9.0	8.0	8.0
Sally Line	6.0	4.0	4.0	4.0
Brittany Ferries	5.0	5.0	5.0	4.0
Cobelfret	9.0	9.0	9.0	5.0
Other operators	26.0	23.0	23.0	22.0
Eurotunnel	-	2.0	10.0	15.0

Source: Drawn from Table 5.6.

*Figures provided by P&O and Stena.

#The P&O and Stena operations which would form the proposed joint venture.

~ Wholly owned by P&O since September 1996.

2.29. As we illustrate in Table 5.3, the fall in fares and freight rates, referred to in paragraph 2.23, accelerated between 1994 and 1996 leading to a decline in profits on the Short Sea routes from £112 million to £51 million in the case of P&O and from £26 million to £2 million in the case of Stena (see Tables 3.7 and 3.15).

2.30. P&O and Stena told us that their profits for 1996 would have been worse if it were not for the fact that Tunnel services were seriously disrupted in the closing stages of 1996 following a serious fire on Le Shuttle-Freight on 18 November 1996. P&O estimated that some £[*] million of its profit on the Short Sea routes was attributable to the resulting diversion of traffic from the Tunnel. Stena estimated that, without the diverted traffic, it would have made a loss on these routes of £[*] million.

Developments in prospect

2.31. The fire in the Tunnel introduces uncertainty into any attempt to forecast the Tunnel's impact on the market in the short term. Le Shuttle-Freight is still not operating at all and other services are restricted.

2.32. However, Eurotunnel expects Le Shuttle-Tourist to be back to full operation again in June 1997 and to have regained the level of passenger traffic previously forecast before the end of 1997. Eurotunnel's Strategic Plan assumes that it will have achieved a 62 per cent share of Dover-Calais car traffic and a 48 per cent share of coach traffic by 1999.

2.33. As Eurostar does not carry vehicles, it competes most directly with the airlines. However, Eurostar (UK) Ltd told us that surveys suggest that 20 per cent of its passengers starting from UK stations would otherwise have used the ferries. It regarded itself as a direct competitor of Le Shuttle and the ferries in the coach market and, in the longer term, intended to compete for car travellers who might be attracted by rail-drive packages.

2.34. As to freight, Eurotunnel's assumption until the fire occurred was that Le Shuttle-Freight would capture 43 per cent of Dover-Calais traffic by 1999. However, the service will remain suspended pending the outcome of the safety inquiries we describe in paragraphs 4.20 and 4.21. Eurotunnel told us that it hoped to be in a position in the very near future to agree with the Intergovernmental Commission (IGC) and Tunnel Safety Authority (see paragraph 4.5) the operational conditions for the resumption of Le Shuttle-Freight service. It considered agreement to a continuation of the service with semi-open shuttle wagons as extremely important to its freight business. We are not in a position to predict the nature of any conditions which will be set for the resumption of the service but we find it inconceivable that, in the longer term, Le Shuttle will not be carrying freight vehicles. We are less certain of the shorter-term position but we have been guided by Eurotunnel's own assessment that Le Shuttle-Freight will be operational again in the course of 1997. Eurotunnel's own report on the fire, published on 3 April 1997, announced a series of improvements to safety procedures and systems but envisaged no need for fundamental changes to the design of Le Shuttle rolling stock. We also note that through-freight trains are already operating again.

2.35. We describe in paragraphs 4.32 to 4.39 Eurotunnel's financial situation and the position now reached in discussions with the consortium of banks which financed the Channel Tunnel project. The scale of Eurotunnel's debt is well publicized. However, we attach significance to the fact that, whatever the current operating company's financial position, the Tunnel

*Figures omitted. See note on page iv.

itself, its systems, the terminal and Le Shuttle rolling stock will comprise a major source of competition in the market for cross-Channel transport for the foreseeable future.

2.36. For their part, the ferry operators are facing two significant additional developments. First, as we describe in paragraphs 5.13 and 5.14, they must meet the costs of compliance with new design and safety standards arising from the International Convention on the Safety of Life at Sea (SOLAS convention) as supplemented by the requirements of the Stockholm agreement. P&O estimated its costs at £12 million overall and Stena at £25 million, although the upgrading and costs involved vary significantly from one vessel to another. Secondly, duty-free concessions for travel between member states of the EU are due to be abolished from 1 July 1999. Although there is continuing opposition to this proposal from parts of the transport industry, we understand that, as recently as November 1996, the Council of Finance Ministers of the EU considered and rejected a suggestion that the matter should be the subject of further study. It took the view that there was no new case for prolongation of duty-free concessions and that a further study would serve no purpose. We have therefore assumed for the purposes of our inquiry that these concessions will be abolished as and when currently planned. As we illustrate in Table 2.3, this will have substantial implications for P&O, Stena and Le Shuttle, which obtain between 35 and 45 per cent of their total revenues from duty-free sales. We would expect other ferries to be in a similar position.

TABLE 2.3 Revenue sources, 1996

	<i>P&O (Dover-Calais, Dover-Zeebrugge)</i>		<i>Stena (Dover-Calais, Newhaven-Dieppe)</i>		<i>Le Shuttle</i>	
	<i>£m</i>	<i>%</i>	<i>£m</i>	<i>%</i>	<i>£m</i>	<i>%</i>
Duty-free sales (gross)	108.0	37	84.4	44	99.3	40
Other sales (gross)	<u>42.2</u>	<u>14</u>	<u>22.1</u>	<u>11</u>	<u>5.8</u>	<u>2</u>
Total retail sales (gross)	150.2	51	106.5	55	105.1	42
Freight and other revenue	91.4	31	47.1	24	68.9	28
Passenger tickets	<u>50.9</u>	<u>18</u>	<u>40.4</u>	<u>21</u>	<u>75.8</u>	<u>30</u>
Total revenue	292.5	100	194.0	100	249.8	100

Source: Prepared from information provided by the operators-see Appendices 3.1, 3.3 and 4.1.

2.37. In spite of this, all the main competitors of P&O and Stena on the Short Sea routes are in the process of developing their services. As we note in paragraph 5.90, Sally Line has recently commenced a new service using fast craft (as defined in the glossary) on the routes from Ramsgate to Ostend and Dunkirk under a joint venture (Holyman Sally) with the Australian company Holyman. Hoverspeed has ordered two fast monohulled craft for delivery in late spring 1997 and has an option on four more. SeaFrance has been investing in improvements to the accommodation and services on its three multi-purpose vessels.

The joint venture

2.38. The joint venture is described in detail in paragraphs 3.72 to 3.110. It would provide ferry services for tourist and business travellers, cars and coaches and accompanied or unaccompanied freight (as defined in the glossary). For convenience, we refer to these simply as passenger or freight services. The joint venture would be confined by the terms of the agreement between P&O and Stena to operate these services only from ports on the section of the UK coastline from (and including) Newhaven to (but excluding) Harwich and on the stretch of the French/Belgian coastline between (and including) Dieppe and Zeebrugge.

2.39. P&O and Stena see the joint venture as a necessary response to the situation we have described in paragraphs 2.24 to 2.37. They said that it would enable them to maintain existing services on the Newhaven-Dieppe and Dover-Zeebrugge routes and to operate a comprehensive sailing schedule on the Dover-Calais route with fewer ships. The Dover-Calais service would offer a sailing every 45 minutes with continuous loading for 18 hours a day and a sailing every hour for the rest of the time. Duplication of shore-based handling, marketing and administration operations would be eliminated and the quality and range of on-board services would be improved. P&O and Stena estimated that the joint venture would allow cost savings of some £75 million a year (except in the first year when one-off restructuring costs of £38 million and possibly losses on the sale of vessels would be incurred); and by dispensing with three vessels it would avoid some of the cost of upgrading to meet safety requirements. They believed that by improving their schedules and on-board services, by lowering costs and by installing a single, focused management the joint venture would stand a better chance than their existing separate services of offering effective long-term competition to rail services using the Tunnel.

Markets affected

2.40. We describe in Chapter 5 the markets in which Eurotunnel and the ferries operate and the types of traffic carried.

2.41. P&O and Stena considered that the joint venture would operate in two separate markets: a passenger market comprising the Short French Sea routes including the Tunnel, and a wider freight market comprising all Anglo-Continental routes, also including the Tunnel. In order to take a view on this we need to consider four issues:

- (a) whether there are separate markets for the carriage of passenger and freight traffic;
- (b) whether the Tunnel operates in the same market or markets as the ferries;
- (c) whether the 'unitized' freight market is separate from the 'bulk' freight market; and
- (d) the geographical scope of the relevant market or markets.

Passenger and freight markets

2.42. As a substantial number of ferry services operated from the UK to the Continent use multi-purpose vessels capable of transporting freight, passenger vehicles and their passengers simultaneously (see, for example, Tables 3.1 and 3.12), there is a degree of overlap in the means of supply to the passenger and freight markets. But the overlap is not complete. There are a significant number of operators of freight-only vessels and most fast craft are designed primarily to carry passengers and passenger vehicles. Le Shuttle also provides separate schedules and rolling stock for passenger and freight vehicles.

2.43. As we describe in paragraphs 5.15 to 5.24, there are also significant differences in the pattern of demand. Passenger travel on the Short Sea routes is characterized by a need for speed of crossing; peaks of demand at holiday periods; and a substantial element of demand

generated by promotional offers and the availability of duty-free or cheap tax-paid goods. By contrast, the freight market has less prominent peaks of demand; it cannot be expanded by promotional offers and it is little affected by the availability of duty-free goods. Although a freight transporter's choice of route is determined by a range of factors including speed of crossing, we have been told that the key factor is the overall cost of journey from the point of origin to the final destination.

The Tunnel and the ferries

2.44. It has been put to us that there will be progressive segmentation of the market as between customers who systematically prefer to use the ferries and those who prefer to travel on rail services through the Tunnel. As we note in paragraph 5.22, there is some evidence of firm preferences in the passenger sector as between the two modes of transport. However, only a minority of travellers fall into this category; and the rapid build-up of passenger traffic using one or other of the services through the Tunnel leads us to believe that a large proportion of the travelling public regards services which use the Tunnel as substitutable for ferry services and vice versa.

2.45. As for freight, there are some categories of hazardous and non-hazardous goods which cannot be carried through the Tunnel. We consider these further in paragraphs 2.111 to 2.113. However, P&O, Stena and the Freight Transport Association Limited (FTA) have estimated that these represent only a small proportion of total freight traffic. The evidence available indicates that most freight traffic could and would switch between the Channel Tunnel and the ferries if such a switch was justified by the calculations referred to in paragraph 5.21.

Unitized and bulk freight

2.46. The majority of freight traffic carried across the Channel is 'unitized', that is, it is transported in one of a variety of standardized modes (see glossary). However, as we note in paragraph 5.68, a certain amount of cross-Channel freight traffic is carried in non-unitized or 'bulk' form. We were told by the FTA that for some types of freight there is a degree of substitutability between bulk and unitized forms of transport. For example, some chemicals carried in bulk railway tankers could alternatively be carried on board ferries in lift tanks. However, we believe that, in many cases, conversion from unitized to bulk methods of shipment is likely to be impracticable because the goods concerned are packaged and shipped in separate units to allow for delivery to many different destinations. Even where such a change might be practicable, the cost and inconvenience of changing loading facilities and finding different forms of road and sea transport may be prohibitive unless there were a very significant rise in rates for unitized freight. We do not therefore consider that bulk shipment methods provide a sufficient degree of competition to carriers of unitized freight to be regarded as part of the same market.

Geographical scope of the passenger market

2.47. P&O and Stena believed that, in the case of passenger services, the Short French Sea routes, including the Tunnel, have sufficient special characteristics to be regarded as a separate market. They offer faster crossings than services on other routes, a wider choice of operators, greater frequency of services and better motorway access. They also cater for excursion traffic more than other routes and carry a far higher volume of traffic overall. In 1995 some 70 per cent of all passenger vehicle traffic from the UK to the Continent was carried on the Short French Sea routes.

2.48. We consider that services on routes other than the Short French Sea may well offer some competition to the joint venture. However, as in the MMC's 1989 report, we take the view that competition from the longer routes would be limited. In the case of excursion traffic, the longer routes are not a practical alternative. For other traffic, the scale, speed of crossing and other advantages of the services on the Short French Sea routes are such that there would have to be a very significant increase in prices before travellers would switch to Western Channel or North Sea services in large numbers.

2.49. It is proposed that the joint venture should operate a service from Newhaven to Dieppe. By conventional ferry this would involve a crossing time of some 4 hours but the introduction of fast craft has reduced this to 2 hours or less. P&O and Stena considered that this route was therefore substitutable for services on other Short French Sea routes. We accept that, as long as it offers a fast craft service, the Newhaven-Dieppe route may be expected to offer a significant degree of competition to other Short French Sea crossings. We note that the joint venture's proposed services on that route would involve a conventional ferry as well as a fast craft but we take the view that the presence of fast craft on the route might be expected to increase the appeal of the route in general.

