

**REFERENCE RELATING TO THE ANTICIPATED ACQUISITION BY STENA AB
OF CERTAIN ASSETS OPERATED BY THE PENINSULAR AND ORIENTAL
STEAM NAVIGATION COMPANY ON THE IRISH SEA**

Provisional findings report

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The Competition Commission has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂.

Provisional findings report

Anticipated acquisition by Stena AB of certain assets operated by The Peninsular and Oriental Steam Navigation Company on the Irish Sea

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Executive summary

1. On 22 August 2003 the Office of Fair Trading referred the proposed acquisition by Stena AB (Stena) of certain assets operated by The Peninsular and Oriental Steam Navigation Company (P&O) on the Irish Sea to the Competition Commission for investigation and report. The reference was made under section 33(1) of the Enterprise Act 2002. We are required to publish our final report by 6 February 2004.
2. The parties signed a Memorandum of Understanding (MoU) on 27 May 2003 setting out the arrangements for the proposed acquisition of P&O's ferry operations on the Irish Sea between Liverpool–Dublin and Fleetwood–Larne and a second transaction concerning the establishment of a joint venture for port operations at the port of Cairnryan. The possible closure of P&O's Mostyn–Dublin route was announced by P&O in its press release issued on the same day. Separate sets of conditional agreements relating to the two transactions were signed on 10 October 2003. The OFT only referred the first transaction to us. Under this transaction Stena would acquire five vessels currently operated by P&O on the two routes concerned, together with related assets, inventory and goodwill. It also agreed to time charter two vessels from P&O presently deployed on its Mostyn–Dublin route.
3. We found that the share of supply test was met in respect of both the tourist and freight services provided by Stena between Great Britain and Ireland. We also concluded that arrangements were in progress which, if carried into effect, would result in the creation of a relevant merger situation.
4. Our report focused on the freight market. We defined the relevant markets affected by the proposed merger to be the markets for transporting roll-on/roll-off and lift-on/lift-off freight between Great Britain and Ireland, first in the northern corridor (in

relation to Fleetwood–Larne) and second in the central corridor (in relation to Liverpool–Dublin). We did not accept that these two markets should be further divided between driver-accompanied and unaccompanied freight, although we recognized that these could be regarded as two market segments.

5. Pricing in the freight ferry market is opaque. It is based on bilateral negotiations between individual customers and the ferry company concerned and results in agreed terms on specific routes. These are generally based on the previous year's prices, expectations of volumes for the following year, and any other features specific to that particular customer. Prices may in part reflect the importance of that customer to the company as a whole, including business outside the Irish Sea. Different prices are charged for accompanied and unaccompanied traffic, and according to time of crossing. We found a high degree of variation in prices paid by individual customers. The opaque nature of this market means that ferry operators currently have the potential to price discriminate between customers.
6. There are currently three major operators in the market for freight traffic on the northern corridor: P&O, Norse Merchant Ferries and Stena. P&O's Fleetwood–Larne route constitutes around 20 per cent of the relevant market on the northern corridor. Norse Merchant Ferries provides the most direct competition with its diagonal routes from Liverpool and Heysham to Belfast. Competition is also provided by the short-sea northern routes operated by P&O and Stena, and by Seatruck's operation from Heysham to Warrenpoint.
7. As a result of the transfer of the Fleetwood–Larne route, Stena's market share in the northern corridor would approximately double. Three significant ferry operators would, however, remain, but Stena would replace P&O as the largest ferry operator

on the northern corridor. The merger reduces concentration in this market, at least in the short term. Despite the removal of Stena as a potential entrant on the diagonal routes, we concluded that the transfer of the Fleetwood–Larne route from P&O to Stena could not be expected to result in a substantial lessening of competition.

8. On the central corridor, there are currently four major operators. P&O has the largest share of the central corridor, followed by Norse Merchant Ferries, Irish Ferries and Stena. The freight transported on P&O's Liverpool–Dublin route made up just over 20 per cent of central corridor traffic. Again the most direct competition to P&O's Liverpool–Dublin route is from Norse Merchant Ferries, which provides a similar service on the same route out of the river berths at Birkenhead, although there is also competition from all other routes into Dublin, including the short-sea route Holyhead–Dublin.
9. Post merger, the four main competitors on the central corridor would reduce to three, as P&O would exit the market, and Stena's market share would more than double. Market concentration on the central corridor would be significantly increased, and the merger would give Stena a market share significantly larger than its nearest rival. In addition, unlike its rivals, it would have a route on both the short and long central corridor crossings.
10. We believed that there was likely to be a reduction in capacity on the central corridor as a result of the proposed merger. We considered that the Mostyn–Dublin route would close regardless of the merger. However, if P&O were to retain the Liverpool–Dublin route, we believed that it would have a clear incentive to replace more of the withdrawn Mostyn–Dublin capacity than would Stena were it to acquire the route.

11. We concluded that there would be scope for Stena post-merger to exercise market power, for example by increasing prices to certain customers, and that this would be possible given the lack of pricing transparency in the market. In practice, such price increases would be likely to be focused on the Liverpool–Dublin route. We therefore expected Stena to increase prices on the Liverpool–Dublin route to encourage traffic to move to its Holyhead service, rather than to increase capacity on the Liverpool–Dublin route and continue to operate the Holyhead service at lower levels of utilization. In addition, there would be less of an incentive for Stena to reduce prices at Holyhead in an attempt to attract additional traffic to fill some of its spare capacity. Absent the merger, on the other hand, P&O would be more inclined to put additional capacity on the Liverpool–Dublin route and possibly to lower prices. We thought it unlikely that either Norse Merchant Ferries or Irish Ferries would seek to increase capacity on the central corridor to deter Stena from such a strategy.
12. We did not believe our findings in the central corridor to be very sensitive to the definition of the relevant market for the Liverpool–Dublin route in terms of accompanied and unaccompanied freight. We recognized that the hauliers and ferry operators in the two market segments may react differently to any potential price rises but believed that the effects that we described would apply similarly to the accompanied segment as they would to the market as a whole.
13. Although we believed that entry was not intrinsically difficult, and that potential entrants existed who would be prepared to come into the market under appropriate market conditions, it would be particularly important to have access to suitable berths and sufficient surrounding land available at peak times. We did not believe that at the current time, or within the next two to three years, we could rely on large-scale

entry to offset any potential substantial lessening of competition in the central corridor.

14. We therefore concluded that, as a result of the proposed merger, we would expect there to be no substantial lessening of competition on the northern corridor but would expect a substantial lessening of competition on the central corridor. We did not expect that such a lessening of competition would be offset by other competitive constraints, in particular entry.

Provisional findings

1. The reference

1.1 On 22 August 2003 the Office of Fair Trading (OFT) referred the proposed acquisition by Stena AB of certain assets operated by The Peninsular and Oriental Steam Navigation Company on the Irish Sea to the Competition Commission (CC) for investigation and report. The reference was made under section 33(1) of the Enterprise Act 2002 (the Act). Our terms of reference are set out in Appendix A. We are required to publish our final report by 6 February 2004.

1.2 This document, together with the appendices, constitutes our provisional findings report which we are required to notify to the main parties under the CC's Rules of Procedure. Further information, including non-sensitive versions of main party and third party written submissions, summaries of third party key arguments and views, and the reports of the two customer surveys which we commissioned, can be found on our web site.¹ We cross-refer to these documents as appropriate.

2. The companies and the Irish Sea

Stena

2.1 Stena AB is a private company registered in Sweden and owned by the Sten Allan Olsson family. Stena AB is one of three private parent companies collectively known as Stena Sphere, which reported a worldwide turnover of around £1.9 billion in 2002. We use the term Stena in the remainder of this report to refer to Stena AB and its subsidiaries.

¹www.competition-commission.org.uk.

2.2 Stena comprises a number of different business divisions, including Stena Line, providing ferry services in Scandinavia, Great Britain, the island of Ireland (Ireland), the Netherlands, Germany and Poland; Stena RoRo, providing services to the ferry industry including chartering; and Stena Bulk, providing crude oil and petroleum transportation. Stena reported a worldwide turnover of approximately £0.9 billion in the year ended 31 December 2002, of which around £0.6 billion came from ferry operations. Stena's income from operations² was £80 million in the year ended 31 December 2002, of which £35 million was from ferry operations. At 31 December 2002 Stena had net assets of £0.9 billion and a gearing ratio³ of 53 per cent.

2.3 Stena's Irish Sea operations include ownership of two ports in the UK (Holyhead and Stranraer) and ownership of 50 per cent holdings in the ports of Fishguard and Rosslare. In relation to ferry services from Great Britain, it operates passenger and freight services to Ireland and Holland. On the Irish Sea, Stena's existing routes are Stranraer–Belfast,⁴ Holyhead–Dublin, Holyhead–Dun Laoghaire and Fishguard–Rosslare. These routes were acquired in April 1990 from Sea Containers Ltd, and their history dates back to Sealink (UK) Ltd.

2.4 Stena reported a turnover from its ports and ferries businesses on the Irish Sea of £167 million in the year ended 31 December 2002 (2001: £152 million),⁵ of which around a quarter, £[] million, related to freight. Total earnings before interest, taxation, depreciation and amortization (EBITDA) were £[] million, a margin of

²Total revenues less total operating expenses, before income from affiliated companies and joint ventures, financial income and expenses, minority interests, and income taxes, calculated in accordance with Swedish GAAP.

³Debt/(debt + equity).

⁴Originally operated from Stranraer to Larne when acquired from Sealink (UK) Ltd.

⁵Turnover reported in Stena Line Limited's statutory accounts.

[X] per cent on turnover, and its return on assets⁶ was [X] per cent in the year ended 31 December 2002.

