SLC theories in *Eurotunnel* after a material change of circumstances

A SUBMISSION TO THE CMA PREPARED ON BEHALF OF THE SCOP

Executive summary

The Competition and Markets Authority (CMA) has received numerous submissions from the Société cooperative et participative (SCOP) and other parties throughout the remittal process that there has been a material change of circumstances since the publication of the Competition Commission's (CC's) Final Report. In particular, the evidence presented relates to the prospect of the Dover-Calais line supporting three providers given the improved economic conditions, market growth (particularly on the short sea maritime routes), the recent success of DFDS A/S (DFDS) in growing its market share, and new environmental rules likely to favour the short sea.

This submission explains why the SLC theories identified in the CC's Final Report are highly unlikely to hold after such a material change in circumstances.

The first SLC concern identified by the CC – that DFDS will exit the market – directly falls away if there is a material change in circumstances which means that the market can accommodate all three of P&O, MFL and DFDS.

The relevant counterfactual situation to the acquisition by Group Eurotunnel S.A. (GET), after the material change in circumstances, is that DFDS would have acquired and continued to operate the assets. We find that competition in this counterfactual is weakened relative to the factual situation, particularly on the Dover-Calais crossing:

- even under a material change in circumstances, DFDS's incentive to deploy the SeaFrance S.A. (SeaFrance) assets on the Dover-Calais crossing is significantly weaker than that of MyFerryLink (MFL), given its existing presence on the Dover-Calais route;
- DFDS might also choose to restrict Dover-Calais capacity in the counterfactual in order to benefit its existing ferry services elsewhere in the short sea (specifically Dover-Dunkirk); and
- even if DFDS did choose to use all the SeaFrance assets to expand capacity on Dover-Calais following the material change in circumstances, this would still represent a significantly more concentrated and less competitive situation than the post-merger market situation with three ferry competitors on the short sea.

In this case, the relevant conceptual framework to apply is therefore whether the acquisition of the assets by GET is to be preferred to the acquisition of the assets by DFDS. This turns on the question of whether the "internalisation effect" between Eurotunnel and MFL is more concerning than a "competition weakening" effect arising from the reduction of ferry operators on the short sea from three to two under a DFDS acquisition. We find that this is highly unlikely to be the case because:

- the material change in circumstances significantly weakens the strength of the internalisation effect (relative to the original findings in the Final Report), due to the increased level of competition in short sea ferries; and, in any event,
- the "competition weakening" effect from a DFDS acquisition in the counterfactual is highly likely to be greater than any remaining "internalisation effect" because it involves a merger between close ferry-based competitors, rather than a merger with the more distant Eurotunnel competitor.

We find that evidence reported in the CC's original Final Report supports this conclusion, since it shows that ferry operators are close competitors selling homogenous products, while Eurotunnel is a somewhat differentiated and therefore more distant competitor. Moreover, this finding would be even stronger to the extent that DFDS would reduce the capacity on the Dover-Calais route relative to that in the factual situation.

We therefore conclude that the SLC identified in the original Final Report is highly unlikely to hold, if there is a material change in circumstances such that three ferry operators can be expected to remain in competition on the short sea and on the Dover-Calais line in particular.

Background

In October 2012, the Office of Fair Trading (OFT) referred the acquisition by Groupe Eurotunnel S.A. of certain assets of the former SeaFrance S.A. to the Competition Commission. SeaFrance was a wholly-owned subsidiary of Groupe SNCF which operated ferry services between Calais and Dover prior to November 2011.[1]

SeaFrance was placed in liquidation in November 2011 after heavy losses and its ferry services ceased operating. In early 2012 DFDS launched a new service between Calais and Dover, using two chartered ships. DFDS had previously operated short-sea ferry services only between Dover and Dunkirk and between

[1] Material in this section taken from CC, Final Report, Summary, paragraphs 1-9.

Dieppe and Newhaven, in conjunction with its joint venture partner, Louis Dreyfus Armateurs.