2.50. We have also considered whether the same arguments apply to the fast craft services which Holyman Sally is operating from Ramsgate to Ostend. We accept that a minority of travellers currently using the shorter routes would regard the service to Ostend as a serious alternative. However, it is clear that services on the Short French Sea routes do carry traffic destined for the Benelux countries and beyond as well as for destinations to the south. The fast craft service to Ostend would offer a crossing time at least comparable to that envisaged on Newhaven-Dieppe; and Sally Line told us that the service has the potential to generate excursion traffic which might otherwise go to the French ports. We therefore take the view that a significant fast craft service on the Ramsgate-Ostend route would also offer a substantial degree of competition to services on the Short French Sea routes and that the services commenced by Holyman Sally on this route in March 1997 should be regarded as serving the same market.

Geographical scope of the freight market

2.51. In their 1986 report on the proposed merger between P&O and European Ferries,¹ the MMC took the view that the North Sea, Western Channel and Short French Sea routes were all interlocking markets as far as freight was concerned. They took the routes to northern France, Belgium and Holland together for the purposes of assessing the effect of the merger because it was felt that the routes were all real alternatives for freight transporters *en route* to destinations deeper into the Continent. In our inquiry, we have considered whether we should revise this approach in the light of the opening of the Tunnel and the further development of the Short French Sea ferry services and their supporting infrastructure.

2.52. As we have noted in paragraph 2.43, the overall cost of the journey from origin to final destination is often the most influential factor in the choice of route for the shipment of freight to and from the Continent. This may dictate that freight should be shipped on the route which has the shortest crossing or from the port which is closest to the point of origin of the freight. Alternatively it may be commercially sensible to use a longer sea journey to reduce the length of the road journey or to keep the freight on the move during a driver's mandatory rest period. These factors may be given more or less weight than the cost of the sea or Tunnel crossing depending on the significance of the crossing in relation to the overall length of the journey.

¹*The Peninsular and Oriental Steam Navigation Company and European Ferries Group PLC: a report on the merger situation*, HMSO, Cm 31, December 1986.

2.53. We were told by the FTA that good motorway access, the short crossing, the range of freight facilities that have built up around Dover, the frequent sailings and the choice of options as between the ferries and Le Shuttle have made the Short Sea routes of particular importance to the freight transport industry. But it also told us that other routes could and would be taken if freight rates on the Short Sea routes made an overall journey more costly.

2.54. As we note in paragraph 5.61, freight volumes on North Sea and Western Channel routes appear to have been affected by the decline in freight rates on the Short Sea crossings. We have also received specific evidence of freight business being switched to the Short Sea routes from operators on both the Western Channel and the North Sea routes as a consequence of changes in freight rates. We consider that it is the fall in freight rates, brought about by the factors we have described in paragraphs 2.24 to 2.30, more than any non-price advantages which have made the Short Sea routes such an attraction to the freight transport industry. The FTA was able to give us only one example of business being transferred back to longer routes on grounds of price, but this is not surprising given the decline in freight rates on the Short Sea routes relative to other routes (see Table 5.3). We have therefore taken the view that freight services on the Western Channel and North Sea to northern France, Belgium and Holland offer a significant degree of potential competition to services on the Short Sea routes.

Conclusions on the markets affected

2.55. We therefore conclude that:

- (a) there are two separate markets for the carriage of passenger and freight traffic;
- (b) the proposed joint venture and the Tunnel would compete in the same passenger and freight markets;
- (c) the passenger market affected by the proposed joint venture comprises services on the Short Sea routes, including those using the Tunnel and the current and proposed services on the Newhaven-Dieppe and Ramsgate-Ostend routes; and
- (d) the freight market affected by the proposed joint venture comprises all services, including those using the Tunnel, for the carriage of unitized freight on Anglo-Continental routes.

Effects of the merger

2.56. We now examine the effects of the proposed merger, if it were to proceed, on competition in the relevant passenger and freight markets and in other markets in which P&O and Stena operate, or could operate. We then consider its effects on employment.

Effects on competition in the passenger market

2.57. As we have shown in Table 2.1, P&O and Stena together carried around 46 per cent of all passenger vehicles carried on the Short French Sea passenger routes¹ in the first ten months of 1996. Le Shuttle, with approximately 39 per cent of this market, is by far the most significant potential competitor for the joint venture; and P&O and Stena told us, unequivocally, that the coming into operation of the Tunnel is the cause of the joint venture. We therefore need to consider four main issues:

- (a) whether there are any constraints, in terms of capacity or costs, on the ability of Le Shuttle and the joint venture to compete effectively;
- (b) whether, in practice, Le Shuttle and the joint venture would compete effectively;
- (c) whether there is likely to be continued and effective competition from other operators; and
- (d) whether there are barriers to entry to the market.

Capacity constraints

2.58. As illustrated by Tables 5.11 and 5.13, current ferry capacity on the Short French Sea routes is sufficient, by itself, to meet all demand for the carriage of freight and passenger traffic forecast up to 1999 and beyond. P&O and Stena told us that although the mix of traffic carried could affect the level of capacity utilization, they estimated the maximum achievable rate of utilization to be not lower than 85 per cent. As Table 5.11 also shows, Le Shuttle has nominal capacity of around half that of all the ferries together. However, it has been put to us that there may be limitations on Le Shuttle's ability to deploy this capacity to the full.

2.59. Immediately before the fire in November 1996 the Tunnel itself could accommodate more than twice the number of trains then using it and this capacity could be increased significantly by the adoption of the latest technology (see paragraph 4.26). Given that Le Shuttle was able to carry 39 per cent of passenger vehicle traffic on the Short French Sea routes during 1996, we estimate that the Tunnel should be able to accommodate sufficient trains to carry almost all the passenger vehicle traffic forecast on these routes up to 1999 (see Table 5.13) without the need for significant new investment.

2.60. However, as we note in paragraph 4.28, Le Shuttle has encountered loading constraints which limit the load factor of its rolling stock. Eurotunnel told us that, because of problems of congestion at the terminals, passengers would be subject to delays which it regarded as unacceptable if demand exceeded 67 per cent of the carrying capacity operated during the peak month of August. We were told that the problem is not susceptible to solution by the addition of more shuttles and that no new investment in passenger shuttles is envisaged for at least the next three years. Eurotunnel is instead seeking to deal with the problem by the greater use of advanced bookings to spread demand to less busy times. This might be expected to raise the effective maximum load factor in the long run but would involve a partial departure from the turn-up-and-go system which has been offered for most of the last two years. On this basis, Eurotunnel expects Le Shuttle-Tourist to increase its yearly average load factor to 51 per cent by 1999 and hopes to raise this to 60 per cent in the longer term.

¹We do not consider it appropriate to take account of the historical position on routes to Belgian ports in this context. In our view those routes are mainly of future relevance by reason of the introduction of a significant fast craft service from Ramsgate to Ostend from March 1997.

2.61. As we illustrate in Table 5.12, with an effective maximum load factor of 67 per cent, Le Shuttle-Tourist would be able to meet up to 80 per cent of expected demand on the Short French Sea routes in 1999. Eurotunnel's Strategic Plan assumes that with a load factor of 51 per cent, Le Shuttle-Tourist would capture 62 per cent of passenger traffic crossing by the Tunnel and Dover-Calais ferry route by 1999. This translates to some 61 per cent of all passenger traffic expected on Short French Sea routes in 1999. It is therefore clear that Le Shuttle-Tourist has scope to increase its market share significantly before encountering overall capacity constraints. But we take the view that Eurotunnel would have to introduce significant price differentiation as between peak and off-peak periods if it is to achieve its forecast market share without generating demand at peak times which exceeds Le Shuttle-Tourist's ability to handle it. We consider the implications of this further in paragraph 2.160.

Cost constraints

2.62. P&O and Stena put it to us that Le Shuttle's variable operating costs are substantially lower than those incurred by the ferries. This is consistent with Eurotunnel's public statements in advance of the opening of the Tunnel.¹ It is also consistent with the analysis made in 1990 by John Kay, Alan Manning and Stefan Szymanski of London Business School and Birkbeck College² who then estimated that the Tunnel's marginal costs would be around one-tenth of those of the ferries.

2.63. We have looked at the operating costs of P&O, Stena and Le Shuttle both on a narrower basis (limited to variable costs) and on a wider basis (including semi-variable and other costs). For each operator, we have compared 1996 costs with the level of capacity (for passenger and freight traffic measured in car equivalents or passenger car units (PCUs)) provided. The results vary according to the level of capacity utilization assumed and are shown for each company on three different bases in Tables 3.9, 3.17 and 4.11. Assuming a 50 per cent level of capacity utilization, which is above the rates actually achieved in 1996 (see Table 5.14) but close to the load factor which Eurotunnel hopes to achieve by 1999, the results are as shown in Table 2.4.

¹In a document issued in connection with its 1990 Rights issue, Eurotunnel stated that 'It is expected that the system will have low marginal operating costs associated with handling additional traffic. Its unit operating costs are likely to be lower than its competitors' enabling Eurotunnel to improve profitability as traffic increased and giving it greater flexibility in its pricing policy'.

²'Pricing a new product: Eurotunnel', John Kay, Alan Manning and Stefan Szymanski. Published in *Business Strategy Review*, Spring 1990.

TABLE 2.4 1996 operating costs per unit of capacity provided, assuming 50 per cent capacity utilization
£

	<i>P&O</i>	<i>Stena</i>	<i>Le Shuttle</i>
Variable costs*	9.10	11.20	1.13
Semi-variable costs#	<u>14.05</u>	<u>16.61</u>	<u>22.77</u>
	23.15	27.81	23.90
Overheads~	<u>8.86</u>	<u>9.31</u>	<u>14.74</u>
	32.01	37.12	38.64
DepreciationĐ	<u>2.58</u>	<u>2.62</u>	<u>8.10</u>
	34.59	39.74	46.74

Source: Drawn from Tables 3.9, 3.17 and 4.11.

*Variable costs consist of travel agents' commission and, in the case of P&O and Stena, port transit costs.

#Semi-variable costs include payroll costs, fuel and maintenance in all cases. In addition, Stena's figures include charter hire and Le Shuttle's figures include a share of Tunnel operating costs.

~ Overheads include administration and marketing costs.

ĐLe Shuttle depreciation relates only to rolling stock and does not include a depreciation charge for the Tunnel.

2.64. It is clear that Eurotunnel's variable costs, strictly defined (limited, as we note in the footnote to Table 2.4, to travel agents' commission) are significantly below those of either P&O or Stena and that the cost of carrying additional passengers on existing Le Shuttle services is therefore relatively low. However, we consider that variable costs would only be a good guide to the kind of pricing policy which Eurotunnel might be expected to pursue in very limited circumstances. If it were the case that Eurotunnel's aim was to increase market share in the context of highly competitive market conditions we could accept that it may be prepared to price—though only for the short term—according to its strictly variable costs. It would also have flexibility to generate additional demand through low-priced promotional offers in off-peak periods. However, under any strategy designed to operate a business on a sustainable basis we would expect it to have to adopt a general pricing policy aimed at generating revenues to cover such items as wages, fuel and essential maintenance to the Tunnel and rolling stock. In the longer term, the banks will be concerned as to Eurotunnel's ability to pay the interest on its debt and to start to repay the debt itself. In practice, Eurotunnel told us that, by agreement with the banks, its pricing strategy for the immediate future is designed to generate a surplus of cash over its cash operating costs. This means that it would have to take account of all semi-variable costs, excluding depreciation on rolling stock and of cash outlays on certain overheads such as marketing. On this or any other basis, apart from a comparison of strictly variable costs, Eurotunnel's operating costs are at best comparable to and, at lower levels of capacity utilization, are somewhat higher than those of P&O and Stena.

Competition between Le Shuttle-Tourist and the joint venture

2.65. We have received expressions of concern that, in a duopoly situation, Eurotunnel and the joint venture could be expected to come to an understanding, by one means or another, on fares and this would lead to uncontrolled price increases. SeaFrance suggested to us that now that Eurotunnel had achieved a significant market share, it was likely to recognize the need for a degree of interdependence with the joint venture since in the absence of ferries it would be likely to attract regulatory control of its own affairs. Other users, including representatives of the tourist trade, thought that the joint venture and Eurotunnel would be subject to sufficient external competition to ensure that the market remained competitive.

2.66. P&O and Stena suggested a number of reasons why the joint venture and Eurotunnel would have a continuing incentive to compete on price and quality in the passenger market.

The joint venture would have lower costs than the current P&O and Stena independent operations and would wish to exploit this to the full to gain market share. It would have significant spare capacity which it would wish to fill, not least because increased capacity utilization reduced unit costs and increased profitability. It would also wish to attract passengers in order to maximize revenues from on-board sales. The importance of these revenues was such that a 1 per cent change in the joint venture's market share would lead to a £[*] million change in its profitability. For its part, Eurotunnel would have lower variable costs and a need to generate as much cash as possible to contribute to its fixed costs and might therefore be expected to compete aggressively on price. More generally, they suggest that keeping fares down in the passenger market is attractive because it expands overall demand to the benefit of all operators. In any event, differences in the cost structures of Le Shuttle and the ferries, and in the nature of the services offered, would make it extremely difficult for the two operations to agree on an appropriate level of fares. Even if they did so, the arrangement would soon be destabilized by other ferry operators.