P&O

2.5 The Peninsular and Oriental Steam Navigation Company is listed on the London Stock Exchange, and its subsidiaries include P&O Ferries, P&O Ports, an international container terminal operator; Cargo Shipping, including the P&O Nedlloyd and Associated Bulk Carriers joint ventures; and P&O Cold Logistics, a temperature-controlled logistics business.⁷ P&O Ferries operates ferry services between Great Britain and Ireland, France, Belgium, Holland and Spain. We use the term P&O in the remainder of this report to refer to The Peninsular and Oriental Steam Navigation Company and its subsidiaries. P&O reported worldwide turnover of £4.5 billion in the year ended 31 December 2002. At 31 December 2002 P&O had net assets of £1.3 billion and its gearing ratio⁸ was 50 per cent. At 30 September 2003, P&O's market capitalization was £1.7 billion. P&O's Ferries division reported a turnover of £1.0 billion in the year ended 31 December 2002 and an operating profit of £13.7 million.

2.6 The majority of P&O's Irish Sea ferry business dates back to 1975 when P&O combined its services operating on the Cairnryan–Larne route with other Irish Sea routes run by its haulage/maritime services business, Pandoro. Its current Great Britain–Ireland ferry routes are Cairnryan–Larne, Troon–Larne, Fleetwood–Larne, Liverpool–Dublin and Mostyn–Dublin. It also owns the ports of Cairnryan in Scotland and Larne in Northern Ireland. P&O also operates on two routes between Ireland and France, Cherbourg–Rosslare and Cherbourg–Dublin.

⁶EBITDA as a percentage of net operating assets employed.

⁷Not exhaustive. Also P&O Properties, containing the group's property development and investment portfolio.

⁸Debt/(debt + equity).

2.7 P&O reported a turnover from its ferry business on the Irish Sea of £107 million in the year ended 31 December 2002 (2001: £98 million),⁹ of which the majority, £[✂] million, is related to freight. In total for its Irish Sea business it reported an EBITDA of £[✂] million, a margin of [✂] per cent on turnover. Net operating assets at 31 December 2002 were £[✂] million, resulting in a return on assets¹⁰ of [✂] per cent in 2002.

2.8 The turnover attributable to each of the routes which P&O proposes to cease operating on the Irish Sea, namely Liverpool–Dublin, Fleetwood–Larne and Mostyn–Dublin, was between £50 million and £60 million in 2002. The turnover on the Liverpool–Dublin and Fleetwood–Larne routes are of the same order of magnitude [✂], whereas the turnover on the Mostyn–Dublin route is somewhat smaller (£[✂] million).

The Irish Sea

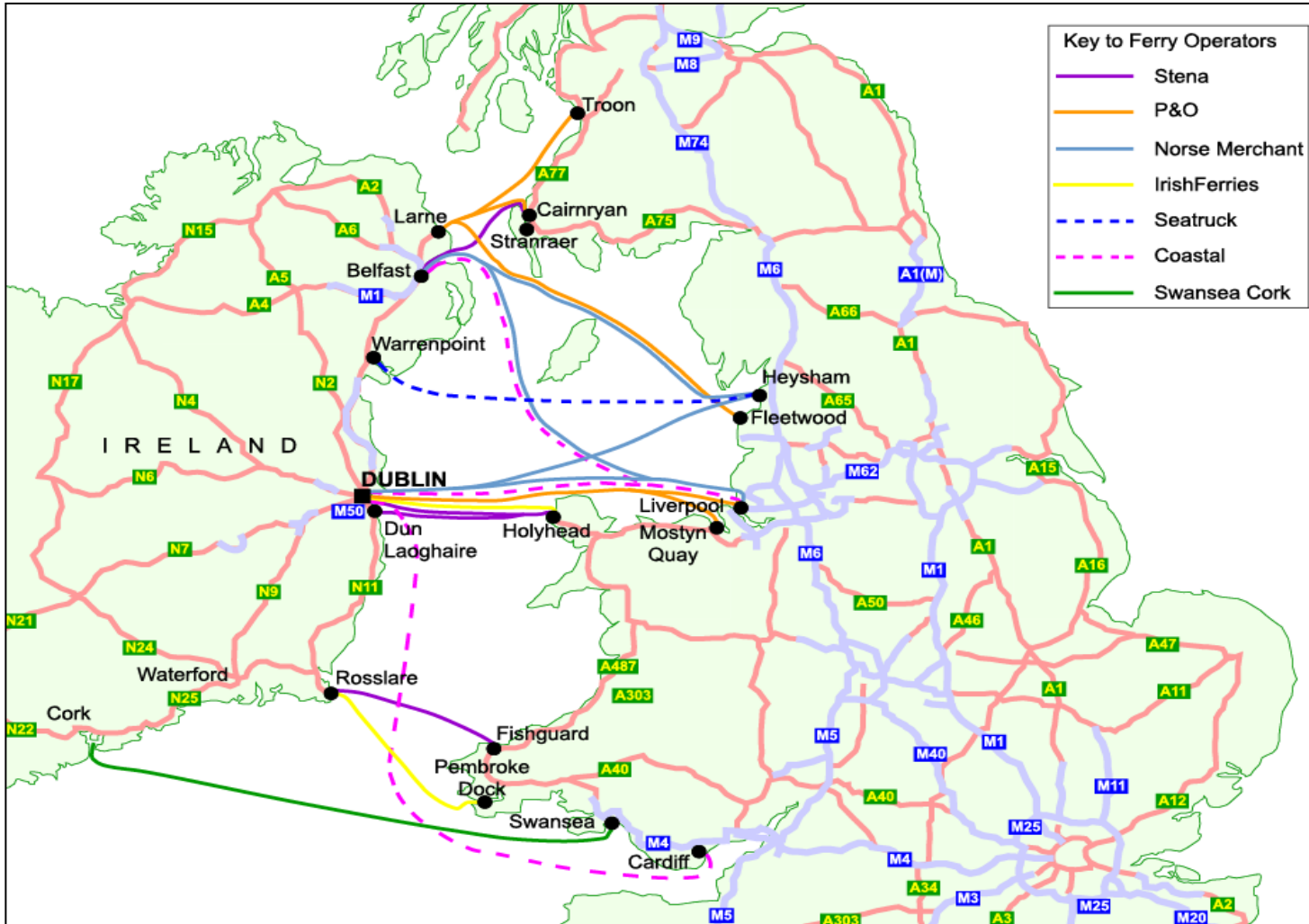
2.9 Figure 1 shows all major freight ferry routes on the Irish Sea. These divide into five broad groupings of routes:

- (a) Northern short-sea routes: Services between Scotland and Northern Ireland; characterized by short crossings (between 1 hour and 4½ hours). The combined P&O and Stena services provide a sailing on average every 60 to 120 minutes.
- (b) Diagonal routes: Services between north-west England and Northern Ireland. They typically take 8 to 12 hours and individual ferry operators offer a maximum of three sailings per day.

⁹As reported in P&O Ferries (Irish Sea) Limited's statutory accounts
¹⁰EBITDA as a percentage of net operating assets employed.

FIGURE 1

Major freight ferry routes on the Irish Sea



- (c) Central short-sea routes: Services between North Wales (Holyhead) and Dublin Bay, offering frequent daily services taking between 1½ and 3½ hours. The combined Irish Ferries and Stena services from Holyhead offer a maximum of ten sailings per day.
- (d) Central long-sea routes: Services between North Wales/north-west England and the Dublin area. These include routes from Heysham or Liverpool/Birkenhead to Dublin, as well as P&O's Mostyn–Dublin service. They typically take between 6 and 10 hours and individual ferry operators offer a maximum of two sailings per day.
- (e) Southern routes: Services between South Wales and the southern part of the Republic of Ireland.

Further details of these routes, as well as relevant industry background on economic trends, key operators, types of freight and vessels, ports, and regulatory factors, can be found in Appendix B.

Previous transactions between the parties

- 2.10 The parties told us that they had been involved in a number of high-level negotiations over the past few years.
- 2.11 In 1998 the parties combined their respective Dover Straits routes (Dover–Calais and Dover–Zeebrugge) into the P&O Stena Line joint venture (P&OSL). This joint venture received merger clearance from both the UK¹¹ and French competition authorities subject, in the UK, to a price undertaking in relation to tourist fares. Following notification to the European Commission, the joint venture was granted

¹¹*The Peninsular and Oriental Steam Navigation Company and Stena Line AB: a report on the proposed merger*, Cm 3664, The Stationery Office, November 1997.

Article 81(3) exemption with effect from March 1998, renewed in June 2001. Stena sold its 40 per cent stake in P&OSL to P&O on 13 August 2002.

- 2.12 In July 2002, P&O sold the assets (primarily three vessels) on its Felixstowe–Rotterdam route to Stena. P&O closed its Felixstowe–Rotterdam and Felixstowe–Zeebrugge routes in the same month. Stena used these vessels and other assets on a new Harwich–Rotterdam route, resulting in P&O’s exit from the southern North Sea. P&O continued to operate on the North Sea from Hull and Teesport.
- 2.13 In the autumn of 2002, after completion of the sale of Stena’s stake in P&OSL, discussions (which we believed started in 2000 between Stena and P&O) recommenced in relation to the possibility of Stena acquiring various P&O Irish Sea routes, including not only Liverpool–Dublin and Fleetwood–Larne, but also Mostyn–Dublin. Discussions soon focused around the first two of these routes. Stena had also put a proposal to P&O in April 2002 in relation to a possible joint development of Cairnryan, but at this time P&O was only prepared to accept part of this proposal (namely, that involving the development of a berth for Stena’s HSS vessel).
- 2.14 The parties told us that it was only after Stena announced its intention to develop a new port at Old House Point (about 1 mile from Cairnryan and nearer to the mouth of the loch) in February 2003 that P&O agreed to a revised proposal at Cairnryan to include both Stena’s HSS and ropax vessels. Stena would only acquire Liverpool–Dublin and Fleetwood–Larne, but would recognize the additional goodwill that the closure of Mostyn–Dublin would bring to the Liverpool–Dublin route. This led in turn to the Memorandum of Understanding that is discussed in more detail in Section 3.