Three vessels operated by SeaFrance and other assets were sold in a sealed bid process. Bids were received from GET, P&O Ferries (P&O), Stena RoRo AB (Stena RoRo) and DFDS. The acquisition of the three vessels and other assets by GET was completed in July 2012. GET subsequently launched ferry services between Calais and Dover in August 2012 under the MyFerryLink brand with the vessels operated by a workers' cooperative (a Société cooperative et participative, referred to as the SCOP).

The CC found that there were two relevant markets:

- transport services to passengers on the short sea (the passenger market); and
- transport services to freight customers on the short sea (the freight market).

The short sea refers to routes via Eurotunnel, between Calais and Dover, between Dunkirk and Dover and certain other routes across the English Channel.

The CC also found that the relevant counterfactual to the acquisition of the assets by GET was a situation in which DFDS acquired one, two or three of the vessels and continued to operate five vessels across the short sea, having replaced one or more of its existing vessels with the acquired vessels.

The SLC findings

The CC explored how it expected the supply of ferry services in the two markets to evolve in the short to medium term. It concluded that, in the context of excess capacity and continuing competition from MFL, an effect of the merger would be that DFDS would be likely to cease operating services between Dover and Calais in the short term (although not on the Dover–Dunkirk route).[2]

The market situation resulting from the merger would therefore be a situation of one ferry operator (P&O) competing against Eurotunnel and MFL. The market situation in the counterfactual would be two ferry operators (P&O and DFDS) competing against Eurotunnel.

The CC explored three separate SLC concerns in its Statement of Issues.[3]

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2 CC, Summary, paragraph 10.

3 CC, Final Report, 8.19.

- **The exit of an operator induced by the acquisition.** If only two strong ferry competitors are viable on the short sea and the purchase of the SeaFrance assets by GET results in the displacement of another operator, the CC considered that this situation may result in a reduction in the number of major operators from three (GET, DFDS and P&O) to two (GET including MFL, and P&O), thus potentially leading to higher prices.

- **Horizontal unilateral effects.** The CC considered Eurotunnel may have an incentive to increase prices following the transaction because it would be likely to lose a smaller proportion of its sales as a result of a price rise. This is because a proportion of the sales that would have been previously lost to its ferry competitors would be likely to divert to MFL and thus the associated profit would be retained within GET.

- **The bundling of ferry-based services.** The CC considered that by offering a bundle of Eurotunnel shuttle services and MFL ferry services, GET may be able to disadvantage customers and other ferry operators.

In relation to the possibility of exit, the CC concluded that the level of demand on the short sea would be insufficient for three ferry operators simultaneously to offer services in competition with Eurotunnel.[4] It considered that, on the balance of probabilities, the firm that was most likely to exit the market was DFDS.[5]

In relation to the horizontal unilateral effects concerns, the CC examined the effect of the merger on the incentives of Eurotunnel and the ferry operators to increase prices, in two ways. The CC considered two possible effects:

  - an 'internalisation effect', resulting from the retention of lost profit within GET following a price rise by Eurotunnel; and

  - a 'competition-weakening' effect due to the changed incentives resulting from a change in the competitive pressures exerted on all ferry operators in the relevant markets.

The internalisation effect relates to the concern that Eurotunnel would raise its prices post-merger in the knowledge that some of the sales lost to the ferries would be recaptured by MFL.[6] The competition-weakening effect would result in higher pricing by MFL because of the knowledge that post-merger some of the sales it lost from a price increase would be recaptured by Eurotunnel.[7] The CC supported these findings with a combination of arguments from economic

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4 CC, Final Report, 8.52.

5 CC, Final Report, 8.98.

6 CC, Final Report, 8.112-8.129.

7 CC, Final Report, 8.128-8.136.

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theory and evidence on gross margins on ferry services and diversion ratios between Eurotunnel and ferry services.

The CC considered whether the ability of GET to bundle Eurotunnel and MFL services would give it a competitive advantage that would be sufficiently large to contribute materially to the exit of the other party. In particular, the CC concentrated on 'mixed bundling' in the freight market. However, the CC concluded that the ability of GET to bundle services across its Eurotunnel and MFL operations was unlikely to have a material impact on competition on the short sea in the short to medium term.

