7 Views of the main parties

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Introduction

7.1. We received a joint submission from P&O and Stena (the parties), supplemented where appropriate by separate evidence from each company.

The proposed merger

Aims of the merger

7.2. The parties told us that the proposal to merge their ferry operations on the Short Sea (that is, the Short French Sea and the Belgian Straits) was a consequence of the opening of the Channel Tunnel, which had massively increased the capacity for the carriage of passengers and freight across the Channel. Within two years of the Tunnel's opening, Eurotunnel had captured 45 per cent of the passenger vehicle market and 15 per cent of the Anglo-Continental freight market. Much of this growth had been at the expense of the ferry operators, whose own volumes had declined. It was clear that the parties' ferries on the Short Sea routes had substantially greater capacity than could be run economically and that the economics would continue to worsen. This would be due in part to further encroachment by the Tunnel's operations but also to loss of revenue from the expected abolition in 1999 of duty-free sales and the need for further expenditure on the fleet in order to comply with The Merchant Shipping (Ro/ro Passenger Ship Survivability) Regulations 1997 (the 1997 Regulations) which came into force on 1 April 1997 to implement the Stockholm agreement on ferry safety. On any credible assumptions, it would not be economically viable for the parties to continue their Short Sea operations on their present scale.

7.3. The aims of the proposed merger were to rationalize the parties' Short Sea ferry operations so as to take out the least efficient capacity and eliminate duplication of costs whilst maintaining frequency of sailings and, by remaining price-competitive and improving on-board facilities, to minimize loss of revenue. The commercial assumptions underlying the proposal included: removal of the three least efficient of the parties' vessels, accounting for a significantly larger share of the direct costs than of the capacity of the relevant operations; a resulting percentage loss in the number of passengers much smaller than the percentage reduction in capacity; and no increase in the level of ticket prices. The projected annual cost savings, once the reorganization costs had been absorbed in the first year, amounted to £75 million. Nevertheless, the long-term viability of maintaining Short Sea ferry operations at the initially projected level, especially from 1999 onwards, remained problematic. Further details of the proposed joint venture are contained in Chapter 3.

7.4. We asked P&O why it had added capacity to the market in 1993 by the introduction of a new vessel on the Dover-Calais route and the enlargement of a second. P&O said that its aim had been to increase the frequency of service in anticipation of the introduction of Eurotunnel's services and in particular to attempt to match the turn-up-and-go product that Eurotunnel was expected to offer. Stena told us that on acquiring Sealink it had sought to improve productivity by increasing the number of crossings undertaken by its ferries. This greater frequency of crossings had also increased capacity.

7.5. We asked the parties why they intended the joint venture to include the Newhaven-Dieppe and Dover-Zeebrugge routes when, in contrast to the intentions for the Dover-Calais route, no increases in frequency of service or rationalization of capacity were planned.

Newhaven-Dieppe service

7.6. The parties maintained that services on the Newhaven-Dieppe route were substitutable for services on the Dover-Calais route, especially when a fast craft, with a crossing time of 1½ to 2 hours, was used. Stena would not wish to have a 100 per cent-owned subsidiary in such direct competition with a joint venture in which it had a 40 per cent equity interest and believed that the competition authorities might have raised legal

objections based on potential spill-over effects if such an arrangement had been proposed. Closure of the service would be costly and would have difficult financial implications, especially in view of Stena's investment in a new ferry port in Dieppe, where it jointly owned the terminal with the Dieppe Chamber of Commerce. The parties commented that their Short French Sea ferry operations were Anglo-French in character and they could not, therefore, disregard the effects on Dieppe of closure of the service.

7.7. In the parties' view, the joint venture offered the best opportunity of returning the Newhaven-Dieppe service to viability. It would allow the deployment of high-quality ships, and in particular a high-quality Lynx fast craft with good reliability in bad weather. This would allow the route to be marketed to day-trip passengers to a greater extent than had previously been possible. The joint venture would, however, be prepared to terminate the service if it did not prove successful.

Dover-Zeebrugge service

7.8. The parties proposed to include the Dover-Zeebrugge route, on which P&O operated a three-ship freight-only service, within the joint venture. The route had always been viewed strategically by P&O as an adjunct to its Dover-Calais business. The geographical proximity of the two routes made it easy for freight customers to make round trips using both of them or to alternate between the two, and the longer crossing time from Dover-Zeebrugge was a convenient means of satisfying the legal requirements for drivers' rest periods. P&O estimated that a majority of its top 100 freight customers had dual rates agreements for the two routes, demonstrating the importance they attached to the facility to switch between them. The parties also drew attention to the importance of an alternative route in the event of industrial action or other difficulty at either Calais or Zeebrugge: because P&O operated both routes through a single office and port administration, it was able to switch vessels, reservations and port handling between the two at very short notice so that both passengers and freight could be transferred with minimum inconvenience. The value of this had been demonstrated in 1996, when the port of Calais had been closed on several occasions.

7.9. As both routes were run from P&O's office in Dover, the sharing of administration and port overheads allowed substantial cost savings (estimated by P&O at some £[*] million a year). If P&O were to continue the Dover-Zeebrugge service outside the joint venture it would incur a substantial cost penalty (estimated at £[*] million a year), since that service would then be its only one operating out of Dover. (P&O said that it would not allow the joint venture to provide port handling services at Dover for the separate retained Dover-Zeebrugge service which would be in competition with the joint venture's own Dover-Calais service.)

7.10. The parties said that the Dover-Calais and Dover-Zeebrugge services were substitutable for each other. P&O would not want to be in the position of competing directly with an independently- managed joint venture in which it had a 60 per cent equity interest, and the parties believed that the competition authorities would appraise this critically on account of potential spill-over effects.

7.11. The parties had considered the possibility of closure of the Dover-Zeebrugge service. They said that it would be more likely to be terminated if it were excluded from the joint venture; however, it could not be assumed that the joint venture could be successfully renegotiated without this element. Although the service probably had a better chance of surviving as part of the joint venture than as part of a 100 per cent P&O-owned business, the commercial judgment of those concerned was to keep it in operation in either case, because the costs of termination and book losses on the sale of vessels would be substantial and there would also be a potential loss of contribution to the overheads of the remaining Dover-based business. The parties also believed that the Dover-Zeebrugge service still offered a reasonable prospect of long-term profitability. They said that maintenance of the service was clearly in the public interest because it would provide customers with a valuable freight service. Furthermore, there was no evidence that the existence of the service had deterred others from entering the market in recent years.

Assessment of the merger

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*Figures omitted. See note on page iv.

7.12. In the parties' view, given that the Tunnel had low short-run marginal costs it would have a strong economic incentive, as well as the capacity, to accommodate large volumes of passenger and freight traffic despite the fact that its true average unit costs (when account was taken of the cost of capital) were considerably higher. The success of Eurotunnel's first two years' trading would therefore continue and the merger and its effects had to be assessed in that context. The parties argued that existing over-capacity was not the result of uneconomic investment decisions by the ferry operators. If Eurotunnel had been constrained to charge prices that covered its average unit costs, including capital costs, the ferry operators would not have needed to cope with the excess capacity in the market. Their need to rationalize their operations resulted from investment decisions by others which, with hindsight, could be seen to have been uneconomic.

7.13. The parties believed that there was a strong public interest in the survival of substantial cross-Channel ferry capacity as an insurance against the consequences of disruption of the Tunnel's operations; the recent fire demonstrated that this was a point of real importance. Continued ferry capacity would also strengthen safeguards against monopolistic conduct by Eurotunnel in the Short French Sea passenger market. It was, therefore, in the UK public interest that P&O and Stena should not be prevented from jointly taking steps to reduce their costs and increase their efficiency to the maximum possible extent.

7.14. A great deal had changed since the MMC had considered, in 1989, a proposal of P&O and Sealink to combine their Short French Sea operations. First, data were now available about Eurotunnel's trading performance and strategy and their effects upon other operators. Secondly, in 1989 P&O and Sealink controlled an estimated 91 per cent of the Short French Sea passenger market. In October 1996, with Eurotunnel taking an increasingly large share of the market, the parties held in aggregate an estimated share of 40.2 per cent. Thirdly, if the 1989 proposal had been approved, there would have been (until the inception of Eurotunnel's services) just two operators on the Short French Sea passenger market: a combined P&O Sealink and Sally Line. In contrast, the P&O Stena Line joint venture would face competition from a range of independent third party competitors in the passenger market: namely Eurotunnel, SeaFrance, Hoverspeed, Holyman Sally and Eurostar. The structure of the market after the proposed merger would be markedly more competitive than the market in 1989.

Definition of the relevant markets

7.15. In the parties' view, the joint venture would be active in two transport markets: the Short French Sea market for cross-Channel passenger transport services; and the Anglo-Continental market for freight transport services. Although it was arguable that, because of supply substitutability and the availability of suitable port facilities, the Anglo-Continental market for freight formed part of a wider market for Short Sea unitized freight, the parties had retained the traditional definition of an Anglo-Continental freight market as a relevant market; and would discuss the contestability of that market in terms of ease of entry and cross-entry, whether based on new vessels or existing vessels previously used on other routes.

7.16. Although P&O and Stena both operated multi-purpose vessels on the Short French Sea that were able to accommodate passenger and freight traffic simultaneously, the nature of supply and demand for passenger and freight maritime transport services was fundamentally different, so that the two services fell into distinct markets.

The passenger market

7.17. The parties said that maritime routes for Anglo-Continental passenger ferry services had traditionally been treated as falling into three clusters:

(a) *The Short French Sea routes*, which they defined as the shortest-distance links between UK ports in Kent (Dover, Folkestone and Ramsgate) and East Sussex (Newhaven) and ports on the north- east coast of France (Calais, Boulogne, Dieppe and Dunkirk). The Tunnel now formed part of this sector, offering a fixed link between Folkestone and Fréthun/Coquelles in the Pas de Calais. Although, at 4 hours, the crossing time by traditional ferry from Newhaven to Dieppe was considerably longer than that on other routes, in the parties' opinion Newhaven-Dieppe should nevertheless be included in the Short French Sea category. The introduction of fast craft on that route had at least halved the crossing

time to 1½ to 2 hours and the route offered the benefits of good accessibility, relatively uncongested ports and good road links with London and Paris. In terms of overall journey time, a car journey from London to Paris would be quicker via Newhaven-Dieppe than Dover-Calais. The parties noted that the MMC's 1989 report[1] had recognized that Newhaven-Dieppe could be considered as being a rather closer alternative to the Short French Sea routes than other routes in the Western Channel.

(b) *The Western Channel routes*, which the parties defined as longer routes between the South of England (from ports such as Portsmouth, Southampton, Poole and Plymouth) and ports on the north coast of France (such as Le Havre, Caen, Cherbourg, St Malo and Roscoff) together with routes substantially employing the Western Channel between ports on the south coast of England (Portsmouth and Plymouth) and ports in northern Spain (Bilbao and Santander).

(c) *The North Sea routes*, which they defined as routes on the North Sea and Belgian Straits with sailings from ports on the east coast of England (such as Newcastle, Hull, Felixstowe, Harwich, Sheerness, Ramsgate and Dover) to ports in Holland (Hook of Holland and Rotterdam), Belgium (Ostend and Zeebrugge), Germany (Hamburg) and Denmark (Esbjerg).

7.18. We asked the parties whether a fast craft service on the Ramsgate-Ostend route should be regarded as equally substitutable for a Dover-Calais service as the Newhaven-Dieppe fast craft service. The parties said that both routes were indeed substitutable for a Dover-Calais service. However, holiday traffic from the UK tended to go southwards, which meant that Newhaven-Dieppe was a more attractive route than Ramsgate-Ostend for such traffic. Conversely, those travelling to northern Europe would be unlikely to use the Newhaven-Dieppe route and would find Ramsgate-Ostend more attractive. The parties also considered that both routes competed to attract excursion traffic.