3. The proposed merger and relevant merger situation

Outline of merger situation

- 3.1 A Memorandum of Understanding (MoU) between Stena and P&O setting out the route transfers and arrangements at Cairnryan was agreed and signed on 27 May 2003, and a press release was issued on the same day. Separate sets of conditional agreements relating to these two transactions were signed on 10 October 2003.
- 3.2 As noted in paragraph 3.1, the MoU referred to two transactions which had been negotiated simultaneously. Under the first transaction (the Central transaction), Stena would acquire five vessels currently operated by P&O on the Liverpool–Dublin and Fleetwood–Larne routes on the Irish Sea, together with related assets and inventory. It also agreed to time charter two vessels from P&O presently deployed on its Mostyn–Dublin route. The possible closure of P&O's Mostyn–Dublin route was announced by P&O in the press release issued on the same day. As a consequence of the route transfers, certain P&O staff would transfer to Stena, and P&O would also assign certain agreements and leases relating to port facilities, although customer contracts would not be transferred.¹² P&O would agree not to operate passenger or freight ferry services on Liverpool–Dublin, Fleetwood–Larne, or any route from the port of Mostyn for a period of [X] years from completion. The OFT has referred only the Central transaction to us. The parties both gave us assurances that this transaction would not be completed until the deal had received clearance from the relevant competition authorities. The Central transaction was notified to the Irish Competition Authority on 7 November 2003.

¹²There are no formal written contracts between ferry operators and customers.

3.3 Under the second transaction (the Cairnryan transaction), Stena and P&O would establish a joint venture company (JV). The JV would purchase P&O's port assets and operations at Cairnryan and then oversee the financing and construction of new berths, with the intention of P&O and Stena both operating ferry services from Cairnryan. Stena would then cease operations from Stranraer. After the development of the Cairnryan port, the JV would ensure safe navigation at the port, and maintain port infrastructure and security.

3.4 We noted that there were contractual links between the Central and Cairnryan transactions and between the Central transaction and the closure of the Mostyn–Dublin route. In the signed agreements, the total consideration estimated at between £75 million and £85 million is structured as a payment for the five vessels and port assets on the two routes to be transferred of approximately £[redacted] million, a £[redacted] million payment expressed as a contribution to the costs P&O will incur to close its operations at Mostyn and Fleetwood, and a contribution of £[redacted] million towards the land and port assets to be transferred to the Cairnryan JV.¹³ The parties told us that of the £[redacted] million payment expressed as a contribution towards closure costs, almost half related to the Cairnryan transaction (reflecting an upfront payment from Stena for port dues) and the remainder related to goodwill on the Central transaction. Further details are set out in Appendix D. The parties told us that this structure had been designed to optimize P&O's cash flow and that although the transactions had to be considered together to understand the financial arrangements, they did not consider them to be interdependent.

3.5 We concluded that the Central and Cairnryan transactions were capable of proceeding independently. We also concluded that although the closure of the

¹³To be paid indirectly via port dues.

Mostyn–Dublin route was inextricably linked with the Central transaction, the route was uneconomic and would be expected to close in any event (see paragraph 5.29).

The rationale for the merger

3.6 Stena told us that ferry operations were its core competence. It said that its strategy for the Irish Sea was to extend the range of services it offered to its customers, in particular offering more unaccompanied services, and to continue to invest as and when suitable opportunities arose. Stena stated that the acquisition of the Fleetwood–Larne and Liverpool–Dublin routes would enable it to offer a greater choice of routes to its freight customers as well as the opportunity to use overnight services for traffic to and from Dublin and Larne. After completion of the transaction, Stena would have six routes on the Irish Sea, with sailing frequencies of 20 to 25 departures a day, doubling its existing freight capacity.

3.7 Stena said that the removal of the Mostyn–Dublin capacity would result in additional traffic on P&O’s Liverpool–Dublin route and on its own Holyhead–Dublin route and would improve the viability of its Irish Sea business post-merger. Stena expected EBITDA on the two routes it was taking over to be around £[redacted] million in 2004 (£[redacted] million after capital costs¹⁴), plus an increase in EBITDA of £[redacted] million in 2004 on its existing Holyhead–Dublin route as a result of the Mostyn–Dublin closure. In addition, Stena wished to link the route transfers to the arrangement at Cairnryan.

¹⁴Notional capital costs including interest, calculated according to Stena’s internal management accounting policy.

3.8 Stena did not anticipate significant cost synergies as a result of the transfer of routes, although there were significant cost savings associated with the Cairnryan development in comparison with the alternative plan to develop a new port at nearby Old House Point.

3.9 P&O said that the overall deal reflected its decision to rationalize its activities on the Irish Sea because of the inadequacy of current and anticipated returns compared with those it could achieve elsewhere in the group. In particular, it said that the returns it achieved from its container terminals business (P&O Ports) were significantly higher than those of its ferries business.

3.10 P&O also said that the two transactions represented a restructuring of its Irish Sea business which would allow it to focus on higher-yielding routes, in line with its strategy to focus on passenger routes with a strong freight underlay.

3.11 P&O said that the transactions were structured to generate certain financial benefits. [



]

3.12 As the parties have explained, the two transactions were originally conceived as part of Stena and P&O's respective strategies for their Irish Sea ferry services. The parties said that the transactions were now structured in a way that they could

proceed independently of one another. This report only covers the Cairnryan transaction to the extent necessary to understand the Central transaction. We believe the closure of the Mostyn–Dublin route to be inextricably interwoven with the Central transaction, and to form part of the rationale for the transfer of the two routes.

3.13 It has also been put to us by several third parties that these transactions are part of Stena and P&O's wider strategies for ferries generally. Some argue that P&O will withdraw entirely from the Irish Sea over the next two to three years, in return for Stena having sold its stake in P&OSL in 2002. The parties vigorously deny this. In any event, our terms of reference require us to consider only the effects of the proposed merger.

3.14 Shortly after the reference was made to us, the European Commission independently launched an investigation into alleged fixing of prices and trading conditions for cross-Channel transport services and suspected market-sharing agreements in relation to the provision of ferry services to and from the UK. The timescale for the European Commission's investigation extends well beyond the timescale of this inquiry, and we have not allowed the fact of the European Commission investigation to influence our decision in this merger inquiry.

Jurisdiction

3.15 Under our terms of reference (see Appendix A), we are required to investigate and report on whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation. Under the Act there are a number of considerations relevant to determining whether there is a relevant merger situation:

- (a) whether two or more enterprises cease to be distinct; and
- (b) whether either the turnover test or share of supply test is satisfied.

3.16 In terms of (a), an 'enterprise' is defined as the activities or part of the activities of a business (section 129(1) of the Act). Although the contractual documentation focuses on the purchase of assets and charter of vessels, the non-compete clause between the two companies as well as the transfer of certain P&O staff lead us to conclude that the deal is one in which two or more enterprises cease to be distinct. The parties agreed with this view.

3.17 We noted that the closure of the Mostyn–Dublin route would not amount to a merger situation under the Act. The arrangements at Mostyn are relevant, however, when considering the counterfactual against which the merger should be assessed, as discussed further in paragraphs 5.23 to 5.32.

3.18 The share of supply test is satisfied if as a result of the merger the following condition prevails or does so to a greater extent:

In relation to the supply of services of any description, at least one-quarter of all the services of that description which are supplied in the United Kingdom, or in a substantial part of the United Kingdom;

- (a) are supplied by one and the same person or are supplied to one and the same person; or
- (b) are supplied by the persons by whom the enterprises concerned are carried on, or are supplied to those persons.

3.19 The figures in Appendix F show that the share of supply test is met in respect of both the tourist and the freight services provided by Stena between Great Britain

and Ireland, both in aggregate and individually. The parties agreed with this view.

We are therefore not required to consider whether or not the turnover test is met.

Conclusions on relevant merger situation

3.20 For the reasons set out in paragraphs 3.15 to 3.19, we therefore conclude that arrangements are in progress which, if carried into effect, will result in the creation of a relevant merger situation.

4. Market definition

4.1 There are a number of dimensions to the definition of the relevant markets. We consider first a number of aspects of the product transported (tourist vs freight traffic, and types of freight traffic), and then discuss the appropriate level of aggregation of routes. In coming to our view of market definition we have taken into account the parties' views on market definition, as well as third party views and the results of our two surveys. See Appendix H for further details of the methodology underlying our two surveys.

Tourist vs freight

4.2 The key sources¹⁵ of demand for ferry transport on the Irish Sea are:

(a) tourist (including foot passengers and private cars with their drivers and passengers); and

(b) freight (driver-accompanied and unaccompanied roll-on/ roll-off (ro/ro) and lift-on/ lift-off (lo/lo); see Appendix B for more details).

4.3 Both Stena and P&O carry tourist traffic as well as freight. However, tourists account for less than 10 per cent of revenue on each of the two routes to be

¹⁵In addition, there is demand from trade cars. The majority of trade cars are imported directly from the Continent to Ireland on specialized vessels; trade cars carried on ferries are primarily those assembled in Great Britain.

transferred, and on the Mostyn–Dublin route, and in total these routes represent a very small proportion of total tourist ferry traffic to Ireland. Appendix F sets out the relatively modest changes in market share expected as a result of the merger on the tourist side.