Accordingly, the CC was ultimately concerned about two related theories of harm. First, the direct effect that DFDS would exit. Second, the indirect effect that GET would increase prices on either MFL or Eurotunnel (or both) as a result of the internalisation of the pricing externalities between them.

The prospect of a material change in circumstances

During the remittal process both GET and SCOP have identified that there are factors which suggest there has been a material change in circumstances since the publication of the CC's Final Report. These relate to:

- significantly higher passenger and freight traffic to date than anticipated by the CC;[8]
- stronger economic growth (and hence higher future passenger and freight traffic than anticipated by the CC);[9]
- the introduction of environmental regulation, the consequence of which would shift demand from longer ferry crossings to the short sea.[10]

Each of these effects makes it more likely that there will be room for three ferry providers on the short sea in the short term and possibly in the medium term. We have not explored the evidence on these factors or whether they would in practice result in the presence of three ferry providers. Rather, we look at the consequences for the CC's SLC findings on the basis that a material change of circumstances of this nature has occurred.

There are two aspects to the analysis:

8 SCOP Submission in relation to material change of circumstance, paragraph 1.2.

9 GET, Submission on material change in circumstances, Section 3.

10 GET, Submission on material change in circumstances, Section 4.

- first, we discuss the appropriate counterfactual against which the CMA should now assess the post-merger situation in view of a material change of circumstances;
- second, we discuss whether the original SLC identified by the CC still holds when comparing the post-merger situation to the counterfactual under a material change in circumstances.

Based on the evidence put forward in the original CC Final Report, we find that the SLC identified in that report would not continue to hold in a world where the short sea can accommodate three ferry operators post-merger.

The impact of the material change in circumstances on the counterfactual

The CC's original Final Report identified DFDS as the only candidate buyer (or ultimate operator via charter) of the SeaFrance vessels, on the basis that there were no credible alternative buyers of the assets who would have used them to enter the short sea (other than by chartering them to DFDS).[11]

On this basis, the CC established the following counterfactual:[12]

1. that DFDS would have acquired the *Berlioz* and either acquired or chartered the *Rodin*;

2. that DFDS would have operated either one or both of these vessels on the Dover-Calais route; and

3. it would have done so to replace the existing vessels it had chartered from LD Lines and Brittany ferries, rather than to add incremental capacity.

It is necessary to consider whether each of these elements of DFDS's behaviour in the counterfactual would remain the same in view of a material change in circumstances – in particular given the improved outlook for demand on the short sea routes.

First, it is clear that DFDS would still have mounted a successful bid for the SeaFrance assets in the counterfactual. This is because the material change in circumstances came to light only after the sales process had concluded. This follows directly from the fact that:

- the sales process preceded the CC's decision; and

11 Final Report, paragraphs 5.11 to 5.20.

12 Final Report, paragraphs 5.17 to 5.27.

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- the material change in circumstances necessarily (by definition) post-dates the CC's decision.[13]

Second, it is also straightforward to conclude that DFDS would have continued to use the new vessels on the short sea routes. Higher demand on the short sea routes would tend to increase the incentive for DFDS to deploy its new vessels on the short sea, in particular on the Dover-Calais route, relative to the situation where no such additional demand growth had taken place.

The aspect of the counterfactual that is most relevant to the material change in circumstances is the third point: whether DFDS's control of the new vessels would have affected total capacity on the Dover-Calais route (and in the short sea more generally). This is a question that the CMA will need to address in its assessment of the material change in circumstances, but broadly two possibilities exist:

- that DFDS would have deployed the additional capacity on the short sea when it became apparent (following the material change in circumstances) that ferry demand is and will be higher on the Dover-Calais route and other short sea routes; or
- that DFDS would have still used the vessels to replace its existing chartered vessels (and therefore would not have increased overall capacity) and instead benefitted from higher demand through higher prices and/or utilisation of its pre-acquisition level of capacity.

