

Anticipated merger between Transocean Inc. and Globalsantafe Corporation

ME/3310/07

The OFT's decision on reference under section 33 given on 26 November 2007. Full text of decision published 6 December 2007.

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

PARTIES

1. **Transocean Inc.** (Transocean) is the leading provider of offshore contract drilling services to the oil and gas industry. Transocean is active worldwide and has its headquarters in the United States. Transocean's UK turnover was US\$462 million in 2006 (at the current exchange rate around £223 million).
2. **GlobalSantaFe Corporation** (GSF) is the second largest provider of offshore contract drilling services to the oil and gas industry. GSF is active worldwide and has its headquarters in the United States. GSF's UK turnover was US\$463 million in 2006 (at the current exchange rate around £224 million).

TRANSACTION

3. Transocean proposes to merge with GSF through a share exchange. The parties filed a satisfactory submission on 19 September 2007. The administrative deadline, as extended, is 26 November 2007.

4. The parties also notified the merger to the United States Department of Justice, which closed its investigation on 19 September 2007, and with the competition authorities in Brazil.

JURISDICTION

5. The EC Merger Regulation (Regulation 139/04; ECMR) does not apply because each party achieves more than two-thirds of its EC-wide turnover in the UK, thus meeting the two-thirds rule in Article 1(3) ECMR.
6. As a result of this transaction Transocean and GSF will cease to be distinct. The UK turnover of both Transocean and GSF exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. 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.

MARKET DEFINITION

7. Transocean and GSF overlap in the provision of offshore contract drilling services to oil and gas companies. These services are provided using mobile offshore drilling rigs and consist of drilling wells during exploration for oil and gas, developing reservoirs to bring them into production, maintaining existing wells and capping wells at the end of their lives. These services are typically provided on the basis of a 'dayrate' that covers the cost of the rig and the crew.
8. Mobile offshore drilling rigs can be broadly classified as 'jack-ups' and 'floaters'. Jack-ups have legs that sit on the seabed and hence are constrained as to the depth of water in which they can operate (generally up to 400 feet). Floaters float on the sea and are kept in position with an anchoring or mooring system (moored rigs) or with onboard computer-controlled thrusters (dynamically positioned rigs). Floaters comprise of 'semis' (semi-submersibles, with part of the hull submerged during drilling) and drillships (rigs in the shape of a ship). Floaters are capable of operating in water of depths ranging from around 400 feet to over 10,000 feet, depending on their specifications. Globally, both parties provide drilling services with jack-ups as well as floaters.

Product market

9. The parties submitted that the provision of drilling services with jack-ups and floaters form two separate product markets, as they are used mainly in different water depths and hence competition between jack-ups and floaters is rare. This was broadly supported by third parties and is consistent with the OFT's analysis in its report on the acquisition by Transocean Sedco Forex Inc. of R&B Falcon Corporation.¹
10. In the geographic frame of reference that the OFT considers appropriate (see below), the parties do not overlap in the provision of drilling services with jack-ups. No third parties raised concerns specifically in relation to jack-ups. For this reason, the OFT will not consider jack-ups further.
11. Both the parties and third parties noted that floaters have different capabilities, for example in relation to water depth and harsh environment capability. Floaters that are capable of operating in deep water and harsh environments can and do also operate in shallower water and more benign environments and hence form a constraint on floaters that are less capable.
12. The only suggested segmentation of the product scope of the floater frame of reference was in relation to ultra-deep water (UDW) rigs. Neither the parties nor third parties suggested other segmentations of the product scope of the floater frame of reference and no concerns were raised about the merger in relation to any particular type of floaters except for UDW rigs. UDW rigs are floaters that are capable of working in water with a depth of more than around 7,000 to 7,500 feet. One of the parties' customers argued that UDW rigs constitute a separate product market, because only UDW rigs can be used in ultra-deep water and UDW rigs are too expensive to be used in water that is less deep given the high opportunity cost.
13. The parties submitted that although currently there is sufficient demand for UDW rigs to ensure that they are used only in ultra-deep water, this could well change over time, as it is expected that the supply of UDW rigs will match or exceed demand due to the large number of UDW rigs currently under construction. The parties also noted that UDW rigs incorporate a

¹ Report by the then Director General of Fair Trading to the then Secretary of State for Trade and Industry of 8 February 2001.

number of improvements on older rigs, including the latest drilling technology, which makes them more efficient than older rigs in the fundamental tasks of drilling and can reduce the number of days required for drilling. This can justify a higher dayrate for using UDW rigs in water that is less deep. Also, the parties pointed out that the very fact that UDW rigs are expensive to build means that contractors have a strong incentive to keep them working, if necessary in water that is less deep. The parties submitted that currently a significant number of UDW rigs is working in water that is less deep. Finally, although the parties noted that some non-UDW rigs can compete with UDW rigs through the use of various technologies (such as lightweight risers and artificial seabeds), they accept that such rigs do not provide a constraint for the use of UDW rigs in ultra-deep water.