4.4 From a demand perspective, tourist and freight services are very different. Tourist demand is seasonal, being concentrated in the summer months, on the shorter sea crossings, and during the day. Freight demand is driven primarily by the strength of the Irish economy. It is much more constant during the year, although volumes increase from September to the third week of December, in the run-up to the festive season. Westbound flows are often supplies of components and retail goods into Ireland; eastbound flows are primarily of agricultural and manufactured products out of Ireland. This freight demand is particularly high on evening and night-time crossings, for delivery early the following day, especially in the westbound direction, ie late night crossings from Great Britain arriving in the Dublin or Belfast areas for early morning deliveries.

4.5 Taking account of the different demand characteristics of passenger and freight services set out in paragraph 4.4, we conclude that tourist and freight services should constitute separate markets. This provisional findings report will focus on the freight market. The OFT also concluded that the P&O tourist services to be acquired by Stena were unlikely currently to represent a significant competitive constraint on Stena and hence would not significantly alter the competitive situation with regard to tourists.

Types of freight

- 4.6 It is useful first to understand the ferry journey in the context of the overall freight journey. The ferry companies' operations form part of a logistics chain from the original consignor of the goods to the ultimate recipient. Consignors range from large-scale distributors of goods, such as manufacturers and supermarkets, with highly-developed distribution planning functions, to small companies that may not be able to ship a complete lorry load of goods. The way that shippers use ferries and road transport depends on a number of factors including the nature of the goods being transported. Consignors of perishable goods, for example, will often set rigorous specifications for the times that goods are to be collected and delivered, with the objective of minimizing stock levels and ensuring that their outlets are supplied on a 'just-in-time' basis. The choice of ferry route is only one element in the decision as to how best to meet these requirements. See Appendix B for more details.
- 4.7 Freight may be transported across the Irish Sea by air or by sea, and the sea journey may be made in a variety of types of vessels including ro/ro, lo/lo and bulk carrier. Our surveys and evidence that we have taken from third parties consistently confirmed that neither air freight nor bulk shipment were economic alternatives to ro/ro and lo/lo for more than a very limited amount of freight, and on the basis of this evidence we conclude that these do not form part of the same market.
- 4.8 Unitized freight can be carried in lorries and trailers on ro/ro services or in containers on lo/lo services. Containers to be carried on lo/lo vessels are lifted on and off by special-purpose cranes. P&O provides a lo/lo-type service on its ro/ro ferries which competes with dedicated lo/lo operators by placing containers on

special trailers. Lo/lo door-to-door services may compete with hauliers using ro/ro services and are thus a potential substitute for less time sensitive shipments. We received little information on the extent of competition between lo/lo and ro/ro, though we understand that there is at least one example of lo/lo services taking business from ro/ro. Given the potential substitutability of lo/lo for ro/ro as evidenced by this example and the fact that P&O itself provides a lo/lo-type service, we have included lo/lo in the market. We do not, however, expect lo/lo to provide a major competitive constraint on ro/ro.

- 4.9 A further issue was whether the freight ferry market should be subdivided into accompanied and unaccompanied services. Accompanied freight is unitized freight carried on a vehicle with its own traction, typically a lorry or an articulated vehicle, accompanied by a driver. Unaccompanied freight travels on the ferry without a traction unit or a driver, typically either on a trailer or in a rigid container. The parties argued that the key characteristics of the two modes differed markedly. They told us that accompanied freight was generally time-sensitive, requiring delivery on the following working day. It often comprised next-day (morning) deliveries for supermarkets or other retailers, perishable goods, parcels, groupage,¹⁶ or high-value goods with particular security requirements. Reliability was key for this type of freight. Accompanied freight tended to be handled by smaller road-haulage operators, as such hauliers did not participate in the more logistically complex unaccompanied market, other than on an occasional basis. The parties also told us that accompanied freight hauliers had greater flexibility in determining their route, but often favoured the shorter sea crossings with their later departure times. They also told us that an accompanied service attracted a price premium compared with an unaccompanied service.

4.10 In contrast, the parties told us that unaccompanied freight was generally not used for 'next-day' deliveries. It would not usually travel on higher-cost peak sailings, but would be transported on lower-cost daytime and weekend sailings. It was less suitable for perishable goods and groupage, and tended to be tied to a limited range of ports because of the substantial organizational infrastructure required. This included an administration/ordering/logistics centre and a depot for a fleet of traction units and trailers, which needed to be situated close to the port and industrial area that it served. The parties told us that hauliers tended to operate exclusively in accompanied or unaccompanied mode due to the different operational characteristics of the two modes of transport.

4.11 We found evidence of a variety of practices, and, in particular, unaccompanied freight being used fairly extensively for 'next-day' delivery, for perishable goods, for parcel delivery, for groupage, and travelling on peak and short-sea crossings—characteristics the parties generally attributed to accompanied freight:

(a) Several, but not all, major food retailers used either an unaccompanied service or a mixture of unaccompanied and accompanied services to supply perishable goods on ferries to Ireland for next-day delivery.

(b) Many hauliers said that an unaccompanied service was used to provide a next-day or even next-morning service, not only for retailers, but also for groupage and parcels. They estimated the additional time at the port required for loading and unloading to be of the order of 60 to 90 minutes, which could be built into the required delivery schedule.

(c) Security issues were sometimes dealt with by setting up secure areas at each port, rather than sending freight with a driver. A major haulier told us of computer components and finished products that were shipped unaccompanied between Holyhead and Dublin.

¹⁶Groupage: refers to a haulier collecting a number of part-loads which are transported as a single trailer load.

(d) Around half of peak night-time traffic on Liverpool–Dublin, Fleetwood–Larne and Mostyn–Dublin was accounted for by unaccompanied traffic, despite peak crossings generally being associated with accompanied freight.

(e) Although Stena’s Holyhead–Dublin short-sea route carried almost exclusively accompanied traffic, the parties told us that around a quarter of Irish Ferries’ traffic on that route was unaccompanied freight.

4.12 There are undoubtedly a large number of smaller hauliers carrying out an accompanied operation that would be unlikely to shift to an unaccompanied operation, other than on an occasional basis. On the other hand, unaccompanied hauliers are able to accept accompanied business and many do so. In fact, many large hauliers have a division specializing in each mode, and we believe that they would have few difficulties in shifting the balance of their work. Our quantitative survey showed that around one-third of those interviewed carried a mix of accompanied and unaccompanied freight. A large-scale shift from accompanied to unaccompanied operations might require a change in infrastructure, which would take several months to achieve, and would only be worth doing if the circumstances giving rise to the change were expected to prevail over a longer period. In addition, the user of the haulage services, such as a retailer, would be able to switch from accompanied to unaccompanied services by switching between service providers. This might require reorganizing its logistics and, in all likelihood, investing in some warehousing or storage facilities. We decided, however, that these investments were not so large as to rule out the possibility of switches occurring within months were circumstances to favour such a shift.

4.13 Some ferry operators that were primarily focused on providing an unaccompanied service would be able to provide more accompanied spaces in response to a price

rise by a hypothetical monopolist supplier of an accompanied service. To the extent that unaccompanied ferry operators were using vessels with limited driver accommodation, they could still supply some accompanied spaces immediately and would be able to increase the accompanied spaces further in considerably less than one year by chartering vessels with more accommodation for drivers. In most cases we expect that accompanied ferry operators could provide unaccompanied spaces in response to a price rise by a hypothetical monopolist supplier of an unaccompanied service, at least at the margin.

- 4.14 It is hard to interpret the observed difference in price between accompanied and unaccompanied services paid by particular hauliers. Prices are probably best compared when expressed in 'lane metres' (the measure of capacity for vessels carrying ro/ro vehicles), and in part the differences are due to the fact that unaccompanied loads, without a traction unit, are shorter and therefore cheaper. Prices also reflect the additional costs for unaccompanied loads associated with loading and unloading the vessel, and, for accompanied freight, the costs of driver accommodation and food, as well as the value placed by hauliers on reliability, flexibility and security. There are a number of other cost factors that affect the total cost to a haulier, in addition to the price charged by ferry operators. Accompanied traffic, for example, ties up a driver for the duration of the journey; unaccompanied traffic requires a greater initial investment in terms of depots and other infrastructure, as dictated by the requirements of the shipper. Ferry customers must take account of the total costs of the door-to-door journey, of which the ferry forms only a part, as set out in paragraph 4.6. Overall, while noting the price differential, we did not believe that there was sufficient evidence to suggest that there were two different markets for the two modes of transport.

4.15 The parties responded to our suggestion that the two modes of transport may not constitute separate markets. In addition to the arguments already made in paragraphs 4.9 and 4.10, they highlighted the following:

(a) Hauliers were still prepared to use the more expensive accompanied mode of transport, and Stena and Irish Ferries had both invested substantially in new capacity designed primarily for the accompanied market. This suggested that many customers saw additional value in an accompanied service.

(b) The increased speed and reliability of the accompanied service was the key differentiating factor between accompanied and unaccompanied.

(c) Whilst switching was possible for small volumes of freight, entry into the high-volume unaccompanied business would require considerable up-front investment in logistics, drivers, premises, and above all, trailers.

4.16 However, the parties also said that they did not believe the market definition with regard to accompanied and unaccompanied freight to be critical to the overall conclusion on the effects of the proposed merger, provided the distinction between the two types of freight was recognized fully.

4.17 Having taken account of the parties' arguments, for reasons set out in paragraphs 4.11 to 4.14, we conclude that we should treat accompanied and unaccompanied services as a single market. We recognize, however, the existence of two market segments, and believe that there may be some differences in the degree of reaction of hauliers and ferry operators in each of these segments to market events.