7.19. Describing the specific characteristics of passenger services on the Short French Sea routes, the parties said that those routes offered the shortest sea crossings in distance and time between the UK and France. They also offered the greatest choice of types of service and the highest frequency of service: Eurotunnel shuttles departed every 15 minutes for a large part of the day (and every 12 minutes during peak periods); P&O's services left every 45 minutes at peak times whilst those of Stena, Hoverspeed and SeaFrance departed at hourly intervals. The high frequency of service was advantageous to passengers and facilitated flexible travel, without requiring prior booking. The services had been able to meet to a maximum extent the high demand (particularly from the UK) for excursion travel, typically day returns or short-stay trips of one to five days. The parties told us that excursion travel was primarily driven by the desire to buy duty-free and/or VAT-free goods or goods at a lower rate of duty or VAT than in the customer's country of origin. For such travellers, the Short French Sea routes had distinct advantages over the longer Western Channel and North Sea crossings since travelling time was kept to a minimum.

7.20. The parties commented that users of the Short French Sea routes enjoyed better motorway access in the UK and, to an even greater degree, France than users of the Western Channel and North Sea routes. The construction of the Tunnel had led, in France, to the creation of motorway links between the ports of Calais and Dunkirk and the Channel Tunnel terminals at Coquelles, on the one hand, and the motorway systems of northern Europe on the other hand. In the UK, it had led to the connection of the ports of Folkestone and Dover to the UK motorway system (via the M20 and A20 links respectively).

7.21. The success of Eurotunnel's Le Shuttle-Tourist service and the media attention given to it had reinforced the attraction of the Short French Sea passenger routes and public awareness of their specific characteristics: in particular, speed, choice, convenience, through frequency and good access, and low costs. These characteristics were reflected in their share of traffic: in 1995 they accounted for some 70 per cent of all passenger vehicle traffic between the UK and the Continent.

7.22. The parties maintained that the specific characteristics of the Short French Sea routes distinguished them from the longer Western Channel and North Sea routes and that, therefore, they constituted the relevant market for the purposes of the proposed merger in so far as it related to passenger services.

[1]See footnote to paragraph 2.17.

The freight market

7.23. The relevant market for the provision of Anglo-Continental freight maritime services was, in the parties' view, a broad one in which many routes were to varying degrees substitutable and in competition. The parties distinguished three geographic sectors: the North Sea (including the Belgian Straits), the Short French Sea (including Eurotunnel's Le Shuttle-Freight and through-freight services using the Tunnel) and the Western Channel. Within the freight market, the choice of route was influenced by accessibility to home base origin and destination, speed of crossing, frequency of service, price, speed of embarkation and disembarkation, limitations on driver's hours and the cost of the road journey versus the cost of the sea crossing. There was considerable route substitutability between the three sectors and this was most apparent in movements of business between the Western Channel and the Short French Sea and between the North Sea (including the Belgian Straits) and the Short French Sea. In both cases, since the inception of Eurotunnel's services in 1994 most of the migration of traffic flows had been towards the Short French Sea, as was illustrated by that sector's increasing share of the total amount of ro/ro freight (35.6 per cent in 1995 and 38.1 per cent in the period up to and including October 1996). The parties believed that a wider analysis, including all forms of freight traffic, for example lo/lo and intermodal freight, would reveal the same trend.

7.24. The growth in the Anglo-Continental freight market since 1991 had occurred almost entirely on the Short French Sea. The parties said that the draw of traffic to that sector was due to a number of factors and cited three in particular as being the most significant. First, the difference between freight rates on the North Sea and Western Channel (the peripheral routes) on the one hand and the Short French Sea on the other hand had increased. Operators on the peripheral routes had been unable fully to match the price reductions on the Short French Sea without endangering the viability of their operations. Thus, even though rates had fallen on the peripheral routes, the differential with rates on the Short French Sea had widened. Secondly, new services and significant additional capacity had been introduced on the Short French Sea routes, in particular by Eurotunnel's Le Shuttle-Freight service and intermodal freight trains through the Tunnel system. Thirdly, motorway access to the Short French Sea ports on both sides of the Channel had been improved.

7.25. The parties told us that virtually all freight transported on the Short French Sea routes was unitized-that is, stored in one of a variety of standardized modes for the purposes of transportation. This gave freight forwarders and other door-to-door transport companies a considerable choice of modes by which goods could be consigned. Ro/ro freight ferry operators on all the Anglo-Continental routes had to compete with a range of other freight transporters, including Eurotunnel's Le Shuttle-Freight service, intermodal operators that offered combined road/rail freight services to the Continent by running their own trains through the Tunnel, road transport companies that provided the sea leg of a door-to-door delivery service in-house and/or sold excess capacity on the market to third parties and lo/lo container operators (although lo/lo freight traffic was not a significant proportion of the overall market).

Competition in the Short French Sea passenger market

7.26. The parties said that the joint venture would face five competitors in the Short French Sea passenger market: Eurotunnel; SeaFrance; Holyman Sally; Hoverspeed; and Eurostar.

Eurotunnel

7.27. The parties commented that Eurotunnel's competitive strength in the Short French Sea passenger market was based upon a unique mix of economic and commercial factors that also established a fundamental asymmetry between Eurotunnel and its competitors. First, Eurotunnel operated from a radically different platform in terms of capital employed (£12 billion compared with £410 million in the case of the joint venture). Secondly, it was removed from ordinary commercial and financial constraints. Applying normal commercial standards, it was an insolvent business. However, the exceptional size of the Eurotunnel debt and the exposure of lenders to such debt had produced a unique situation where lenders were unwilling to, and arguably incapable of, abandoning the project. This seemed virtually certain to result in Eurotunnel securing a refinancing (to the value of some £4.7 billion) despite its disastrous financial performance. Refinancing would strengthen Eurotunnel's financial position, in particular reducing its interest payment obligations, but the date

when, if ever, dividends would begin to be paid remained entirely uncertain. Eurotunnel's aggregate losses dwarfed any further loss that it might need to incur in order to gain further market share from the ferries; the parties feared that the normal commercial considerations that would otherwise constrain Eurotunnel's behaviour would, therefore, be negated.

7.28. The third factor contributing to Eurotunnel's competitive strength was its vast capacity. The parties said that Eurotunnel's own statements indicated that, had the fire in November 1996 not occurred, it would have expected its nominal capacity in 1996 to have been 6 million PCUs, and it seemed reasonable to assume that its annual nominal capacity would be not less than that figure once the physical effects of the fire had been eliminated. This nominal capacity was broadly equal to the total size of the passenger vehicle market on the Short French Sea routes, which was 5.4 million PCUs in 1995 and was estimated to have been 6.4 million PCUs in 1996. The parties submitted figures of Eurotunnel's passenger traffic operations from January 1995 to October 1996. They noted that 316,000 passenger vehicles were carried in August 1996 and commented that if allowance was made for the 7,000 coaches included in that figure then (on the basis that one coach equals 4 PCUs) Eurotunnel's practical (as distinct from nominal) capacity in months other than January and February must have been at least 339,000 PCUs. On the information available to the parties, they could not see why Eurotunnel's practical capacity, when the physical effects of the fire had been eliminated, should not be of the order of 4.0 million PCUs a year; if, therefore, Eurotunnel were to operate at or near its practical capacity, its share of Short French Sea passenger vehicle traffic would be in excess of 60 per cent. The parties believed it would be technically possible for Eurotunnel to increase its carrying capability yet further at relatively low average incremental cost, so that growth in the market could not be expected to reduce its market share in the foreseeable future. They concluded that, on reasonably conservative assumptions, Eurotunnel was, and would continue to be, capable of taking a share of at least 60 per cent of Short French Sea passenger vehicle traffic and of expanding its present share to that level at very little average incremental cost. The parties drew attention to the frequency with which Eurotunnel was able to schedule departures-every 12 minutes at peak times. They said that it offered more than four times as many crossings a day as its next largest competitor.

7.29. Fourthly, the parties believed that Eurotunnel's variable operating costs were substantially lower than those incurred by ferry operators because Eurotunnel owned its terminals and so did not pay the equivalent of vessel port charges and port transit charges. (P&O estimated that in 1996 it would pay £[*] million of such charges on its Short French Sea operations, equivalent to [*] per cent of its operating costs on those routes of £[*] million. Stena estimated that it had paid £[*] million in 1996 on its Dover-Calais operations, equivalent to [*] per cent of its Dover-Calais operating costs of £[*] million.)

7.30. The fifth factor was that a high proportion of Eurotunnel's total costs were fixed costs that were sunk and unavoidable. The parties commented that in the case of ferries, fixed vessel costs (which accounted for the greater proportion of total costs) could be avoided by selling vessels, not replacing old ones or not renewing chartered vessels. In contrast, Eurotunnel's substantial capacity was committed to the market and would remain operational provided that it could cover its low variable costs of operation. The parties stated that Eurotunnel's avoidable fixed costs were substantially lower than the ferries' by virtue of the sunk nature of its investment in capacity.

7.31. Lastly, the parties noted that Eurotunnel enjoyed a number of distinct commercial advantages. It owned and controlled an essential facility for the purposes of connecting and running trains between railway networks on the UK mainland and continental Europe. As through-rail traffic (both passenger and freight) using the Tunnel system developed, Eurotunnel stood to gain significant revenues in the form of Tunnel usage fees. The parties commented that Eurotunnel had benefited from substantial public sector support, most prominently the backing by SNCF, SNCB and the UK Government of associated high-speed rail projects and the subsidization at national and EU levels of intermodal rail freight services. Furthermore, Eurotunnel had exclusive control of the only transport system linking the UK and continental Europe that was largely immune to bad weather. The parties added that, in contrast with other Channel operators, Eurotunnel owned and controlled the infrastructure at both its terminals, giving the advantage of the cost savings mentioned in paragraph 7.29 and also allowing Eurotunnel to control the development of the terminals. In contrast, most ferry operators had no control over the development of port facilities.

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*Figures omitted. See note on page iv.

SeaFrance

7.32. At the end of 1995, SNAT (now called SeaFrance) had ended its most recent five-and-a-half-year pooling agreement with Stena on the Short French Sea and had started an independent service in 1996. The parties said that SeaFrance had needed to introduce additional capacity on the Dover-Calais route in order to be able to offer a sufficiently frequent service to compete with other operators. It had, therefore, made a substantial commitment to the market. In addition to introducing an extra multi-purpose vessel, and subsequently a freight-only vessel as well, it had recruited some 250 people to its own UK marketing/sales and operational staff and had spent an estimated FFr40 million (about £4.7 million) in upgrading vessels. The parties asked us to note that SeaFrance was part of SNCF, which, they said, was under the political influence of the French Government. They suggested that SeaFrance had the financial support of the SNCF group and the French public sector and that its commercial and competitive strategy was influenced by political considerations (such as employment and regional development) and not solely by market forces.

Holyman Sally

7.33. Sally Line owned the port of Ramsgate and had been trading in the Short French Sea passenger market for 15 years. It had the backing of a large Finnish corporate group, Silja Oy, and provided the lowest-priced cross-Channel ferry services. Its pooling agreement with RMT was replaced in March 1997 (following RMT's cessation of operations) by a joint venture between Sally and Holyman, the Australian fast craft specialist, on the Ramsgate-Ostend and Ramsgate-Dunkirk routes. The parties said that Holyman would be the lead partner and suggested that the Holyman Sally joint venture would amount for all practical purposes to new market entry. It had begun operating two twin-hulled fast craft between Ramsgate and Ostend on 1 March 1997 offering a travelling time of 90 minutes (port to port), making the service highly competitive with, and substitutable for, Short French Sea routes, in particular for passengers travelling to the Benelux countries. It had also announced that one twin-hulled fast craft would be deployed on the Ramsgate-Dunkirk route.