14. Hence, while UDW rigs may in some circumstances work in water that is less deep than ultra-deep water, non-UDW rigs do not form a significant constraint for drilling in ultra-deep water. Therefore, the OFT takes a cautious approach and considers UDW rigs as a separate product frame of reference.
15. For the reasons set out above, the OFT considers that floaters and UDW rigs form appropriate product frames of reference.

Geographic market

16. Ordinarily, application of the hypothetical monopolist test for geographic market definition would begin with the narrowest conceivable definition, in this case, the UK continental shelf, discussed below. However, for convenience and because the numerous supply-side substitution arguments advanced by the parties in favour of wider definitions are also relevant to the analysis of entry, the following considers the robustness of wider geographic definitions first.
17. The parties submitted that there is a worldwide market for mobile offshore drilling services. They argued that rigs are mobile by design and can be moved to any area of the world within the time that typically exists between the award and start of a contract. They also submitted data showing that a number of rigs had moved between regions.

18. However, several third parties noted that the costs of relocating rigs could be significant. Some customers argued for a frame of reference for Northwest Europe (NW Europe)² and, separately, the UK continental shelf (UKCS). In the OFT's report on the acquisition by Transocean Sedco Forex Inc. of R&B Falcon Corporation,³ the OFT noted that the geographic market had a global dimension but focussed its analysis on the northern stretch of the North Sea and on the Norwegian Sea. This was because exceptionally hostile conditions prevailed in these waters, UK and Norwegian regulations excluded floaters that were not built to certain design specifications, and there were high sunk costs in modifying floaters to ensure they met the required standards.

Northwest Europe

19. The parties provided the OFT with estimates of the cost of moving floaters into NW Europe from West Africa and the Gulf of Mexico, including the opportunity cost of missed revenues during relocation (in the current tight market conditions this cost is generally paid by customers in the form of the agreed contract dayrate). These costs were estimated at US\$13 million, which amounts to five and 10 per cent of the total cost of a typical UKCS contract with a duration of two years and one year respectively. One of the parties' customers also provided estimates of relocation costs, which were broadly similar.
20. One of the parties' customers argued that, in addition to the costs of moving floaters, floaters that are moved into NW Europe from elsewhere in the world require modification to comply with the relatively strict regulatory requirements and the relatively harsh conditions in NW Europe. The customer estimated these modification costs at US\$24 million (including opportunity cost in the form of the dayrate generally paid during the modification period by the customer), which amounts to nine and 19 per cent of the total cost of a typical contract with a duration of two years and one year respectively. Also, this customer argued that its experience with relocating a floater into NW Europe demonstrated that for a certain period immediately after relocation there could be a substantial efficiency

² Northwest Europe is defined by the parties as consisting of the North Sea, the Norwegian Sea, the Barents Sea, the Faeroes and the part of the UK continental shelf that is west of the Shetland Isles.

³ Report by the then Director General of Fair Trading to the then Secretary of State for Trade and Industry of 8 February 2001.

disadvantage compared to floaters that were already located in NW Europe. Another customer also noted that given the more benign conditions in many other parts of the world, some contractors will no longer keep old floaters up to the standards required for NW Europe. One of the parties' competitors noted that, additionally, movement of personnel carries a significant cost and that local employment regulations are a large impediment to the free movement of personnel.

21. The parties acknowledged the environmental, operating and regulatory differences between NW Europe and other regions of the world. They also accept that, as a result, not all floaters currently operating in more benign waters are capable of working in NW Europe. While the parties acknowledged that modifications were sometimes required before a floater could operate in NW Europe, they disputed that this was generally the case and that any modifications were necessarily connected to the floater's relocation. According to the parties, there is a large number of floaters that have been moved out of NW Europe in the past and can be moved back in response to an increase in dayrates in NW Europe (see further at paragraph 57 below). In addition, the parties argued that there are many floaters that have not worked in NW Europe recently but can be easily modified to produce NW Europe capability. The parties stated that of the five floaters that moved into the UKCS from outside NW Europe since 2002, two floaters did not require modification at all. While the other three floaters required some service time, the parties noted that it is not clear if this was related to relocation.

