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13 JAN 2005

Dear John Doyle.

Thank you for your letter dated 15 December, seeking my views on the proposed acquisition by Brittany Ferries of certain assets used by P&O Ferries to supply ferry services between Portsmouth and Le Havre.

/ I attach a paper on this matter prepared by my officials. I am content for the Department's views to be published and attributed.

DAVID JAMIESON

Competition Commission investigation of Brittany Ferries and P&O Ferries merger: Department for Transport submission.

This paper sets out the Department for Transport's views on the above proposed merger.

(a) the relevant markets

(i) Product market

The relevant product market under this particular acquisition proposal would engage in the supply of ferry services to cater for both freight (i.e. roll on-roll off, lift on-lift off traffic) and passenger (i.e. mostly ro-ro services for vehicle plus some foot passengers) customers on the Western Channel. Freight and passenger traffic represents two separate demand markets.

Freight movements will typically have fixed origins and destinations and thus the choice of routes/operators will predominantly be determined by factors such as price, journey time, and the reliability and frequency of services. Our view is that for most ro-ro freight traffic the routes from Portsmouth to France are probably a part of a larger geographical market that includes operators offering services across the Dover Strait. The cross-channel market is characterised by a high degree of price competition both between the ferry companies and between the ferries and Eurotunnel. The competition provided by services across the Dover Strait would indicate that the relevant market extends beyond the immediate freight services offered on the Western Channel.

Passenger ferry trips (principally accompanied car) are likely to be more flexible than freight. For most passenger movements, especially leisure trips, typically only the home end of the trip is fixed so demand is variable and is less captive to a particular route or mode. In common with freight traffic, we believe that the appropriate product market for a significant share of ro-ro passenger movements is likely to extend beyond the immediate competing ferry routes/operators on the Western Channel.

In particular, the increasing number of low-cost airline services operating between UK and the Continent has placed growing constraint on the ferry operators' competitiveness by increasing the size and range of options in the passenger travel market. For example, both Southampton[1] and Bournemouth[2] airport serves destinations to mainland Europe.

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[1] Destinations include: Aberdeen, Alderney, Alicante, Amsterdam, Belfast City, Bergerac, Bordeaux, Brussels, Cherbourg, Cork, Dublin, Edinburgh, Faro, Glasgow, Guernsey, Ibiza, Isles of Scilly, Jersey, Leeds, Limoges, Liverpool, Majorca, Malaga, Manchester, Menorca, Murcia, Newcastle, Paderborn, Paris, Perpignan, Prague, Rennes, Salzburg and Toulouse.

[2] Destinations include Alderney, Amsterdam, Barcelona-Girona, Belfast, Dinard, Dublin, Faro, Glasgow-Prestwick, Guernsey, Jersey, Malaga, Palma, Paris, Pisa, St. Brieuc and Valencia.

(ii) Geographical market

The principal sea routes between the UK and the Continent via the Western Channel includes ports such as Portsmouth, Southampton, Poole, Plymouth and Newhaven (UK), Le Havre, Caen, Cherbourg, Roscoff and St. Malo (France), Santander and Bilbao (Spain). Currently both Brittany (BAI) and P&O ferries are actively operating services between UK, France and Spain. Table 1 below highlights the current and proposed (post-acquisition and announced exit by P&O*) position on routes and operators offering services across the Western Channel.

Table 1: Western Channel operators by principal routes

UK (Western Channel) - Continent Routes From	**To**	**Current Operator**	**Proposed Operator**
Newhaven	Dieppe	Hoverspeed	Hoverspeed
Portsmouth	Bilbao	P&O	P&O
	Caen	Brittany, P&O	Brittany*
	Cherbourg	Brittany, P&O	Brittany*
	Le Havre	P&O	Brittany
	St Malo	Brittany	Brittany
Poole	Cherbourg	Brittany	Brittany
Plymouth	Santander	Brittany	Brittany
	Roscoff	Brittany	Brittany

* P&O have announced on September 2004 its intention to withdraw its remaining Portsmouth-based ferry services to the French ports of Caen and Cherbourg.

The surviving Portsmouth - Bilbao P&O service will see a reduced frequency of service with just one ship deployed in place of the current six. Brittany already operates between Portsmouth and Caen, and will use its new ferries and staff to operate a service between Portsmouth and Le Havre. Therefore, these changes will leave Brittany as the dominant ferry operator on the Western Channel.

We believe that service frequency will influence the degree of demand-side substitutability between Dover Strait and Western Channel. For example, there are up to 80 daily ferry crossings via the Dover Strait[3], in contrast the Western Channel offers just up to 36 daily crossings. The Dover Strait services can thus, to some extent (in particular for more time-sensitive movements), provide an alternative route to Europe.

It seems likely that if Brittany attempted to raise tariffs following the acquisition, that there would be significant switching of demand to the Dover Strait and low-cost airlines.

