Anticipated acquisition by Freightliner Limited of two inter-modal inland rail ports located at Doncaster and Daventry from Deutsche Post A.G.

The OFT's decision on reference under section 33(1) given on 8 June 2007. Full text of decision published 21 June 2007.

Please note that the square brackets indicate figures or text which have been deleted or replaced with a range at the request of the parties for reasons of commercial confidentiality.

PARTIES

1. **Freightliner Limited (Freightliner)** is a UK rail haulage operator. It also owns and operates eight inter-modal inland rail ports (terminals) throughout the UK.

2. **Deutsche Post A.G.** is ultimately the owner of two inter-modal inland rail ports located at Daventry and Doncaster (the Target Sites). The Target Sites facilitate inter-modal inland terminal handling services with 2006 UK turnover in Doncaster of £[ ] and in Daventry of £[ ].

TRANSACTION

3. Freightliner proposes to acquire the operating leases, assets, employees and contracts relating to each of the Target Sites which are enterprises for the purposes of section 23 of the Enterprise Act 2002 (the Act). The administrative deadline expired on 17 April 2007.

4. [ ]. The value to Freightliner of the transaction is enhanced by the ability to bring additional business and improve operational efficiency.

JURISDICTION

5. As a result of this transaction, Freightliner and the Target Sites will cease to be distinct within the meaning of section 26(1) of the Act.

6. The parties overlap in the supply of inter-modal (between rail and road) inland terminal handling services to third parties in the UK, for which their combined share of supply in the UK will exceed 25 per cent. The share of supply test in section 23(4) of the Act is therefore met. The OFT therefore

believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

BACKGROUND

7. So-called inter-modal containers (IMCs), as the term suggests, are designed to be equally able to be transported by different modes of transport -- road, rail or sea.

8. Food and non-food retailers and other downstream customers (together, downstream customers) employ freight haulage and logistics forwarding companies to ensure that their freight is shipped in IMCs from the point of origination to final inland destination (for line haul) or within Great Britain from a specific port of arrival to a specific inland destination (e.g., the retailer's warehouse) (for merchant haul).

9. Across Great Britain the majority (around 80 per cent by volume) of freight shipped on behalf of downstream customers in IMCs by hauliers and forwarding firms (IMC hauliers) is done by road. The OFT has received no evidence suggesting that the situation is substantially different at the areas the Target Sites serve. Thus, most IMC hauliers have a business model primarily if not exclusively based on road transport, but will use rail if it is competitive to use it for the relevant portion of an end-to-end service from origin to destination. If rail is chosen to substitute for road, the rail network will typically not cover the entire origin to destination journey end to end: lorries will typically deliver the IMCs at least for the last mile(s) to their final destination.

10. A minority of upstream IMC hauliers use rail rather than road as their business model. These suppliers are of course 'captive' to rail and the associated terminal handling services for on- and off-loading of IMCs between rail and road for the scope of their relevant inter-modal rail freight business. This minority of inter-modal freight competitors to Freightliner -- whose own business model is rail-only freight services -- is referred to below as rail-based IMC hauliers.

11. The term terminal handling services includes the provision of rail access to the terminal, lifting IMCs to and from trains and lorries as well as, on occasions, other services such as container storage. This payment typically represents about 10-20 per cent of total costs of the end-to-end service including the inter-modal 'shift' between road and rail.

MARKET DEFINITION

12. Market definition is not an end in itself; it is a framework for analysing the direct competitive pressures facing the merged firm. As noted, Freightliner

is a significant provider of rail-based IMC haulage in competition with road-based IMC haulage and other rail competitors, to downstream customers. It is appropriate in this case to focus on market definition in this respect before considering the cost-component of terminal handling services, which the OFT will address directly within the competitive assessment.

Supply of IMC haulage services

Competitive constraints facing rail-based IMC haulage across Great Britain as a whole

13. In this particular case, the OFT considers that the strong base of evidence on the nationwide constraints from road on rail is relevant also to its more localised assessment around the Target Sites areas.