Routes

4.18 The parties said that in their view the overwhelming competitive pressure was head-to-head rivalry on a particular route, which they said would be unaffected by

the merger. Thus, for example, with regard to the central routes, the commercial decisions taken by Stena relating to Holyhead–Dublin were, they said, primarily driven by competition against Irish Ferries; similarly, Norse Merchant Ferries was said to provide the head-to-head competition to P&O on the Liverpool–Dublin route.

4.19 The parties said that the importance in competition terms of interaction across routes was secondary to this head-to-head rivalry. To the extent that it was relevant, the parties viewed the appropriate groupings of routes as being determined by the different characteristics of accompanied and unaccompanied freight. This led them to argue that the market for accompanied freight should be defined as the Irish Sea as a whole, largely on the basis that a driver-accompanied vehicle has a high degree of flexibility in choosing its ports of origin and destination, and can, if necessary, use indirect routes (for example, going to Dublin via Belfast). For unaccompanied freight, due to the constraints caused by the substantial organizational infrastructure required, the parties argued that a number of narrower markets should be defined:

(a) In the case of unaccompanied freight from England and Wales:

- (i) long-sea central corridor routes (including Liverpool–Dublin), serving Dublin and its hinterland;
- (ii) short-sea central corridor routes (including Holyhead–Dublin), serving Dublin and its hinterland; and
- (iii) long-sea diagonal routes (including Fleetwood–Larne) and short-sea Scottish routes serving Belfast and its hinterland.

(b) In the case of Scottish corridor freight, short-sea Scottish routes serving both Belfast and its hinterland and Dublin and its hinterland.

- 4.20 The parties also argued that there was no obvious second-best alternative to the preferred route for the minority of accompanied traffic on the central corridor which would choose to switch in response to a price rise of 5 to 10 per cent. As regards unaccompanied traffic, they considered the relevant geographic markets for Liverpool–Dublin and Holyhead–Dublin to be separate.
- 4.21 We started by considering each of the two routes (Liverpool–Dublin and Fleetwood–Larne) as separate markets, and then extended our market definition as far as was necessary, using the SSNIP (small but significant non-transitory increase in price) test methodology. A market may be widened either because of demand-side (customer) substitution or supply-side (ferry operator) substitution. We consider demand-side substitution in paragraphs 4.22 to 4.27. We consider that supply-side substitution, which occurs if a price rise prompts other firms to start a service at short notice with existing facilities, is not likely to be significant for firms currently at existing ports with tourist facilities; we discuss market entry in the central corridor in paragraphs 5.44 to 5.52.
- 4.22 Our two surveys both suggested that location of ports, relative to the origin and destination of the goods and any depots, was only one, albeit key, factor affecting hauliers' choice of routes. Other important factors included the availability of timely crossings, the reliability of the crossings, road and ferry costs, the operational relationship between the haulier and the ferry company, and the drivers' facilities and comforts. We therefore had to look more broadly at demand-side substitution to determine our market definition.

Liverpool–Dublin

4.23 The results of our quantitative survey did not support the narrowest possible market definition of Liverpool¹⁷–Dublin. Of those regular users of P&O’s Liverpool–Dublin service who said that they would switch routes in response to a 5 per cent price rise (29 in number), Stena’s Holyhead–Dublin route emerged as the strongest alternative to Liverpool–Dublin, followed by Irish Ferries’ Holyhead–Dublin and Norse Merchant Ferries’ Liverpool–Dublin. This preference was particularly strong for hauliers with only accompanied freight. When asked about substitutes to Stena Holyhead–Dublin, the strongest alternative by those who said that they would switch in response to a 5 per cent price rise (34 in number) was considered to be the head-to-head competition from the Irish Ferries service on the same route, but many also referred to P&O Liverpool–Dublin. In addition, the larger group of regular users of P&O’s Liverpool–Dublin and Stena’s Holyhead–Dublin routes who said that they would not switch in response to a 5 per cent price rise (55 and 85 respectively in number), when asked to state a preference, supported the views expressed by those who said that they would switch (see Appendix F (Table 10) for more details). We therefore consider it unlikely that a hypothetical monopolist on the Liverpool–Dublin route could profitably impose an SSNIP, and that the market should be defined at least as widely as the central routes, both long and short (the ‘central corridor’).

4.24 We noted other arguments consistent with defining the market as the central corridor:

¹⁷In referring to Liverpool, we are also including the river berths used by Norse Merchant Ferries at Birkenhead; Liverpool should therefore be taken as referring to all routes from Merseyside.

- (a) Stena's own management papers showed that it considered the competitors to its Holyhead–Dublin Bay crossings to include not only Irish Ferries, but also P&O and Norse Merchant Ferries.
- (b) The modelling that P&O and Stena carried out with regard to the redistribution of the Mostyn–Dublin traffic assumed that the traffic, most of which was originally displaced from Liverpool, would be redistributed between Holyhead–Dublin and Liverpool–Dublin.
- (c) The examples given to us by P&O of customers who had switched business focused on customers who had switched business between Stena's Holyhead–Dublin route and P&O's central corridor routes (Liverpool–Dublin and Mostyn–Dublin); only two of the twelve referred to Norse Merchant Liverpool–Dublin as a possible substitute. Stena also included several examples of business being lost from Holyhead–Dublin to P&O's central corridor routes, although the majority of its examples focused on business gained or lost to Irish Ferries.

4.25 The survey results also suggested that, whilst in certain cases the northern and southern corridor routes represented a viable alternative particularly on an occasional basis, they were in general a much less strong alternative to P&O Liverpool–Dublin than the central corridor routes (see Appendix F, Table 9), and we consider that a hypothetical monopoly provider of ferry services in the central corridor could profitably impose a 5 per cent price rise.

4.26 In view of the discussion in paragraphs 4.18 to 4.25, we decided that the relevant market for the Liverpool–Dublin route was the central corridor and that the market should not be widened further.

Fleetwood–Larne

4.27 The closest alternatives from a geographical perspective to the Fleetwood–Larne route are the other diagonal routes including Norse Merchant Ferries’ two crossings Liverpool and Heysham–Belfast, and Seatruck’s Heysham–Warrenpoint. Our survey results and other evidence from third parties suggested that the shorter Loch Ryan¹⁸ crossings to Northern Ireland were regarded as substitutes for diagonal crossings terminating in Northern Ireland, and certainly were better demand-side alternatives to P&O Fleetwood–Larne than were the central or southern routes. On the basis of demand-side substitution, we therefore consider that the market in which P&O Fleetwood–Larne competes should be the ‘northern corridor’, including both the diagonal and the Loch Ryan crossings, but that this market should not extend to either the central or the southern corridors.

Conclusions on market definition

4.28 In conclusion, we defined the relevant markets affected by the proposed merger to be the markets for transporting ro/ro and lo/lo freight between Great Britain and Ireland, first in the northern corridor (in relation to Fleetwood–Larne) and second in the central corridor (in relation to Liverpool–Dublin). We do not accept that these two markets should be further divided between accompanied and unaccompanied freight, although we recognize that these could be regarded as two market segments.

5. Assessment of the competitive effects of the merger

5.1 This section of the report discusses the competitive effects of the merger having regard to the CC guidelines.¹⁹ We first outline briefly some key features of the

¹⁸Loch Ryan includes the ports of Cairnryan and Stranraer.

¹⁹CC 2—*Merger References: Competition Commission Guidelines*, June 2003.

existing competitors in the market, and then discuss a number of underlying factors affecting existing rivalry in the relevant markets, including capacity and utilization, concentration, and pricing. Following a discussion of the counterfactual, we discuss the competitive effects of the merger themselves, and finally discuss whether market entry might mitigate these effects. This leads to our conclusion about whether or not we expect a substantial lessening of competition (SLC) as a result of the proposed merger. Unless otherwise specified, the effects discussed apply to the two relevant markets defined in Section 4.

Existing competitors

5.2 There are four major freight ferry companies operating on the Irish Sea: Stena, P&O, Norse Merchant Ferries and Irish Ferries. In addition, there are a number of smaller ferry operators, including Seatruck, which provides a two-ship freighter service between Heysham and Warrenpoint, and Coastal, which provides a lo/lo service between Liverpool on the Great Britain side and Dublin and Belfast on the Irish side.

5.3 A brief overview of the key financial details of Stena and P&O was given in paragraphs 2.1 to 2.8. Stena told us that it was a company committed to operating ferries in the long term, with a strong European network. It owned a charter business, and had considerable flexibility in its deployment of vessels on routes around the UK and Scandinavia, giving it the ability to open up routes or make changes in capacity relatively quickly. Being privately owned, it was not subject to short-term stock market pressures. Stena told us that it had invested in IT systems and ran a centralized booking service.

- 5.4 P&O told us that its strategy was to reduce its presence in relatively less profitable areas and focus on businesses with a higher return across the globe, particularly container terminals. In relation to ferries, P&O had made known its intention to withdraw from less profitable routes and focus on passenger routes with a strong freight underlay, where it had recently invested heavily.
- 5.5 Irish Ferries is the main Irish shipping company operating in the Irish Sea. It is a subsidiary of Irish Continental Group plc, listed on the London and Dublin Stock Exchanges. It has a strong reputation and has invested substantially in ferry operations over recent years, and in particular now owns the largest vessel on the Irish Sea, the *Ulysses*, operating between Dublin and Holyhead. Irish Ferries is not present on any other route on the central or northern corridors (it has a route in the south, Pembroke–Rosslare, as well as two services from Ireland to France). It therefore currently provides competition in the central corridor, in particular to Stena on the Dublin–Holyhead route, but does not provide an option for a significant amount of traffic coming from northern England, or from Scotland.
- 5.6 Norse Merchant Ferries is the trading name of Merchant Ferries plc and Norse Irish Ferries plc, both subsidiaries of Cenargo International plc, a vertically integrated shipping group. The Irish Sea ferries business is the largest part of Cenargo's operations. Norse Merchant Ferries' strategy was to set up hub operations, focused primarily on unaccompanied freight, providing a service between Liverpool (Birkenhead) and Heysham on the Great Britain side and Dublin and Belfast on the Irish side. It was generally considered to have access to some excellent port facilities, and some good vessels. In particular, Norse Merchant Ferries operates from the new river berths at Birkenhead, thus avoiding the additional 30 minutes required to access Liverpool docks with its system of locks. Cenargo is currently in

administration, but a debt for equity swap has been agreed and Norse Merchant Ferries told us that it was likely to exit from administration in January 2004. This should provide short-term stability, although we were told that it may be financially constrained (its financial resources will depend on the strategy of the new owners). It had reduced capacity on the Heysham–Belfast service, although the frequency of sailings had been increased on the Liverpool–Belfast route. Norse Merchant Ferries provides the closest direct competition to the two routes to be transferred—head-to-head competition on Liverpool–Dublin, and competition to Fleetwood–Larne from its Liverpool–Heysham to Belfast routes.

