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Svitzer/Adsteam: Assessing unilateral effects when monopolists merge

In February 2007, the UK Competition Commission (hereafter, the "CC") cleared the acquisition of Adsteam Marine Ltd. ("Adsteam") by SvitzerWijsmuller A/S ("Svitzer").[1] Each of the two parties was the sole supplier of harbour towage services in a number of UK ports and after the merger the new entity would have accounted for around 90% of such services in the UK. The CC concluded that no substantial lessening of competition would arise post-merger except in the port of Liverpool, the only UK port in which the parties were both present prior to the merger. As a result, the transaction was cleared subject to the sole divestment of Adsteam's operations in this port.

In assessing the likelihood that this acquisition would give rise to unilateral effects, the CC considered not only how the reduction in the number of competitors would affect competition within a relevant market, but also the extent to which the merger might result in the elimination of potential competition. Such concerns occur if, pre-merger, the threat of entry by one of the merging parties into a market served by the other party exerts an important influence on the outcomes in that market and if no other firm represents an equally credible potential entrant.[2] In short, the elimination of potential competition can give rise to unilateral effect concerns only if the merging parties are uniquely placed to enter each other's markets.

This Brief summarises the bases upon which the CC cleared this merger focusing in particular on the assessment of the impact of the acquisition on potential competition.

No actual competition between ports

The CC started by examining the extent to which the two parties represented actual competitors to one another. Despite concerns expressed by the OFT during its initial review of the deal that customers might have the ability to threaten to switch ports when they negotiate their towage tariffs, the CC found that no such competitive constraints between ports existed. Specifically, the CC concluded that the degree of demand-side substitution (i.e. the extent to which customers would switch ports in response to a change in relative towage prices) is very limited for a number of reasons.

First, there were no recorded instances of Svitzer's customers switching ports in response to changes in relative harbour towage prices.[3] Second, harbour towage prices in the various Svitzer ports did not tend to move in parallel over time, as one would have expected to observe if changes in the prices at one port affected demand in another. Third, the margins prevailing at those Svitzer ports that were located relatively "close" to rivals' ports were not systematically lower than the margins prevailing at more isolated ports, suggesting that proximity to a rival's port did not systematically result in more competitive outcomes. Fourth, towage costs account for a very small percentage of total port calling costs, so the attractiveness of a particular port to a customer is unlikely to be determined by the level of harbour towage costs.

The CC was also able to dismiss the possibility of supply-side substitution. Although it is technically possible to move tugs from port to port, commercial considerations imply that

1
RBB Economics advised the parties after the proposed transaction had been referred to the CC by the OFT.

2
See paragraphs 59 and 60 of the EC merger Guidelines.

3
The few instances of observed customer switching had occurred within the port of Liverpool, where the two parties were competing against each other for harbour towage business.

there is little or no scope to do so since both parties were operating within each port with the minimum number of tugs required by the Port Authority to meet peak demand. Indeed, there were no examples of tugs being re-deployed to another port in response to changes in relative prices.

Analysis of potential entry

With the exception of Liverpool, the proposed transaction could only give rise to unilateral effects to the extent that one party was a potential entrant into a port served by the other, and that this provided an important constraint on the behaviour of the incumbent in that port. This would require that:

1) the other merging party would find entry into the port profitable at current prices; and

2) other operators could not also enter profitably at current prices.

In assessing the feasibility of entry, it was important to take account of the high fixed costs that characterise the harbour towage business. Such costs imply that any entry strategy could only be viable if a sufficient number of customers could be secured so as to benefit from economies of scale. This could be achieved either by displacing the incumbent entirely or by "cherry-picking" certain key customers who had the ability to confer minimum viable scale on the entrant's operation. The CC accepted that either strategy might involve entry being sponsored by a group of customers, since many respondents to their customer questionnaire said that the threat of sponsoring entry was an important source of bargaining power.[4] Such sponsored entry would most likely take the form of customers offering their business to the new entrant at a guaranteed price. By offering a long term contract to the entrant, sponsoring customers can reduce the risks to the entrant, thereby overcoming what would otherwise be an entry barrier that would expose customers to dependence on the incumbent supplier.

In order to determine whether or not the threat of customers sponsoring entry in the event of a price rise was credible, the parties undertook an in-depth investigation of the viability of entry in each port in which they operated. This was conducted both from the point of view of an entrant with similar costs to the incumbent in each port (i.e. Svitzer or Adsteam) and from the point of view of an entrant that could achieve lower costs by employing a non-unionised crew.[5] The model of entry incorporated a detailed analysis of:

1) the cost structure of the incumbent at each port that quantified the fixed and variable costs that would be incurred at every level of supply, taking account of the minimum number of tugs that the parties considered necessary to operate at any given level of supply; and

2) the profile of customers in each port, taking account of the volume of tug jobs each demands per year, the number of tugs each requires for their vessels, and the average net prices that each obtains from the incumbent.

The model enabled the calculation of the market share an entrant would have to obtain in order to break even by targeting individual customers, taking into account the fact that the net prices obtained by the different customers in a port vary. It also showed that in the event that "cherry-picking" entry occurred, the effect of loss of business volume to the incumbent meant that its average unit costs would increase significantly, making its business unprofitable. This strongly indicated that the threat of losing even a relatively

4 See CC's final decision, paragraph 8.30.

5 Svitzer considered that an international entrant into its ports could operate at a lower cost by avoiding the legacy costs associated with unionised wages and pension costs that it incurred.

small portion of business was likely to provide an effective constraint on the incumbent's behaviour. Indeed, this was consistent with the available evidence that the profitability of harbour towage services in UK ports is generally low due to the effective competitive constraints posed by the threat of entry.[6]

6 The CC acknowledged that the most likely constraint on prices in ports where there is only one operator is the threat of new entry. See CC's final decision, paragraph 8.31.