14. The weight of such evidence before the OFT indicates that a hypothetical monopolist supplier of the relevant rail-based IMC haulage would not be able to raise price profitably because downstream customers would switch in sufficient volume to road-based alternatives within any given area of Great Britain. Evidence in support of this general proposition is as follows:

    - of the over 20 third parties who responded to the question of substitutability between road and rail inter-modal inland transportation, all but one submitted that downstream customers regard the two modes of transport as competitive substitutes for IMC transportation such that road constrains rail for this type of freight traffic

    - both the Office of Rail Regulator (ORR)[1] and Network Rail[2] have recently concluded that for IMC freight traffic, haulage by road is by far the predominant means employed by customers in Great Britain, and a major substitute to haulage by rail for this type of freight[3]

    - consistent with this pattern of relative usage of the two modes, the OFT notes that there have been several public initiatives to facilitate the transfer of IMC inland haulage from road to other modes including rail (because rail is more environmentally friendly, but private economic incentives have not proved sufficient)[4]

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[1] Periodic Review 2008 – Consultation on Caps for Freight Track Access Charges, ORR, December 2006.
[2] Network Rail, Freight- Route Utilisation Strategy, March 2007.
[3] Periodic Review 2008 – Consultation on Caps for Freight Track Access Charges, ORR, December 2006.
[4] The Freight Facilities Grant Scheme introduced first in 1974, the Company Neutral Revenue Support scheme (CNRS) which ceased on 31 March 2007 and the current Rail Environmental Procurement Scheme (REPS), approved by the European Commission Decision: State Aid N 427/2006, United Kingdom-Rail Environmental Benefit Procurement Scheme which commenced on 1 April 2007.

- for journeys below 400 kilometres for port traffic[5] and 575 kilometres for domestic traffic[6] in particular, government subsidies under the so-called Rail Environmental Benefit Procurement Scheme[7] exist to ensure that a certain volume of relevant freight travels by rail. Otherwise, there would be less participation by rail freight in supplying customers whose IMC freight forwarding needs are across such distances; but for the subsidy to make rail less uncompetitive on cost, closer to 100 per cent of IMC freight would travel by road, rather than around 80 per cent as is currently the case (across all distances). Suppliers of haulage services have factored in the expected impact of this REPS rail subsidy since its implementation on 1 April 2007 and have assumed that inter-modal road and rail transportation continue to be part of the same market. Business forecasts are also made on the basis of a single market encompassing IMC rail and road haulage.

15. Some generalised concerns were raised that congestion of the road network and restrictions on drivers' hours due to the implementation of the European Working Time Regulation[8] may mitigate the extent to which road constrains rail. However, no downstream customer or freight company raised specific concerns that road was an insufficient substitute within the areas served by the Target Sites. On this basis alone, therefore, such concerns need not be considered further in this case. In addition, given the relative sizes of road and rail volumes, customers could switch from rail to road such that even a substantial loss of rail volume would amount to only a modest increase in road traffic, suggesting that road-based IMC hauliers have the ability to absorb switched volume from rail-based rivals.

16. The OFT therefore concludes that, as a general proposition across Great Britain, road constrains rail-based IMC haulage such that a hypothetical cartel between all rail-based competitors could not profitably raise price because sufficient downstream customers would switch to road-based alternatives to render such a price increase unprofitable.

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[5] This is the inter-modal haulage traffic which arrives into (or departs from) the UK via a sea port such as Felixstowe or Southampton. On arrival, the containers are loaded straight onto the rail at a sea port, trunk-hauled by rail to a terminal (such as the Target Sites) and then delivered by road to end destination.

[6] This is the inter-modal haulage traffic where containers are delivered by road to a terminal, trunk hauled by rail and then delivered by road to the end destination, with all stages taking place in Great Britain.

[7] The Rail Environmental Benefit Procurement Scheme (REPS), a government subsidy for inter-modal rail freight which aims at promoting 'the transfer of freight traffic flows from road to rail. See European Commission Decision: State Aid N427/2006 –United Kingdom Rail Environmental Benefit Procurement Scheme, paragraph 40.

[8] European Regulation (EC) No 561/2006 on drivers' hours which came into force on 11 April 2007.

Immediate competitive constraints facing Freightliner in the local area around the Target Sites

17. The OFT also carefully verified that this general proposition for Great Britain held true in respect of the particular geographic areas around the Target Sites: all downstream customers said they would switch to road-based IMC hauliers in response to small but significant price increases charged by rail-based ones and did not doubt the viability of road as an alternative in the relevant areas.