Which of these situations pertains is a factual matter for the CMA to assess in its investigation. For the purposes of our analysis, we assume that DFDS would have deployed the additional capacity on the Dover-Calais route, as this is the least favourable assumption to GET for the purposes of assessing the impact of the merger.

However, it is important to note that DFDS's incentives to deploy additional capacity on the Dover-Calais route are likely to be lower than GET's incentives to do so. This is for the following reasons:

- DFDS was already present on the Dover-Calais route, and so deploying additional capacity would have resulted in significant cannibalisation of sales from its existing services (as well as enabling it to take advantage of market growth);[14]

13 It cannot be the case that the material change in circumstances would have been foreseeable during the sales process – if that was the case, then these changes in circumstances should also have been foreseeable by the CC in taking its original decision.

14 CC, Final Report, Appendix G, paragraph 43.

- DFDS is also present on Dover-Dunkirk – and given there is some substitution between the Dover-Calais and Dover-Dunkirk ferry routes, that would further reduce DFDS's desire to increase capacity on the Dover-Calais route;[15]
- in contrast, GET's only existing presence on the short sea was Eurotunnel, which the CC accepts is significantly differentiated from the Dover-Calais ferry crossing.[16]

Accordingly, considering a counterfactual where the same total capacity is operated by two players (DFDS and P&O) rather than three (MFL, DFDS and P&O) may be unreasonably optimistic.

In any event, the following section demonstrates that the original SLC finding is unlikely to hold after the material change in circumstances even if the same total capacity is present on the Dover-Calais ferry route (and hence in the short sea as a whole) relative to the factual situation.

The impact of the material change in circumstances on the SLC analysis

The first SLC concern identified by the CC – that DFDS will exit the market – directly falls away if there is a material change in circumstances which means that the market can accommodate all three of P&O, MFL and DFDS. The relevant consideration is therefore whether the "internalisation effect" originally identified in the Final Report can still be expected to result in an SLC. This concern arose because the CC considered that:

- the effect of the transaction would be to cause Eurotunnel to raise prices because it would now benefit from recapturing some of the profit on sales lost to Dover-Calais ferry crossings; and
- the incentive to raise prices would be increased by an overall reduction in the level of price competition between ferries (thereby relaxing the overall competitive constraint on Eurotunnel pricing).

However, following a material change in circumstances, the comparison now is between the following two situations:

- the counterfactual situation: two ferry operators (DFDS and P&O) competing with each other and with Eurotunnel; and

15 CC, Final Report, Appendix C, paragraph 66.

16 CC, Final Report, Appendix G, paragraph 41.

- an updated post-merger factual situation: three ferry operators (MFL, DFDS and P&O) competing with each other and with Eurotunnel.

The crucial change brought about by these new circumstances is that the "competition weakening" effect in ferries now applies to the counterfactual acquisition of the assets by DFDS, not to the post-merger factual situation. In the factual situation, the merger actually enhances competition between ferries by increasing the number of ferry operators (and/or the incentive to deploy ferry capacity) on the short sea and on the Dover-Calais route in particular.

We find that the SLC finding in the CC's Final Report no longer holds in these new circumstances. This is because:

- the material change in circumstances significantly weakens the strength of the internalisation effect (relative to the original findings in the Final Report), due to the increased level of competition in short sea ferries; and, in any event,
- the "competition weakening effect" from a DFDS acquisition in the counterfactual is highly likely to be greater than any remaining "internalisation effect" because it involves a merger between close ferry-based competitors, rather than a merger with the more distant Eurotunnel competitor.

The material change in circumstances significantly weakens the internalisation effect

With three ferry operators remaining on the short sea, the magnitude of the internalisation effect is likely to be significantly reduced by the material change in circumstances. The internalisation effect has three main components:

- the diversion ratio from Eurotunnel to MFL ferry services;
- the variable earned margin on sales recaptured at MFL; and
- the relative price of MFL ferry services versus Eurotunnel.

All of these three components will be reduced by the material change in circumstances.