Hoverspeed

7.34. The parties said that Hoverspeed, owned by the Sea Containers group, had ordered six new high-speed monohull ferries to replace its existing older hovercraft and catamarans and increase its capacity on the Short French Sea. The first vessel had now been delivered. The new craft were expected to have double the vehicle capacity of the hovercraft, each vessel having a capacity of approximately 150 PCUs (compared with 55 to 75 PCUs) and their introduction would, among other things, increase the size of Hoverspeed's fast craft fleet operating out of Dover and upgrade services for 1997.

Eurostar

7.35. Eurostar operated as a three-way joint venture between European Passenger Services (owned by the London and Continental Railways consortium which had been selected to build the London/Tunnel high-speed rail link), SNCF and SNCB. It offered direct city-to-city rail services between London (Waterloo) and Lille/Paris and Lille/Brussels. The parties considered that Eurostar had had, and would continue to have, an impact on the foot passenger and the passenger vehicle sectors of the ferry market. The existence of city-to-city rail services constituted a direct alternative to driving to continental destinations. The parties told us that Eurostar promoted its ability to interconnect with other continental rail links (particularly high-speed links) to offer a wide range of destinations. It also offered packages to tourist resorts and, within the UK, regional connections to the Eurostar terminal at Waterloo. A night sleeper service was being planned under a separate international rail joint venture (European Night Services) for 1997. The parties commented that in both the passenger and freight markets they and other operators faced a twin competitive threat: Eurotunnel's own Le Shuttle services and direct rail services operated by others that used the Tunnel-for example, Eurostar and European Night Services in the passenger market and intermodal rail operators in the freight market.

Market shares

7.36. The parties provided estimated market shares of P&O, Stena and other Short French Sea operators (including Eurotunnel) over the decade 1985 to 1995-see also Table 5.7 and paragraphs 5.79 and 5.80. They said that the most significant feature was the market share gained by Eurotunnel as a new entrant in 1995 and in the first ten months of 1996. Between 1995 and 1996, Eurotunnel had achieved a 100 per cent increase in passenger vehicle carryings. It had made significant gains in each of the months of July, August, September and October 1996, with market shares of 37.6 per cent, 39.2 per cent, 43.2 per cent and 45.4 per cent respectively. Although the fire in November 1996 had temporarily halted further market share gains, the parties saw no grounds for believing that Eurotunnel would not continue to make significant gains following full resumption of services. By way of a historical comparison, they said that the experience of P&O and Stena was that incidents such as the loss of the *Herald of Free Enterprise* and the *Estonia* did not result in any long-term loss of market share.

7.37. Stena had gained market share in 1996, in contrast to its losses in 1995, as a result of the ending of the pooling arrangement with SNAT. In 1996 it had gained a higher proportion of what had been pool traffic than SeaFrance had captured, because under the pooling agreement Stena had been responsible for the marketing operation in the UK, from where 65 per cent of passenger traffic emanated.

Market size, value and growth

7.38. The parties said that there had been considerable growth in the passenger market in volume terms from 1988 onwards. One reason for this had been the ferry companies' use of promotional fares in an attempt to expand the market before the Channel Tunnel opened. Another reason had been the change in people's holiday habits, with more choosing independent motoring holidays rather than packaged holidays at resorts and more taking short breaks instead of a single two-week holiday a year. The main growth had been at the cheaper end of the market, from people travelling on day trips and short excursions.

7.39. Data provided by the parties indicated that the number of passengers (that is, foot passengers and passengers accompanying vehicles) carried on the Short French Sea routes had grown by 13.8 per cent in 1995 and 17.6 per cent in the ten months to October 1996 and the number of passenger vehicles carried had grown by 21.7 per cent and 21.3 per cent in the same periods. The parties commented that the increase in market size by volume had, however, not been accompanied by a corresponding increase in value. They estimated that in terms of ticket sales and on-board spending the value of the Short French Sea market would amount to £490 million in 1996, compared with £492 million in 1995. The explanation was that a large proportion of the growth in volume had consisted of excursion traffic paying much reduced promotional fares (typically between £1 and £10). Passengers paying full fares had recently accounted for only about 25 per cent of all passengers in the annual peak period of mid-July to mid-September, and for only about 10 per cent of all passengers outside that period. The future developments referred to in paragraph 7.2 would pose a further threat to ferry operators' revenues and viability.

Entry and expansion

7.40. The parties said that the need to secure berthing slots at appropriate ports was liable to act as a barrier to new entry or to the expansion of existing operators. The costs of entry, another potential barrier, were principally the need to procure vessels and establish UK and French marketing operations. The significance of these costs would, however, differ for, on the one hand, an operator with existing ferry services in another sector and, on the other hand, a new operator with no existing ferry services.

7.41. The investment in vessels could vary substantially: for example, the parties told us that a bare boat charter of a vessel (where the operator would have to provide its own crew) would cost in the region of £5 million to £10 million a year for a multi-purpose ferry and £3.5 million to £4 million for a fast craft whereas the cost of purchasing a new ferry would amount to approximately £60 million to £70 million, although fast craft could be purchased for £20 million to £25 million each. The cost of refurbishing or altering vessels currently used on other routes would depend, among other things, upon the age, condition and suitability of the vessel, as would the cost of purchasing and modifying second-hand ferries. The use on the Short French Sea route of a vessel that had previously been used on longer routes would typically involve the

conversion of some cabin space into retailing space. The parties pointed out that none of the Stena vessels which would be retained by the joint venture had been purpose-built for the Short French Sea and that they had all operated at different times in Scandanavian waters, the Irish Sea or the Black Sea. The parties suggested that, with the exception of switching suitable vessels from another route, the lowest-cost forms of entry in investment terms would be to charter three multi-purpose ferries or two fast craft, or to purchase two fast craft. They said that fast craft were used on a variety of routes around the world, had reasonably high resale values and could be relocated easily because it was not difficult to meet their berthing requirements.

7.42. A new entrant would also need to publicize and sell its services, and in particular to set up its own UK and French marketing/sales operation and engage in advertising. Other EU countries could be covered relatively inexpensively through the use of a general sales agent (an intermediary who would make arrangements on behalf of an operator with travel agents in a given territory). The parties estimated that advertising was likely to cost in the region of £1 million to £2 million a year, somewhat greater in relation to sales than the average annual cost for the industry (at least during the start-up period). They said that the additional marketing costs would be considerably lower for an existing operator, such as Brittany Ferries or Irish Ferries, which already had UK and continental marketing/sales outlets.

7.43. The parties commented that the risk of anti-competitive abusive behaviour by Eurotunnel represented another potential barrier to entry.

7.44. The parties believed that barriers to expansion for existing operators on the Short French Sea routes were not high, as was evidenced by recent initiatives on the part of SeaFrance, Holyman Sally and Hoverspeed.

Competition in the Anglo-Continental freight market

7.45. The parties said that the joint venture would have to compete in the freight market with Eurotunnel and intermodal operators of through-freight trains via the Channel Tunnel, with a number of other ferry operators, and with door-to-door transport providers and lo/lo operators.

Eurotunnel

7.46. The parties believed the factors that underlay Eurotunnel's strengths as a competitor in the passenger market (described in paragraphs 7.27 to 7.31) also applied in the Anglo-Continental freight market and had enabled it to secure a 15 per cent share of that market (as at October 1996) in a little over two years. Any analysis of the competitive challenge from Eurotunnel in this market had to take account of its available and future capacity. The parties said that, on any view, Eurotunnel was capable of taking large additional quantities of Anglo-Continental unitized freight from the ferry operators. It would, if necessary, increase its effective capacity in small increments. The parties drew our attention to Eurotunnel's announcement in September 1996 of its intention to increase freight capacity by a further 33 per cent.

7.47. The parties said it was to be noted that both accompanied and unaccompanied freight was carried through the Tunnel. Eurotunnel's Le Shuttle-Freight service currently carried only accompanied freight; however, subject to the procurement of the tug units necessary to tow trailers on to a shuttle and to disembark at the other end, there was no practical reason why Eurotunnel could not handle unaccompanied freight, as intermodal operators already did.

7.48. The Tunnel system was unable to carry certain types of freight (see paragraphs 5.74 to 5.76) but the parties believed that it was able to carry most hazardous goods falling into the on-or-under-deck category, which they told us amounted, on the Short Sea routes, to 113,900 units in the ten months up to and including October 1996, representing 62 per cent of the aggregate hazardous freight carried by the parties in that period on the Short Sea. The parties told us that the Tunnel system, unlike the ferries, was able to carry marine pollutants. They estimated that in 1996 the Tunnel would have carried 40,000 to 50,000 units of freight falling into that category, equivalent to approximately 24 per cent of the parties' aggregate hazardous freight carryings on the Short Sea in the ten months up to and including October 1996.

Intermodal operators using the Tunnel

7.49. A number of companies ran freight trains via the Tunnel as part of international road/rail intermodal transport services. In so doing they competed for business directly with other freight market operators (for example, ferry and door-to-door ro/ro operators and Le Shuttle-Freight). Eurotunnel's interim results to June 1996 indicated that the amount of intermodal freight using the Tunnel and bypassing port-to-port services offered by the ferries and Le Shuttle was increasing rapidly. The parties estimated that the volume of freight shipped through the Tunnel by intermodal operators over the first eight months of 1996 represented some 3.2 per cent of the Anglo-Continental freight market and 8.4 per cent of the Short French Sea freight sector. The parties drew our attention to Eurotunnel's statement in its interim results that its railfreight traffic had increased by more than 40 per cent in July and August 1996 compared with July and August 1995, principally because the average tonnage per train had increased. The announcement in September 1996 that Road Railer, an established European intermodal transport company, was to set up through-freight services using the Tunnel also confirmed that this was a growing sector of the market. The parties commented that the UK Government's privatization proposals for Railfreight Distribution, the international freight operation of British Rail, were reported to include a £200 million contribution to Tunnel usage charges in the form of a debt write-off; this would, in practice, allow Railfreight to operate intermodal freight services through the Tunnel without paying usage charges until the year 2006. They also commented that the promotion of rail freight had been specifically identified for subsidy at both national and European level. The parties said that there was, and would continue to be, a significant financial benefit to Eurotunnel from the growth of intermodal freight traffic via the Tunnel, because of the obligation on rail freight operators to pay Eurotunnel fees for use of the Tunnel and a contribution to its maintenance.

Other ferry operators

7.50. The parties gave details of eight other ferry operators that they would expect to provide competition for the joint venture (see paragraph 5.45). These included two P&O and two Stena companies providing freight services on the Western Channel and North Sea routes. The parties commented that in 1996 SeaFrance had competed very aggressively on freight rates on the Dover-Calais route and had increased its share of the Short French Sea sector from 4.3 per cent in January 1996 to 11.6 per cent in October 1996.

Door-to-door transport providers and lo/lo operators

7.51. The parties said that freight did not as a rule originate and/or terminate in a port, but had to be collected from its point of departure and delivered to a final destination. The key customers of the providers of maritime freight services were, therefore, the door-to-door transport companies. Several such companies operated their own freight vessels so that they were able to provide a fully integrated door-to-door road/sea/road service. Such transport providers manifestly competed directly with ro/ro ferry and other freight market competitors. Within the Anglo-Continental freight market, companies which operated their own ro/ro vessels (Maersk (Norfolk Line) and Cobelfret) did so on the North Sea. The lo/lo operators also competed on the North Sea routes.

Market shares

7.52. The parties provided estimated market shares of the principal competitors in the Anglo-Continental freight market in the period 1990 to 1995-see also Table 5.6 and paragraph 5.78. They drew particular attention to Eurotunnel's continued rapid progress in the freight market in the year to October 1996. In October, its share of Short French Sea freight was 42.3 per cent compared with 29.6 per cent in October 1995. The parties commented that Stena's growth in freight volumes in 1996 and SeaFrance's loss of volume relative to 1995 was attributable largely to the end of the pooling arrangement between these two operators at the end of 1995 and the fact that SeaFrance was in the process of establishing itself as an independent freight operator. It had been making significant progress in 1996.