18. It is clear that Freightliner and other rail-only competitors are primarily constrained by road competitors in serving downstream customers, though the rail-only competitors do of course also compete with one another. In terms of rail terminal options that provide a competitive alternative to the respective Target Sites, the available evidence from market participants is that:

    - the Doncaster Target Site is one of four realistic alternative inter-modal rail terminals able to serve terminal users in the relevant area, alongside Leeds (Freightliner), Wakefield (EWS) and Selby (Potter's), and

    - the Daventry Target Site may be the only realistic option for terminal users, or one of two -- Hams Hall was identified by some third parties as a competitive choice to Daventry.

19. As explained above, the issue of choice of terminal is only material for Freightliner's rail-only competitors, all other IMC hauliers having the option of relying purely on road transport thus bypassing the issue of terminal handling services entirely.

20. It is clear from the evidence outlined above that, for purposes of market definition, rail and road are in the same relevant market for IMC haulage in the areas around the Target Sites. There is no reason to believe from the evidence that one component of rail-based IMC haulage – the terminal charges – are insulated from the pronounced competitive pressures facing rail hauliers in competing with road, and it would appear inappropriate to assess terminal charges divorced from this context.

COMPETITIVE ASSESSMENT

21. The weight of concern in this case was foreclosure arguments from competitors, and one competitor in particular. The argument depends on the ability and incentive to foreclose terminal handling services – for example, raising the cost or otherwise offering less favourable terms and service or, at the extreme, refusal to supply. Analogous concerns in relation to certain maintenance services necessary for rail freight haulage have found to be material in relation to freight markets where rail is the only or predominant means of transport, such as coal haulage, and where the acquirer had

market power in the downstream market: see for example the CC report in *EWS/Marcroft*.[9] In this case, the reverse is true: road is the principal means by which inter-modal containers are transported throughout Great Britain, including the relevant local areas, and – as is shown below – Freightliner has no downstream market power in IMC haulage.

22. For the following reasons, the OFT is satisfied that the merger does not materially change the ability or incentive of Freightliner to engage in foreclosure strategies against its rail-only competitors:

- The merger does not create or increase any market power at the terminal level. Freightliner will have no market power whatsoever in relation to road-based IMC hauliers that do not use these terminals. As regards rail-based IMC hauliers, for these purposes Deutsche Post is assumed to be operating the terminal as a rational profit-maximising owner, exploiting any market power that may exist in relation to any captive customers. The merger could have an affect on the ability to foreclose if there were an increase in market power (and thus power to raise price). However, this horizontal effect can be ruled out in this case because the only material horizontal overlap in terminals is around Doncaster, but market participants confirm that EWS's terminal at Wakefield, Potter's Selby, (and potentially the planned but as yet uncompleted Ministry of Defence's terminal at Castle Donnington) are all alternatives for rail-only competitors. At Daventry, to the extent the current terminal owner has any market power in respect of rail-only users, there is no increment as a result of the merger because there are no Freightliner terminals sufficiently close by.

- Freightliner has no downstream market power in IMC haulage. Unlike EWS in the *Marcroft* case[10], Freightliner has no pre-existing market power in the downstream market that a foreclosure strategy might protect or enhance. By way of indication, Freightliner's share of total inter-modal freight in Great Britain is at most around 20 per cent[11] and the OFT has received no evidence suggesting that Freightliner has a very large share in the relevant areas. Furthermore, Freightliner does not currently serve the IMC domestic traffic market[12] and the OFT has received no evidence to support any intention by Freightliner to make such a move

- The merger does not materially change incentives to foreclose, because raising rivals' costs would in all probability benefit Freightliner's road

[9] Final Report on the acquisition by Railways Investments Limited of Marcroft Holdings Limited, Competition Commission, 12 September 2006.
[10] Final Report on the acquisition by Railways Investments Limited of Marcroft Holdings Limited, Competition Commission, 12 September 2006.
[11] By volume of UK inland deep-sea IMC.
[12] This is the inter-modal haulage traffic where containers are delivered by road to a terminal, trunk hauled by rail and then delivered by road to the end destination, with all stages taking place in Great Britain.