- 5.7 The survey results show that customers tend to consider Stena and P&O to be the market leaders, providing the best service on the Irish Sea. There was also generally considered to be a small price premium associated with these two companies. Irish Ferries and, in particular, Norse Merchant Ferries were regarded as being less reliable than either Stena or P&O. Other constraints from these two competitors included the limited choice of routes on offer from Irish Ferries and any financial constraints that may affect the owners of Norse Merchant Ferries.

Underlying factors affecting existing rivalry in the relevant markets

Capacity and utilization

- 5.8 Ro/ro capacity on the Irish Sea has increased significantly since 1996, particularly on the central corridor. All of the major competitors have contributed to this increase: Norse Merchant Ferries introduced a Liverpool–Dublin service in 1999, both Irish Ferries and Stena expanded capacity on the Holyhead–Dublin route,²⁰ and P&O started the Mostyn–Dublin service in 2001. P&O has recently increased

²⁰Irish Ferries replaced the *Isle of Innisfree* in 1997 with the *Isle of Inishmore* and doubled its capacity in 2001 with the introduction of the *Ulysses*. Stena introduced the *Stena Forwarder* in 2001, increasing capacity by 40 per cent, and then introduced the *Stena Adventurer* in July 2003, increasing freight capacity by a further 70 per cent.

capacity on the northern corridor by introducing new larger vessels on its Cairnryan–Larne route. See Appendix B for more details.

5.9 Capacity utilization²¹ is generally higher for the long-sea crossings than for the short-sea crossings. We have been told, however, that with the exception of some of the very frequent services (for example, Loch Ryan–Northern Ireland), peak night-time services, particularly travelling from Great Britain to Ireland, tend to be fully booked or even overbooked. Several hauliers told us that occasionally freight units (generally unaccompanied) were left on the quayside. Stena told us, on the other hand, that since the introduction of the *Adventurer*, there has almost always been spare capacity on its sailings between Holyhead and Dublin, including at peak. Appendix F gives more details of capacity and utilization, particularly on the central corridor.

Market concentration

5.10 The competitive structure in each of the relevant markets is as follows.

- *Northern corridor*

5.11 There are three significant ferry operators on the northern corridor: P&O with a 48 per cent market share,²² Norse Merchant Ferries with 24 per cent and Stena with 17 per cent. The remaining operators are Seatruck and Coastal. In 2002 the total freight volume on Fleetwood–Larne made up around 20 per cent of the market on the northern corridor. On the Fleetwood–Larne route around two-thirds of the volume was unaccompanied. The most direct competition to the Fleetwood–Larne

²¹Across peak/off-peak and combining east/west and west/east flows.

²²Market share should be taken to be in terms of volume throughout unless otherwise stated. The figures are based on the parties' estimates.

route comes from Norse Merchant Ferries with their diagonal routes from Liverpool and Heysham to Belfast. Competition is also provided by the short-sea northern routes operated by P&O and Stena. Seatruck's service from Heysham to Warrenpoint also offers some competition, although this is a relatively small-scale operation that is running more or less at full capacity.

- *Central corridor*

5.12 On the central corridor, the position is rather different. P&O currently has the largest share of the central corridor at 33 per cent, with Norse Merchant at 25 per cent, Irish Ferries at 20 per cent and Stena at 17 per cent. In 2002 the freight transported on P&O's Liverpool–Dublin route made up around 20 per cent of central corridor traffic. Around one-quarter of the freight on this route was accompanied. Again the most direct competition to P&O's Liverpool–Dublin route is from Norse Merchant Ferries, which provides a similar service on the same route out of the river berths at Birkenhead. There is also competition from all other routes into Dublin, including in particular Mostyn–Dublin and Holyhead–Dublin, as well as Norse Merchant Ferries' operation from Heysham to Dublin and, at the margins, Coastal's lo/lo service from Liverpool to Dublin. These market share figures would change somewhat with the closure of Mostyn–Dublin (see Appendix F).²³

5.13 The overlap in the central corridor between Stena and P&O currently is primarily in the area of accompanied freight, since Stena's current share of unaccompanied freight is very small. However, given the market definition outlined in paragraph 4.28, and the potential flexibility between accompanied and unaccompanied services, the distinction between accompanied and unaccompanied freight does not

²³In calculating market shares on the central corridor we have assumed that the traffic on the Mostyn–Dublin route is shared as follows: accompanied traffic shared between Stena and Irish Ferries' Holyhead–Dublin routes; unaccompanied traffic shared between P&O and Norse Merchant Ferries' Liverpool–Dublin routes.

have a significant bearing on the assessment of the competitive effects of the proposed merger. Further details on market shares by route and by type of freight can be found at Appendix F.

Pricing

- 5.14 Pricing in the freight ferry market is opaque. The parties told us that there were no published tariff rates, although there was a 'cash' or 'spot' price at the port for a haulier looking to ship a single load. Pricing is based on bilateral negotiations between individual operators and the ferry company concerned. There are no formal contracts in place, but rather agreed terms on specific routes, based generally on the previous year's prices, expectations of volumes for the following year, and any other features specific to that particular customer (see Appendix G). Prices may in part reflect the importance of that customer to the company as a whole, including business on other Irish Sea routes or outside the Irish Sea.
- 5.15 Prices are generally negotiated annually. Customers then book themselves on to ferries as required on a day-to-day basis. Our surveys showed that many customers, particularly the larger ones, will have pricing frameworks in place with a number of ferry companies. The surveys also indicated that many customers, given the linkage between price and the volume of freight shipped, will have a preferred supplier of ferry services, with whom they will carry out the majority of their business where feasible and practical. This was less feasible for some of the very large hauliers due to lack of available capacity at peak times. Although several parties told us that brand loyalty as such was low, hauliers tended to develop good working relationships with operational staff for a particular crossing.

- 5.16 There are very few explicit volume-related discounts, but we have been told by several third parties that the initial negotiation of price reflects volume expectations, not just on a particular route, but between customer and supplier as a whole. However, there are many factors influencing price, and volume is only one factor. We understand that the prices actually paid by an individual customer on a particular crossing also reflect the negotiating strength of the customer (heavily influenced by the volume of freight shipped), the length of the vehicle, and the time of the sailing (peak vs off-peak). As noted in Appendix G, we considered a variety of other evidence on prices paid by individual customers. This showed a high degree of variation in prices paid by individual customers, although there was a tendency for larger customers to pay lower prices.
- 5.17 Paragraph 4.14 discussed the difference in prices between accompanied and unaccompanied loads. Stena's [] prices for accompanied freight are [%] per cent above its prices for unaccompanied freight. P&O's average price differential between accompanied and unaccompanied freight on its Liverpool–Dublin route is much greater [], regardless of time of day; however, it was lower on its Scottish routes. Individual customer price differentials for both Stena and P&O also show considerable variation. See Appendix G for more details.
- 5.18 Different prices are also charged according to time of crossing, with night-time crossings (peak crossings) being more expensive. The price differential between peak and off-peak is variable, but off-peak crossings will generally be significantly [] cheaper. We note that peak capacity is not rationed only by price. The parties have told us that some hauliers are allocated

spaces on peak crossings and this allocation may be subject to 'off-peak support'²⁴ on some routes. Rather than ferry operators offering hauliers a set of prices and hauliers deciding how much to purchase on the basis of those prices, negotiations between ferry operators implicitly or explicitly cover both price and volume, peak and off-peak.

- 5.19 The opaque nature of this market means that ferry operators currently have the potential to price discriminate between customers. In particular, it is possible in principle for them to charge more for less flexible customers with few viable alternative routes. We have analysed the results of our quantitative survey in order to get a better understanding of potentially vulnerable customers (see paragraph 5.36).
- 5.20 The parties have argued that major customers, who account for a significant proportion of a ferry operator's total volume (particularly for unaccompanied operations), hold very substantial bargaining power. They say that experience shows that large customers, both unaccompanied and accompanied, will move substantial volumes between ferry operators in response to changes in competitive conditions, primarily price discounting. Smaller customers, whilst not themselves enjoying the same level of bargaining power, may by choice use either third party agents or larger hauliers to buy on their behalf and thus benefit from lower prices than they would otherwise be able to achieve.
- 5.21 We agree that customers have different amounts of bargaining power and that larger customers have more bargaining power and get lower prices than smaller customers. However, given the relationships customers build up with ferry

²⁴ie an understanding that a certain amount of freight will be carried off-peak.

operators, it is not necessarily easy for them to switch between operators or to promote entry if prices rise. Moreover, the spend of even the largest hauliers on Irish Sea ferry services is much less than the Irish Sea turnover of ferry companies such as Stena and P&O. Hence we do not accept the argument that most customers have sufficient countervailing power to prevent the exercise of market power by ferry companies. We consider in paragraph 5.36 the effects of the merger on different groups of customers.