22. The parties submitted data on the number of floaters that moved between NW Europe and elsewhere in the world since 2002. They argued that these data demonstrate that customers in NW Europe are not limited in their choice of competing floaters to those that are located in NW Europe. The data, which are publicly available and were not disputed by third parties, show in the period between 2002 and 2007 eight floaters moved into NW Europe and 12 floaters moved out, while the average total number of floaters operating in NW Europe in this period was around 38. Around four per cent of the new NW Europe drilling contracts in this period was met by floater movements into NW Europe. The parties noted that in particular during 2004 and 2005, when demand recovered from the downturn in the late 1990s and early 2000s, several floaters moved into NW Europe (two in 2004 and four in 2005, resulting in five and 12 per cent of new drilling contracts being met by floater movements into NW Europe in 2004 and

2005 respectively). However, in 2006 and 2007 no floaters moved into NW Europe at all and two floaters moved out of NW Europe.

23. The parties provided floater dayrate data for NW Europe and other regions between 1991 and 2008⁴ and utilisation data for these regions between 2000 and 2004. They submitted that dayrates in all of these regions exhibit common patterns (for example, dayrates were relatively flat between 2000 and 2004 and steadily rose since 2005) despite a lack of correlation of rig utilisation between the regions and that this demonstrates that NW Europe forms part of a wider market. However, as the parties themselves pointed out, there is increased demand in all areas in the world based on higher oil prices. There has therefore been upward pressure on prices across the world. In these circumstances it is difficult to use the data to draw conclusions as to the geographic frame of reference.
24. The OFT considers that the evidence available to it indicates that the competitive constraint posed by floaters outside NW Europe is insufficient to consider that the appropriate frame of reference should be wider than NW Europe. In particular, the cost of moving floaters alone indicates that the hypothetical monopolist test may be met, because a small but significant price increase (typically five to 10 per cent) may not be prevented by relocation of floaters as the cost of relocation is similar to such a price increase, even before consideration of possible modification costs and initial inefficiency costs. This view is supported by the limited number of floaters that moved into NW Europe since 2002.

UK continental shelf (UKCS)

25. Some customers argued that there is only limited competition between the UKCS and Norwegian waters and that hence these areas should be considered separately. These customers identified some differences between the UKCS and Norwegian waters that were not themselves materially disputed by the parties. Norwegian regulations are stricter than UK regulations. For example, one customer estimated that operating costs in Norwegian waters are higher than in the UKCS by US\$30,000 to US\$40,000 per day, which amounts to around 10 per cent of a typical dayrate due, primarily due to the longer time off the rig that personnel are

⁴ For 2008 this is a forecast based on publicly available information for contracts that have already been awarded.

entitled to. Also, contract durations in Norwegian waters are longer. These are more typically four to five years rather than one to two years in the UKCS, partly due to the more mature character of the UK oil and gas fields.

26. The costs of moving a floater from Norwegian waters into the UKCS are not substantial. The parties estimated that these are at most around US\$1.9 million, including the opportunity cost of missed revenues during relocation (in the current market conditions generally paid by customers in the form of the agreed contract dayrate). This amounts to 0.75 and 1.5 percent of the total cost of a typical UKCS contract with a duration of two years and one year respectively. One of the parties' customers submitted that these proportions are one and two per cent respectively (relocation costs of nearly US\$2.7 million).
27. Two customers submitted that due to the strict Norwegian regulations there are significant upgrade costs to make floaters suitable for working in Norwegian waters. According to one customer, these differences can result in modification costs in the tens of millions of dollars. Another customer estimated modification costs at US\$11.5 million (including opportunity cost in the form of the dayrate generally paid during the modification period by the customer), which amounts to 4.5 and nine per cent of the total cost of a typical UKCS contract with a duration of two years and one year respectively. This customer argued that due to the investments necessary to make floaters capable of working in Norwegian waters and also in view of the longer duration of contracts in Norwegian waters, these floaters are unlikely to move to the UKCS.
28. The parties agreed that floaters in the UKCS cannot easily work in Norwegian waters without significant upgrades. However, they noted that the reverse does not apply, as floaters currently in the Norwegian waters can move to the UKCS without such upgrades. The parties argued that the additional costs of making a floater compliant with Norwegian regulations will have been recovered after two to three years and that margins are not higher in Norwegian waters. They concluded that, therefore, floaters in the Norwegian waters constrain the pricing of floaters in the UKCS, even if this constraint does not apply in the other direction.
29. The parties also argued that a significant number of floaters has in fact moved between the UKCS and other parts of NW Europe. The parties submitted that between 2002 and 2007 18 floaters moved into the UKCS

(six each from Norwegian and Irish waters, one from French waters and five from outside NW Europe) and 23 floaters moved out (eight each to Norwegian and Irish waters, two to French waters and five to outside NW Europe). During this period the average total number of floaters operating in the UKCS was around 22. Around nine per cent of the new UK contracts in this period was met by floater movements into the UKCS from other parts of NW Europe. The equivalent proportion for floaters coming in from only Norwegian waters is around four per cent.