2.67. We have considered Le Shuttle's operating costs in paragraphs 2.62 to 2.64. For the reasons stated in those paragraphs, we cannot put as much weight as P&O and Stena on Le Shuttle's ability and willingness to undercut the joint venture's fares. Even in the absence of any payment of interest on Eurotunnel's debt, Le Shuttle's operating costs are likely to be at best comparable to those of the joint venture. As we have shown in Table 2.3, the joint venture is also likely to have the advantage of higher revenues from retail sales to offset against ticket prices, although an important part of this advantage is likely to be lost when duty-free concessions are abolished in 1999.

2.68. The incentive for the joint venture and Le Shuttle to compete for a higher share of passenger traffic in order to reap the benefits of revenues from retail sales is clearly likely to remain an important influence on ticket prices at least until duty-free concessions are abolished. This influence may continue to some extent after 1999 if Eurotunnel and the ferry operators develop their non-duty-free retail businesses. However, as we show in Table 3.20, on-board sales for the joint venture are forecast to drop substantially after the abolition of duty-free concessions and we would expect both the joint venture and Eurotunnel to attach correspondingly greater importance to achieving higher revenues from ticket sales.

2.69. We also note that the incentive for Eurotunnel to generate revenue by increasing the number of vehicles carried only applies in so far as there are no capacity constraints. In the event that Le Shuttle felt conditions of competition would enable it to attract more demand than it had capacity to carry, we would expect it to wish to increase its revenue by raising prices rather than seeking new customers. As we have noted in paragraph 2.61, this situation might be expected to arise during peak periods or more generally if Eurotunnel succeeds in substantially increasing its overall market share. We have considered whether, in such situations, the joint venture might be expected to take the initiative in price-cutting, particularly if it had substantial unused capacity to fill. However, we take the view that, if experience showed the joint venture that Eurotunnel would have all the traffic it could handle during, for example, peak holiday periods, it would be more likely to take the opportunity to raise its prices.

*Figure omitted. See note on page iv.

Competition from other operators

2.70. There are currently four operators who might be expected to compete with the joint venture and Le Shuttle in the relevant passenger market: SeaFrance, Hoverspeed, Holyman Sally and Eurostar. We have described the current and planned operations of these companies in paragraphs 5.54 to 5.57 and 5.89 to 5.91.

2.71. P&O and Stena put it to us that all these operators have very recently demonstrated a firm commitment to the market. SeaFrance has invested in the establishment of a UK marketing organization following the break-up of its pooling arrangement with Stena. Hoverspeed has ordered two new fast craft. Holyman Sally has just launched a new fast craft service to Dunkirk and Ostend. Eurostar is an indirect competitor at present but, as we note in paragraph 5.55, it aims to compete for customers of the ferries and Le Shuttle in the longer term with rail-drive packages.

2.72. It has also been suggested to us that SeaFrance's continued presence in the market is assured by the fact that it is state owned and by the French Government's desire to avoid the consequences of closure for jobs. Although SeaFrance told us that [*Details omitted. See note on page iv.*], it emphasized that it had so far been able to fund its losses as a stand-alone operation by drawing on reserves built up during the pooling arrangement with Stena. It had no reason to believe that continued losses would be funded by the French Government and regarded the suggestion that this was so as an outdated idea of the way the French public sector operated. It pointed out that similar suggestions were made when, as SNAT, it announced its intention to close its service on the Newhaven-Dieppe route. But in spite of protests by the trade unions involved, the French Government did not intervene and SNAT's service closed in 1992.

2.73. SeaFrance is the only operator which raised with us the possibility of its withdrawal from the market if the joint venture were to proceed. It did not suggest that this was inevitable. It said only that formation of the joint venture would leave it with only two options, 'to sustain its fleet (or possibly add one vessel) or to exit the market'. SeaFrance's recent investment in a UK marketing organization and in the uprating of its ferries leads us to believe that it is most unlikely to leave the market at least until duty-free concessions are abolished. But we have no firm evidence that it would be maintained indefinitely as an independent operator on the Short Sea routes if it remained unprofitable.

2.74. All the ferry operators expressed concerns to us about the possible effect of the joint venture on their ability to compete effectively. Sally Line was concerned that the joint venture would price in a predatory way. Hoverspeed was more specifically concerned about the possibility of the joint venture starting up a fast ferry service with no incremental overheads in direct competition to smaller niche operators, who might then be driven out of business by what Hoverspeed regarded as predatory pricing.

2.75. P&O and Stena emphasized that, in order to compete effectively with Le Shuttle, the joint venture would have to price competitively. However, they pointed out that, under the terms of their agreement, the joint venture would only be able to operate within a limited area (see paragraph 2.38). Any attempt at predatory pricing within that area would inevitably have an adverse impact on the joint venture's own core business. Moreover, since Eurotunnel could not be driven out of the market, there was little prospect of the joint venture reaping monopoly profits. Predatory action would damage the business of the joint venture without producing any rewards. It was also an unattractive option for a joint venture which had just cut out capacity to save costs then to invest in new capacity solely for the purposes of predatory action against competitors.

2.76. We accept P&O's and Stena's view that it would be difficult for the joint venture to take predatory action against a competitor in the Short Sea passenger market without temporary adverse effects on its core services. We also agree with them that there is an important distinction between competitive pricing and predatory pricing. The latter is broadly defined as pricing at below cost with the intention of eliminating a competitor in the expectation of benefiting from the higher prices and profits which would arise from the situation of dominance in which the survivor would then find itself. However, the joint venture would be likely to have access to sufficient resources to bear a period of below-cost pricing. In the event of a decline in traffic such as might occur following the abolition of duty-free concessions in 1999, it would also have an incentive to hasten the departure from the market of other ferry operators; and as we note in paragraph 2.154, higher prices may be expected to result from a situation of duopoly with Eurotunnel.

2.77. Although it has not raised concerns about predatory pricing, SeaFrance has put it to us that the joint venture's competitive advantage would be such as to make it difficult, if not impossible, for any ferry competitor to survive in the same market. In particular, it has expressed concern that the frequency of the joint venture's sailings and the marketing strength conferred on it by its continued association with the P&O and Stena parent organizations could squeeze SeaFrance out of the ferry business on the Short Sea routes.

2.78. As we note in paragraph 2.39, the joint venture would have a ferry sailing from Dover and Calais every 45 minutes for 18 hours a day and every hour for the rest of the time. SeaFrance calculates that this would ensure that there would be one or other of the joint venture's ferries in Dover and Calais at all times of day. It estimates that even if it shared the available traffic equally with the joint venture when one of its ferries was in port, it could still not hope to gain more than one-sixth of all traffic on the Dover-Calais route.

2.79. We consider the benefits of the proposed schedule in paragraphs 2.135 to 2.137. SeaFrance accepts that frequency of sailings is an important aspect of quality of service to the consumer. Indeed, it has suggested, as an alternative, that there might be an even more comprehensive schedule based on the co-ordinated use of joint venture and SeaFrance ferries. However, as we understand it, SeaFrance's concern is that any benefits would be short term and would be outweighed by the loss of competition in the longer term if it was driven out of the market. We consider the effect of a loss of effective competition in paragraphs 2.157 to 2.162. At this stage, we need to consider if it is indeed the case that the proposed schedule might be expected to weaken or eliminate competition.

2.80. Neither Sally Line nor Hoverspeed raised concerns about the proposed schedule but it is arguable that its effect on them would be less direct. Holyman Sally operates to different destinations and Hoverspeed offers high-speed crossings by fast craft from a separate terminal at Dover.

2.81. We cannot see any feature of the proposed schedule which restricts competition. As we note in paragraph 2.89, rationalization resulting from the joint venture would free up berthing space for use by SeaFrance if it wished to expand its own schedule. We also consider that a ferry service from Dover which offered continuous loading and a sailing every 45 minutes might be expected to increase the proportion of travellers arriving at the port without pre-booked tickets. This could benefit SeaFrance as well as the joint venture.

2.82. SeaFrance's calculation that it could not hope to achieve more than a one-sixth share of Dover-Calais traffic rests on the assumptions that it could not do better than share traffic equally with the joint venture on any one of its sailings and that it would not expand its own fleet. However, SeaFrance told us that it had improved its market share throughout the course

of 1996. It was prepared to compete on price and was investing in uprated ships and improved services. As we noted in paragraph 2.73, it has also not ruled out the possibility of using an additional ferry as a response to the joint venture's schedule. We cannot be certain whether SeaFrance would benefit or lose from the joint venture's schedule. But, by attracting uncommitted passengers to Dover and Calais, the proposed schedule would at least offer SeaFrance the prospect of additional business and the company's ability to exploit that potential would depend substantially on its own policies on prices, service and frequency of sailings.

2.83. SeaFrance's concern about the marketing power of the joint venture centres on two main issues: the retention of the P&O and Stena names in the joint venture's title; and the possibility that, by association with its parent organizations, the joint venture would receive preferential or exclusive access to racking space and other services of travel agents and to special promotional arrangements with newspapers and magazines. Sally Line and Hoverspeed also expressed concern about the difficulty of obtaining racking space; and Sally Line told us that it had found it almost impossible to enter into promotional arrangements with large circulation publications.

2.84. P&O and Stena acknowledged that use of their names in the joint venture's title would carry with it some of their goodwill and that this was intended. By itself, this does not seem to increase greatly the advantage which the P&O and Stena operations on the Short Sea routes already have over SeaFrance. We accept SeaFrance's point that linking the P&O and Stena names for the purposes of the joint venture may lead to some confusion as to whether the two companies were operating in tandem or independently on other routes, but we do not believe this would affect competition in the Short Sea passenger market.

2.85. As to travel agents, P&O and Stena told us that the position was difficult for all operators. Commissions had declined in line with the reduction in fares on the Short Sea routes and travel agents were increasingly reluctant to devote their resources and racking space to travel on those routes. Telephone sales and other means of direct booking had reduced the importance of travel agents from the point of view of handling ticket sales but they still had an important role in raising awareness of the services on offer. The joint venture would produce a brochure separate from that of its parents. A decision had yet to be taken as to whether the parents' brochures would also advertise the joint venture's services. But the joint venture would be required to negotiate its own arrangements with travel agents. The retained businesses would be run independently of the joint venture and could be expected not to compromise their own commercial interests by making arrangements for the joint venture. However, both companies considered that the joint venture and other operators should be free to enter into preferential or exclusive arrangements. We were told that P&O had no such arrangements at present but that Stena had an exclusive arrangement with one chain of travel agents.

2.86. We accept that, to provide effective competition to Le Shuttle, the joint venture would need to give its services an adequate profile in the market. However, the production of a separate brochure for the joint venture would clearly increase the competition for racking space; and any linkage between travel agents' arrangements with the joint venture and its parents could give the joint venture a significant advantage over its competitors. We also accept that it would not assist competition for the joint venture to be unable to negotiate preferential terms in the same way as other operators. But we believe that association with the P&O and Stena names would by itself give the joint venture a degree of preferred access to travel agents; and competitors could be severely disadvantaged if that access was used to secure arrangements which excluded other ferry operators.

2.87. As to special promotions through newspapers and magazines, P&O and Stena acknowledged that these were an important means of generating business. They could provide

as many as four pages of free advertising in a mass-circulation newspaper. P&O estimated that such promotions could generate up to half a million additional passenger crossings in a good year. However, P&O and Stena felt that SeaFrance's difficulty was no worse than their own situation in France where SeaFrance was involved in a higher share of the available promotions; and, since newspaper promotions were concerned almost exclusively with travel on the Short Sea routes, P&O and Stena would be in no better a position than the joint venture itself to gain the co-operation of the newspapers concerned. The formation of the joint venture would also reduce, by one, the number of Short Sea ferry operations competing for the opportunities available.

Barriers to entry

2.88. We also need to consider whether, in the event that competition among existing operators was ineffective or became ineffective, new operators might be expected to enter the market.

2.89. In the past, the lack of suitable berthing slots at both Dover and Calais has been a significant barrier to entry to the passenger market. P&O and Stena told us that formation of the joint venture would release one and a half berths for conventional ferries and a separate berth for fast ferries at both Dover and Calais. This would allow room for additional passenger ferry services using up to five conventional ferries and two fast ferries. Dover Harbour Board (DHB) agreed with this assessment. DHB told us that it would use the released space to give SeaFrance improved berthing arrangements and to offer facilities to new entrants. It also emphasized that it had statutory responsibilities regarding access to the harbour and these were reinforced by a 1995 legal case concerning the carriage of livestock.¹ We do not therefore regard berthing space as a barrier to the entry of new competitors or to the expansion of existing operations in the foreseeable future.