5.22 This pricing mechanism, and the need to develop relationships with ferry companies to secure peak bookings, means in practice that once pricing frameworks have been agreed, price does not play a major role in day-to-day decisions about which ferry operator or route a haulier uses. For many of the respondents to our qualitative survey, other factors including availability of places on peak sailings and reliability mattered more than price. The surveys identified a relatively high level of inertia to switch routes in response to price rises, which is consistent with relatively settled and predictable decisions taken with regard to routes. Our quantitative survey showed that, of regular users of Fleetwood–Larne, Liverpool–Dublin and Holyhead–Dublin, only around one-third would definitely choose to switch for a hypothetical price increase of 5 per cent. We concluded that although hauliers are very concerned about their costs, the demand for ferry services is relatively price inelastic, at least in the short to medium term.

Counterfactual

5.23 Before we turn to the effects of the proposed merger, we need to assess what would be likely to happen in the absence of the merger ('the counterfactual'). The counterfactual provides a benchmark against which the expected effects of the proposed merger can be assessed. We have focused on those factors we consider


to be most important for the purposes of identifying a counterfactual for each relevant market.

- *Northern corridor*

5.24 We considered whether or not we would expect to see a new entrant on the diagonal routes in the absence of the merger. Stena told us that for some time it had wanted to enter or acquire a diagonal route, both in order to offer greater choice to its customers, and also to provide an alternative to the short-sea northern routes since the forthcoming tighter regulation of drivers' hours may, in the future, deter more English customers from choosing the long drive to Loch Ryan. P&O suggested that Stena would have had plenty of opportunity to enter this route over the past few years, and put forward its view that Irish Ferries would be a more likely entrant. We conclude the appropriate counterfactual in the northern corridor to be that Stena would be one of possibly a number of potential entrants on the diagonal routes. We also note that P&O could not be considered to be a potential entrant on this route post-merger (quite apart from P&O's desire to withdraw from this service, they have signed a non-compete clause).

- *Central corridor*

5.25 The key factor associated with the likely counterfactual in relation to the central corridor is the future of the Mostyn–Dublin route. P&O told us that prior to opening the Mostyn–Dublin route it had planned to move to new river berths at Liverpool, to improve the service on the Liverpool–Dublin route particularly for accompanied traffic. For a variety of reasons, however, P&O decided to develop a ro/ro terminal at Mostyn. The Mostyn–Dublin route opened in November 2001. Two vessels operate on this route: the *Ambassador*, a new Ropax vessel, and the *Envoy*.

5.26 P&O told us that there were problems with the new route from the outset. In order to use Mostyn as a ro/ro terminal, dredging was required in an environmentally sensitive area of the Dee estuary. Although the initial capital dredging consents were obtained without difficulty, there were, and are, ongoing issues associated with obtaining long-term consents for adequate maintenance dredging. This has resulted in a service which is unable to operate in some tidal conditions and is therefore relatively unreliable in relation to timing. Variable timetables are published at the start of each month. In addition, in the first half of 2002 there were issues associated with the ramp at the Dublin terminal. P&O's management accounts showed that the route made a loss in 2002 []. Although lower freight rates have been introduced in an attempt to compensate for the unreliability of the service, this, combined with the lower-than-anticipated traffic volumes, has led to the economics of keeping the route open being questionable.

5.27 Initially we had some reservations about whether or not P&O would close the Mostyn–Dublin route in the absence of the proposed merger. We noted that the intended closure of the route was announced in conjunction with the proposed merger, and that payments in the MoU were expressed as contributions by Stena to the cost of closing Mostyn. We also considered a number of factors that could have led to P&O keeping open the route in the absence of the merger, namely whether:

- (a) it would be more profitable to continue to operate the route in its current form than it would be to close it absent the merger;
- (b) P&O might change the vessels currently used on the route and relaunch the service as a lower-cost service focused on unaccompanied freight;
- (c) the current dredging problems were likely to be resolved; and
- (d) considerations of disclosure or accounting presentation might influence the timing of the closure of the route.

- 5.28 The parties themselves, as well as many third parties, told us consistently that P&O was likely to close the Mostyn–Dublin route, regardless of whether or not the proposed merger went ahead. The main parties’ arguments in support of the closure of the Mostyn–Dublin route are discussed in further detail in Appendix E.
- 5.29 On balance, and taking account of the discussion in paragraphs 5.25 to 5.28 and Appendix E, we decided that the appropriate counterfactual in relation to the central corridor market was the closure of P&O’s Mostyn–Dublin route.
- 5.30 If the Mostyn–Dublin route closed, the traffic that currently used this route would have to find alternatives. It is likely that the vessels on Holyhead–Dublin Bay have sufficient spare capacity, even at peak times, to absorb the additional Mostyn traffic that would choose to reroute via Holyhead. At Liverpool, however, particularly at peak times and travelling east/west, there would appear to be a shortage of capacity, particularly on the P&O Liverpool–Dublin route (see Appendix F). P&O told us in its initial submission that, in the absence of the merger, it had formed a preliminary view (although such a view had not been developed in full detail), that it might add a third, freight-only charter ship to the Liverpool–Dublin route, in order to be able to accommodate more of the ex-Mostyn–Dublin traffic. We believed this to be a likely scenario, particularly since, in the absence of an additional vessel, Norse Merchant Ferries would be likely to benefit more than P&O from the displaced Mostyn–Dublin traffic as there was significantly more spare capacity on both Norse Merchant Ferries routes (Liverpool–Dublin and Heysham–Dublin) than there was on the P&O service. Thus, by adding a third vessel, P&O would preserve as far as possible the goodwill on the assets it employed on the Liverpool–Dublin route, although it later emphasized to us that the decision to add a third vessel would have

to be taken at the time depending on the current circumstances. We discuss the post-merger capacity situation further in paragraph 5.35.

Effects of the merger

5.31 The effects of the merger are discussed in relation to each of the relevant markets in turn.

- *Northern corridor*

5.32 As a result of the transfer of the Fleetwood–Larne route, Stena’s 17 per cent market share in the northern corridor would rise to 36 per cent, and P&O’s share would fall from 48 to 29 per cent. Three significant operators would remain on the northern corridor, but Stena would replace P&O as the largest ferry operator, with short- and long-sea crossings on the northern corridor much as P&O has currently. In this sense, the merger does not create a market leader but rather changes the identity of the leader. Indeed, the merger reduces concentration in this market, at least in the short term (see Appendix F).

5.33 Whilst the appropriate counterfactual as set out in paragraph 5.24 was that Stena was one of a number of potential entrants on the diagonal routes, we did not receive evidence to suggest that its threat of entry has had much impact on the competitiveness of the market. Further, we were unable to form an expectation that Stena would have entered a diagonal route with a new service in the next two to three years, not least because of its clearly stated preference for entry by acquisition. Finally, we found no evidence to form an expectation that the merger would reduce capacity on this route. We conclude, therefore, that the transfer of the Fleetwood–Larne route from P&O to Stena could not be expected to result in an SLC.

- *Central corridor*

5.34 Post merger, the four main competitors on the central corridor would reduce to three, as P&O would exit the central corridor, and Stena's market share would rise to 44 per cent. Market concentration on the central corridor would be significantly increased, and the merger would give Stena a market share significantly larger than its nearest rival (Irish Ferries would have a market share of 22 per cent and Norse Merchant Ferries 29 per cent). In addition, unlike its rivals, it would have a route on both the short and long central corridor crossings. We note, too, that as stated in paragraph 5.7, both the smaller competitors, but in particular Norse Merchant Ferries, have some constraints in their ability to compete. Whilst the change in market shares would be less significant with regard to unaccompanied freight, since Stena was only a very small unaccompanied central corridor operator pre-merger, Stena would have an even stronger position with regard to accompanied freight operations post-merger. The proposed merger results in a large increase in concentration both in the market as a whole and in the accompanied segment (see Appendix F).

5.35 The relative capacity on the Liverpool–Dublin route post-merger compared with the counterfactual depends on a number of factors. Stena told us that it had no clear plans to add capacity to the route post-merger, although it did not rule out such a move. P&O, on the other hand, initially indicated that it had formed a preliminary view (although such a view had not been developed in full detail), that it might add a third, freight-only vessel to its existing two vessels on the Liverpool–Dublin route following the closure of the Mostyn–Dublin route if the merger did not go ahead (see paragraph 5.30). Overall this would result in a reduction in capacity post-merger. We believe this to be the most likely scenario, since P&O would have a strong incentive to capture some of the displaced traffic at Liverpool by adding a

third ship in the absence of the merger, whereas post-merger, Stena's incentive to add a third ship is likely to be less, since it would be seeking to fill the considerable spare capacity on the *Adventurer* between Holyhead and Dublin and would, for that reason, be more reluctant to make a further investment in capacity at Liverpool than would P&O. Stena also suggested that it might be able to generate modest amounts of new capacity without the need to invest in a third ship on the route [



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5.36 We concluded that, whether or not there was a reduction in capacity post-merger, with peak crossings from Liverpool already largely full, there would be scope for Stena post-merger to exercise market power, for example by increasing prices, particularly at peak times. We expect this to affect a number of customers, including:


- (a) those customers who were regular users of P&O's Liverpool–Dublin service who regarded Stena's Holyhead–Dublin route as their closest alternative. The merger would weaken the negotiating position of such customers since they would no longer be able to threaten to switch volume to Stena;
- (b) those customers who were regular users of Stena's Holyhead–Dublin service who regarded P&O's Liverpool–Dublin route as their closest alternative;
- (c) those existing users of P&O's Mostyn–Dublin route who preferred to reroute via Liverpool but whose next best alternative was Holyhead–Dublin;
- (d) those existing users of P&O's Mostyn–Dublin service who preferred to reroute via Holyhead but whose next best alternative was Liverpool–Dublin; and

(e) those existing users of P&O's Mostyn–Dublin service for whom, post-merger, the constraints on capacity at Liverpool would force them to take an alternative, less favourable, crossing;

Most of these effects would be most applicable to accompanied freight. We expected, however, that the anticipated price rises in the accompanied segment would have at least an indirect effect on the prices for unaccompanied services, and hence that unaccompanied freight would also be affected by the merger.

