

Confidential

Freight Logistics Market Study

**KPMG review of the economic framework in the draft report published by the
JCRA on 17 February 2022**

March 31 2022

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Introduction

1. The JCRA is undertaking a market study in the freight logistics market in Jersey, which aims to consider the key areas of competition and of supply resilience. A draft report was published on 17th February 2022 (the “**Draft Report**”).¹
2. KPMG has been engaged by Ferryspeed to undertake an independent assessment of the economic framework adopted in the Draft Report. This paper presents that assessment.²

Overall comments on the economic framework in the Draft Report

3. The JCRA market study is intended to be “a flexible tool to explore whether a market, or a feature of a market, is working well for consumers”, and is aimed at the “key areas” of competition and of supply resilience.³
4. It aims to distinguish between “economic fundamentals” and non-economic barriers to “a less concentrated market”. Such barriers could be regulatory or policy drivers that can be adjusted to influence the extent of competition in the market. The study includes a consideration of market structure; and a comparison to markets that are considered to be similar (Isle of Wight, Menorca, Isle of Man, Bornholm and Shetland).⁴
5. While such a comparison might in principle be relevant, the Draft Report has not set out and applied a systematic economic framework for assessing the question of whether the market is working well for consumers. Such a framework would be needed to appropriately evaluate the implications of the evidence on Jersey and comparators, and what it means for competition. The lack of an appropriate framework might lead to incorrect conclusions being drawn from the evidence gathered.

¹ Draft Report 17 February 2022 (ref JCRA 22/15) in the Freight Logistics Market Study (Case M-002).

² Any questions in relation to this report can be directed to Dr Nicola Mazzarotto, Partner at KPMG UK LLP (Nicola.Mazzarotto@kpmg.co.uk).

³ Competition is defined as “what choice is available to purchasers of freight logistics services”; resilience is defined as “what is the market’s ability to handle unexpected events and to respond and recover quickly to these disruptions”. JCRA Freight Logistics Market Study, Consultation Paper, paragraph 1.3 and Draft Report, page 4.

⁴ Draft Report, page 12.

6. Establishing an economic framework is a key step commonly followed by competition authorities when analysing the competitive dynamics in a market.⁵ While there is no set methodology,⁶ a framework would usually cover:
 - a) defining the relevant market(s);
 - b) identifying relevant market characteristics;
 - c) assessing market outcomes (including price, quality, innovation, and other non-price indicators);
 - d) analysing structural and behavioural features of competition;
 - e) identifying the features of the market, if any, which are harming competition;
 - f) having identified any such feature, the authority would normally then turn to identifying suitable, effective, and proportionate remedies.
7. The validity of the findings and the suitability of the remedies proposed will depend on having established the correct framework to assess the market; and in gathering and assessing valid evidence within this framework.
8. The approach adopted in the Draft Report does not address these requirements and has not appropriately assessed (1) the outcomes in the market; (2) the competitive dynamics in the market, and how these dynamics relate to outcomes; (3) the interplay of competition, resilience and concentration. We explain these aspects in more detail in the rest of the paper.
9. As a result, the "options for recommendations" outlined in the Draft Report cannot be considered to be based on sound economic evidence.

1) The assessment of customer outcomes in the Draft Report

10. The Draft Report does not provide a systematic assessment of the outcomes of interest for (i) relevant economic actors in Jersey (such as freight logistics operators); (ii) customers (such as grocery chains); and (iii) end-consumers. The Draft Report has failed to set out a clear set of metrics to be observed in order to understand whether the market is working well.
11. From the JCRA publications, it appears that outcomes are positive for customers. In particular:

⁵ This is an approach that has been used in the UK by the Competition and Markets Authority ("CMA") in a wide range of markets including private healthcare, energy, retail banking, investment consultants, funeral director and crematoria services, digital advertising, and digital ecosystems.

⁶ For example, see Competition Commission, "Guidelines for market investigations: Their role, procedures, assessment and remedies", April 2013.

- a) The 2017 study found that customers were satisfied with the level of quality in the market;⁷
- b) The present Draft Report finds that customers are happy with the service provided, including during the pandemic,⁸ and some providers, like Ferryspeed, have made significant investments to improve customer experience.⁹

12. Instead of inferring from these findings of customer satisfaction that the market is functioning well, the Draft Report appears to consider “a less concentrated market” as a desirable outcome in itself.¹⁰ However there is no economic basis for the conclusion that a less concentrated market should necessarily deliver better outcomes in terms of any of the parameters that the Draft Report appears to be focusing on.¹¹

13. This is because market fundamentals – including intensity of competition, market size, fixed cost base etc. – will determine the number of firms that can profitably operate in a given market. In certain markets, the level of costs and the overall size of the market could lead to fewer firms being able to operate profitably. In other markets, high intensity of competition might result in fewer firms operating in the market as a whole.

14. The kind of “choice” which matters to customers and consumers and direct their utility, is a choice of service options available in the market. This kind of choice is unrelated to the number of firms operating in the market. In fact, a single operator – by for example exploiting economies of scale in the presence of high fixed costs - can deliver more options for customers than a number of operators in a fragmented, but less efficient market, where those economies of scale are not achieved. It appears that the Draft Report did not consider this important distinction and proceeded on the assumption that a greater number of operators would invariably also deliver greater service options. However, there is no evidence presented in support of this presumption.

⁷ “Review of Customer Choice in the Freight Logistics Sector between the UK and the Channel Islands, A report for CICRA”, June 2017, page7-8.