Market size, value and growth

7.53. Figures provided by the parties illustrated the annual growth in the volume of the Anglo-Continental ro/ro freight market for the years 1990 to 1995 and the variations in shares of total traffic between the three principal sectors (Short French Sea, Western Channel and North Sea) over the same period. In the parties' view, figures relating to other freight service providers would show the same trend. They commented that in the period 1990 to 1995 there had been a gradual decline in the predominance of the North Sea routes and a corresponding increase in importance of the Short French Sea and Western Channel routes. After Eurotunnel's freight services had started in 1994, the increase in freight volumes on the Short French Sea had accelerated further with a 20.6 per cent increase in the calendar year 1995 over 1994 and a 12.6 per cent increase in the ten months to October 1996 over the corresponding period for 1995. In contrast, both Western Channel and North Sea freight traffic had moved from a position of modest growth into decline over the same period.

7.54. The parties commented that whilst the Anglo-Continental ro/ro freight market had experienced significant growth in volumes from 1994 onwards, the total value of the market had fallen. They estimated the value of the market (at 1996 prices) as £550 million in 1996 compared with £575 million in 1995. They attributed this fall to the intensely competitive nature of the market and, in particular, the significant increase in capacity, and resultant excess capacity, brought about by the entry of Le Shuttle-Freight.

Attributes of the market

7.55. The freight market was described by the parties as being highly competitive for a number of reasons. First, barriers to market entry and the minimum efficient scale were low and the incidence of market entry was high. Secondly, excess capacity enabled operators to accommodate switches in trading allegiance. Thirdly, price competition was fierce, fuelled by excess capacity, strong purchasing power and the negotiating strength and tactics of the larger purchasers. Whilst Eurotunnel had had a material impact upon the market neither it nor any other operator had been able, or was expected to be able, to dominate the market, because there was diverse competition and the larger purchasers of freight services would avoid becoming over-dependent upon a single supplier. Dominance in any one transport category would still leave a party subject to actual and potential competition from other categories of competitor. The parties said that the ultimate requirement of importers/exporters was for a door-to-door transportation service. Any attempt by a ro/ro operator or other subcontractor of the sea leg of the journey to raise prices above a competitive level would have the immediate effect of encouraging the providers of door-to-door transport services (either individually or collectively) to run their own vessels. This type of integration was stimulated by high rates and reduced by low rates.

7.56. A majority of customers seeking to move goods internationally would not deal directly with the provider of the sea leg of the journey, but would instead contact an international road haulier, a freight forwarder or consolidator or an integrated through-transport operator. These were the principal purchasers of freight services and formed the core client base for ro/ro ferry operators and their competitors. They specialized in the economics and logistics of selecting the most cost-effective manner of moving freight from door to door. The parties said that the larger of these operators and certain companies with their own transport divisions possessed considerable purchasing power. Allegiances to operators and routes could easily be, and were in practice, switched; in the case of accompanied freight in 24 hours or less and with minimal operational inconvenience. Furthermore, the existence of excess freight-carrying capacity encouraged operators to cut rates in order to attract business and to hold on to business they had gained. Principal purchasers could therefore exploit their position by citing offers to competing operators, inviting the latter to match or undercut the rate; the result was a market characterized by a constant process of tariff changes, competitive realignments and frequent shifts in customer allegiance.

Entry and exit

7.57. The parties said that examples of recent entry and exit from the Anglo-Continental freight market (see Appendix 5.1) demonstrated that barriers were low and the incidence of entry was relatively high. Freight vessels were readily available on short-term charter and a viable scheduled service could be provided with a minimum of two vessels. The parties suggested that the capital cost of acquiring two new freight vessels

without substantial driver accommodation would be in the order of £30 million. Second-hand vessels could be bought for considerably less and the cost of a bare boat charter of a freight vessel would be in the region of £4 million a year. Used vessels, such as could be drawn from other routes, would cost less. The rapid introduction of independent livestock services by road transporters in response to the ban imposed by ro/ro operators on the carriage of livestock in 1995 provided a cogent example of the ease and potential speed of market entry. It also demonstrated that a constant source of potential new entrants was to be found in road haulage groups which decided to undertake the maritime leg of the journey in-house. The parties said that access to berths was not an issue in the freight market since a freight-only service required no more than a single linkspan between the quay and vessel and minimal terminal facilities. There were a substantial number of freight ro/ro berths available at UK and continental ports.

Effects of the proposed merger

7.58. The parties said that if the likely evolution of the market was such that they would be unlikely, as independent companies, to compete effectively in the future, then a merger between them could not meaningfully be said to reduce competition. On the contrary, a merger that would enhance the parties' ability to compete effectively would contribute to the maintenance and promotion of competition. The parties had concluded from their analysis, set out below, that the proposed merger would be pro-competitive rather than anti-competitive.

7.59. The parties drew attention to the major changes in the market that had occurred since the MMC's 1989 report was published. These had resulted in a substantial fall in aggregate market share for P&O and Stena in both the Anglo-Continental freight market and the Short French Sea passenger market. In the former, their combined share (excluding the Western Channel) had fallen from 68 per cent in 1986 to 47 per cent in the year to October 1996. Their combined share of the carriage of passenger vehicles on the Short French Sea routes had fallen from 91 per cent in 1989 (excluding Newhaven-Dieppe) to 46 per cent in the year to October 1996 (including Newhaven-Dieppe). The parties said that the structural and economic impact of Eurotunnel, together with other developments in the market, had created intensely competitive and unstable conditions, as was demonstrated by the sharp fall in fares since Eurotunnel's entry.

The Short French Sea passenger market

Competition

7.60. The parties stated that Eurotunnel's entry to the market had substantially undermined the competitive equilibrium, which would be further undermined by changes in the economics of ferry operations. Current price competition in the Short French Sea passenger market was so intense that, because of the importance of promotional fares, even in the peak summer months, ferry operators' average realized fares were only a small fraction of published brochure fares. There was little relationship between brochure fares and promotional fares. Some scaling back of ferry services was inevitable, because the intense competition did not allow the parties to earn an adequate return on their capital assets or to fund necessary replacement and upgrading of vessels. The parties drew attention to the capital-intensive nature of ferry operations, the ongoing financial impact of regulations concerning ferry safety and the expected loss of duty-free sales in 1999, and told us that over 68 per cent of Stena's and 73 per cent of P&O's gross passenger turnover in 1996 on the Short French Sea routes came from on-board sales (including sales to freight drivers), a substantial proportion of which were duty-free sales.

7.61. In the parties' view, market forces would not guarantee that the most efficient ferry competitors would remain in the market. They said that there was no automatic link between a firm's efficiency and its ability to fund losses or investments. This was particularly the case in the ferry industry where at least two competitors could be said to be indirectly supported by the public sector (SeaFrance on the Short French Sea and Brittany Ferries on the Western Channel).

7.62. The parties submitted that the proposed merger would not lead to an appreciable loss of competition, when, in the absence of such a merger, their competitiveness as independent operators could be expected to

decline to a level at which, individually, they could no longer provide workable competition with Eurotunnel, and where the balance of probabilities was that at least one of the parties would leave the market in due course.

7.63. The cost savings that the parties expected to be achieved by the joint venture would reduce average costs per vessel, and therefore the minimum fare that could be charged on a sustainable basis, and would increase profitability so that the joint venture would have the prospect of securing a sufficient return on its investment to maintain an efficient fleet with a high standard of on-board amenities. As a result of the cost savings and other benefits, the joint venture would be better placed to compete effectively with Eurotunnel over the medium to long term, in contrast with the likely position in the absence of the merger.

7.64. The parties saw no reason to doubt that sufficient competition in the Short French Sea passenger market would be preserved after the merger. They said that the joint venture would have strong incentives to compete with other operators on price and quality in order to stem further losses in its market share. One benefit of the merger would be a greater and more efficient use of capacity, but the joint venture would still have substantial spare capacity. P&O and Stena had forecast the joint venture's capacity utilization rate across various times of peak demand during a peak week in August and estimated that even across peak periods it would still have spare operational capacity. Its market share would be under competitive pressure not only from Eurotunnel but also from Hoverspeed, Holyman Sally and SeaFrance. It would therefore be important for the joint venture to maintain, and if possible increase, its market share. The parties commented that increases in capacity utilization substantially lowered a ferry operator's average costs per passenger vehicle, since, once a ferry schedule was set, a high proportion of total costs were fixed costs which did not increase as volumes changed. The contribution to profits made by on-board spending would also influence the success of the joint venture. Whilst the contribution from on-board spending was expected to fall sharply after June 1999 with the elimination of duty-free sales, it was nevertheless forecast still to amount to a substantial proportion of total revenue. The joint venture would therefore have a strong incentive to compete actively on fares in order to attract as many passengers as possible, in addition to investing in amenities so as to increase on-board spend per passenger.

7.65. The parties said that the principal constraints on the pricing policy of the joint venture would include: the high cross-price elasticity of demand for the services offered by the joint venture with services offered by Eurotunnel and other cross-Channel ferry operators; the own-price elasticity of demand for cross-Channel ferry services as a whole (particularly catered for by promotional fares, offering under eight-, five- and three-day returns and day trips); and the loss of contribution from on-board sales to each passenger lost as a result of a ferry fare increase. The last of these constraints alone would render an increase in fares by the joint venture highly disadvantageous, unless the increase resulted in a substantially smaller percentage reduction in the number of passengers. The parties believed that, given these constraints, the merger would not open the door to monopolistic or oligopolistic pricing by the joint venture. They said that, unless the size of its fleet changed, a very significant amount of a ferry company's operating costs did not vary with the number of passenger vehicles, passengers or freight carried, and therefore reductions in volume did not generate any material cost savings. In other words, a small loss in traffic volumes would have a major effect on the parties' contribution to their fixed and semi-variable costs and therefore their profitability. The joint venture would be able profitably to increase its average ticket fare only if demand for its services was extremely price inelastic to changes in fares; this was inconceivable in view of the high degree of price sensitivity exhibited by customers. The parties estimated that, on the basis of 1995 results, each 1 per cent loss or gain in market share would translate to a £[*] million a year change in operating profits before tax. In the case of P&O, this would represent some [*] per cent of the profits (after interest) for its Short French Sea ferry operations in 1996 (excluding the effect of the Tunnel fire). Reductions in the level of promotional and excursion fares stimulated market demand from passengers and led to increased on-board sales. Competition in relation to such fares did not increase one operator's sales solely at the expense of competitors' sales; rather, it increased the volume of passenger traffic and hence profitability. This heightened operators' incentives to compete on price.

7.66. Eurotunnel would similarly have commercial reasons to compete aggressively on price in order to increase its market share, in view of its commitment to the market, its lower variable costs and the significance of its retailing activities at the terminals. It would have the incentive that each additional vehicle it

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*Figures omitted. See note on page iv.

carried would increase the contribution to its fixed costs. The parties considered that Eurotunnel had sufficient capacity to increase its market share substantially. They told us that there was no evidence that Eurotunnel had suffered any material capacity constraints at peak times in 1996. Its market share had grown continuously and dramatically throughout the peak summer season and the parties considered that that level of growth could not have been achieved, under a turn-up-and-go system, had customers experienced significant delays. In response to our suggestion that there had been adverse press comment about delays to Eurotunnel's services, the parties (who stated that they had extensive press coverage facilities) said that they could find no evidence of such adverse comments. In their view, to the extent that there were any delays to Eurotunnel's services, they should be attributed to insufficient control of demand resulting from the lack of a reservations system rather than to capacity constraints. They drew our attention to the recent introduction by Eurotunnel of a reservations system. The parties stated that a variety of other solutions was available to Eurotunnel to address any passenger capacity constraints that might emerge: improved signalling allowing more frequent departures, and the introduction of a wider spread of pricing bands so as to attract travellers away from peak times. (The parties pointed out that Eurotunnel's most recent 1997 brochure retained a very simplified approach to pricing, the only qualification being the introduction of a higher price for peak weekends.) Eurotunnel's history, and in particular the fare cuts it had announced in May 1996, showed that it could be expected to exploit its unique market position in order to secure as much traffic volume as possible.