2.90. P&O and Stena identified the cost of vessels and marketing as two of the most significant costs involved in entry to this market. There was a consensus among ferry operators who gave evidence to us that it would be necessary to operate at least three ships to offer a conventional ferry service on the Short Sea routes which passengers would find credible. We were told that a new conventional ferry would cost at least £70 million to £80 million to buy and between £5 million and £10 million a year to charter, excluding the cost of crew. The largest of the latest generation of fast craft would cost some £65 million to buy but other modern fast craft could be bought for around £25 million and chartered for £3.5 million to £4 million a year. The cost of purchasing and, if necessary, converting a second-hand ferry would vary considerably according to age, condition and suitability for the route. There may also be a requirement for expensive upgrading to meet the safety standards referred to in paragraph 2.36.

2.91. P&O and Stena also suggested that it would be easy for an existing operator to enter the market at lower cost by transferring vessels from other routes. They pointed out that all the

¹DHB is under a general statutory duty arising from the Harbours, Docks and Piers Clauses Act 1847 to keep the harbour open to all persons for the shipping and unshipping of goods and the embarking and landing of passengers. This is subject to a power to appropriate property of DHB for the exclusive, partial or preferential use of any particular trade, person, vessel or class of vessels or goods (see the Dover Harbour Revision Order 1969 (SI 1969/1578). In *R v Coventry City Council ex parte Phoenix Aviation, R v Dover Harbour Board ex parte Gilder & Sons and other applications* (1995 3 AER 37) it was held that this power could be used only to promote the efficient functioning of the harbour; DHB did not have a general discretion to distinguish between different lawful trades; but even if it did have such a discretion DHB could not exercise it to ban the livestock trade on grounds that it would generate unlawful disruption.

ferries in Stena's current fleet on the Short French Sea routes were originally built for other markets. However, SeaFrance put it to us that ferries built for routes other than the Short French Sea or the Baltic would need substantial modification. Cabin space would have to be converted to lounge and retail space reflecting the predominance of daytime traffic on the Short Sea routes.

2.92. As to the cost of marketing, P&O and Stena estimated that a new entrant would have to spend some £1 million to £2 million a year on advertising in addition to setting up a local sales and marketing organization. These costs would be considerably lower for a ferry operator such as Brittany Ferries or Irish Ferries which had no presence on the Short Sea routes but had existing sales organizations and a familiar name. SeaFrance, which, as a new name to the UK market, was in a similar position to a new entrant, told us that it had spent some £2.7 million on media advertising in the UK market in 1996 and just under £2 million on other aspects of its marketing effort.

2.93. The costs of entry to this market with conventional ferries and a full year-round schedule are undoubtedly high. However, we do not regard the costs associated with marketing as of such significance as to be a barrier to entry. We also note that it should be economically feasible for a new operator to charter, for example, a fast craft and enter the market for a specific season if there was a prospect of high fares.

2.94. SeaFrance put it to us that the scale of the joint venture and the comprehensiveness of its schedule would also act as a barrier to entry. For the reasons given in paragraphs 2.81 and 2.82, we consider it unlikely that the schedule alone would be sufficient to deter a new entrant. However, the relative economic strength and marketing advantage of the joint venture may act as a barrier to entry. The joint venture's ability to trade on the P&O and Stena names; the possibility for P&O and Stena to assist with the marketing of the joint venture's services; the ability of the joint venture and its parents to negotiate jointly with travel agents; and any exclusive arrangements with those travel agents would together amount to a formidable prospect for a new entrant seeking to make an impact on the market. There would also, inevitably, be a fear that attempts to gain market share by undercutting the fares of the joint venture could provoke predatory pricing or some other form of price war which the new entrant could not win.

2.95. We have also considered whether the inclusion within the joint venture of the current Stena service from Newhaven to Dieppe would have the effect of closing off the option of an otherwise attractive separate route for a new entrant. However, we note that SeaFrance closed down its service on this route in 1992 [

Details omitted. See note on page iv.

]. We therefore take the view that any barrier to entry arising from the joint venture's occupancy of this route is largely theoretical.

Effects on competition in the freight market

2.96. P&O and Stena and their subsidiaries (including North Sea Ferries) had a share of 46 per cent of the Anglo-Continental freight market in the first ten months of 1996 (see Table 2.2). The share held by the P&O and Stena Short Sea operations which will form the joint venture was around 24 per cent. Le Shuttle-Freight, with a share of 15 per cent, was by far the largest single competitor for the two companies.

2.97. In considering the effect of the merger on competition in the Anglo-Continental freight market, we need to consider five main issues:

- (a) whether there are any limitations, in terms of cost or capacity, on the ability of Le Shuttle-Freight and the joint venture to compete effectively;
- (b) whether, in practice, Le Shuttle-Freight and the joint venture would compete effectively;
- (c) whether competition from other operators in the freight market is likely to be effective;
- (d) whether there will be sufficient competition for the carriage of freight which cannot be carried through the Tunnel; and
- (e) whether there are barriers to entry to the market.

Capacity constraints

2.98. As we have noted in paragraph 2.58, there is no evidence that the ferry operators' ability to compete with Le Shuttle will be constrained by capacity considerations.

2.99. Equally, for the reasons given in paragraph 2.59, we do not consider the capacity of the Tunnel itself to be a constraint on Le Shuttle-Freight's ability to compete effectively in this market. The implications of the fire in the Tunnel are addressed in paragraph 2.34. Eurotunnel told us that if, as a result of the current safety inquiry, it could not persuade the IGC that Le Shuttle should continue with semi-open shuttle wagons, the task of redesigning and rebuilding the wagons would put the freight business back by a minimum of three years. However, we believe, on the basis of Eurotunnel's own expectations, that it is probable that Le Shuttle-Freight will recommence operation later this year.

2.100. The loading constraints which we have noted in relation to Le Shuttle-Tourist (paragraph 2.60) apply equally to Le Shuttle-Freight. Eurotunnel told us that demand in excess of 67 per cent of capacity operated during November, which is the peak month for freight, would lead to delays which it regarded as unacceptable for the freight market. As with Le Shuttle-Tourist, the problem could not be solved by bringing in additional rolling stock and Eurotunnel was trying to deal with it by using pre-booking arrangements to spread demand. However, as demand in the freight market is spread more evenly throughout the year, the effect of the loading constraint on Le Shuttle's average load factor over a year is somewhat less than for Le Shuttle-Tourist. Eurotunnel expects Le Shuttle-Freight to be using 63 per cent of its yearly capacity by 1999 and eventually to achieve 64 per cent. We estimate that with an effective maximum load factor of 67 per cent, Le Shuttle could achieve a share of up to 19 per cent of the Anglo-Continental Freight market (see Table 5.12). With an average load factor of 63 per cent, Eurotunnel expects to achieve a share of around 45 per cent of Dover-Calais freight traffic by 1998, slipping back to 43 per cent in 1999 as a result of the continuing capacity constraints. That would represent a share of some 17 per cent of the Anglo-Continental freight market.

2.101. We therefore take the view that Le Shuttle-Freight has limited scope to increase its market share in the short to medium term and, as with Le Shuttle-Tourist, might be expected to be constrained as to the volume of traffic it can carry at peak times. The significance of this depends on the extent of other options available in the freight market and we consider this further in paragraphs 2.105 to 2.110.

Cost constraints

2.102. Our analysis of the unit costs of Le Shuttle and the ferries in paragraphs 2.63 and 2.64 and Table 2.4 was based on standardized units of passenger and freight capacity. Our finding that Le Shuttle's costs are broadly comparable to, but not significantly lower than, those of the ferries therefore applies equally to the Le Shuttle-Freight. We would note, however, that, before the fire, Le Shuttle-Freight had a higher level of capacity utilization than Le Shuttle-Tourist and for that reason its costs per unit of traffic were slightly closer to those of the ferries.

Competition between Le Shuttle-Freight and the joint venture

2.103. We have considered the prospects for effective competition in the event of a duopoly between Le Shuttle and the joint venture in paragraphs 2.65 to 2.69. However, for the reasons given in paragraphs 2.105 and 2.107, we consider it unlikely that the joint venture and Le Shuttle-Freight would find themselves in a duopoly situation in the Anglo-Continental freight market.

Competition from other operators

2.104. We have received a number of representations from the freight transport industry expressing concern that the joint venture would have an effective monopoly of the market, leading potentially to higher prices and a decline in service. By implication, these concerns relate to the Short French Sea routes where P&O and Stena had a 46 per cent share of all freight traffic carried in the first ten months of 1996.

2.105. For the reasons given in paragraphs 2.51 to 2.54, we consider that the joint venture's freight services would operate in a wider Anglo-Continental market. P&O and Stena put it to us that this market is characterized by a high degree of competition. They referred particularly to the large number of competitors and different forms of freight service operating in the market, to the relative ease of entry and to the strong purchasing power of customers who regularly switch between operators.

2.106. We have considered whether we should regard freight ferry operations outside the joint venture but nevertheless owned by P&O or Stena as genuine potential competitors for the joint venture. These operations, collectively, carry some 22 per cent of all freight traffic in the Anglo-Continental market. As we note in paragraph 3.96, P&O and Stena and their other subsidiaries would be free to compete with the joint venture on services to and from Zeebrugge as well as on routes wholly outside the Short Sea area. P&O and Stena emphasized that these other operations would be managed independently of the joint venture. We accept that they may therefore offer a degree of competition for the joint venture. However, we find it inconceivable that their strategy would not be influenced in some way by the fact that P&O and Stena have an interest in the success of the joint venture. Our judgment is that they would tend to offer complementary services rather than vigorous competition.

2.107. Nevertheless, as shown in Table 5.6, there are a number of potential competitors of the joint venture in the Anglo-Continental freight market who are completely independent of P&O and Stena. We estimate that, collectively, other ferry operators held a share of around 39 per cent of the market in the first ten months of 1996. This is in addition to the 15 per cent share of freight traffic carried by Le Shuttle-Freight; and, as we note in paragraph 5.69, through-freight trains are a further source of competition.

2.108. SeaFrance's concerns about the effect on competitors of the joint venture's proposed schedule of sailings (see paragraphs 2.77 to 2.82) are also relevant to the freight market. We acknowledge that the potential benefit of a schedule which attracts uncommitted passengers to Dover (see paragraph 2.81) may not apply to this market where a large proportion of customers will have pre-negotiated contracts with one or other ferry operator. However, as we note in paragraph 5.106, the freight market is very price-sensitive. We therefore believe that there is considerable scope for successful price competition against the joint venture's own schedule.

2.109. SeaFrance has also questioned whether the inclusion of P&O's current freight-only service between Dover and Zeebrugge within the joint venture could be justified given that it would not contribute any of the benefits claimed for the joint venture. P&O and Stena told us that the majority of P&O's top 100 freight customers had tickets which could be used on either the Dover-Zeebrugge or Dover-Calais services. This allowed them to switch between the two services at short notice if route plans dictated or to use the Dover-Calais service in one direction of a round trip and Dover-Zeebrugge in the other in order, for example, to fit in a driver's rest period on the longer journey. The Dover-Zeebrugge and Dover-Calais services would also be under the control of a unified port administration and ticketing system which would allow a rapid switch of traffic from one route to the other in the event of disruption at either Calais or Zeebrugge. The Dover-Zeebrugge route was used in this way by P&O during 1996 on occasions when Calais was closed to ferry traffic. Moreover, P&O estimated that separation of the management and administration of the Dover-Zeebrugge service from the rest of the joint venture's services would add some £[*] million to operating costs.

2.110. We have considered whether the joint venture's occupancy of the Dover-Zeebrugge route would deter potential competition for the joint venture in the Short Sea sector of the market. We take the view that, if the service concerned was not included in the joint venture, the most likely outcome is that it would be operated by P&O. For the reasons given in paragraph 2.106, we do not believe this would contribute greatly to competition for the joint venture. It would serve only to raise operating costs to the potential disadvantage of users. Even if P&O were not to take over the route, there is no certainty that an alternative operator would run at least an equivalent service; and as we note in paragraph 2.114, berthing capacity would in any event be available to accommodate additional freight services from the Kent ports to Zeebrugge, if other operators wished to enter the market.

Freight excluded from the Tunnel

2.111. We have also considered the extent of competition for the carriage of freight which cannot be transported through the Tunnel. As we note in paragraphs 5.72 to 5.76, this involves mainly hazardous freight, livestock and unaccompanied freight.

2.112. The FTA was unable to give us an accurate assessment of the proportion of all freight carried on Anglo-Continental routes which was hazardous but estimated that it would be of the order of 5 to 10 per cent. This is consistent with P&O's and Stena's own estimate that 'cargo-only' and 'on-deck-only' hazardous freight (see glossary) represented around 9 per cent of the freight they carried on Short Sea routes in 1996. P&O and Stena told us that they did not carry livestock intended for slaughter and that the livestock which they did carry, principally horses, amounted to a tiny proportion of their total freight traffic on the Short Sea.

*Figure omitted. See note on page iv.