- **Diversion ratio**. In a world where DFDS remains active on the Dover-Calais route, MFL's share of Dover-Calais ferry customers would be correspondingly reduced and hence so would the diversion ratio from Eurotunnel to MFL - the CC argued that market shares are a reasonable proxy for diversion ratios in ferry services on the same route, since they are relatively undifferentiated products in the eyes of customers.

- **Variable margins in ferries**. With three firms competing on the Dover-Calais route (and in the short sea as a whole), variable margins would also be expected to fall relative to the counterfactual in which two firms remain, because ferry prices would fall but there is no reason to expect any reduction in variable costs.

- **Relative price of ferry services versus Eurotunnel**. Lower ferry prices would also (other things equal) tend to reduce the internalisation effect, since the value of recaptured sales in ferries would be worth relatively less compared to (higher priced) Eurotunnel services.

This means that the CMA would need, at the very least, to re-estimate its quantification of the internalisation effect following the material change in circumstances.

The "competition weakening effect" from a counterfactual DFDS acquisition is highly likely to outweigh any remaining "internalisation effect"

Compared to the counterfactual situation one would now expect greater competition between three rather than two independent ferry operators. In other words, in the counterfactual there is a "competition weakening effect" relative to the factual. There can be no SLC finding if this competition weakening effect in the counterfactual results in a worse outcome for consumers than the (now more limited) internalisation effect in the post-merger situation.

The question facing the CMA after the material change in circumstances is therefore whether overall competition is stronger with the SeaFrance assets owned by GET or owned by DFDS. Effectively, with the GET acquisition there is a concern about the "internalisation" effect. With the (implied) DFDS acquisition there is a concern about the "competition weakening" effect.[17] This is illustrated in **Figure 1** below.

[17] "*This concern is the traditional concern that as companies gain very large shares of a market, they will have increasingly less incentive to discount due to the increasing cost to their existing business of discounting.*" (CC, Final Report, Appendix G, paragraph 43.) There would be a further concern if DFDS would also reduce capacity following such an acquisition, as discussed above.

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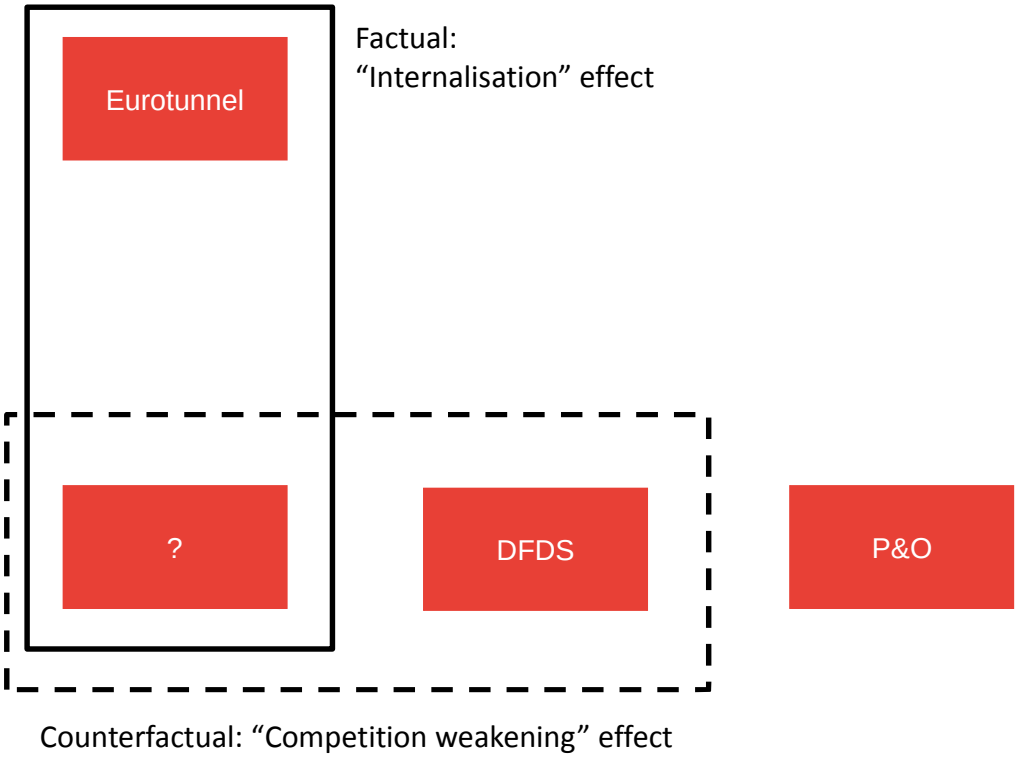
Figure 1. Competition effects in factual vs. counterfactual