In summary, we believe that the relevant market should include the routes/operators on the Dover Strait as their service provides a substitute to the Western Channel. The larger volume, frequency, and stiff price competition on the Dover Strait, mentioned in the following section, is already

[3] In addition, Eurotunnel operates up to 53 daily Channel crossing to France (Calais). Source: www.ferriesdirect.com

attracting ro-ro traffic that might otherwise have used a Western Channel route. Current Dover Strait operators include P&O, Sea France, Norfolk Line, Hoverspeed and Speedferries.

(b) competition within the product and geographical markets identified in the terms of reference, and any other market definition you may consider relevant

As mentioned in the previous section, the current competitive environment for cross-Channel services is fiercely contested. As well as internal competition with other ferry operators, growing external pressures such as competition from low-cost airlines and Eurotunnel also poses a competitive constraint.

Overall freight and passenger volumes on the Western Channel have experienced significant decline since the early 1990s. For example, Western Channel share of total road good vehicles (RGVs) travelling to mainland Europe has declined from 12% in 1989 to 6% by 2003[4]. In contrast, RGVs volumes employing Dover Strait services (on ferries and the Channel Tunnel) have increased by almost threefold since 1989 and seen its share increase from 44% of total traffic in 1989 to nearly 60% by 2003. The growth in demand in the Dover Strait reflects in part the opening of the Channel Tunnel and the competitive response of the ferries which has drawn traffic from other routes. Since the Tunnel's opening (Spring 1994), the average annual growth rate of ro-ro traffic via the Dover Strait has been 8.4%, whilst on the Western Channel there has been an average annual decline of 3.8%.

Unpublished research carried out earlier this year for the Department concerning Eurotunnel's prospects suggested that freight rates across the Dover Strait dropped between 1992 and 1997, and were only then recovering. Moreover, since this research was completed Speedferries has been an aggressive price cutter and Eurotunnel's new management have announced plans to reduce capacity and adopt airline style yield management pricing. Eurotunnel has said their average yield per lorry transported has been in decline since the beginning of 2003. Moreover, Hoverspeed who offers services between Dover-Calais and Newhaven-Dieppe have recently announced plans to reduce their services in 2005 and to quit offering services on the latter route in face of fierce competition from rivals.

Passenger ro-ro volumes in general have been falling since the mid-90s. Passenger traffic volumes on the Thames and Kent, and South Coast region have shown an average annual decline of 4.6% and 2.5% for the two regions respectively since 1995[5]. Figures for Portsmouth point towards an average total decline of 0.8% per annum over this period. We believe that this decline in traffic reflects a wide range of factors. For example, the abolition of duty free sales for goods sold on intra-EU services in July 1999 as well as the

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[4] Figures from Table 4 of *'Road Good Vehicles Travelling to Mainland Europe: Q3 2004'*, Transport Statistic Bulletin.

[5] Figures from Table 3.1(a): *UK international sea passenger movements, by port and port area: 1995 - 2003*, of Maritime Statistics 2003.

more recent narrowing of excise duties between the UK and France that has reduced demand for "booze cruises". In addition, there has been increasing competitive pressure from low-cost airlines. Note the strength of the "no-frills" operators pricing also serves to constrain the fare traditional "flag carriers" can charge. Passenger traffic at Southampton airport, for example, was up by over 30% since the start of 2004 compared to the same period in 2003[6]. Some passenger travel demand, for example, people with a second home in north west France may be more captive to the Western Channel ro-ro routes for some of their trips. However, some of these passengers may be already use a combination of low cost flight plus hire car as an alternative ferry access.

The Department does not monitor market shares, however figures from *Maritime Statistics 2003* indicates that Portsmouth facilitates about two-thirds of total Western Channel passenger ferry traffic. If Brittany takes over the proposed route to Le Havre and P&O pulls out of the Cherbourg and Caen routes, Brittany has the potential to significantly increase its market share of Western Channel market. However, the decline in cross channel passenger volumes, coupled with internal and external competition, and the theoretical possibility of entry by a new ferry operator will no doubt place some constraint on Brittany's ability to exercise its market power.

(c) barriers to entry to such markets

In order to explain whether significant barriers to entry exist, one needs to consider the costs that are involved in setting up a ferry operation. Assuming that the relevant berthing facilities exists (as in this particular case), the cost associated with entering a market will include the price/lease cost of vessels (which in turn depends on the availability on the world market), the specialist expertise required to operate it and the time involved in constructing a strategy regarding the operation and frequency for use on the Western Channel. Furthermore, this will coincide with the time and cost involved to promote the new services/routes offered to establish itself as a reliable supplier.

Barriers to entry for a totally new entrant would potentially be higher than would be for say an existing cross-Channel operator wishing to expand its services to the new location. Barriers to entry facing existing firms operating in the same industry will potentially be lower, as they are able to benefit from their existing reputation (i.e. lower sunk costs) and consumer base, expertise in the trade and possibly economies of scale. Experience gained through existing operations will indeed assist in reducing the costs, time and risk involved in facilitating this new service. This is particularly the case for Brittany, who from its existing operations in the Western Channel, will help give them a comparative advantage over new entrants.