7.67. The parties said that Eurotunnel and the ferry operators had inherently different competitive profiles. They believed that the differences would stimulate competition between Eurotunnel and the joint venture. Whilst Eurotunnel exploited its exclusive control of a substantially weather-immune transport system, the shortest cross-Channel transit times and its control over its terminal facilities, ferry operators exploited the on-board amenities and services offered by their ships, as well as greater space, opportunities for relaxation and a traditional maritime experience. The parties also commented that Eurotunnel and the joint venture would make pricing decisions by reference to radically different cost structures (see paragraphs 7.29 and 7.30). It was, therefore, highly improbable that the proposed merger would result in a stable duopoly between Eurotunnel and the joint venture, in the absence of stable focal points for prices. The factors influencing the joint venture's and Eurotunnel's competitive decisions would be not only radically different but also in the process of evolving, so that it would be extremely difficult for them to reach any sustained competitive co-ordination in relation to fares.

7.68. The parties argued that co-ordination of fares would not lead to stability in market share, because customers' perceptions of the relative attractiveness of the two services would vary according to seasonal weather conditions and in response to changes in the relative quality of Eurotunnel's and the ferry operators' services. The parties believed that active price competition was inevitable in such circumstances, as one party would wish to exploit improvements in the relative attractiveness of its services and the other would wish to arrest the decline in market share by competing on price. In a market in which traditional operators were battling for survival and to retain their customer base against the Tunnel, a ferry operator that failed to compete actively would not survive in the long term. The parties thought it would be difficult for the ferry operators to win back customers who had switched to Eurotunnel's services. Eurotunnel was aware that it was in its interest to compete on price with the ferries, not just because of the beneficial effects this would have on demand, market share and the contribution to its fixed costs, but also because aggressive price competition was likely to alter market structure permanently by causing a contraction in ferry capacity, if not altogether eliminating it. The success of the joint venture was, therefore, far from guaranteed.

7.69. The joint venture would also continue to face competition from three existing independent ferry competitors, SeaFrance, Holyman Sally and Hoverspeed, all of which had made substantial commitments to the Short French Sea passenger market (see paragraphs 7.32 to 7.35). The position of the joint venture was to be contrasted in that respect with the proposal for a joint service in 1989, when Sally Line would have been the only remaining ferry competitor. The parties commented that the minor players in the market would operate as a mechanism for price regulation and would destabilize any hypothetical duopolistic behaviour.

Barriers to entry and expansion

7.70. The parties suggested that the relevant test in assessing potential market entry and expansion was the likely reactions of actual and potential competitors if unjustifiable price increases occurred. In a hypothetical situation of that kind, current disincentives to enter the market in difficult trading conditions would not be relevant: a rise in prices above competitive levels would provide an opportunity for existing smaller competitors to undercut those prices and increase their volumes and market shares. Such competition would destabilize any competitive co-ordination between the joint venture and Eurotunnel. The barriers to expansion by existing competitors were low in view of their knowledge of the market, established brand names and established links with travel agents and tour operators.

7.71. The proposed merger would lessen barriers to entry and expansion by, among other things, freeing up berthing slots at Dover and Calais. The extra availability (one and a half ferry berths and one fast craft berth at both Dover and Calais) would be sufficient to accommodate a five-ship ferry service between Dover and Calais and at least a two-fast-craft service. The formation of the joint venture would therefore have a favourable impact upon entry conditions and would generate another safeguard against a Eurotunnel joint venture duopoly. The parties commented that the Dover-Calais route, with a passenger volume of about 33 million a year, would always be attractive to ferry companies operating elsewhere. It would be relatively easy to transfer vessels from other routes to Dover-Calais, although some modifications might be needed (see paragraph 7.41).

Marketing

7.72. We raised with the parties a number of concerns that had been put to us that the joint venture would use the existing marketing power of P&O and Stena (whose names it would retain) to ensure that its services were given prominence by travel agents. The parties acknowledged that the use of the P&O and Stena names in the joint venture's title would bring with it some of the parent companies' goodwill, and this was intended. They did not, however, accept that the joint venture's title would give it any particular influence with travel agents.

7.73. We put to the parties a suggestion made to us that the joint venture would have the effect of reducing the racking space available in travel agencies for the display of other ferry operators' brochures, because there would be an additional brochure setting out the joint venture's services and prices as well as individual brochures for P&O and Stena. The parties said that there were regional differences as to which brochures were displayed, depending on the strength of particular routes in different parts of the country. The effect of the joint venture would be to free racking space for another company in the key catchment area for Short French Sea services. It was, however, difficult for all companies to gain racking space, which was one means of creating brand awareness, and the arrival of the joint venture was likely to add to the difficulties for P&O's and Stena's retained operations so far as racking in travel agents in the south-east of England was concerned.

7.74. P&O stated that it did not have preferential arrangements with travel agents. Stena told us that it had negotiated preferential status with a small number of travel agents, typically giving it first refusal on opportunities for specific promotional activity run by the agent concerned. In return, Stena would offer higher rates of commission, make extra contributions to marketing and promotional expenditure and provide relevant product support. In only one case had Stena secured terms which gave it any degree of exclusivity and this was limited to brochure racking: [*Details omitted. See note on page iv.*] [*Details omitted. See note on page iv.*]. Stena said that if the joint venture went ahead all these arrangements with travel agents would have to be reviewed and renegotiated. Some, by their terms, would be unable to survive a change of ownership or control. The parties said that the joint venture would negotiate with the travel trade quite separately from P&O and Stena. They commented that a decreasing proportion of bookings was being made through travel agents and that with prices, and therefore the commission on sales, being so low it was increasingly difficult for ferry companies to gain distribution through the travel trade. Despite that trend, some 30 to 40 per cent of business (measured by reference to revenue and not volume) continued to come via travel agents. The parties commented that the proportion of sales measured by volume would give a lower figure; measuring this percentage by revenue did not reflect the large number of low-price promotional sales which were sold directly by the parties rather than through intermediaries. Because of the

continuing significance of sales through travel agents, the Business Plan for the joint venture provided that it would maintain a broad distribution base including the major high street travel agents and other intermediary sales agents. The parties considered that it should be open to the joint venture, and to any other ferry operator, to convince a travel agent that its services were sufficiently attractive to warrant preferential or exclusive arrangements.

7.75. We also invited the parties to comment on statements made to us that certain ferry companies had entered into exclusive promotional arrangements with newspapers. The parties said that newspaper promotions were a valuable tool for the ferry companies as a method of stimulating demand during the off-peak winter months; they estimated that passengers travelling as a result of promotions would spend in the region of £40 a head on board on a round trip (although tickets sold through such promotions were at very low prices). They also acknowledged that editorial content arising from promotions-in some cases as much as four pages-was virtually free advertising in a mass-circulation newspaper. In a good year, such promotions could generate as many as half a million single passenger crossings. There was, therefore, strong competition between ferry companies for promotional deals with newspapers and no newspaper was likely to accept an exclusive arrangement. They commented that any difficulty experienced by SeaFrance or other Short French Sea ferry operators in making such deals in the UK was mirrored by the situation of P&O and Stena in relation to French newspapers. The parties pointed out that as far as the newspapers were concerned, the aim of a promotion was to increase circulation, not to sell ferry tickets; the ferry companies were, therefore, competing for promotions with the commercial world at large. They could not see how the creation of the joint venture would be prejudicial to other operators in this respect; rather the reverse since the newspaper promotions were made primarily in respect of short excursions on the Short French Sea and the number of Dover-Calais operators competing for promotion partnerships with newspapers would be reduced from three to two as a result of the joint venture.

The Anglo-Continental freight market

7.76. The proposed merger would not, in the parties' view, restrict competition in the Anglo-Continental freight market, which was characterized by a high degree of competition, with a large number of competitors, low barriers to entry, a history of frequent entry and customers with strong purchasing power. The parties maintained that the contestable nature of the Anglo-Continental freight market would be unaffected by the formation or operations of the joint venture. There was significant excess capacity in the market, even when the Channel Tunnel was not fully operational.

7.77. Because of the wide variety of operators and routes that served the Anglo-Continental freight market, the parties considered that ferry operators were not in a position to discriminate (in terms of price or other conditions) against any category of Short Sea freight that could not be carried by Eurotunnel or intermodal operators (see paragraphs 5.74 to 5.76). In the event of any such discrimination, the freight customer could be expected to switch immediately to a competing operator or route.

7.78. The parties said that the joint venture's rationalization of capacity and operations would lower its cost base compared with that achievable by either P&O or Stena separately. Economic theory and common sense both dictated that an opportunity to make significant cost reductions in a market where there was excess ferry and Tunnel capacity should be welcomed, especially where ongoing contestability provided more than adequate safeguards against anti-competitive side-effects. Specifically, the opening of the Tunnel and Eurotunnel's entry into service had had a similar (but smaller) structural effect in the freight market as in the passenger market.

7.79. The parties concluded that there was no good reason to believe that the joint venture would operate anti-competitively in any respect in the Anglo-Continental freight market. On the contrary, it should be welcomed for the better use of resources that it would bring about.

Spill-over effects

7.80. The parties rejected any suggestion that the formation of the joint venture would be likely to lead to co-ordination of P&O's and Stena's independent ferry operations on the Western Channel and North Sea passenger markets or freight sectors. They said that P&O's and Stena's ferry businesses on the North Sea and Western Channel routes were markedly different. P&O operated conventional multi-purpose ferries on those routes. On the North Sea route, Stena intended in 1997 to discontinue operation of its two-ship multi-purpose ferry Harwich-Hook of Holland service and to replace it with a one-fast-craft service (carrying predominantly passenger traffic but also some freight). On the Western Channel route, Stena had already terminated its multi-purpose ferry service on the Southampton-Cherbourg route: if it were to resume operation on the Western Channel, it would probably introduce a fast craft service. The parties said that although multi-purpose ferry and fast craft services were certainly directly substitutable so far as passenger traffic was concerned, the quality of the product was different; for example, in summer fast craft offered shorter journey times but in winter they had been more susceptible to disruption by bad weather. That fact, plus differences in cost structures, in operating procedures and in operators' views about the relative values of their distinctive offerings and the relative advantages to them of different promotional fares, all militated strongly against co-ordination of competitive behaviour by the joint venture and its parent companies.

7.81. The parties added that P&O's and Stena's separate businesses were and would continue to be separately managed, would have at stake substantial separate assets, investments and liabilities and would be under pressure by each parent company (and institutional and other shareholders) to show satisfactory returns. In the case of the Western Channel and North Sea, the separate businesses would be trading in peripheral sectors where a failure to compete against Short French Sea services would lead to a rapid erosion of profitability through loss of market share. There was also no reason to suppose that either party would be prepared for the joint venture to adopt a policy of cession of business to another sector where both parties were in competition, or to allow a wholly-owned subsidiary in another sector to cede business to, or to forgo opportunities in favour of, a joint venture in which it held only 60 or 40 per cent of the ordinary share capital. Even supposing, therefore, that complex market forces between sectors could be manipulated, the parties believed that the conflicting commercial interests could not be reconciled. Furthermore, any attempt by the parties' separate businesses to increase prices on the peripheral sectors of the Western Channel and North Sea would expose them immediately to price undercutting in their own sector from competitors or new entrants.

The Irish Sea

7.82. Both P&O and Stena provided mixed and freight-only services on the Irish Sea. These are listed in paragraph 5.42. A very small proportion of freight customers and passengers based in the Republic of Ireland or Northern Ireland and continental Europe purchased through tickets, referred to as landbridge tickets, for travel across both the Irish Sea and the Short Sea. In such circumstances, services on the Irish Sea and the Short Sea were complementary rather than competitive. (There were also landbridge arrangements for travel across the Irish Sea and Western Channel and across the Irish Sea and the North Sea.)