⁸ Draft Report, page 9.

⁹ For example, see Draft Report, page 44.

¹⁰ Consultation paragraph 3.1 and Draft Report, page 4.

¹¹ The Draft Report has mentioned on page 22 a series of customer outcomes, noting for example that “In markets where competition works well, it provides incentives for firms to innovate, leads to increases in productivity, and provides customers with more choice, better quality of service and lower prices.”.

15. Therefore, a concentrated market should not in itself be considered an issue; and lowering concentration should not in itself be considered an aim. As noted above, the evidence in the Draft Report in relation to customers' views appears in many respects consistent with that of the 2017 study; and consistent with the view that the market is working well for customers, and the current level of concentration is not in itself a problem.

2) The importance of bilateral negotiations in understanding competitive dynamics

16. Using the correct analytical framework is important to reach sound conclusions on the relevance of concentration in the market.

17. In the freight logistics market, terms of trade (including outcomes such as price, quantity, quality, service) are agreed through bilateral negotiations.

18. Competitive dynamics are therefore best understood within what economists call the “**bargaining framework**”. This is a tool commonly used by competition authorities in B2B settings.¹²

19. This framework accounts for the fact that outcomes are determined by the relative bargaining power of buyers and sellers, which in turn is determined by considerations such as the relative importance of the contract to each buyer and seller (i.e., what is the share of the buyer's purchasing budget, and what is the share of the seller's revenue); and the value of each party's “outside option” (i.e., their best alternative to concluding the deal in question).

20. This perspective has important implications for competitive dynamics:

a) It will be in the interest of both parties to explore alternative options to maintain leverage in contract negotiations. In particular, the buyer may consider options such as switching to a different seller (which will depend on its switching costs); as well as sponsoring the entry of new sellers.

b) In a bilateral context where buyers can switch, factors such as innovation and resilience of sellers (and their product) will be important to reduce the competitive threat posed by alternative providers.

21. It is expected that sellers will always consider the prospect of a medium to long-term relationship even when agreeing the terms of a short-term contract with their

¹² Recent examples include the UK CMA Private Healthcare Market Investigation.

buyers. Consequently, what often matters in determining the relative bargaining power of buyers and sellers (and hence ultimately the terms of trade) is whether there are credible medium-term strategies for customers to adopt that could replace current sellers.

22. This framing can explain why it is possible to have positive customer outcomes (low prices, high quality, significant investment, and innovation) even when there is apparently limited competition between the current providers “in the market” (i.e., within a potentially very concentrated market). Not having explicitly applied this framework in the freight logistics market may be a reason why the Draft Report appears to consider the level of concentration as an issue that needs addressing.

3) The interplay of competition, resilience, and concentration

23. The lack of a clear framework and approach when assessing outcomes also seems to undermine the Draft Report's assessment of resilience, as resilience is addressed as an issue separate from competition.

24. The Draft Report notes that “relying on one supplier, one customer, one key asset etc., is a risk prone position for any company or economy” and that “whilst this market structure has served Jersey well [...], there are risks to future resilience”.¹³

25. The framing therefore assumes that the high level of concentration undermines resilience, which leads to an analysis of market resilience being undertaken by looking at assets and providers whose failure might lead to supply issues in Jersey.

26. The "options for recommendation" put forward by the Draft Report in this regard is to increase diversification in the supply of freight to Jersey through the introduction of new routes.¹⁴

27. However, this approach is too simplistic and could be misleading. Resilience is ultimately determined by the type and level of investments made by providers in the market. Market dynamics, on the other hand, determine the incentives that companies have to make such investments both in the present and in the future. The Draft Report does not appear to have investigated whether there have been in fact shortcomings in investments that would lead to less-than-optimal resilience in the market, nor does the Draft Report appears to have considered the extent to

¹³ Draft Report, page 33.

¹⁴ Draft Report, pages 39-40.

which its options for recommendation would lead to stronger incentives or ability for market participants to invest and, therefore, build their resilience.

28. Instead, the Draft Report appears to assume that a market with fewer providers would be less resilient than a market with more providers. This, as explained above, is incorrect.
29. Firstly, resilience should matter to freight logistics suppliers as customers (such as grocery chains) will use resilience as an important consideration of their choice of suppliers. Concerns about providers' resilience could lead to strategies to increase diversification. In turn, as noted above, suppliers will be aware that resilience is important. A breakdown in service provision today could jeopardise future contracts, generating an incentive to invest in resilience. Positive market outcomes (as evidence in the Draft Report) could indicate that the market should currently also be delivering in terms of resilience, particularly in a context where there appears to be no evidence pointing to specific underinvestment in this area, or more generally lack of financial resilience.
30. Secondly, it should be noted that, even at a conceptual level, there is no economic rationale to presume that a less concentrated market is *per se* a more resilient market. For example, in a market characterised by significant fixed costs smaller scale might make all providers less profitable and so undermine the resilience of each provider and therefore of the market as a whole. In this scenario, lower concentration makes the market *less* resilient.
31. Any intervention by the JCRA will likely require consideration of the impact on individual operators' incentives and ability to invest to improve service resilience to ensure that changes in the market would not have the opposite effect - of decreasing resilience instead of increasing it. The appropriate approach will have to be assessed on a case-by-case basis through an empirical analysis of the market.
32. Such an assessment is not set out in the Draft Report and the Draft Report does not appear to present economic evidence to support the need for the JCRA to intervene in the market to increase resilience; or evidence of the potential effect on resilience of any measures aimed at decreasing market concentration.