30. The parties submitted floater dayrate data for the UKCS and Norwegian waters between 2000 and 2008.⁵ These data show that during this period relative prices shifted significantly. In 2003, dayrates in Norwegian waters were more than double those in the UKCS, while by 2008 they will be only a little higher (possibly reflecting the higher operating costs in Norwegian waters). If the UKCS was part of the same geographic market as the Norwegian waters, it would typically be expected that over this relatively long period relative prices would have been broadly constant due to scope for substitution when relative prices change. Relative price changes could be explained by changes in relative costs between the UKCS and Norwegian waters, but the OFT did not receive evidence to indicate that this explanation could apply. The parties suggested that the pricing data are unreliable for a number of other reasons, including greater stickiness of Norwegian dayrates due to longer contract durations and the presence of relatively more high-specification floaters in Norwegian waters with higher dayrates. However, the OFT considers that, despite these possible qualifications, relative dayrates in the UKCS appear to have increased significantly compared with dayrates in Norwegian waters. The OFT also notes that the rise in relative UKCS dayrates has not resulted in a substantial move of floaters into the UKCS from Norwegian waters. In fact, while six floaters moved in this direction between 2002 and 2007, eight floaters moved in the other direction. The OFT considers that this evidence is the best proxy for whether sufficient floaters in Norwegian waters would be redeployed to the UKCS to render a hypothetical UKCS monopolist's five to 10 per cent price increase unprofitable. Although it is not inconceivable that the UKCS price level has reached the so-called 'cellophane' point at which there would be substitution from Norway, the better view at this stage of inquiry is that the floater fleet located in

⁵ For 2008 this is a forecast based on publicly available information for contracts that have already been awarded.

Norway does not sufficiently constrain the UKCS fleet to warrant inclusion as part of the same geographic frame of reference.

31. On balance, the OFT therefore considers that there is insufficient evidence available to it to conclude that the appropriate geographic frame of reference is wider than the UKCS. Accordingly, consistent with principles of geographic market definition, the OFT has taken a cautious approach and has assessed the effects of the merger in the UKCS, while also taking into account possible entry into the UKCS of floaters coming from elsewhere in NW Europe or other regions.

UDW rigs

32. With regard to UDW rigs, the customer that argued for a separate product market for UDW rigs submitted that such a market is worldwide. At a minimum, the geographic market for UDW rigs should comprise the main ultra-deep water areas featuring oil and gas exploration, that is, the Gulf of Mexico and in the Atlantic near Brazil and west of Africa. No evidence received suggest a narrower geographic frame of reference and because UK waters are not ultra-deep and the analysis does not turn on the geographic scope of the market for UDW rigs, the OFT's assessment below proceeds on the basis that that the geographic frame of reference for UDW rigs is worldwide.

HORIZONTAL ISSUES

33. Competition between suppliers of floaters generally operates through bidding for contracts. Customers invite competitive tenders from suppliers that may have floaters available around the time the customer intends the work to start. The parties argued that this means that suppliers' historic market shares are unreliable as a guide to relative market power, as the choice available to customers does not depend on the number of floaters owned by each supplier but on having a choice of available floaters at around the time that the customer wants the contract to start. The parties noted that there are six competing floater suppliers in the UKCS. However, the OFT considers that the number of floaters available to the parties and their competitors provides useful information about the scope for competition in the market following the merger.

34. The parties argued that a better measure than the number of floaters would be the number of rig years, which identifies the average number of rigs working every day in a year. The OFT notes that the parties' shares are broadly similar on the basis of both measures (due to current utilisation rates being close to 100 per cent, as confirmed by the parties and third parties), and the OFT considers that the number of floaters is a better broad measure for future competition since it better reflects capacity. The figures provided by the parties were based on independently collected market information and were largely supported by third parties.