competitors: in the abstract, Freightliner may be thought to have an incentive to raise terminal handling services charges to rail-only competitors relative to the incentives of the former owner, Deutsche Post, because Freightliner is an important downstream rail competitor to users of the Target Sites in a way that Deutsche Post is not. Yet Freightliner would only have a materially increased incentive to foreclose, relative to the pre-merger situation, if it could be confident that it would be profitable on the theory that any lost terminal revenues – caused by denying access or charging higher prices causing rail-only competitors to lose business and therefore the need for terminal services – would be 'recouped' as downstream gains to itself, as its competitors' customers switched to Freightliner.

However, as is manifestly apparent from the evidence on road versus rail competition, the downstream customers of rail-only competitors are not captive to the minority rail portion of the overall market and there is no suggestion on the evidence that Freightliner would be the next alternative to their chosen (rail) supplier. On the contrary, evidence from market participants confirms that if a rail-only competitor of Freightliner were to pass on inflated costs via a small but significant price increase, they would switch to road, consistent with road's predominant share of the market. Thus, rather than standing to benefit from switching volumes by downstream customers, Freightliner would likely be rewarding its road competitors downstream while potentially sacrificing upstream revenues from terminal handling that help it to spread the fixed costs of terminal operation. Accordingly, the merger does not result in any material incentive to foreclose.

23. The above analysis, built upon public evidence and the weight of customer opinion, is further supported by a lack of any evidence of a foreclosure theory in relevant Freightliner internal documentation reviewed by the OFT. A supplementary factor not necessary to support the overall conclusion is the fact that the Target Sites are subject to Open Access Regulations[13] aimed at facilitating the provision of terminal handling services to third party operators on a fair and non-discriminatory basis. Third parties had mixed views on the effectiveness of the Open Access Regulations. It was noted that they have recently been implemented and at present there is a lack of guiding precedents on how they would be enforced and the timeliness of the response its remedies provide.

THIRD PARTY VIEWS

24. The vast majority of downstream customers who expressed a view were unconcerned as they considered that road haulage is an alternative which could be used if inter-modal terminal handling service prices increase or quality declines increasing overall contract prices for inter-modal inland

[13] The Railway Infrastructure (Access and Management) Regulations 2005.

transportation services. In particular, customers were contacted in the Daventry warehousing and distribution park area as we considered that these would be most at risk if third party access was foreclosed and if inter-modal road transportation was in fact not an alternative.

25. All Freightliner's rail-only competitors in inter-modal inland rail transportation services were concerned about foreclosure and their ability to continue using the Target Sites in a fair and non-discriminatory manner as the Target Sites will be controlled by a rival rail-based IMC haulier and terminal operator.

26. However even those competitors who were concerned were of the view that inter-modal road haulage provides a constraint to inter-modal rail haulage, both in general terms and, in most cases, in terms of the Target Sites. Accordingly, the weight of competitor views does not support a theory of harm to competition, in other words, harm to customers flowing from harm to rail-based IMC haulage competitors.

ASSESSMENT

27. Freightliner is a rail-based competitor active in the wider market for IMC haulage, which is predominantly road-based but also features several rail-based suppliers such as Freightliner itself. It is acquiring two inter-modal terminals at Doncaster and Daventry that facilitate transfer of IMCs between rail and road.

28. The OFT tested the competitive constraint posed by road-based hauliers on rail-based IMC haulage in the relevant local areas, which reinforced the general conclusion applicable to Great Britain as a whole. Downstream customers confirmed that they perceive no adverse merger effects because of their ready ability to switch to road-based IMC hauliers should rail-based alternative become less competitive from their standpoint. This fact is also a principal reason why the acquisition does not change the competitive incentives of the terminal owner of Doncaster and Daventry to raise prices or otherwise offer less favourable terms to any 'captive' rail-based IMC haulier competitors using those terminals because it does not stand to benefit downstream, where it has no market power and no prospect of gaining such power as a result of any foreclosure strategy. Accordingly, for the reasons developed in more detail above, the competitive constraints of road-based alternatives are unchanged by the merger and, for the reasons developed above, preclude any competition concerns in this case.

29. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

30. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.