2.113. Unaccompanied freight is more significant. As can be seen from Table 5.5, it accounted for some 13 per cent of all freight carried by P&O and Stena on their Short Sea services in the first ten months of 1996. However, P&O ferries carried over 80 per cent of this traffic, mostly on its freight-only ferries to Zeebrugge. P&O and Stena suggested to us that Le Shuttle-Freight could in practice carry unaccompanied freight by employing tug units in the same way as the ferries but Eurotunnel has told us that it has no plans to do this. However, we note that in addition to other freight operators, through-freight rail services using the Tunnel are a potential alternative carrier of unaccompanied freight; and that the freight carried by such services increased by 75 per cent during 1996 (see Table 4.4). As we also note in paragraph 5.72, the freight transport industry would have the option of carrying freight in driver-accompanied vehicles if rates for unaccompanied freight were to rise to an unacceptable level.

Barriers to entry

2.114. We have been told that on some routes at least, it is possible to offer a credible service with a daily sailing so that the minimum number of vessels required for entry to the market is likely to be lower than in the passenger market. The joint venture would free up space at Dover which could be used for an additional freight service; and Sally Line, which owns the port of Ramsgate, told us that its joint venture with Holyman would leave space at that port for further freight or passenger operations. P&O and Stena also told us that freight ships were less costly than multi-purpose vessels, particularly if purchased on the second-hand market. We therefore take the view that barriers to entry to the freight market are relatively low. This is borne out by the high incidence of entry to and exit from the market which we have noted in paragraph 5.121.

Effects on competition in other markets

2.115. We have also considered two ways in which the joint venture might affect competition outside the markets in which it will operate:

- (a) by co-operation between P&O and Stena within the joint venture spilling over into their independent operations on other routes; and
- (b) by promotional and marketing arrangements between the joint venture and its parent companies including 'landbridging' arrangements, which disadvantage competitors of P&O and Stena.

2.116. We consider first whether the degree of co-operation to which P&O and Stena would become accustomed within the joint venture would lead to alignment of prices, schedules or strategies on other routes. If it happened, this could affect services which the two companies currently operate in competition or decisions on the nature and location of new services.

2.117. Outside the Short Sea routes, direct competition between P&O and Stena is now confined largely to services on the Northern Corridor of the Irish Sea (see paragraph 5.42) where the two companies and their subsidiaries together carry some 79 per cent of passenger traffic and 65 per cent of all freight. We received a number of expressions of concern from organizations in Northern Ireland about the possible effects of the joint venture on fares and freight rates charged to Northern Ireland businesses and travellers. The Department of Economic Development for Northern Ireland told us that there had been a past suggestion of co-operation between P&O and Stena on the Irish Sea, based on the similarity of fare structures. The Department suggested that any past tendency to reduce competition on the

Northern Corridor routes may be strengthened by a merger of the two companies' Short Sea operations.

2.118. P&O and Stena emphasized that their services on the Irish Sea would be managed quite separately from the joint venture. They would have their own strategic and competitive objectives and the institutional and other shareholders of their respective parent companies would expect them to make satisfactory returns. The number of different operators on the routes concerned also ensured that services were very competitive and subject to frequent change.

2.119. We note that ferry services between Great Britain and Northern Ireland, unlike international sea transport services, are subject to the Restrictive Trade Practices Act 1976 (the 1976 Act). This means that any written or unwritten agreement between P&O and Stena in which they accept a restriction relating to, for example, their prices or services would need to be registered with the DGFT in advance of it coming into force. The DGFT may also ask the Restrictive Practices Court to rule on such an agreement. Though it would then be possible for the Court to allow an agreement to continue, it has rarely allowed price-fixing agreements. We therefore have no reason to expect that an exception would be made in the case of any such agreement relating to services on the Northern Corridor of the Irish Sea.

2.120. Nevertheless we have considered whether formation of the joint venture would increase the likelihood of the two companies' operations on the Northern Corridor settling into a pattern of parallel behaviour on prices and services of a kind which would not be caught by the 1976 Act. This is most likely to occur in situations where both competitors have significant shares of the market, where there is insufficient competition to destabilize any parallel action and where they have sufficient experience of each others' services to have become familiar with the strategy being followed.

2.121. P&O and Stena clearly meet the first condition. As to the second, we note that, at present, there is one significant competitor (with 19 per cent of the market) for the companies' passenger services and a number of competitors in the freight market (see Table 5.15). We were also told by Irish Ferries that there is a significant degree of substitutability between freight services on the Northern Corridor and those on the Southern and Central Corridors. We therefore consider that the degree of competition for both passenger and freight services on the Northern Corridor may well be sufficient to destabilize any parallel conduct. Given their respective shares of the passenger market, P&O and Stena may also meet the third condition. However, it is difficult to see how the formation of a joint venture on the Short Sea routes would affect this situation one way or the other. The risk associated with allowing the two companies to co-operate within the joint venture is that it would increase the opportunity for them to conceive agreements of the kind which would be caught by the 1976 Act. If there is also a risk of parallel behaviour not caught by that Act, it flows from the current conditions of competition on the Northern Corridor routes and, in our view, is unlikely to be increased by the joint venture.

2.122. We also need to consider whether the joint venture would inhibit future competition between P&O and Stena on routes on which there is not at present direct competition between them. The companies said that the joint venture is unlikely to lead to co-ordination on these routes for the reasons outlined in relation to Irish Sea routes in paragraph 2.118. They also pointed out that Stena's plan to replace its conventional ferry service on the Harwich-Hook of Holland route with a large fast craft, and its declared intention to use fast craft if it resumes operations in the Western Channel, would make it unlikely that a basis could be found for co-ordination with P&O's conventional ferry operations in the North Sea or Western Channel. They emphasized that any attempt by their separate businesses to raise prices on routes outside the Short Sea would expose them immediately to price undercutting by competitors.

2.123. As we describe in paragraph 3.92, the Board of Directors of the joint venture would include two co-chairmen and eight non-executive directors who are also serving directors of the parent organizations. Our concern is essentially whether the working relationship developed within this Board of Directors would be exploited to resolve competitive tensions between P&O and Stena or to develop common strategies for the wider ferry market.

2.124. We consider that, in markets where there is significant competition from third parties or a constant threat of new entry, an attempt by P&O and Stena to co-ordinate prices or services may not serve their interests and would be unlikely to have lasting adverse effects if it did take place. As we have noted in paragraph 2.107, this appears to be the position for the Anglo-Continental freight market. In passenger markets, we note that there are already significant competitors for P&O and Stena on the Central and Southern corridors of the Irish Sea and on the Western Channel (see Figures 5.2 and 5.3). There is more limited third party competition in the North Sea passenger market and this increases the risk that P&O and Stena would find it in their interests to co-ordinate future activity. However, we have received no expressions of concern in relation to this particular market and we accept that Stena's commitment to a fast craft service in this sector reduces the likelihood that common ground could be found with P&O's conventional ferry operations.

2.125. Irish Ferries raised with us a concern that the joint venture and its parents might combine their marketing and other activities to the detriment of competitors on routes outside the Short Sea. In particular it was concerned about the joint venture being used as a vehicle for the promotion of its parents' services on the Irish Sea and about the future of Irish Ferries' arrangements with P&O for joint promotion and through ticketing, or landbridging, for journeys involving travel on both the Short Sea and Irish Sea (see paragraphs 5.128 and 5.129). It advocated that the joint venture should be prevented from entering into such arrangements with P&O or Stena.

2.126. P&O and Stena said that the joint venture would negotiate the landbridge and joint promotion arrangements which served its own commercial interests. It would be principally concerned about the effect of such arrangements on its own Short Sea business rather than on the business of its partner. This may lead it to enter into arrangements with its parent companies or with third parties. But all such arrangements would be negotiated at arm's length. We consider that there must be some risk of the joint venture favouring its parent companies in these arrangements. However, as we have noted in paragraph 5.129, the proportion of Irish Ferries', P&O's and Stena's traffic on the Irish Sea which is currently covered by landbridging arrangements is very small and the number of joint promotion arrangements is limited. Even if existing arrangements were to be adversely affected by the joint venture, the overall impact on competition on the Irish Sea routes is likely, in our view, to be small. We also note that Eurotunnel and Short Sea ferry operators other than the joint venture are potential alternative partners for these arrangements.

Other effects

2.127. We received a number of representations about the effect of the proposed joint venture on employment. It was generally understood that the figure for job losses would be around 1,000 although NUMAST suggested that it may in practice be closer to 2,000. NUMAST was also concerned that the adoption by the joint venture of the live-on-board arrangements currently used by Stena could lead to unrested staff and a consequent decline in safety standards and quality of service on board the joint venture's ferries. Others expressed concern about the effect on employment, both in the ferry services and the towns which they served, of a decision not to proceed with the joint venture. The GMB and the National Union of Rail, Maritime and Transport Workers (RMT Union) both noted that the consequences for employment of an uncoordinated reduction of ferry capacity, or even of complete withdrawal from the market of one or other operator, could be worse than those arising from the joint venture.

2.128. P&O and Stena told us that the joint venture would lead to a reduction in the workforce of the equivalent of 900 full-time staff. This was in addition to 600 sea staff redundancies expected to result from capacity reductions due to take place in 1997 whether or not the joint venture proceeded. They also told us that, while the fears expressed about live-on-board arrangements had not been borne out in Stena's experience, there was as yet no firm commitment to the extension of these arrangements under the joint venture. If such arrangements were introduced, any cost savings would be additional to those notified to us (see paragraph 2.39).

2.129. We take the view that, in the long term, job losses are inevitable and their number may be expected to reflect the scale of excess capacity in the market. However, it is a feature of the ferry industry that capacity is difficult to fine tune and a reduction brought about by attrition in the market may be more damaging in terms of job losses and labour relations than an orderly rationalization of two fleets. To the extent that it results in a more competitive ferry service, the joint venture would also make the jobs of retained employees more secure in the longer term.

2.130. We note the concern of Thanet District Council that this may be achieved at the expense of ferry operators based at Ramsgate. We cannot predict the effect of the joint venture on Ramsgate. We believe that it will depend on the success of the existing users of the port relative to Eurotunnel as much as to the joint venture. However, subject in particular to the considerations set out in paragraphs 2.74 to 2.87, we take the view that, in principle, improving the ferry operators' competitiveness in relation to the Tunnel is generally in the interests of long-term employment in and around ports in the South-East.

2.131. East Sussex County Council emphasized to us the importance of the continuation of the Newhaven-Dieppe service to the local economy. We have been told that decisions on essential improvements to the port of Newhaven are dependent on a long-term commitment to the use of the port by the principal operator-currently Stena. As we have stated in paragraph 2.95, our judgment is that Stena would not be prepared to enter into such a commitment if the joint venture were not to proceed.

2.132. As to live-on-board arrangements, we note that the position remains unsettled. We do not regard such arrangements as an inevitable outcome of the joint venture and we think it likely that P&O would want to consider their adoption whether or not the joint venture went ahead. We therefore consider that the possibility that they might be extended to P&O ships is not a matter on which we can usefully comment in the context of our inquiry.

Benefits claimed for the joint venture

2.133. P&O and Stena put it to us that the joint venture would produce a number of benefits to the public interest. They claim that it would, in particular:

- allow an *increased sailing frequency* and improved regularity of sailings while keeping spare operational capacity in reserve for use in periods of exceptional demand;
- offer *continuous loading* throughout the day, adding to the convenience of the public by allowing immediate embarkation and removing quayside waiting;
- involve the *improvement of on-board services*, taking the best features of P&O and Stena's current services, leading to improved customer choice and service;
- promote *the reduction of costs* by allowing savings in operating costs;
- allow the *release of ferry berths and ticketing facilities* at the ports of Dover and Calais, thereby improving the ease of entry or expansion by other ferry operators;
- promote the *continued operation of ferry services* on the Dover-Calais, Newhaven-Dieppe and Dover-Zeebrugge routes;
- help to ensure the availability of *an alternative high-volume transport system* in the event that services operating through the Tunnel cease operation for whatever reason;
- help *the preservation of a UK-based fleet* capable of fulfilling demand at times of national emergency; and
- contribute to the *long-term maintenance of employment* in Dover and Newhaven in particular.

2.134. We now examine each of these possible benefits before moving on to our assessment of the public interest.

Increased sailing frequency

2.135. In practice, the joint venture would operate 30 round trips (60 crossings) a day on the Dover-Calais route compared with up to 44 round trips (88 crossings) provided by the existing vessels operated separately by P&O and Stena during 1996 (see paragraph 5.33). There would be no change in the frequency of sailings on the Dover-Zeebrugge or Newhaven-Dieppe routes. P&O and Stena acknowledged that this is a reduction in overall frequency but suggested that, in the case of passenger or freight customers who have pre-booked tickets, or who have booked a return fare, it is the frequency of sailings offered by the operator with which they have booked which matters.