Floaters in the UKCS

35. The parties submitted that in the UKCS, Transocean currently has nine floaters and GSF has three floaters out of a total number of 20 floaters, giving shares of 45 and 15 per cent, respectively, with a combined share of 60 per cent.
36. However, one of GSF's floaters (GSF Arctic III) is [] to relocate [] when it comes available from its current contract in the UKCS in February 2008. The parties therefore argued that the increment in the UKCS as a result of the merger amounts to only two floaters. If the GSF Arctic III relocates, the adjusted share of Transocean and GSF will be 47 and 11 per cent respectively, with a combined share of 58 per cent. There is some risk in attaching too much weight to figures holding all other rivals' fleets at constant numbers while adjusting that of GSF, given the (unconfirmed) possibility that other players might also have plans to relocate floaters out of the UKCS.
37. The number of floaters in the UKCS is not expected to change in 2010, except for one additional floater moving into the UKCS in 2008. Also, according to figures provided by the parties, around four floaters designed for NW Europe are currently under construction and may move into the UKCS although they do not yet have contracts UKCS (see further at paragraphs 39 and 40).
38. In the UKCS, the parties' largest competitor, Diamond, currently has three floaters (15 per cent), their next-largest competitor, Dolphin, has two floaters (10 per cent) and there are four competitors with one floater each (five per cent) (Stena, Noble, Petrolia and Ocean Rig). On the basis of the information available to the OFT, these figures are currently expected to be

broadly similar in 2010. Hence, after the merger the parties will have a much larger number of floaters available in the UKCS than their largest competitor (12 floaters (or 11 if the GSF Arctic III will relocate) versus three floaters).

39. Some customers submitted that after the merger the parties will have by far the largest share of the remaining available capacity (i.e., those floaters that are not yet under contract) in the UKCS for the next few years. The parties accepted that they had a significant proportion of floaters coming available, but argued that this is due to the large size of Transocean's fleet and cannot be attributed to the merger. They argued that in fact no competition between the parties will be lost until at least 2010. The two GSF floaters that will remain in the UKCS after the GSF Arctic III moves [] come available in July 2008 and in September 2010. The parties submitted that the first Transocean floater that is not already in advanced negotiations for a contract, does not come available until November 2008. They also noted that by 2010 a number of new floaters designed for NW Europe will have been delivered. Some of these floaters are already under contract for work in the Norwegian waters, but the parties argued that floaters that do not yet have contracts may start work in the UKCS and that the delivery of new floaters for Norwegian waters may result in displacement of older floaters from the Norwegian waters into the UKCS.
40. The parties argued that therefore, even if competition from floaters from outside the UKCS is ignored (this is discussed further at paragraph 57 below), the merger results in only a minimal increase in the parties' share in available capacity and that this cannot result in a substantial lessening of competition. However, the OFT notes that, given the long lead times between contract award and contract start, most of the competition for 2008 has already taken place. Based on information provided by the parties, [] at most only five out of 19 floaters currently operating in the UKCS are still available in 2008, of which one is a GSF floater and two are Transocean floaters. The GSF floater becomes available within around four months of both Transocean floaters. This means that they are in competition, because, as noted by the parties and confirmed by third parties, customers generally have some flexibility in contract start dates. Also, the consequences of the delivery of new floaters by 2010 for competition in the UKCS are uncertain, because these new floaters may be more likely to work in Norwegian waters given the mature nature and short

contract duration of the UKCS, and because older floaters may not move out of Norwegian waters if demand in that area remains high.

41. Almost all of the parties' customers that responded to the OFT expressed a concern that the large difference in the number of available floaters between the parties and their competitors after the merger will mean that the parties are more likely to be the owner of the only available floater(s) and that this will significantly restrict competition and reduce leverage for customers, with higher dayrates, more onerous contract terms (such as the requirement of longer durations) and reduced quality of service as the probable result. Some customers considered that Transocean already has a dominant position in the UKCS and that the merger will only increase Transocean's ability to dictate dayrates. The parties provided information that showed that since around 2004 dayrates have increased significantly across the world, partly in response to higher demand due to higher oil prices. By one measure, during this period dayrates rose in the UKCS from around US\$60,000 (which according to the parties was an unsustainably low level) to around US\$300,000. This was confirmed by third parties.
42. The OFT accepts that in some circumstances 'bidding markets' may require only relatively few participating bidders to generate competitive outcomes. This result is more likely to hold if competing bidders have sufficient (spare) capacity to incentivise them to bid aggressively for all contracts, if competing bidders are relatively homogenous in the proposition they offer to customers, and if contract awards are infrequent.
43. However, in this industry it is generally recognised that capacity utilisation is close to or at 100 per cent and there are no good grounds for the OFT to conclude that downstream demand for oil and gas, and in turn floaters, will subside in the foreseeable future so as to loosen the tightness of supply. Hence, there are floater availability constraints on suppliers' ability to bid in any given contest, and there is little, if any, possibility of expanding supply rapidly.
44. Also, there is some differentiation between bidders with respect to quality and possibly location. All of the parties' customers that responded to the OFT stated that a supplier's experience and safety record were important considerations in selecting a supplier. Some customers noted that an experienced supplier can drill significantly more efficiently. All customers considered the parties to be close competitors, because they both have a