7.83. P&O's landbridge partner for passenger traffic was Irish Ferries and for freight its partners were both Pandoro (the P&O road haulage company that operated ro/ro vessels on the Irish Sea) and Irish Ferries. There were reciprocal arrangements between P&O and Irish Ferries and Pandoro in relation to their requirements for a service provider on the Short Sea routes. P&O offered passenger landbridge arrangements only on its Cairnryan-Larne route (either ex-Northern Ireland or from the Continent to Northern Ireland). Stena did not need a landbridge partner on the Irish Sea in view of the range of services it provided on the Irish Sea, but it did carry landbridge traffic on behalf of Sally Line on the Irish Sea routes.

7.84. The parties stated that the joint venture company would offer landbridge fares covering the Short French Sea and the Irish Sea. Its partnership arrangements would be determined by the competitiveness of the offers made to it, whether by the separate interests of P&O and Stena or by third parties, subject to the commercially normal consideration of avoiding over-reliance on any one trading partner and the prospect of reciprocity in trading relationships.

7.85. The parties said that there was no reason to suppose that the formation of the joint venture would have any anti-competitive results in relation to the provision of services on the Irish Sea for a number of

reasons. First, there was no competitive interaction between the joint venture and the parties' businesses on the Irish Sea. The businesses operated in wholly separate and distinct markets.

7.86. Secondly, landbridge tickets which were sold for travel across both the Irish Sea and Short Sea were not of such significance as to create any material relationship or interdependence between the two distinct markets. Similarly, freight and passenger traffic received from Irish Sea operators accounted for a very small proportion of P&O's and Stena's Short Sea businesses. Accordingly, the parties would be much more concerned to ensure the overall competitiveness of those landbridge tickets so as to secure for themselves their own leg of the journey than to get business for a separate undertaking with its own distinct ownership.

7.87. Thirdly, the Irish Sea businesses of P&O and Stena were subject to a number of factors that would militate against any possible spill-over:

(a) P&O's and Stena's business activities on the Irish Sea would be run by companies that would be wholly separate from the joint venture company, and which would have their own strategic and competitive objectives and their own responsibilities to their shareholders.

(b) The nature of P&O's and Stena's freight and passenger businesses on the Irish Sea were substantially different. Stena offered mixed passenger and freight services on all of the three corridors; P&O operated a mixed freight and passenger service on only the Northern Corridor; while Pandoro's freight-only services were provided in the context of an integrated road haulage business and through a quite separate P&O division.

(c) There were a number of competing ferry operators on all the corridors of the Irish Sea as well as on routes between Ireland and the Continent. Conditions were very competitive and subject to frequent change.

(d) The parties' business on the Irish Sea remained subject to UK, EC and Irish competition law.

The public interest

7.88. The parties believed that, analysed by reference to the aspects of the public interest that were specifically mentioned in the various paragraphs of subsection 1 of section 84 of the Act and looked at generally, the proposed joint venture would operate positively in the public interest and was not to be expected to operate against the public interest. The merger was intended to create a ferry operator capable of providing and sustaining more effective competition to Eurotunnel over the medium to long term. The parties submitted that, in the absence of the merger, competition to Eurotunnel would be continuously weakened and Eurotunnel's exceptional market power would continue to increase. The merger would therefore promote effective competition between persons supplying services in the UK (section 84(1)(a) of the Act).

7.89. The parties submitted that the merger would promote the interests of consumers of services in the UK in respect of the quality and variety of the services supplied (section 84(1)(b) of the Act) in the following ways:

(a) The merger would allow the joint venture to offer increased sailing frequency and improved regularity of sailings. The frequency of the joint venture's service would be slightly less than the frequency of current sailings by P&O's and Stena's ferries taken together. The parties pointed out, however, that what mattered to customers with pre-booked tickets was the frequency of sailings offered by the operator with which they had booked. P&O's service currently consisted of 45-minute intervals between sailings in peak periods only, interspersed with hourly sailings and with longer intervals during the night. Stena's service was also irregular, with intervals between sailings varying during both day and night. These irregularities made it difficult for customers to exploit with any certainty a turn-up-and-go approach to travel because, for example, of uncertainty about the implications of missing a given sailing. In contrast, the joint venture would offer a regular 45-minute departure rate for 18 hours of the day and a regular hourly departure rate for the 6 hours between midnight and 6.00 am. The parties said that the joint venture would also have the spare operational capacity to sustain regularity and frequency of service during the refit season, and to increase the level of service in periods of

exceptional demand as its fleet would be capable of undertaking up to six (rather than the usual five) return journeys per vessel daily between Dover and Calais.

(b) The joint venture would offer continuous loading throughout the day, emulating Eurotunnel's turn-up-and-go system, allowing immediate embarkation by a passenger or freight vehicle arriving at Dover or Calais. Stena did not currently have a continuous loading system and continuous loading of P&O ships was possible only at certain times of day. The elimination of quayside waiting would add to passenger convenience and make the service more attractive to car passengers without a booking and to the increasing number of passengers who had booked but did not leave on their booked sailing.

(c) The level of on-board service and facilities would be improved on all routes, with the best elements in each of the parties' current operations being combined on all vessels of the joint venture. The merger would thus give rise, in an efficient way, to benefits to consumers in the form of improved choice and service.

7.90. The joint venture was projected to achieve annual savings in operating costs of approximately £75 million, so that it would promote the reduction of costs within the meaning of section 84(1)(c) of the Act.

7.91. The merger would promote the continued operation of ferry services on the Dover-Calais, Newhaven-Dieppe and Dover-Zeebrugge routes: thus promoting the interest of consumers in respect of variety of services (section 84(1)(b) of the Act).

7.92. By releasing one and a half ferry berths and one fast craft berth at the ports of Dover and Calais through the elimination of duplication in sailing times, the merger would improve the ease of entry and expansion into the market and would thus promote the aspect of the public interest referred to in section 84(1)(c) of the Act.

7.93. The merger would contribute to the long-term maintenance of employment in commerce generally and in Dover and Newhaven in particular, thus helping to maintain and promote the balanced distribution of employment in the UK in accordance with the goal referred to in section 84(1)(d) of the Act.

7.94. It was also in the public interest that the merger could be expected to secure an alternative high-volume transport system to the services operating through the Tunnel system in the event of disruption to those services.

7.95. The merger would help to preserve a UK-based fleet capable of fulfilling demand on it at times of national emergency, a benefit which the UK Government had recognized.

Alternatives to the proposed merger

7.96. The parties provided detailed comments on a range of hypothetical alternatives to the proposed joint venture.

Agreements to reduce capacity

7.97. Although in the absence of a joint venture P&O and Stena would each reduce its Dover-Calais fleet by one vessel, the agreement to do so had been concluded in large part because the parties had negotiated the merger presently under consideration. They commented that agreements to reduce capacity were difficult to negotiate, unstable and liable to be overturned by changing market conditions. Indeed, the Tunnel fire had caused the parties to abandon the capacity agreement referred to above. Furthermore, such an agreement, standing alone, would lead to a lower quality of service in circumstances in which, because of the reaction of customers, further reduction in capacity, consequential worsening of quality and loss of competitiveness could be expected to follow. Additionally, an agreement to reduce capacity, standing alone, would not merely make no contribution to a reduction in overheads per vessel but, on the contrary, would be liable to result in an increase in central and port overheads per vessel, at any rate for some years.

Co-ordination of schedules and ticket interlining

7.98. The parties said that load factors, and thus on-board sales, varied by time of day, day of the week and season of the year. In the absence of revenue sharing, co-ordination of schedules would present great practical problems in providing a regular, round-the-clock service, since each party would want the best sailing times for itself. Revenue sharing would not, however, necessarily lead to the creation of a single-minded management which would allow the pooled service to compete as vigorously as possible and to ensure a consistent standard of quality across all vessels. However, without revenue sharing each party would retain an incentive to offer as great a proportion as possible of sailings of any given attractiveness in order to maximize its own revenue. Cost savings through reduction in fleet size would therefore be substantially less than could be guaranteed by a joint venture.

7.99. Ticket interlining by itself would also raise significant practical problems. Without common tariffs, discounts, promotions and freight prices for each and every freight consignor, it would clearly be out of the question for the parties to accept each other's tickets without financial adjustment: for example, P&O could not be expected to accept a Stena ticket that had cost the customer £100 when a P&O ticket for an equivalent vehicle on the sailing in question would have cost the customer £110; and vice versa. Equally Stena could not be expected to carry freight for a consignor with whom it had not negotiated any price and to do so at whatever price had been negotiated by the consignor with P&O; and vice versa.

7.100. The parties considered whether the difficulties could be overcome by each party agreeing to accept the other party's tickets as `tokens' with a value equal to their net purchase price, an additional charge being made or rebate given if the tickets being issued in exchange had a higher or lower price, but dismissed such a system as impracticable. They pointed out that each of the parties used a whole range of promotions to stimulate demand and yield. They also drew attention to the prevalence of confidentially-negotiated discounts and fares with, for example, ITX and coach operators and freight consignors, and the award of retrospective volume discounts to freight customers.

7.101. As an example, they considered how Stena would deal with P&O when a customer with a four-day return bought through a promotional offer presented that ticket to Stena, which was not at that time offering a four-day return. It would be commercially unacceptable for Stena to refuse to carry such customers or to seek compensating payments from them, so an agreement would have to be reached with P&O for some sort of settlement. This would be complex to negotiate and would lead to further inefficiency, since no promotion could be launched without first negotiating its interavailability with P&O, a process which would involve legal and commercial problems.

7.102. On the freight side, there would be legal as well as practical problems since any system that involved the parties in accepting each other's tickets as having a value equal to their net purchase price would necessitate disclosure, by each party to the other, of the discounts and prices that it had negotiated in confidence with the customer. If the arrangement were part of Northern Ireland/Great Britain/Continent landbridge arrangements, such an exchange of information would be subject to registration under the Restrictive Trade Practices Act 1976; and whether or not subject to registration under that Act, the arrangement might well fall within the scope of Article 85(1) of the EC Treaty.

7.103. The parties believed, therefore, that ticket interlining of any kind would be impracticable in the absence of a full-blown price agreement, unless it was accompanied by other arrangements that effectively simulated a full merger, and would deprive the public of price competition without giving them the advantages that would result from a merger.

Pooling of schedules and on-shore facilities but not fares or revenues

7.104. The parties commented that the concept of a pooling of schedules was unclear but must refer either to pooling or the co-ordination of schedules. A pool along the lines of the Stena/SNAT arrangements could not be practicable. Stena and P&O would not have the advantage of naturally separate marketing areas and therefore of having complementary activities in the UK and France respectively. Further, the lack of a single-minded management and the tension over the operation of different sailings which such a pool would encounter would make such arrangements inefficient. The parties' views on a possible co-ordination of schedules are recorded in paragraph 7.98.

7.105. As far as pooling of on-shore facilities was concerned, the parties had forecast that the joint venture would make annual cost savings of £[*] million, but that presupposed a fully integrated schedule and system of ticketing and a single dedicated management. Without these conditions being satisfied, it was unlikely that the savings available to the parties from the pooling of on-shore facilities for their separate businesses would be more than £[*] million a year for P&O and £[*] million for Stena. Moreover, unless the parties could be assured that the pooling would be permanent, they would be reluctant to contemplate the upheaval it would cause.

Other forms of co-operation

7.106. The parties commented that the more extensive the co-operation short of a merger, the greater would be the scope for internal tensions and conflict of interest in the absence of a single-minded management-and the greater the suspicion with which the co-operation was liable to be viewed by national and EC competition authorities. There was an almost inevitable commercial tendency for any co-operative relationship to gravitate towards a full joint venture. This was a reaction both to the commercial exposure any halfway house brought with it and its instability in fast-changing market conditions or partner strategies, and also to the fact that the closer the commercial interests of the partners became, the closer their co-operation (and vice versa). The imperatives facing P&O and Stena on the Short Sea routes meant that a form of co-operation that guaranteed a common commercial interest needed to be adopted without delay.