2.136. In our view a reduction in the overall number of sailings is bound to limit the options available to users to some extent. However, we believe that the proposed schedule offers users as good a service as might be expected to result from the reductions in capacity which we see as inevitable in this market. Indeed, as we noted in paragraph 2.77, there is concern from other operators that the frequency of services offered by the joint venture would give it a powerful competitive advantage. The regularity of sailings also seems an important benefit in its own right in that it would make journey planning easier for passenger and freight customers.

Continuous loading

2.137. We also accept that continuous loading adds to the convenience and comfort of the travelling public. We were told that Stena currently did not operate such a system and that there was continuous loading of P&O ships only at peak times. We consider the extension of continuous loading through most of the day to be a worthwhile improvement in service.

Improvement of on-board services

2.138. P&O and Stena told us that P&O's current Club-Class lounges would be extended to all vessels in the joint venture's fleet and that there would be on-board waiter service, self-service and fast-food restaurants available on all routes. On-board sales outlets for tax-free and duty-free goods would be improved and harmonized training would help to achieve a consistent quality of service across the fleet. We cannot judge, in advance, precisely how much this would improve the overall quality of existing P&O and Stena services. However, we agree, in principle, that a shift of investment from the operation of excess ferry capacity to the improvement of on-board service to passenger and freight customers would be an additional benefit to the public interest.

Reduction of costs

2.139. P&O and Stena told us that, of the expected savings of £75 million a year in operating costs, approximately [*] per cent would be savings in ship operating costs and [*] per cent in savings on port and office administration and marketing. It has been pointed out to us (see paragraph 6.40) that the ferry capacity to be removed as a result of the joint venture is little greater than the capacity which P&O and Stena have introduced to the market since 1993 (see paragraphs 2.23 and 2.26). However, this does not seem to us significantly to reduce the value of the efficiencies now being introduced. If the forecast savings were realized, they would be significant, amounting to over £11 for each unit of traffic (measured in PCUs) carried by P&O and Stena during 1996. As with all mergers, there must be some uncertainty as to the precise amount of savings which will be achieved in practice but, given the proportion of savings attributable to the removal of ships, we are satisfied that the overall figure would be substantial. The extent to which the savings would be passed on to the consumer would depend on the degree of competition for the joint venture. However, in principle, lowering the operating costs of a substantial part of the current ferry fleet and avoiding the cost of upgrading surplus vessels seems to us to permit lower prices without a reduction in the quality of service offered and to that extent is a significant potential benefit to the public.

The release of ferry berths and ticketing facilities

2.140. As we have already noted in paragraph 2.89, the release of berthing facilities at Dover and Calais is likely to result in improved berthing facilities for SeaFrance and freer access to Dover and Calais for potential new entrants to the passenger and freight markets. The release of ticketing facilities would also address problems raised with us by SeaFrance.

*Figures omitted. See note on page iv.

The continued operation of ferry services

2.141. In considering P&O's and Stena's general proposition that the joint venture would promote the continuation of ferry services on the Dover-Calais, Newhaven-Dieppe and Dover-Zeebrugge routes, we need to consider freight and passenger services separately.

2.142. As to freight, we take the view that the number of competitors in the Anglo-Continental freight market and the relative ease of entry are such that it is likely that freight ferry services of one form or another would survive on the Short Sea routes with or without the joint venture. Services on the North Sea and Western Channel sectors also offer the freight transport industry alternative routes to the Continent. However, we acknowledge the importance of the Short Sea routes to the freight transport industry and we accept that, by reducing the cost of operating its Dover-Calais services, the joint venture could make these services more competitive and help to ensure their survival. Although the impact of the joint venture on the competitiveness of P&O's and Stena's freight services on the Dover-Zeebrugge and Newhaven-Dieppe routes would, in our view, be more limited, we consider, for the reasons given in paragraphs 2.95 and 2.110, that these services are more likely to remain competitive within the joint venture than outside it.

2.143. In the passenger market, our judgment is that P&O and Stena will remain in the market, whether or not the proposed joint venture goes ahead, at least until duty-free concessions are abolished in 1999 and, as we have already noted, other operators seem equally committed to the market in the short term. However, we accept that the continuation of high-volume passenger ferry services on these routes beyond 1999 is not secure. It will depend on the ability of the ferry operators to offer a service which is an attractive alternative to Le Shuttle in terms of price, flexibility and quality of service. We therefore agree that, to the extent that it leads to reduced costs and improved vessels, schedules, and on-board services, the joint venture would improve the potential both for significant longer-term ferry competition with Le Shuttle and for the continuation of the existing choice of routes.

Provision of an alternative, high-volume transport system

2.144. We agree that it is in the consumer interest to have one or more sustainable ferry operations with sufficient capacity between them, not only to provide effective competition for services through the Tunnel, but also to provide at least the basis for an alternative cross-Channel transport system for use in the event that the Tunnel's services should wholly or partly cease operation, for whatever reason. To the extent stated in paragraphs 2.142 and 2.143, we accept that the joint venture would help to ensure that such a situation continues.

Preservation of a UK-based fleet

2.145. However, we attach little weight to the claimed benefit of preserving a UK-based ferry fleet for use in times of national emergency. We were told by the Ministry of Defence that ferries were not necessarily suitable for all defence-related transport work; that the Government's policy in recent years had been to charter ships on world markets as necessary in times of need; and that ferries were not always releasable from their commercial role at such times.

Long-term maintenance of employment

2.146. We have considered the likely effects on employment in paragraphs 2.127 to 2.131 and for the reasons given in those paragraphs we accept that the joint venture is likely to be generally beneficial to employment in the joint venture's ferry services and the towns which they serve.

Assessment of the public interest

2.147. We now weigh the likely detriments and benefits of the joint venture in order to form an overall conclusion as to the public interest.

The rationale for the joint venture

2.148. The background to the joint venture is important to our assessment. In summary, the capacity added to the Short French Sea passenger and freight routes since 1993 is greater than the total amount of traffic on those routes in 1996. This is largely the result of the opening of the Tunnel. But the ferry operators have also added significantly to capacity in an effort to establish themselves as independent operators and to provide schedules which are competitive with Eurotunnel's turn-up-and-go services. In spite of the increase in both passenger and freight traffic in recent years (to which we have referred in paragraph 2.27) Eurotunnel and the ferries are now each using little over 40 per cent of their total carrying capacity. Their efforts to make better use of this capacity have involved fierce price-cutting. As a result, fares and freight rates have fallen substantially since 1994. This has benefited the travelling public and the freight transport industry and its customers. P&O and Stena were making significant profits in 1994, particularly on the Dover-Calais route (see Tables 3.7 and 3.15) but events since then have inevitably taken their toll on the profitability of most ferry operators.

2.149. Even ignoring the cost of servicing its debt, Eurotunnel's Shuttle operation is making substantial losses. Three of the five main ferry operators on the Short Sea routes would have made losses on these routes in 1996, if it were not for the additional unexpected revenue at the end of the year in the form of traffic diverted to them following the fire in the Tunnel. Even their current level of profitability owes more to profits being made from the sale of duty-free goods and other retail sales than to fares and freight rates; and this stream of revenue will be substantially cut when duty-free concessions are abolished in 1999.

2.150. Our starting point is that we consider it to be in the public interest that there should be a sustainable alternative to the Tunnel. This is needed to provide effective competition to the Tunnel's services; to allow the travelling public and the freight transport industry a choice of method for crossing the Channel; and to ensure that there is at least the basis of an alternative high-volume cross-Channel transport system on the Short Sea routes for use in the event that services through the Tunnel should cease operation, as was the case following the fire on 18 November 1996.

2.151. P&O and Stena consider that the joint venture would help to ensure that there is just such a sustainable ferry alternative to the Tunnel.

2.152. We have considered the benefits claimed for the joint venture in paragraphs 2.133 to 2.146. We accept, as do a number of those who have made representations to us, that the present level of excess capacity in ferry services, and the costs associated with it, are unlikely to be sustainable. Whatever the financial position of its current operators, we see some form of cross-Channel service through the Tunnel as a long-term feature of the market. It must there-

fore fall to the ferry operators to make at least some adjustments to their capacity. The proposed joint venture would clearly make a contribution to that process. At the same time, it would allow P&O and Stena to retain the most efficient ships in their combined fleet and to continue to offer a comprehensive and, in some respects, improved schedule of sailings. In principle, cost savings brought about by the reduction in the combined fleet and removal of duplication in on-shore activities could help to keep fares down, strengthen ferry competition to Eurotunnel and improve the prospects of a high-volume alternative to the Tunnel being maintained on the Short Sea routes. The promised emphasis on the improvement of loading arrangements and on-board services should also increase the convenience and comfort of passengers and if maintained could improve the joint venture's potential to compete with Eurotunnel.

The likely detriments

2.153. However, we consider that the public would not automatically gain from all these potential benefits. We accept that improvements in schedules and quality of service may be of immediate benefit to passengers and freight customers of the ferries. However, the cost savings, which we consider to be the most important potential benefit, would be unlikely to benefit the travelling public or the freight transport industry at all unless there is sufficient competitive pressure to ensure that they are passed on in the form of lower fares.

2.154. Given the scale of the operations of Eurotunnel and the joint venture, we have had to consider the possibility that the two operations would acquire a duopoly position. By this we mean a position where Eurotunnel and the joint venture have no competitors in the relevant market or have a position of such dominance that they could act independently of other competitors. We take the view that, in general, duopolies of this kind exhibit a tendency to settle down into a pattern of parallel behaviour which denies consumers the benefit of full competition. This leads to higher prices and could result in a decline in levels of service in the longer term. We have therefore considered whether a duopoly situation is likely to arise in either the freight or passenger markets and, if so, whether there are reasons to believe that the joint venture and Eurotunnel would not behave in the way we would normally expect of duopolists. Regardless of our findings on these questions, we also need to consider whether co-operation between P&O and Stena within the joint venture would spill over on to other markets in which they operate.

Competition in the freight market

2.155. We have considered the level of competition that might be expected in the Anglo-Continental freight market in paragraphs 2.106 to 2.110. As we note in those paragraphs, there are a number of competitors for Eurotunnel and the joint venture in that market; and, as we also note in paragraph 2.114, entry to the market is relatively easy. We therefore consider it very unlikely that a duopoly situation would arise. We do not foresee a situation developing in which the joint venture and Eurotunnel could raise freight rates significantly without running a substantial risk of losing business to existing competitors or new entrants on the Short Sea or other routes. Nor do we consider it likely that P&O and Stena would be able to co-ordinate the freight services they would operate outside the joint venture without a high risk of these arrangements being destabilized by other competitors. For similar reasons, we do not foresee a significant loss of competition for the carriage of goods which cannot be transported through the Tunnel. Of the operations which are to be combined in the joint venture, it is P&O's services which currently carry the large proportion of these types of freight, and we believe that the potential loss of competition from Stena would be adequately replaced by other freight-only operators.

Competition in the passenger market

2.156. The situation in the Short Sea passenger market is, however, different. The costs of entry to the market are higher than is the case for freight and our judgment is that there is most unlikely to be a new entrant, other than perhaps on a seasonal basis, at least until after the market has adjusted to the abolition of duty-free concessions in 1999. We now therefore consider in relation to this market:

- (a) the degree of competition that might be expected between Eurotunnel and the joint venture if they were to acquire a duopoly position;
- (b) whether there will continue to be sufficient competition from other operators to prevent a duopoly situation from arising; and
- (c) the effect of the joint venture on competition outside the market in which it would operate ('spillover').

Competition between the joint venture and Eurotunnel

2.157. P&O and Stena laid particular emphasis on the competitive advantage which Eurotunnel gains from the scale of its capacity, its funding arrangements and its low variable operating costs. They suggested that, given Eurotunnel's funding arrangements (see paragraphs 4.32 to 4.39), it would be likely to set its fares and freight rates so as to attract the maximum amount of traffic while covering operating costs.

2.158. We accept that Eurotunnel has substantial carrying capacity and has made rapid inroads into both the passenger and freight markets. However, we do not regard this as a safe guide to the way Eurotunnel might be expected to compete in the future. As we note in paragraph 2.64, Eurotunnel told us that its strategy for the immediate future, by agreement with the banks, is to generate cash as fast as possible. This would not necessarily lead it to maximize traffic. If the state of competition allowed, greater revenues could be achieved by raising fares within its existing market share. We therefore need to consider whether there are other reasons why Eurotunnel and the joint venture would not be content to align prices or to follow the other's price leadership.

2.159. We accept that parallel behaviour might be difficult if, as P&O and Stena suggested, Le Shuttle's operating costs were significantly below those of the joint venture. However, we believe that P&O's and Stena's analysis of the position is misleading in the context of an assessment of future pricing behaviour. Whilst we acknowledge that Eurotunnel's variable costs, strictly defined, are lower than those of P&O or Stena, we believe that the general level of fares in the market will be determined by a more medium-term view of costs by both Eurotunnel and the ferries. We do not believe that Eurotunnel would be content to run its business without recovering, for example, the substantial ongoing costs of maintenance of the Tunnel and rolling stock. Indeed, the strategy which Eurotunnel has agreed with the banks for the immediate future would not permit it to do so. In the longer term, Eurotunnel's investors are likely to want prices to reflect a larger proportion of depreciation. There will also be a need to repay the interest on its debt, and possibly even to repay the debt itself. We therefore take the view that, whilst the operating costs on which Eurotunnel would base its pricing policy for Le Shuttle are likely to be broadly comparable to those of the joint venture (see Table 2.4), they will not be lower. This leads us to expect that both Eurotunnel and the joint venture would see it as in their interests to engage in parallel pricing if a duopoly situation were to arise.