large fleet worldwide and because they are both experienced contractors with a good operational and safety record. Some customers also noted that the parties have actively bid against each other. The parties accepted that they are both experienced operators, but noted that the other contractors currently operating in NW Europe also have significant experience.

45. Bidding data submitted by the parties shows that both parties bid for 18 per cent of contract competitions in the UKCS since 2004. The OFT notes that although this share may seem low compared to other market situations, they reflect the constraints imposed by the limited number of uncontracted floaters and the lack of available spare capacity. The bidding data also shows that there was only one contract in NW Europe that neither party bid for during this period. Transocean bid in 83 per cent of competitions, reflecting its relatively large fleet size. The OFT obtained bidding data from one of the parties' customers that showed that both parties bid for two out of this customer's three possible contracts for the UKCS since 2004. For one of these contracts, there were four other bidders but after evaluation the parties were the top two bidders. For the other contract, there were three other bidders but after evaluation the parties were two of the top three bidders.
46. Another feature of the market is that a bidder offering a floater unsuccessfully in one competition is of course able to bid that asset again in further competitions until it is allocated under a contract. The parties stated that both they and their competitors bid a floater in several tenders and that this creates considerable uncertainty among suppliers as to how many floaters will be bid for any given contract. However, the OFT considers that this can also give suppliers a fall-back option with a likely impact on incentives to bid aggressively in 'early' competitions given that the market is operating close to or at full capacity. Here, the strongest impact would be on Transocean as, by some distance, the largest contractor in the market. This position will be strengthened after the merger.
47. One of the customers also expressed a concern that in any future downturn of the market, the increased size of the parties' combined fleet of floaters after the merger will give them an increased ability to 'mothball' one or more floaters or move them out of the North Sea in order to keep prices at high levels. The OFT considers that the larger post-merger floater fleet may increase the parties' incentive to follow a withholding strategy,

since the benefit of higher prices in the market would accrue across a larger number of remaining active floaters.

48. The parties argued that an additional constraint on them is the possibility that customers will sublet floaters when their work finishes before the end of the contract period. This effectively makes the parties compete with their own floaters. Almost all customers that responded to the OFT indicated that they had sublet a few small number of floaters both to and from other customers in the recent past and that they would consider doing so again in the future. However, some customers also indicated that they were reluctant to rely on sublets. Customers become aware of the availability of sublets generally only at a late stage, when most contracts have already been awarded. The parties submitted data showing that in 2007 sublets were forecast to represent around 12 per cent of the total number of floater activity in the UKCS. However, these data also show that in 2005 and 2006, when the market was already tightening, this figure was only three per cent. The OFT considers that subletting does not take place on a scale that is sufficiently large and sufficiently predictable to constitute a constraint strong enough to prevent any substantial lessening of competition.

UDW rigs

49. One of the parties' customers submitted that Transocean and GSF currently have 15 and five UDW rigs respectively out of a total number of 35 UDW rigs. The customer expressed a concern that therefore the merger will result in a combined share of 58 per cent (increment 14 per cent). However, this customer acknowledged that, as submitted by the parties, many new UDW rigs are being built which will be delivered in the coming years. According to the customer, as a result Transocean and GSF will have 21 and seven UDW rigs respectively out of a total number of 93 UDW rigs in 2011, resulting in a combined share of 31 per cent (increment eight per cent).
50. The customer argued that a significant share of the new UDW rigs (30 rigs, which will amount to 33 per cent of UDW rigs in 2011) are being built for small contractors which have very limited demonstrated experience of offshore drilling, while Transocean and GSF are among the most experienced UDW rig contractors. The customer also doubted whether many new contractors could staff their UDW rigs given the shortage of

skilled crews. Hence, this customer considered that many new-build UDW rigs will not form a strong constraint on the parties after the merger. However, the parties noted that a significant number of the new-build UDW rigs in fact already have contracts.