7.107. The parties said that the possible alternative transactions would all be less satisfactory than the joint venture, both commercially and in terms of national and EC competition law. They believed it was self-evident that none of the possible alternatives would result in cost savings comparable to those that would be achieved through the formation of the joint venture. Nor would any alternative arrangement be capable of creating the unified and single-mindedly dedicated management that was essential if the parties' Short Sea ferry businesses were to compete most effectively with Eurotunnel. They concluded that all practicable forms of co-operation short of merger would be of trivial significance or would carry with them public interest detriments, or both. Ongoing arrangements to restrict capacity would be extremely difficult to justify to the responsible competition authorities, and other forms of co-operation between the parties would entail the acceptance of express or implied restrictions on the exercise of the commercial discretion normally enjoyed by separate undertakings. This would inevitably involve a distortion of the relationship between such undertakings themselves and between them and their customers. Precisely for such reasons, national and EC competition law had traditionally frowned upon most types of horizontal agreements between competitors whilst adopting a neutral stance towards mergers. The parties concluded that any co-operative arrangement between P&O and Stena would need to be well-conceived and commercially attractive to both parties if it were to be capable of having any significant effects. They did not believe any such arrangement could be devised.

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*Figures omitted. See note on page iv.

Continuation on a stand-alone basis

7.108. In view of the commercial pressures on ferry operators, the parties believed that prudent management on the part of P&O and Stena as stand-alone operations would require drastic remedial action to reduce costs and minimize losses. At the least, a scaling down of operations would be necessary and, ultimately, market exit might prove unavoidable. Both parties were under institutional and shareholder pressure to achieve adequate rates of return on capital employed. Given the substantial amounts of capital employed in the Short French Sea ferry business, at book values of approximately £280 million for P&O and £185 million for Stena, and the current prospects for the market, continuing pressure could be expected for redeployment to other activities where better rates of return could be achieved or, as a minimum, for a clear reduction in exposure to the Short French Sea market. The parties would be compelled, therefore, to act to improve their financial position. They would each need to scale back services, resulting in a reduction in frequency which would be likely to lead to reduced demand. The parties said that overheads would not fall in proportion to the reduction in turnover, at any rate for some time. The resulting higher unit costs for the balance of the business would tend to offset the cost savings. A reduction in capacity and frequency would therefore be likely to create a downward spiral, the consequence of which would be a further erosion of the parties' market shares and pressure for them to cut capacity and frequency further. The parties emphasized that ferry capacity could not be varied only slightly; the withdrawal of one ship out of four, for example, could imply a 25 per cent reduction in capacity.

7.109. Eurotunnel, given its capacity and other competitive advantages and its market share gains in 1996, must be expected to gain a large part of any traffic lost by the parties. The end result would be a widening of the competitive gap between the ferry operators and Eurotunnel and an increase in Eurotunnel's competitive strength. The parties believed that at some juncture they were likely to face an all-or-nothing choice: frequency of service could not be reduced beyond a certain level, which, in the case of traditional ferries on the Dover-Calais route, the parties believed to depend on operation of three vessels, without wholly undermining the attractiveness of the service to passengers.

7.110. The parties also commented separately on the implications of continuing their Short Sea services on a stand-alone basis.

P&O

7.111. P&O said that the joint venture would not be a complete answer to the problems facing its Dover-based ferry business because it could not guarantee the longer-term future of a Short Sea operation in which it had an interest. It was, however, a partial answer; the immediate alternatives of limited retrenchment, a clampdown on expenditure or a policy of wait-and-see combined with the exploration of such opportunities as might present themselves were not attractive.

7.112. Although P&O's Dover-based operations were currently operating at a profit, the level of profitability was not high enough, even if the duty-free concession were to be extended, to support the longer-term renewal of the Short Sea fleet. [

Details omitted. See note on page iv.

] Moreover, decisions about fares, whether negotiated with consignors of freight or ITX and coach operators or published in brochures, would have to be taken in little more than one year. The need to find a solution was, therefore, urgent.

7.113. P&O said it appeared that the only solution, albeit only a partial solution, was the formation of the joint venture with Stena. The arrangements for this had been laboriously negotiated and could not easily be altered. P&O had to assume, therefore, that the only alternative course of action to the agreed joint venture arrangements would be the imposition of an effective standstill on anything other than absolutely unavoidable expenditure; waiting to see whether someone else was required by economic forces to pull out of the market before P&O was forced to do so, even though P&O was almost certainly the lowest-cost producer if all costs were properly taken into account; and seizing any opportunity that was not incompatible with P&O's reputation for safety and integrity to hold on to its Short French Sea business. P&O did not find this an attractive course.

7.114. One cost-saving measure had already been announced by P&O, namely the reduction in the size of its Dover-Calais fleet by one vessel, which would take effect when Eurotunnel had returned to full, normal operation. P&O said that this measure was not intrinsically desirable since, if the Dover-Calais service were to remain on a stand-alone basis, the reduction in the size of the fleet would reduce the frequency of service, which was an important part of the quality of the offering. Any further such reduction would be proportionally more damaging.

7.115. P&O did not believe that it could easily reduce costs by going over, on a stand-alone basis, to operating a crew live-on-board operation. Only one of its Dover-Calais ferries, namely the *Pride of Burgundy*, could be operated on that basis without capital expenditure to construct cabin accommodation for the crew. Such capital expenditure could not easily be justified given the uncertainty surrounding the future of the service and given the concerns about the effect of live-on-board operation on standards and quality of service.

7.116. P&O and Stena had given further thought to the implementation of live-on-board arrangements on the ex-P&O vessels in the context of the joint venture. [

Details omitted. See note on page iv.

]

7.117. [

Details omitted. See note on page iv.

]

7.118. Cessation of the Dover-Zeebrugge freight service by P&O was not considered to be an option, for the reasons set out in paragraph 7.11. Curtailment of the service would also have disadvantageous consequences. With only two vessels, the frequency of the service would fall from the current 4 hours to 6 hours, and with one vessel would fall to an average of 12 hours. It would be doubtful whether the resulting loss of revenue would be less than the cost savings.

7.119. P&O said that cost savings made in its Dover-based business on a stand-alone basis would reduce the competitiveness of that business and could be expected to result in a downward spiral of reduction in demand, further need to reduce costs, a consequential reduction in competitiveness and so on. The withdrawal of a further vessel from the Dover-Calais fleet would lead to a 25 per cent reduction in the frequency of the four-vessel service offered by P&O on a stand-alone basis. Frequency of service was very important since it enabled customers to sail when they wanted to and reduced the time that they spent waiting for the vessel to leave. With frequent departures offered by, in particular, Eurotunnel, a reduction in frequency of sailings could be expected seriously to affect the demand on P&O's Dover-Calais service. At the same time, P&O told us, a reduction in capacity would not achieve a proportional reduction in average total costs. Central overheads (such as office administration, information technology and marketing) and shore costs would not fall by an equivalent proportion. Reductions in marketing expenditure would adversely affect public perceptions of P&O's service and awareness and take-up of promotional offers. As a result, even with a relatively small loss of traffic, the average total costs per passenger vehicle/freight unit for the remainder of the business might fall only slightly, particularly before any overhead reductions were further implemented. It was likely that any further reduction in the size of P&O's Dover-Calais fleet operated on a stand-alone basis would render the service non-viable.

7.120. P&O commented that, in order to compete with Eurotunnel's technologically advanced service, ferry operators needed to provide an attractive alternative, including on-board amenities and services. The development of such services was generally incompatible with cutting operational costs. The ferry operator faced a dilemma: unless costs could be cut, they would exceed revenues, but if costs were to be cut, the

service would be less attractive and revenues would fall, potentially to a point where they would again be exceeded by costs. Therefore, a downward spiral of the kind already described was likely to result.

Stena

7.121. Stena said that the joint venture negotiations with P&O had been the priority for its senior management and development of an alternative stand-alone strategy had not been pursued since the rejection by Stena Line AB of an earlier rationalization plan. The rejected plan had indicated that a stand-alone strategy would have to extend to all Stena routes, not just the Short Sea routes. Stena's Southampton-Cherbourg service had already been closed and the next option would be closure of the Newhaven-Dieppe service. This would not be an easy option because Stena had invested in a new ferry terminal in Dieppe and was a 50 per cent shareholder in the Société de Terminal Transmanche de Dieppe (STTD). In addition, the Newhaven-Dieppe route would have relatively high closure costs [

Details omitted. See note on page iv.

]. If the vessels used on the Newhaven-Dieppe route could not be chartered or sold to third parties, additional lay-up costs would need to be added to the closure costs, [*Details omitted. See note on page iv.*].

7.122. Any further cost reductions would have to be sought on the Dover-Calais services. Stena said that few cost savings could be achieved from head office, port facilities, administration and marketing; attention would therefore have to focus on the number and quality of vessels. Reduction in capacity and frequency of service would not, however, be a satisfactory solution because customers lost to Stena as a result would be picked up by other operators, in particular Eurotunnel. This would further increase Eurotunnel's market power, whilst Stena's reduced service would be less able to compete with Eurotunnel and so lose further customers. The pressure on Stena to cover the costs of the reduced operation by the revenues from reduced passenger numbers but with largely unchanged overheads and a less marketable service would lead to further capacity reductions and an even less competitive service. Stena commented that the situation would be exacerbated by the large investment that would be needed on the *Invicta* in a few years' time to meet the survivability standards laid down in the 1997 Regulations-an investment that would be unnecessary for the joint venture since the *Invicta* would be surplus to its requirements. Whereas the stand-alone alternative was likely to result in poorer frequency and quality of service, the joint venture would create a combined fleet of six efficient and capacious vessels which would result in a visible upgrading of service and amenities.

7.123. Stena observed that P&O, as well as itself, would probably be forced to make capacity reductions if the merger did not take place. Both operators would then provide a less attractive service and would lose customers to Eurotunnel, so that the pressure to withdraw further ships would mount. Eventually, one or both of them would have to contemplate leaving the market. If one of them survived it would be in a weakened financial position and ill-placed to invest in the additional capacity needed to regain market share.

Remedies

7.124. We raised with the parties a number of remedies that we might recommend in the event of a finding that the merger might be expected to operate against the public interest. We suggested that price controls or undertakings designed to deter predatory behaviour by the joint venture might be appropriate.

7.125. The parties reiterated their view that the joint venture would not increase the likelihood of predatory behaviour and pointed out that existing competition law in the UK and EU already provided adequate remedies against such behaviour. Nevertheless, they would be willing to give an assurance that, in October of each year, the joint venture would provide the DGFT with financial information on a route-by-route basis showing traffic volumes, revenue, capital employed and allocated costs (on a basis to be agreed with the DGFT) for (*a*) the previous calendar year's operations (to be supplemented by audited accounts when available) and (*b*) the year to date. In addition the joint venture would provide its forecast for the current full year and its projections for the subsequent calendar year. This assurance would apply from the time it assumed operations on the Short Sea routes, regardless of its market share and independently of any price increases.

These data would enable the DGFT to assess the propriety of the joint venture's pricing and other market behaviour.

7.126. We asked the parties for their views on a hypothetical undertaking based on:

(a) one of the key assumptions underlying the projections on which the proposed joint venture was based, namely that there would be no increase in the level of ticket prices as a result of the joint venture (see paragraph 7.3); and

(b) a requirement for prior approval by the DGFT of changes to brochure prices.