2.160. Secondly, we believe that Eurotunnel would only seek to undercut the ferries' fares if it had additional capacity to fill. As we note in paragraph 2.60, the extent to which Le Shuttle will be able to use its capacity will be limited by loading constraints for the foreseeable future. As it is still developing its traffic management techniques, a precise forecast of the impact of these constraints on its capacity in the longer term is not possible. However, we believe there is a limit to the market share it could achieve in the medium term at least. We also believe that, for the foreseeable future, there will be constraints on the volume of traffic Le Shuttle-Tourist could carry at peak times. Eurotunnel is currently using non-price means to try to overcome this problem but our view is that, far from having an incentive to undercut the ferry prices to gain market share during peak periods, it would willingly follow a trend towards higher fares in those periods if the market would allow.

2.161. We have considered the reasons suggested by P&O and Stena as to why the joint venture, for its part, would want to compete with Eurotunnel (see paragraph 2.66) but we do not find these compelling. We accept that the benefit to the ferries, and to a lesser extent Eurotunnel, of revenue from duty-free and other retail sales is at present a significant incentive to compete on ticket prices in the passenger vehicle market. However, we consider that this will have much less force after duty-free concessions are abolished in 1999.

2.162. In our view, only effective competition from other ferry operators on the relevant routes would be sufficient to prevent a duopoly arising, to prevent parallel behaviour between Eurotunnel and the joint venture or to destabilize such behaviour by undercutting prices or introducing innovative services. We now therefore consider whether such competition from other ferry operators might be expected.

Competition from other operators

2.163. In the period up to 1999, we would expect the potential rewards from duty-free sales, including a possible surge of interest in the run-up to 1999, actively stimulated by the ferries and Eurotunnel, to ensure that all existing ferry operators remain in the market, whether the joint venture is formed or not. The recent investments by SeaFrance, Holyman Sally and Hoverspeed to which we have referred in paragraph 2.71 support this view. The market is therefore likely to remain highly competitive, with Eurotunnel and the ferry operators both aiming to take their profits from duty-free sales as much as from ticket prices. With the joint venture, capacity would be reduced, the structure of competition would change and there might be some movement in fares, but we would expect them to remain competitive.

2.164. After abolition of duty-free concessions, we would expect market conditions to become much tougher. All the ferry operators who have submitted evidence to us have expressed great uncertainty about the position beyond 1999. As can be seen from Appendices 3.2 and 3.4, P&O and Stena are forecasting falls in revenue of between 17 and 27 per cent (depending on Eurotunnel's performance) from 1998 to 2000. But both companies expect this to be temporary and for recovery to take place as growth in the market resumes after 2000. Forecasts produced for Eurotunnel at the end of 1995 put growth in the passenger vehicle market at around 2 per cent a year between 1998 and 2003 and slightly higher from then up to 2013. In our view, SeaFrance, Holyman Sally and Hoverspeed are likely to find these conditions very difficult, particularly alongside a ferry operator on the scale of the proposed joint venture. If these three operators remained in the market, they could, in principle, deter or undermine any parallel behaviour between the joint venture and Eurotunnel. However, we believe that the economic and marketing power of the joint venture is such that, in practice, it could and would weaken these competitors to the point where they would either leave the market or be unable to offer effective competition.

2.165. We have taken account of concerns expressed to us by these ferry operators about possible predatory pricing or other forms of predatory behaviour by the joint venture. As we have noted in paragraph 2.76, we draw a distinction between predatory and competitive behaviour. However, as we have also noted in that paragraph, we believe the joint venture would have the resources and might have the incentive to act in a predatory way in the period immediately after 1999. More probably, we consider that it would be able to eliminate or subdue competitors without resorting to predatory pricing as we have defined it. From its position of strength, the joint venture could, in our view, achieve this by aggressive pricing or scheduling against new entrants or existing operators trying to build on a small market share.

2.166. For the reasons given in paragraphs 2.81 and 2.82, we do not agree with SeaFrance that the frequency of the joint venture's sailings could, by itself, eliminate or weaken competitors. However, we do accept that the joint venture's size and its association with the P&O and Stena names would give it a considerable marketing advantage in this respect. Any extension of this advantage by the use of joint marketing arrangements with its parent companies or by the use of exclusive arrangements with travel agents could be sufficient to limit severely the impact of other smaller operators in the market. We therefore consider that issues such as ticketing and berthing arrangements, access to travel agents and the breadth of the joint venture's marketing options would be likely to have a significant bearing on the relative health of the joint venture and its competitors in the post-1999 period.

2.167. We take the view that the factors we have identified in paragraphs 2.164 to 2.166 might be expected, in combination, to lead to a situation in which effective competition for the joint venture and Eurotunnel in the passenger market would be eliminated. We would expect the resulting duopoly situation to lead to increases in prices to a level higher than is required for the maintenance in the long term of an efficient ferry operator. We would not, however, expect this situation to arise until after 1999.

Effect on competition in other markets

2.168. We have considered whether co-operation between P&O and Stena within the joint venture might be expected to spill over into their operations in other markets (see paragraphs 2.115 to 2.124) but have concluded that this is unlikely to be the case. In most of these markets, there is significant competition for the two companies which might be expected to destabilize parallel behaviour. In the case of passenger services on the Northern Corridor of the Irish Sea, where P&O and Stena have a substantial share of the market, we note that any co-ordination between the two companies is also likely to be constrained by application of the Restrictive Trade Practices Act 1976.

2.169. We also considered the likely effect of the joint venture on current landbridging and joint promotion arrangements with Irish Ferries. We accept in principle the view of P&O and Stena that the joint venture would generally be concerned to select the partner in this kind of arrangement which best served its own commercial interests rather than those of its parents. We also note that the volume of traffic covered by landbridging arrangements is small and that Eurotunnel and other ferry operators may offer alternative partners for Irish Ferries or others who may not be able to negotiate arrangements with the joint venture. We accept that there is a risk of the joint venture favouring its own parent organizations in negotiating these arrangements, but we believe that the overall impact on competition of any such preferences will be very small.

The situation without the joint venture

2.170. Before drawing conclusions as to the public interest, we now consider whether the detriments we have identified would arise in the event that the joint venture were not to proceed. As these detriments arise only in relation to the passenger market we have focused on the likely situation in that market and on two broad possibilities in particular:

- (a) that P&O and Stena would enter into some form of co-operation arrangement falling short of a full joint venture; and
- (b) that P&O and Stena would continue to operate independently ('stand-alone') without any form of co-operation.

Co-operation arrangements

2.171. P&O and Stena told us that they had agreed that, in the absence of a joint venture, they would each remove one ship from their Dover-Calais services.¹ They estimated that this would save, in total, £[*] million in annual operating costs compared with the £75 million of savings envisaged under the joint venture. They did not, however, regard this as a satisfactory alternative to the joint venture. They pointed out that it would involve a restriction of the schedules of both companies to the detriment of their service to customers. In their view there was a risk that this would lead, in turn, to a decline in the attraction of their ferry services as an alternative to Le Shuttle and to a further cut in capacity with a consequential worsening of the quality of their service.

2.172. We believe that a capacity reduction agreement of this kind would at least begin to address the problem of over-capacity in the market. But it would not bring with it all the cost savings or the improvement in schedules envisaged under the full joint venture. Indeed, it is certain to result in a cut in the two companies' schedules and a possible weakening of competition with the Tunnel. In the longer term, there is a risk, in our view, that matching reductions in each company's ferry fleet may lead to the removal of efficient vessels and the retention of less efficient vessels whereas the joint venture would allow the selection of the most efficient ferries from the two fleets. Any attempt by the two companies to address this problem by an uneven reduction in their fleets would, in our view, require a more comprehensive strategic alliance of the kind envisaged under the joint venture. Whilst we therefore consider that a capacity reduction agreement would avoid the detriments to competition likely to arise from the joint venture, it would not produce the key benefits of the joint venture. Any such agreement is likely to have a short-term effect with the parties to it continuing, after the agreed reductions in capacity, as independent operators. The longer-term effects are therefore likely to be similar to those arising in the stand-alone situation which we examine in paragraph 2.176.

2.173. P&O and Stena told us that they regarded all forms of pooling arrangement as inferior to the proposed joint venture, mainly because they would not produce the cost savings or single strategy and management focus which would be provided by the joint venture. In their view the co-ordination of schedules presented great practical problems because the parties concerned inevitably wished to retain the sailing time which was most advantageous from the point of view of load factors and potential on-board sales. Such arrangements were rarely possible without some form of revenue sharing.

¹Though this has yet to be implemented.

*Figure omitted. See note on page iv.

2.174. We take the view that most forms of pooling arrangements between P&O and Stena would involve detriments to competition of the kind which we expect to arise from the joint venture. We agree that it is likely to be difficult to co-ordinate schedules or other operational matters without sharing revenue. We are not aware of any pooling arrangements on the Short Sea routes in the recent past which did not also involve revenue sharing. Such arrangements lead, inevitably in our view, to a degree of co-ordination of pricing policy. Even if a lesser form of co-ordination could be made to work, we would expect the day-to-day contact on operational matters which that would bring about to lead in due course to co-ordination over a wider area of strategy. That, in turn, would entail a risk of parallel behaviour between Eurotunnel and the partners in the pool unless there was sufficient third party competition to prevent or destabilize it. The outcome would therefore be similar to that which might be expected from the joint venture but it would be achieved with less transparency. A pooling arrangement would not necessarily give the participants the kind of marketing and economic power available to the proposed joint venture but this is not guaranteed. The joint marketing by P&O and Stena of a pooled schedule could easily give rise to the detriments to competition which we have identified in relation to the joint venture.

2.175. We therefore conclude that the pooling of schedules or similar levels of co-operation on operational matters would be likely to give rise to the same detriments to the public interest as the joint venture without the level of benefits in terms of management focus, efficiency and consistency in the quality of service which might be expected from the joint venture. However, on the basis of the views presented to us by P&O and Stena, including stand-alone projections for their businesses, we would not expect the two companies to enter into such pooling arrangements if the joint venture were not to proceed.

The stand-alone situation

2.176. As we have observed in paragraph 2.164, we would expect the passenger market to become significantly more difficult for the ferry operators after the abolition of duty-free concessions in 1999. Up to that point we would expect all ferry operators to remain in a highly competitive market, whether or not the joint venture proceeds.

2.177. We would expect ferry operators to have a good idea of their longer-term strategy before duty-free concessions are abolished but the precise point at which the structure of the market will start to reflect these decisions is difficult to predict. However, in the longer term we would expect that:

- (a) on the basis of its scale of operation and profitability relative to other operators, P&O would remain in the market; and
- (b) the market would not be large enough to support three significant operators of conventional ferries; either Stena or SeaFrance would exit.

2.178. We have considered whether, in this situation, P&O might use its relative economic and marketing strength, in the way we have suggested the joint venture is likely to operate, to eliminate effective competition from the remaining ferry operators. On balance, however, we believe this to be unlikely because P&O's dominance would be less than might be expected of the joint venture. As we have noted in paragraph 2.171, P&O has already agreed to reduce its fleet by one vessel and we would expect it to have fewer vessels after 1999, and a thinner schedule, than the joint venture would have by then. We would expect P&O's profits and financial capacity to be less than that of the joint venture with access to both P&O's and Stena's resources; and its costs are likely to be higher. Its marketing strength, though considerable, would also be less than that of a joint venture associated with the two largest ferry operators in the country. We believe that post-1999 a market in which P&O operated on

a stand-alone basis would leave more scope for a third competitive force to develop than a market dominated by the proposed joint venture.

2.179. We would therefore expect that in a stand-alone situation the market would remain competitive beyond 1999. Competition would be provided by one or more of the existing ferry operators. One possibility is that an existing fast craft operator would emerge as a more important participant in the Short Sea passenger market. As we note in paragraphs 5.89 and 5.90, both Holyman Sally and Hoverspeed have recently invested significantly in fast craft. We have been told that recent developments in the design of these craft increases their economy of operation and improves their performance in bad weather. In the absence of duty-free concessions as an incentive to travel, speed of crossing may become a more significant selling factor on the Short Sea routes. Fast craft may then become a particularly effective form of competition for the different formats and comprehensive schedules offered by Eurotunnel and the conventional ferries of the major ferry operators. For the reasons stated in paragraph 2.164 we would not expect the market to remain competitive in this way if the joint venture was to proceed.

Conclusions

2.180. We conclude that, in so far as the carriage of freight is concerned, the joint venture is unlikely to have adverse effects on the public interest. We further conclude that, in so far as the carriage of passengers is concerned, the joint venture is unlikely to have adverse effects on the public interest in the period up to the abolition of duty-free concessions in June 1999.