51. The customer argued that the loss of competition resulting from the merger will lead to higher prices for UDW rigs. According to the customer, prices of floaters in the UKCS are affected by the prices of UDW rigs, because a UDW rig price increase will draw rigs away from the North Sea and prices of non-UDW floaters are benchmarked against the prices of UDW rigs. The parties contested the argument that prices are benchmarked. No other market participants raised concerns in relation to merger effects in the supply of UDW rigs and none provided corroboration of this argument of the one customer in question.
52. The parties also noted that the United States Department of Justice (DOJ) thoroughly examined the effects of the merger on competition between providers of UDW rigs. One of the areas where UDW rigs operate is in the Gulf of Mexico. The DOJ has closed its investigation of the merger.
53. From the above, it is clear that in particular the expansion of capacity in UDW rigs and the lack of corroborating concerns leave the one customer's claim – that the merger will lead to adverse effects in UDW rigs – with very little support. In any event, the OFT must assess the effects of mergers on competition within a market or markets in the UK. UDW rigs do not operate in the UKCS and on the evidence available to the OFT it is not possible to establish a sufficiently clear link between potential price increases of UDW rigs and price increases of floaters in the UKCS. The OFT does not therefore believe that there is a realistic prospect that any effects of the merger on competition between providers of UDW rigs will substantially lessen competition within a market or markets in the UK.

Barriers to entry and expansion

54. The parties argued that there are no substantial barriers to entry or expansion. The parties' competitors also noted that new entry is relatively easy. However, all of the parties' customers that responded to the OFT submitted that barriers to entry are high. The main reasons given by customers were the very high cost of building a new floater, the large shortage of skilled personnel, and the need to acquire a good reputation on

the basis of experience and a proven track record before an entrant is a viable competitor. The mature nature of the UKCS was also thought to limit incentives to build floaters with matching specifications, with likely expansion of drilling activity expected to focus on ultra-deep water areas.

55. The parties provided the names of a number of entrants that are building new floaters, in particular UDW rigs. Many of these are referred to as 'speculative' floater companies on the basis that they invested in floater building without a firm commitment in place for contracts, although the parties noted that approximately 70 per cent of floaters under construction currently have contracts. However, some customers noted that some of these entrants do not have sufficient experience and track record such as to constitute a strong constraint on the parties.
56. The parties also submitted that customers can and do sponsor new entry, for example by offering a contract for a period that is long enough to recover a significant part of the capital investment required for building a new floater. They also noted that some large state-owned oil companies (national oil companies) have their own floaters. Some customers stated that they could sponsor entry, but all customers that responded to the OFT noted that sponsoring was difficult, in particular in a mature area like the UKCS where contract durations are relatively short. None of the parties' customers that responded to the OFT saw in-house provision as a viable option given the required size of capital investment and the risk of owning a floater that after some time may no longer be needed for a customer's drilling requirements. The OFT notes that national oil companies are not active in the UKCS.
57. In addition, the parties submitted that floaters can enter from elsewhere in the world. They noted that there are 126 floaters in the world with designs capable of operating in NW Europe, 68 of which have worked in NW Europe at some point since 1999. Of these, 38 floaters remain in NW Europe and the other 30 work in other locations. The parties noted that these figures were roughly similar to a list of North Sea-capable rigs recently and independently compiled by ODS-Petrodata (a market intelligence agency). However, as set out in the section on the geographic frame of reference (paragraphs 19 to 21), relocating these floaters to NW Europe involves significant relocation and possibly modification costs. Also, according to some customers, a move would not be worthwhile in the current tight market in other parts of the world where conditions are more

benign. In addition, as one customer submitted, even floaters that have worked in the North Sea in the past may be, in its experience, subject to significant initial inefficiencies.

Buyer power

58. The parties submitted that countervailing buyer power will be a significant additional constraint after the merger. Many of the parties' customers are very large oil companies, which have recently undergone consolidation, although the parties acknowledged that given the diminishing size of reserves in the UKCS a greater role will be played by relatively smaller oil companies. The parties also noted that customers can sponsor entry and that some national oil companies have their own drilling rigs.
59. However, one of the parties' customers noted that due to the lack of spare capacity, power in the market is in the hands of suppliers rather than buyers, even if these buyers are large oil companies. As set out above, most of the parties' customers did not consider sponsoring entry to be a preferred option and no customer believed in-house provision of drilling services was viable. The OFT notes in this regard that customers have not been able to prevent the significant price increases in the past few years and that almost all customers were concerned about the effects of the merger.