On the basis of this analysis, and other evidence submitted by the parties, the CC concluded that Adsteam could not be considered a potential entrant into Svitzer's ports, but that Svitzer could be considered a potential entrant into Adsteam's ports. However, Svitzer was by no means unique in this respect. There were a number of well known international towage operators with existing business relationships with Adsteam's customers, and with substantial expertise in the provision of harbour towage services, that could also be considered as potential entrants to the relevant ports. The threat of entry by these operators would continue to exert a constraint on the prices and service quality of the merged entity.

In summary, the CC accepted that neither Svitzer nor Adsteam enjoyed a unique advantage over other credible potential entrants. In consequence, the proposed transaction was held not to reduce the competitive constraints to which each UK "monopoly" port was subjected pre-merger.

What's the relevant price benchmark?

The model of entry submitted by the parties allowed the profitability of entry to be assessed under a range of different assumptions regarding the prices that would be obtained by the entrant. There was, however, some disagreement between the CC and the parties over the price benchmark that was relevant for assessing the viability of entry for the purpose of understanding the competitive constraints that the merged entity would face. The CC argued that the threat of sponsored entry could only be considered to provide a constraint on the behaviour of an incumbent towage operator if an entrant could remain profitable at prices 10% below current prices (or maybe even lower). This is because it considered that after entry, increased competition would drive prices to 10% below their current levels. Therefore, the CC concluded that a towage operator considering entry into a monopoly port would be unlikely to enter unless it could profitably do so at prices 10% below their current levels.

In general, it is true that a rational firm deciding whether to enter a market will be influenced not by the prices currently prevailing in the market, but by the prices that can be expected to prevail once entry has taken place. In some situations, the current market price may be expected to provide a reasonably accurate picture of the likely post-entry price.[7] In other cases, however, the post-entry price may be expected to be substantially below the prevailing price. This will be the case if the addition of a further firm to the industry results in a significant intensification of competition and, therefore, in a very substantial fall in prices. It is therefore perfectly possible for a firm to continue to set inflated prices and earn substantial profits without attracting entry, provided prices would be expected to fall sharply if further entry occurred. Under these circumstances, the threat of entry, and the expected level of post-entry prices, cannot be considered to constrain pre-entry prices.

7 This will likely be the case if entry and subsequent exit could be accomplished instantaneously and without cost. In this context, it would not be possible to maintain a differential between current market prices and post-entry price levels; the threat of entry alone would then effectively constrain pricing in the market.

However, the CC's reasoning is flawed in the context of assessing a horizontal merger in which potential entry has been identified as the factor that constrains current prices. The relevant benchmark for assessing all horizontal mergers is the prevailing price level:[8] the concern in this particular case was whether the elimination of a potential competitor would permit the merged entity to increase prices above that benchmark. For the new entity to

8 See J. Baker, "Unilateral Competitive Effects Theories in Merger Analysis", *Antitrust*, vol. 11, Spring 1997, pp. 21–26.

remain subject to effective competitive constraints post-merger only required that (a number of) customers would be able to sponsor entry by guaranteeing their business at current prices to alternative towage operators, and that these operators would be able to profitably supply them at current prices. If this threat was responsible for constraining prices pre-merger, as explicitly acknowledged by the CC, then it must be unreasonable to expect the parties to demonstrate that after the merger entry would have been attractive at prices 10% lower than current levels.

For example, any attempt by Svitzer to raise prices at a UK port from 100 to 110, say, would be unprofitable provided that a group of customers could respond by guaranteeing their business at a price of 100 to another towage operator, and that the "cherry-picking" strategy of entering the port and supplying that group of customers at a price of 100 would be viable for the towage operator. A new entrant would therefore not need to offer a significant discount over pre-merger prices in order for customers to find it profitable to react to a post-merger price increase by sponsoring entry. And, thanks to the guaranteed contracts that customers would be prepared to provide, the entrant would not need to be concerned about the effects of a possible post-entry price war, implying that the CC's requirement to assess whether entry would be attractive at a price of 90 was inappropriate.

Conclusion

In the majority of merger cases, the assessment of potential competition takes second place to the evaluation of how the transaction affects competition between the existing suppliers. Where actual competition in a market is effective, a merger with a potential competitor is normally viewed as eliminating a more distant competitive constraint, and therefore it could only give rise to unilateral effects concerns under exceptional circumstances. But due to the peculiar facts of the Svitzer/Adsteam case, in which the merger brought together two firms that were the sole suppliers in the vast majority of markets in which they were operating, and in addition accounted for 90% of supply in the UK, the assessment of potential competition and entry conditions took centre stage.
The assessment of entry conditions and the role that potential competition plays must be assessed in each case depending on the facts of the industry concerned. The facts of the Svitzer/Adsteam merger were certainly distinctive, but the analysis of entry scenarios in this case, and the implications of that analysis for the assessment of potential competition, provides lessons for other cases where entry is an important part of the story.