2.181. However, we would expect that, after June 1999, the loss of competition between P&O and Stena would lead to a situation in which the joint venture and Eurotunnel held a position of duopoly (as we have described it in paragraph 2.154) in the relevant passenger market; and that, as a result, cost savings arising from the joint venture would not be passed through to the public, and fares would rise. We would further expect that fares would rise to a level higher than would be required for the maintenance of efficient ferry services in the long term. The public would be likely to benefit from improved schedules and on-board services but those benefits would not, in our view, outweigh the detriment of higher fares. We would not expect the duopoly situation we have described, or the detriments resulting from it, to arise in the absence of the joint venture. We therefore conclude that, on balance, the joint venture may be expected to operate against the public interest in so far as it concerns the provision of ferry services in the Short Sea passenger market after the abolition of duty-free concessions in 1999. The particular adverse effects we have identified are that, after 1999, fares are likely to be higher than they would be in the absence of the joint venture and higher also than would be required for the maintenance in the long term of efficient ferry services.

Recommendations

2.182. We are required under the Act to consider what action, if any, should be taken for the purposes of remedying or preventing adverse effects which we have identified as arising from the merger situation.

2.183. As we have noted in paragraphs 2.165 to 2.167, we consider that the detriments to the public interest are likely to arise as a result of a combination of factors connected with the expected dominance of the joint venture on the Short Sea ferry routes. The fact or prospect of predatory or aggressive action would deter new entrants and inhibit the expansion of existing

operators with a smaller market share. The visibility of the joint venture, the marketing strength it would gain from association with P&O and Stena and its potential to lock out competitors from marketing channels such as travel agents would make it unlikely that other operators could maintain or develop their market positions in the difficult market conditions prevailing in the passenger market after the abolition of duty-free concessions.

2.184. Our opinions differ as to whether it is possible to remedy these threats to effective competition. One of our members believes that the only solution is to ensure that P&O and Stena remain as independent operators and his views are set out in a supplementary note immediately after this chapter. The majority, however, consider that an adequate level of effective competition could be assured by measures designed to allow new entrants or existing operators with a smaller market share to market and develop their businesses with a degree of protection from the dominance of the joint venture. They believe that the maintenance of effective competition which might then be expected would also help to ensure that the potential public interest benefits of the joint venture could be realized.

2.185. We have considered a wide range of remedies for this purpose. They include:

Remedies to encourage the development of competitors with smaller market shares

- (a) a requirement for the reduction in size of the joint venture's fleet;
- (b) a requirement not to operate fast craft on the Short Sea routes;
- (c) a requirement for ticket interlining with other ferry operators on the Dover-Calais route; and
- (d) a requirement to give up a ticket desk and vehicle ticket booths at Dover.

Remedies to prevent action to eliminate competitors

- (e) prior notification of new services and proposed prices to the DGFT;
- (f) regular notification of route profitability to the DGFT;
- (g) a requirement for separate accounts for the joint venture and its parents to be submitted to the DGFT; and
- (h) a requirement for separate accounts for each route to be submitted to the DGFT.

Remedies to limit the joint venture's marketing power

- (i) a requirement that the joint venture should not negotiate agreements with travel agents, or promotional arrangements with the media, jointly with its parent companies;
- (j) a requirement that arrangements between P&O or Stena and a travel agent should not be linked to the granting of that agent's services to the joint venture; and that P&O and Stena should not negotiate on the joint venture's behalf; and
- (k) a requirement that the joint venture should not enter into preferential or exclusive arrangements with travel agents.

P&O and Stena were invited to comment, on a hypothetical basis, on all these possible remedies except (a). We now consider the remedies in turn.

Remedies to encourage the development of competitors

2.186. We have considered carefully whether, in order to increase the room in the market for a significant conventional ferry operation other than that of the joint venture, we should require a reduction in the size of the joint venture's fleet as suggested by SeaFrance. However, we are concerned that the immediate effects of such a step would be to reduce the schedule of sailings envisaged under the joint venture, to reduce its benefits to the public and to weaken its potential to compete effectively with Eurotunnel. We do not therefore consider that such a remedy would serve the public interest.

2.187. We consider that ferry operators with a smaller share of the market have the potential to prevent or destabilize parallel behaviour between the joint venture and Eurotunnel provided that they are not deterred from seeking to increase their market share. We believe that, taking into account the focus of existing small operators on the Short Sea routes and the other factors we have identified in paragraph 2.179, fast craft services in particular offer the prospect of effective passenger ferry competition for the joint venture. However, for the joint venture itself to commence new fast craft operations on the Short Sea routes would, in our view, eliminate the prospect of such services becoming a significant source of competition. We consider that, in the exceptional circumstances created by the formation of the joint venture, restrictions on the joint venture's development into fast craft services on the Short Sea routes would be justified.

2.188. P&O and Stena did not wish to accept constraints on the ability of the joint venture to exploit fast craft technology if it judged that this was the kind of service customers required. This is understandable. However, such craft are relatively cheap to charter and therefore have greater potential than multi-purpose vessels for use as a means of eliminating or preventing competition. Any such action by the joint venture might be expected to affect, in particular, the two competitors of P&O and Stena which currently operate fast craft on the Short Sea routes, both of which have relatively small market shares. The benefits of the joint venture's schedule, on-board facilities and lower costs should allow it to compete strongly with these operators or any others developing fast craft operation for the foreseeable future, but we recognize that trends in the market would need to be kept under review. We therefore consider that any ban should be reviewed by the DGFT after five years. Given our conclusion as to conditions in the market before the abolition of duty-free concessions up to 1999, we also see no useful purpose in preventing the continuation by the joint venture of Stena's current fast craft service on the Newhaven-Dieppe route.

2.189. We have also considered SeaFrance's suggestion that it should be allowed to co-ordinate schedules with the joint venture. We have rejected this idea because, in our view, it would limit still further the potential for effective competition for the joint venture. However, we believe that ticket interlining between the joint venture and its competitors would help to consolidate the position of those competitors in the market and would improve the quality of service to customers. P&O and Stena pointed to the cost and impracticality of agreeing interlining arrangements, given the multiplicity of fare options on offer. We accept that there might be difficulty in providing interlining arrangements across the whole range of fares but it would, in our view, be consistent with the aim of improving convenience for travellers if they at least had the option of an interchangeable full-price ticket, thus giving them the same flexibility as in air travel. We believe that it should be practicable for ferry operators who wished to participate to agree on a single interlinable fare equal to the highest brochure price advertised for the period in question by any of the participants in the interlining arrangement. We therefore consider that the joint venture should be required to participate on this basis in reciprocal interlining arrangements at least for Dover-Calais services if other ferry operators propose it.

2.190. P&O and Stena told us that they would expect to be able to release one of their ticket desks at Dover, although a decision as to which one had yet to be taken. DHB also told us that it would expect to reduce the current allocation of vehicle ticket booths to the joint venture, though it has yet to decide by how much. We consider it most important that there should be a fair and balanced allocation of Dover's facilities between the joint venture and competing ferry operators. The visibility of such operators would also be particularly important given the increasing proportion of passengers who arrive at the port without a pre-booked ticket. We acknowledge that the disposition of ticketing facilities is largely a matter for DHB and the port of Calais. However, we consider that P&O and Stena should be required to give an undertaking in respect of their Dover facilities to release one of their current ticket desks and not to oppose the release of up to four vehicle ticketing booths.

2.191. The same principle should apply to berths. P&O and Stena have already told us that the joint venture would release one and a half berths for multi-purpose vessels and a fast craft berth at both Dover and Calais. We acknowledge that DHB and the port of Calais are responsible for deciding the allocation of berths and we consider it important, if there is to be a realistic prospect of new entry, that the release of these berths should go ahead as we have been told.

Remedies to prevent action to eliminate competitors

2.192. The remedies concerning possible predatory behaviour by the joint venture were felt to be unnecessary by P&O and Stena for the reasons outlined in paragraph 2.75. However, they were prepared to give assurances that they would provide the DGFT, in October each year, with financial information on a route-by-route basis showing traffic volumes, revenue, capital employed and allocated costs for the previous calendar year's operations (to be supplemented by audited accounts when available) and for the year to date. In addition the joint venture would provide its forecast for the current full year and projections for the subsequent calendar year.

2.193. We are concerned here both to deter actual predatory action and to remove the threat of such action which might otherwise inhibit vigorous competition from other operators. In our view, the DGFT should be able to carry out, in advance, the kind of analysis which he would normally undertake in responding to a complaint about predation. The provision of actual and forecast data on a regular basis would provide useful background information but would need to be supplemented as necessary by information on the costs and ticket prices of any proposed new services not included in the forecast data. To ensure that the DGFT had a clear understanding of seasonal changes in the position, the information would also need to be shown on a quarterly basis. We therefore consider that the joint venture should be required to provide the DGFT, annually at a time to be agreed as appropriate with regard to the joint venture's preparation of price lists and schedules for the following season:

- (a) financial and other information described in paragraph 2.192, presented on a quarterly basis; and
- (b) projections for the following year including routes to be served, new services planned, costs and intended fares;

and should notify him, in advance, of any new services and the fares proposed for those services which are not described in the information provided annually.

Remedies to limit the joint venture's marketing power

2.194. For the reasons given in paragraph 2.84, we do not agree with SeaFrance's suggestion that the joint venture should be required to operate under a name which distinguishes it from its parent companies. However, we believe that the marketing advantage which association with the P&O and Stena names would give to the joint venture should not be extended by means of collaborative marketing between the joint venture and its parents. We therefore consider that the joint venture should be required not to advertise its services in the brochures of its parent organizations. P&O and Stena told us that such a requirement would be unnecessary because their marketing organizations would be scaled down if the joint venture took over their Short Sea operations and would have to focus on promoting their retained businesses. They also said that they would not be able to avoid advertising the joint venture's services in the course of promoting their landbridging arrangements. However, as we have noted in paragraph 5.129, such arrangements cover a very small proportion of P&O's and Stena's business on the Irish Sea. We do not accept that the joint venture's services should be advertised in P&O or Stena brochures for general release just to provide information to such a small target audience.

2.195. We also consider that P&O and Stena should not be permitted to use their existing market power to ensure that the joint venture had preferential access to travel agents' services or to lucrative arrangements for promotional offers through newspapers and magazines. P&O and Stena told us that they were prepared to give assurances that the joint venture would negotiate independently with travel agents and would not aggregate the business undertaken by the joint venture and its parent for the purposes of calculating agents' commissions. They also pointed out that newspaper promotions were, almost exclusively, concerned with the Short Sea routes, and the parents would have little influence in this area. The joint venture would, in any event, reduce the number of Short Sea operators wishing to participate in these promotions. We accept the point about newspaper promotions and do not see that any action is necessary on this issue. However, we recommend that the assurance offered concerning negotiations with travel agents should be consolidated into an undertaking.

2.196. P&O and Stena suggested to us that there was no sound basis for an expectation that the joint venture would lead to anti-competitive arrangements which would deny competitors access to travel agents. However, as we have noted in paragraph 2.85, Stena already has an exclusive arrangement with one chain of travel agents. The joint venture would be in a strong position to secure the services of travel agents. If it exploited that advantage by entering into arrangements which excluded competitors, particularly those with a smaller market share, effective competition would be unduly inhibited.

Conclusions on remedies

2.197. We therefore recommend that P&O and Stena, and the joint venture where appropriate, should be required to give undertakings, before implementation of the agreement establishing the joint venture, that:

- (a) the joint venture would not introduce services using fast craft (as broadly defined in the glossary) on any Short Sea route except Newhaven-Dieppe, subject to a review by the DGFT after five years (see paragraphs 2.187 and 2.188);
- (b) it would enter into interlining arrangements on the Dover-Calais route, if requested to do so by other ferry operators, on the basis described in paragraph 2.189;

- (c)* P&O and Stena would give up any existing rights, to be disposed of at the discretion of the harbour authorities, to one of the ticket desks and not less than four of the vehicle ticket booths occupied by them at Dover (see paragraph 2.190);
- (d)* the joint venture would provide the DGFT annually with the information described in paragraph 2.193;
- (e)* P&O or Stena would not advertise the joint venture's schedules or services in their brochures as long as the joint venture publishes its own brochures for that purpose (see paragraph 2.194);
- (f)* P&O or Stena would not negotiate arrangements with travel agents jointly with the joint venture and would not aggregate their own traffic volumes with those of the joint venture for the purposes of calculating commissions (see paragraph 2.195); and
- (g)* the joint venture would not enter into any arrangements with travel agents which provided for those agents not to enter into similar arrangements with other ferry operators (see paragraph 2.196).

2.198. We believe that the implementation of these undertakings, taken as a whole, would lead to sufficient competition to the joint venture from other operators and hence avoid the emergence of a duopoly with the adverse effects we have identified, while not preventing the joint venture from competing effectively with cross-Channel services using the Tunnel.