5.37 We believe that it would be profitable for Stena to increase prices to these vulnerable customers. Stena argued that it would not be in a position to focus price rises on particular customers because of a lack of knowledge of individual customers' continually changing freight characteristics. Our view, however, is that due to a lack of pricing transparency, Stena has the ability to price discriminate, at least to some degree. Indeed we have seen that customers today pay widely differing prices (see paragraph 5.16). In the bilateral negotiation of prices, price discrimination may effectively be achieved by vulnerable customers showing less resistance to price increases than those with greater choice. This would not require a detailed understanding of customers' freight characteristics. The lack of transparency in the market allows such price discrimination to take place. We consider that Stena would be able to focus price increases to some extent on the vulnerable customers but that, given the likely reduction in capacity post-merger, it would also have the incentive to increase prices to other customers, albeit to a lesser extent.

5.38 In practice, we would expect such price increases to be focused on the Liverpool–Dublin route for the following reasons:

- (a) The survey suggested that more P&O Liverpool–Dublin customers viewed Stena Holyhead–Dublin as the closest alternative than vice versa.
- (b) Prices on the Holyhead–Dublin crossing already appear relatively high. Average price levels on the Holyhead–Dublin crossing are [] Liverpool–Dublin, despite the latter being approximately twice as far.
- (c) We think it more likely than not that the merger would reduce capacity on the Liverpool–Dublin route compared with the counterfactual.

5.39 We therefore expect Stena to increase prices on the Liverpool–Dublin route to encourage traffic to move to its Holyhead service, rather than to increase capacity on the Liverpool–Dublin route and continue to operate the Holyhead service at lower levels of utilization. In addition, there would be less of an incentive for Stena to reduce prices at Holyhead in an attempt to attract additional traffic to fill some of its spare capacity. P&O, on the other hand, would be more inclined to put additional capacity on the Liverpool–Dublin route in the absence of the proposed merger, and possibly lower prices, as it would not be able to capture the displaced traffic on a Holyhead service.

5.40 In addition, Stena would now be able to offer customers a choice between Liverpool–Dublin and Holyhead–Dublin, or a ‘one-stop shop’ for both services. Given the evidence in the survey and at hearings with the hauliers about the importance of building up good operational relationships between hauliers and ferry companies, we believe that this would offer Stena a strategic advantage over the single-route operators and potentially the opportunity to ‘lock in’ more customers.

5.41 We also considered how the two main competitors might respond to such a strategy by Stena. Given Norse Merchant Ferries’ financial position, we believed that it

would probably welcome any increase in Stena's prices, since it would give it the opportunity to increase its own prices and hence profitability. We have found no evidence to suggest that it would put any such benefit at risk by introducing new capacity with uncertain levels of utilization. Furthermore, Norse Merchant Ferries has recently significantly reduced its accompanied freight capacity on the Liverpool–Dublin route. We believe that Irish Ferries, like Stena, would benefit from any increase in prices on the Liverpool–Dublin route that displaced traffic to Holyhead, and that this would reduce its incentive to reduce price to fill capacity on its Holyhead–Dublin route. We have found no evidence to suggest that Irish Ferries would be likely to put on another vessel on the central corridor in addition to the *Ulysses*. We therefore thought it unlikely that either Norse Merchant Ferries or Irish Ferries would seek to increase capacity on the central corridor to deter Stena from such a strategy, and we believed that the most likely independent reaction of the two main competitors would be to view any price increase by Stena as an opportunity to raise prices themselves, albeit possibly by a little less.

5.42 We discussed this possible lessening in competition with both Stena and P&O. The parties' views were that the key competitive pressure on each of the routes to be transferred was based on head-to-head competition. This, they argued, would not change as a result of the merger. The competition provided by the wider market was of much less significance, they said, particularly given the reluctance of hauliers to switch routes in response to a 5 to 10 per cent price rise.

5.43 We do not believe that the competitive effects outlined in paragraphs 5.34 to 5.42 are very sensitive to the definition of the relevant market for the Liverpool–Dublin route outlined in paragraph 4.28. We recognize that the hauliers and ferry operators in the two market segments may react differently to any potential price

rise (see paragraph 4.17). We believe, however, that the effects that we describe would apply similarly to the accompanied segment as they would to the market as a whole, and that the scale of the effect would be little altered.

Market entry in the central corridor

5.44 This section of the report addresses the extent to which market entry might offset any possible SLC on the transfer of the Liverpool–Dublin route.

5.45 We have reviewed the recent history of entry and expansion in this market, and note that:

(a) The level of entry over the past ten years has not been high, despite the high level of economic growth in Ireland in the 1990s.

(b) The only entrant on the central corridor in the last ten years was Merchant Ferries (now part of Norse Merchant Ferries), which moved the destination of its Heysham service from Warrenpoint in Northern Ireland to Dublin in 1995 and started operating from Liverpool to Dublin in 1999. On the northern corridor the only entrant was Seatruck which started operating on the Heysham–Warrenpoint route in 1996 after Merchant Ferries ceased operating on this route.

(c) There has been no entry on the short-sea central corridor routes (although Stena moved its conventional vessel service from Dun Laoghaire to Dublin in 1995), but these routes have seen a very large expansion of capacity by existing operators (Stena and Irish Ferries).

5.46 In general, the key requirements for entry into a freight ferry service are:

(a) access to suitable ports, with appropriate berths and sufficient surrounding land, available at peak times;

(b) access to a suitable vessel or vessels.

In addition, the entrant must have sufficient financial strength to be able to make a medium- to long-term investment, and to attract a suitably-located customer base.

5.47 Focusing on the central corridor, we believe that the only Dublin berth currently available is of limited value to unaccompanied ro/ro operations due to constraints on surrounding land. Another Dublin berth may become available in due course as a result of the Mostyn–Dublin closure, but the evidence that we have received means that we cannot expect this to be the case in the near future. There are also possibilities for developing new ro/ro facilities at Greenore and Drogheda in Ireland. On the Great Britain side, there are two dock berths available at Liverpool, with the medium-term option of developing river berths near Langton dock. There is an available berth at Holyhead and we expect one to become available at Mostyn as a result of the Mostyn–Dublin closure. At Heysham the only availability is off-peak. The development of a new berth would be likely to require a significant commitment on the part of the ferry operator. Overall, we have not found sufficient evidence to sustain an expectation that appropriate berths with sufficient surrounding land are available at peak times in the short to medium term, particularly on the Irish side of the central corridor. Further details on berth availability are set out in Appendix C.

5.48 In terms of access to appropriate vessels, we understand that there is currently a surplus of ro/ro vessels and market hire rates are low. Although not all sizes and types of ro/ro vessels are readily available (freighters are the most available), we received no evidence to suggest that the availability of a suitable vessel posed a major constraint on entry. Nevertheless, identifying a suitable vessel and bringing it into service would be likely to take a number of months.

5.49 Provided a potential entrant has access to a suitable vessel and berth at peak times, and has the appropriate level of financial backing, the other key requirement would be to attract sufficient customers quickly. An entrant would need to have or establish a reputation for reliability of service and to be seen as committed to the proposed new route in order to persuade significant numbers of customers to leave the incumbent ferry operator. This suggests that hit-and-run entry in response to high prices is unlikely to be successful.

5.50 We do not expect that the levels of price rises discussed in the context of this merger would be sufficient in themselves to attract new ferry operators of a significant size to enter the market. Given the economies of scale required, and the need for a competitive freight operation to operate a daily timetable with peak and off-peak departures, entry on a small scale is unlikely to be viable, other than for a freighter operation. The smallest ro/ro operator on the Irish Sea is Seatruck, which has a greater than 5 per cent market share on the northern corridor. If, however, large-scale entry were to occur, it would represent a significant increase in capacity, which we believe might result in a price war as the incumbents sought to retain as much of their business as possible. This prospect would, of course, raise the risk of entry as far as the entrant was concerned, and the difficulties that an entrant might face would be further increased to the extent that close working relationships between ferry companies and hauliers tend to 'lock in' customers. Finally, we note that incumbent ferry operators are likely to be able to increase their capacity on existing routes in response to an increase in demand more quickly than entrants can set up and start operating.

5.51 We heard from several third parties that it is common for entry to occur in response to the withdrawal of an existing ferry operator on a route and hence we considered

the likelihood of entry when the Mostyn–Dublin service is withdrawn. We considered it possible that a low-cost freighter operation would be attracted to the available berth at Mostyn, possibly offering services into Dublin if that berth were in fact to become free. However, this too would be unlikely to pose a serious threat to the existing major operators on the central corridor, particularly with regard to the accompanied market segment.

- 5.52 We conclude that although entry is not intrinsically difficult, and that potential entrants exist who would be prepared to come into the market under appropriate market conditions, it would be particularly important to have access to suitable berths and sufficient surrounding land available at peak times. We do not consider that at the current time, or within the next two to three years, we can rely on large-scale entry to offset any potential substantial lessening of competition in the central corridor.

Provisional conclusions on SLC test

- 5.53 We conclude that, as a result of the proposed merger, there would be no SLC on the northern corridor, but we do expect an SLC on the central corridor. We do not expect that this SLC would be offset by other competitive constraints, in particular entry.