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[6] Southampton passenger volumes drawn from Civil Aviation Authority's website. Source: Civil Aviation Authority.

Barriers to entry may also differ according to the relevant product market that the new service will accommodate. As in (a), we have defined that the relevant product markets under this particular acquisition proposal for both freight and passenger customers on the Western Channel. A decision to enter a market will often be based on the expected profitability from providing a service. To determine the potential earnings from the trade, one would analyse the market to understand the expected demand level for the supply. We would thus expect entry barriers to the freight market to be lower due to factors such as: less seasonality of demand; lower marketing costs required to attract customers; and lower staffing requirements.

In contrast, passenger movement is relatively more seasonal than freight, i.e. traffic tends to peak during the summer. Seasonal demand for passenger traffic may attract potential entrants during peak seasons - thus potentially offering an alternative for peak season travellers.

(d) the effect of the proposed acquisition on customers and suppliers

As noted in the above sections, the cross-Channel market at present contains a high degree of competition internally, as well as external pressures. The consumer has undoubtedly benefited from the periods of intense competition and over capacity, with an ensuing price-war reducing fares to very low levels. Such competition is unlikely to be sustainable over the longer term, as fares may have fallen below commercially acceptable levels for most of the market operators. This is reflected in the reason behind P&O's departure from the market[7].

The proposed acquisition would reduce choice, in terms of the number of ferry companies, for the consumer but not in terms of available routes. It is unlikely that Brittany's acquisition of P&O's Western Channel routes will allow Brittany to sustain an increase in fares without losing traffic to competing services. However, this does not necessarily imply that the consumer is going to be worse off. As Brittany concurrently operates other routes on the Western Channel, it is possible that the acquisition of the Portsmouth – Le Havre route may bring a more efficient utilisation of capacity by removing any duplication from existing services. Furthermore, any cost advantages that could potentially be gained by Brittany might, possibly, lead to lower fees or to investment in new facilities that provide additional service benefits to the consumer, e.g. increase frequency, high speed crafts etc.

We believe that other suppliers of services are unlikely to respond to Brittany's proposed entry by furthering the decline in prices, as they are already at low levels. The most likely response strategy may be to try to compete on non-price factors, for example, greater on-board entertainment, restaurants and resting lounges etc.

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[7] "*In 2003, P&O Ferries reported an ..operating loss of £0.2m before reorganisation and impairment charges of £39.8m..In the first half of 2004 it reported a loss of £25.1m (2003 £19.9m loss)*". Source: P&O News Release – Ferries: Outcome of Review, 28 September 2004.

(e) the effect on the level of prices and variety and quality of services.

The DfT does not monitor freight rates nor passenger fares on the concern routes and thus is limited in terms of providing a critical analysis on the potential effects post-acquisition. But as noted in (d), we believe that continued 'cut-throat' price competition is unlikely to be sustainable. Instead operators will compete via product development, in this case, differentiating their service by improving the quality of service offered.

(f) any other issues considered relevant

The proposed withdrawal by P&O Ferries will have significant impact on the employment of seafarers and port-dependent jobs. Our understanding of the proposed transaction is that approximately 350 jobs would be transferred to operate the service by Brittany. However, 1,200 jobs P&O jobs on Western Channel routes are expected to go as P&O withdraws from routes from Portsmouth to Caen and Cherbourg.

Recent studies by Cardiff University[8] and London Metropolitan University[9] highlighted concerns over the declining trends of people equipped with seafaring skills and experience in the UK. In particular, the message from Cardiff University's study concludes that there is a high demand by employers, within the maritime industry and in shore-based sectors, who would prefer to fill posts with experienced seafarers. The shore-based maritime industry was defined to include those industries where there is a demand for ex-seafarers, e.g. classification societies, port services, marine lawyers, marine insurance, ship agents, maritime schools etc. The studies concluded that a shortfall exists between the supply and demand of such expertise in the labour market.

Ruling out the proposed transaction by Brittany Ferries could increase the number of job losses as the 350 transferred jobs will not be realised. This could affect the UK's maritime labour market in the future, for example, reliance on non-seafarers which may lead to a degree of quality loss; recruitment of foreign seafarers as substitutes, reduced incentive to train and recruit young cadets etc. In addition to the immediate effect on the maritime industry, this could potentially lead to subsequent "knock-on" effects on employment in other shore-based industries.

EAMI Division
Department for Transport
12 January 2005

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[8] *The UK's Requirement for People with Experience of Working at Sea 2003*, Cardiff University
[9] *United Kingdom Seafarers Analysis 2003*, The Centre for International Transport Management, London Metropolitan University, London 2003