The parties said that, with or without the joint venture, ticket prices on the Short French Sea routes could not be expected to rise in the run-up to mid-1999 (the expected date for removal of the duty-free concession). Ferry price levels had in fact fallen in the first eight weeks of 1997 despite the reduced service available from Eurotunnel. On a longer-term view, the parties argued that the MMC should not recommend price conditions unless they were satisfied that a duopoly of Eurotunnel and the joint venture was to be expected as a result of the merger, and would not otherwise arise with any other ferry operator, and that the duopoly was to be expected to charge supra-competitive prices and not be prevented from doing so by normal competitive forces. The parties drew attention to the factors which they believed would prevent the emergence of an uncompetitive duopoly (see paragraphs 7.64 to 7.69) and said that any risk, as distinct from expectation, of duopolistic pricing should be dealt with, if and when it arose, under general competition law. Moreover, if an undertaking such as that hypothesized were to be required, then in order to satisfy the test of proportionality, its coming into operation would have to be deferred, according to the parties, until duopolistic conditions actually arose and even then the joint venture's share of the duopoly would have to be substantial if an undertaking regulating the joint venture's prices (but not those of the *ex hypothesi* much larger operator, Eurotunnel) could be justified.

7.127. The parties did, however, consider how an assurance about future pricing action by the joint venture might be achieved if the MMC concluded that one was needed. They said that no workable assurance could be devised to cover the wide range of individually negotiated transaction prices current in the market at any time, but published passenger brochure prices were of real significance in the formulation of transaction prices. This was so not only in relation to passengers who travelled at or near brochure rates but also in relation to a wide range of fares for which brochure prices set a ceiling or bench-mark. The parties indicated that brochure prices could be expected to bear a closer relationship than in the past to average realized rates. In the parties' view, therefore, control over key brochure prices would have a direct effect on realized prices and would also protect those customers who, travelling at brochure rates, might be seen by the MMC as the most vulnerable.

7.128. The parties believed that it would be very difficult to devise any form of workable price cap to apply after 1999 because of the uncertainties about the development of the market and the effects of the removal of the duty-free concession on the economics of the joint venture's operations. (They said that they had not considered a price cap for the short period prior to 1999 as it appeared to them that the MMC were primarily concerned with the post-1999 period.) Instead, they put forward a proposal intended to offer transparency on future brochure tariff increases. The joint venture would be prepared to offer the DGFT as much notice as possible, but in any event not less than one month's notice, of the implementation of any annual increase in UK brochure tariffs. The first brochure tariffs for any given year were typically set in November or December with a view to implementation in January. The specific financial information supplied to the DGFT in October each year (see paragraph 7.125) would enable him to assess the compatibility of the annual brochure price increases with the public interest and to consider whether any action was necessary. In addition, the joint venture would give the DGFT as much notice as possible of any proposed increase in brochure prices during a year (although prices typically went down from the level set by the initial annual increase). The parties explained that the *ad hoc* nature of such price increases would prevent the parties from committing the joint venture to a minimum notice period. They believed that the route-specific information to be supplied to the DGFT, together with any other financial information that he might require, would enable him to determine whether regulatory intervention was necessary. The parties emphasized, however, that the MMC should be concerned about future detriments to the public interest only if the detriments were to be expected and should not seek to provide in advance for risks which were not expected to arise and which, even if they did arise, could be dealt with under general competition law with the benefit of knowledge of the actual circumstances.

7.129. We invited the parties to consider undertakings relating to the co-ordination of the joint venture's schedule with that of SeaFrance and ticket interlining with other operators. The parties believed that such arrangements would be commercially impracticable, for the reasons set out in paragraphs 7.98 to 7.103, and would raise separate regulatory concerns in the UK and elsewhere since they would lead to a muting of competition.

7.130. The parties gave consideration to limiting ticket interlining to full brochure price ticket-holders, but concluded that it would be impracticable without arrangements for compensatory payments, which would in practice be quite complex. They also commented that relatively few passengers travelled at the full brochure price and any such arrangement would be of limited benefit. Whilst it would be open to the joint venture and other operators to enter into such arrangements if they believed they would be mutually advantageous, the parties considered that it would be inappropriate to make them a condition of the clearance of the merger. Moreover, if interlining were to offer any real benefit, it would be necessary to co-ordinate schedules, which would in turn lead to revenue pooling because of the difficulty of allocating the most profitable sailings between two or more operators. The parties suggested that the retention by SeaFrance of an independent schedule would leave it free to compete with the joint venture on the most advantageous sailings and would be in its best commercial interests.

7.131. The parties confirmed that the joint venture would continue the practice of P&O and Stena (and common in the industry) of entering into interavailability agreements on a reciprocal basis with third party operators in order to safeguard customers in the event of a disruption of service.

7.132. We asked the parties to consider whether meaningful undertakings could be given to address concerns raised with us that the joint venture might introduce new services, for example a fast craft service, at a predatory price in order to target particular competitors. We also invited them to consider an undertaking that the joint venture would not extend its activities to new routes or services without the prior agreement of the DGFT.

7.133. The parties commented that the merger proposal before the MMC involved the transfer to the joint venture of their operations on the Short Sea routes. Any extension of the scope of the joint venture's operations would entail a further proposal and agreement between the parties and fresh approval by the European Commission. In such circumstances, the UK authorities would be entitled to require the European Commission to intervene pursuant to Article 12 of Regulation 4056/86 in order to safeguard competition even if such an extension did not constitute a merger qualifying for investigation within the meaning of the Act.

7.134. As to the routes within the joint venture's agreed ambit, in response to the MMC's concern that the joint venture might engage in predatory behaviour to drive other ferry operators from the market, the parties emphasized that the purpose of the merger was cost reduction and rationalization of services on the Short Sea routes. They had no intention of diverting resources to the opening of new routes; in any event the charging by the joint venture of predatory prices on such routes, where the traffic was much lighter than on the Dover-Calais route, would have an immediate adverse economic effect on its core Dover-Calais business. In other words, any predation would inevitably drive down rates on its core route. Since the joint venture would not be dominant, it would have no ability to recoup its losses through monopoly profits, even if, which the parties did not accept, it would be able to fund the loss in the first place. Moreover, it was highly unlikely that, having cut capacity to reduce costs on the principal Dover-Calais route, the joint venture would, within the foreseeable future, increase its costs by investing in new operations on additional routes. The parties believed that the proposed submission to the DGFT of route-specific accounting information (see paragraph 7.125) would facilitate monitoring of the joint venture's conduct.

7.135. The parties said that they would be reluctant to accept constraints on the joint venture's ability to introduce new services and thus compete effectively against Eurotunnel, in particular through the potential development of fast-craft technology. In their view, the joint venture should be free to offer the services and technology that customers wanted; this would promote the public interest and competition.

7.136. We raised with the parties the issue of the combined power of P&O, Stena and the joint venture in the area of marketing and promotional activities, and invited them to consider a number of possible remedies intended to ensure that the joint venture's competitors would not be denied access to marketing opportunities. The parties believed there was no sound basis for an expectation that the joint venture would have anti-

competitive effects of that kind and did not consider that any assurance was necessary or appropriate. They advanced a number of reasons in support of their view.

7.137. First, as a result of changing patterns of customer behaviour, technological changes which had introduced new, cheaper distribution methods and increasing concentration by ferry operators on direct sales methods (in particular telephone sales), the ferry industry was less dependent on traditional travel agents than it used to be.

7.138. Secondly, the joint venture and each of the residual businesses of P&O and Stena would negotiate with travel agents independently and make separate arrangements on such matters as commission rates, racking and promotions. The parties confirmed that they would not aggregate, for the purposes of calculating commission, volumes achieved by an agent with the joint venture and either of the residual businesses.

7.139. Thirdly, P&O's and Stena's services would not be included in the joint venture's brochures. Whilst it had not yet been decided whether the parties would include the joint venture's services in their own brochures, they would need to include details of the passenger landbridge services to be provided by the joint venture on the Short French Sea for their services on the Irish Sea. The parties would also need to be able to inform customers of the possibility of undertaking round trips, for example travelling out by a North Sea service and returning via the joint venture's Dover-Calais service. This would at most entail the inclusion in brochures published individually by the parties of details of services available from the joint venture. The parties submitted that they would not thus be actively promoting the joint venture. They explained that their marketing resources, much scaled down as a reflection of the loss of their principal passenger route to the joint venture, would be directed at promoting their own residual services, particularly where demand for such services was strongest. The catchment areas for those services (essentially Scotland and the north-west and north-east of England) did not overlap to any great extent with the catchment areas for the joint venture (the Midlands and south-east of England). The parties believed, therefore, that steps to prohibit the parties from including details of the joint venture's services in their brochures would be inappropriate. Despite this view, they indicated that if objections in this regard would otherwise jeopardize the implementation of the joint venture, they would be prepared to give an assurance that they would not integrate details of the joint venture's services into their brochures.

7.140. Fourthly, national newspaper proprietors were interested in promoting only day-trip ferry excursions. The market for such excursions was in practice limited to the Short French Sea, where P&O and Stena both operated services. If the merger were to proceed, the joint venture would replace the two parties' individual services, and newspapers would then look to other ferry operators and Eurotunnel to fill the gap. In the parties' view, the joint venture presented a competitive opportunity, not a threat.

7.141. The parties said that it would be practicable to prohibit the joint venture from entering into exclusive arrangements with travel agents and other intermediaries. They feared, however, that it would be difficult to draft any such condition which would at the same time be effective yet not prevent the joint venture from entering into normal pro-competitive arrangements to attract business from travel agents. They believed, therefore, that the appropriate course would be to leave the matter to be dealt with case by case, if necessary, under the appropriate UK or EC competition law.

7.142. We asked the parties whether there would be any difficulty over the formulation of an undertaking in respect of their giving up facilities at Dover and Calais. The parties had not yet given details of likely surplus facilities to the port authorities but did not expect any difficulties to arise. In relation to berths, the parties were operating on a month-to-month allocation from DHB pending decisions on the proposed merger. Ticket booths would be reallocated at the discretion of the port authorities, who would wish to make an allocation that would minimize delays and congestion. Arrangements for the ticket desks were rather more formal, but the question was only one of identifying which desk should be given up. The parties were prepared to write to the port authorities at Dover and Calais to confirm their intentions.

7.143. We invited the parties to comment on a hypothetical recommendation that the joint venture should give an undertaking not to enter into landbridging or joint promotional arrangements on the Irish Sea routes with either of its parent companies without offering equivalent terms to other operators.

7.144. The parties said that they had no wish to deny the services of the joint venture as a landbridge partner to operators on the Irish Sea: to do so would simply depress the joint venture's income. Neither did

the parties wish to be prevented from entering into a landbridge partnership with the joint venture on the Short Sea routes. They stated that it was the joint venture's intention to engage in an arm's length competitive procurement of its Irish Sea landbridge partner or partners and the parties would want their individual businesses to be able to compete. They would, however, be willing to consider giving an assurance that the joint venture would deal with third party operators on the Irish Sea in the context of landbridge arrangements on objective, non-discriminatory and arm's length commercial terms.

7.145. We suggested to the parties that if we were to conclude that the inclusion of the Dover-Zeebrugge and Newhaven-Dieppe routes could be expected to operate against the public interest by acting as economic barriers to the entry of competitors on the periphery of the joint venture, then exclusion of those routes from the joint venture would be an appropriate remedy. The parties indicated that such a remedy would be unacceptable, for the reasons set out in paragraphs 7.6 to 7.11.

7.146. We invited the parties to consider a hypothetical requirement that one or more independent non-executive directors be appointed to the supervisory board of the joint venture, in order to remedy any expected spill-over effects of the merger. The parties believed that such a remedy was unnecessary and inappropriate, given the ring-fenced nature of the joint venture. From a shareholder's perspective, the supervisory board had been carefully designed to create the possibility of deadlock and to ensure protection against either shareholder exploiting the joint venture to the advantage of its residual wholly-owned business. The parties believed the introduction of independent non-executive directors would undermine that position. The parties also believed that it would be inappropriate for non-executive directors to police compliance with competition laws or other regulations. This would be more effectively dealt with by the rigorous compliance procedures applicable to management at all levels that were already in place within P&O and Stena and that would be introduced for the joint venture.

D G GOYDER *(Chairman)*

M CAVE[1]

A T CLOTHIER

P MACKAY

P A BOYS *(Secretary)*

4 April 1997

[1]Subject to his supplementary note following Chapter 2.