Source: Frontier Economics

It appears likely, from the evidence and analysis in the CC's Final Report, that the material change in circumstances means that the "competition weakening" effect will be greater than any remaining "internalisation" effect. This is for the following reasons.

- **Ferry operators are close competitors.** The CC found that:
  - when DFDS entered the Dover-Calais route, it stole freight volume share from P&O and from its own services on the Dover-Dunkirk route, while Eurotunnel's freight volume share was virtually unaffected: "*[t]he analysis suggests that the growth of DFDS on the Dover–Calais route came primarily from P&O and DFDS's Dover–Dunkirk route, and the tunnel's volumes were not significantly affected by it*";[18]
  - prices across ferry operators are close to each other: "*[o]ur analysis of the prices of major ferry operators and Eurotunnel on the short sea shows that while there is a significant difference between the price of a tunnel crossing and that of a ferry*

[18] CC, Final Report, Appendix C, paragraph 24/25 and Table 5/6.

crossing in both the passenger and freight markets, there is relatively little difference between the prices of the major ferry operators";[19]

- ferry operators offer a broadly homogenous product, which one would expect to lead to fierce competition: "*[f]or this reason, we view competition between the major ferry operators with a competitive departure schedule as being competition between firms offering a broadly homogeneous service offering. The implication is that we do not think individual ferry operators will be able to price unilaterally at a level that is significantly different from that of the other major ferry operators on the short sea without risking losing large volumes of business.*";[20]
- Increased competition in the ferry sector would reduce prices in both the ferry sector and on Eurotunnel: "*if MFL expands aggressively by adding capacity to try to gain market share in the ferry business, it is likely to drive down both ferry prices (in general, until other ferry competitors accommodate and reduce capacity) and Eurotunnel's price*"[21] – which also suggests that if DFDS were to reduce capacity following its acquisition, ferry prices would increase.

- **Eurotunnel is somewhat differentiated from the ferry operators (while remaining constrained by ferry competition).** The CC identifies that:
  - Eurotunnel has a different product offering to those of the ferry operators: "*Eurotunnel is significantly differentiated from the ferries by way of its advantages in terms of departure frequency, speed of crossing and location advantage (shorter distance for hauliers in particular)*".[22]
  - Eurotunnel's prices are significantly above those of the ferry operators: "*Figure 4 shows that there is significant premium of Eurotunnel's [freight] price when compared with DFDS and P&O ferry prices.*"[23]

This evidence appears strongly to suggest that a DFDS acquisition of the assets – which is the relevant counterfactual after the material change in circumstances – would be more problematic than a GET acquisition of the assets. Moreover, this finding would be even stronger to the extent that DFDS would reduce the capacity on the Dover-Calais route relative to that in the factual situation.

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19 CC, Final Report, Appendix G, paragraph 38.

20 CC, Final Report, Appendix G, paragraph 40.

21 CC, Final Report, Appendix G, paragraph 42.

22 CC, Final Report, Appendix G, paragraph 41.

23 CC, Final Report, Appendix D, paragraph 13; see also paragraph 36 in relation to car prices (although coach prices are similar between Eurotunnel and P&O, see paragraph 37).

Conclusion

Accordingly, this reasoning and evidence suggests that the SLC reasoning relied on in the CC's Final Report no longer holds after the material change in circumstances.

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