VERTICAL ISSUES

60. The parties are not vertically integrated in any material respect. No vertical concerns were raised by any third party.

THIRD PARTY VIEWS

61. Virtually all of the parties' customers that responded to the OFT expressed concerns about the merger. One of these customers also noted that the merger will not result in any customer benefits. None of the parties' competitors that responded to the OFT expressed concerns.
62. One of the parties' customers also raised a concern about the merger's impact on companies that build, maintain and repair rigs. However, none of these companies expressed concerns to the OFT and none of the parties'

other customers expressed concerns in this respect. Hence, there is no evidence available to the OFT to indicate that the merger will adversely affect competition in building, maintaining or repairing rigs.

ASSESSMENT

63. Transocean and GSF are active worldwide in the provision of offshore contract drilling services to oil and gas companies with mobile offshore drilling rigs known as jack-ups and floaters. In NW Europe they overlap only in floaters. They also overlap in UDW rigs, which are only used outside of NW Europe.
64. Within NW Europe, the principal areas for oil and gas exploration are UK and Norwegian waters. The available evidence creates serious doubts as to whether the geographic market in this case is wider than the UK continental shelf. Norwegian regulations are stricter, resulting in higher operating costs, and the duration of contracts in Norwegian waters is longer than in the UKCS. Critically, since 2003 relative dayrates in the UKCS have increased substantially compared to dayrates in Norwegian waters, but this has not resulted in a substantial move of floaters from Norwegian waters into the UKCS. This evidence is the best proxy for whether sufficient floaters in Norwegian waters would be redeployed to the UKCS to render a hypothetical UKCS monopolist's five to 10 per cent price increase unprofitable. Accordingly, at this stage of inquiry there is insufficient evidence to conclude that the floater fleet located in Norway sufficiently constrains the UKCS fleet to warrant inclusion as part of the same geographic market.
65. In the UKCS Transocean has nine floaters and GSF will have two floaters if one of its floaters currently in the UKCS will [], as expected by the parties, [] work outside of NW Europe. This amounts to 58 per cent of floaters in the UKCS with an increment of 11 per cent. The parties' fleet is substantially larger than the fleet of the parties' largest competitor in the UKCS. The parties will also have the largest share of available capacity for future contracts.
66. Competition between suppliers of floaters generally operates through bidding for contracts. However, the OFT does not consider that in this case this means that the presence of other suppliers is necessarily sufficient to

preserve the same degree of competition going forward as would prevail absent the merger. The parties appear to be sufficiently close competitors to raise unilateral effects concerns because capacity utilisation is close to or at 100 per cent and there is little, if any, scope for expanding supply rapidly. Indeed, some customers argued that the parties were close competitors, which was not contradicted by bidding data that the OFT received (although relatively limited), and floaters are generally bid in several competitions. As Transocean already has the largest fleet and the size of its fleet will be even larger after the merger, this may reduce the parties' incentive to bid aggressively in 'early' competitions given that the market is operating at full capacity. The merged firm may also have an increased incentive to withhold floaters from the market to increase prices.

67. The scope for entry and expansion is limited. It is very costly and it generally takes two to three years to build a new floater. Entry may occur with existing floaters currently operating outside of the UKCS. However, in view of the costs of relocating and possibly modifying floaters, and potentially inefficiency costs, the maturity of the UKCS and the fact that the market is tight in other parts of the world, it is not clear that the threat of entry is sufficient to constrain the parties' behaviour after the merger.
68. Although the parties' customers are generally large oil companies, it is not clear that there is sufficient countervailing buyer power to constrain supplier behaviour because, among other things, sponsored entry and self-supply are insufficiently viable counterstrategies to the exercise of market power in the supply of rigs. This conclusion is supported by the fact that almost all customers that responded to the OFT expressed concerns about the merger, and that customers have not been able to prevent very large price increases in the past few years.
69. Consequently, the OFT believes 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.
70. The parties also currently have a combined share of around 58 per cent of UDW rigs, although their share will be reduced significantly to a combined share of around 31 per cent as UDW rigs currently under construction are being delivered in the next few years. As UDW rigs do not operate in the UKCS and there is insufficient evidence of a clear link between prices of UDW rigs and prices of floaters in the UKCS, the OFT does not consider

that there is a realistic prospect that any effects of the merger on competition between providers of UDW rigs will substantially lessen competition in the UK.

UNDERTAKINGS IN LIEU

71. Where the duty to make a reference under section 33(1) of the Act applies, pursuant to section 73(2) of the Act the OFT may, instead of making such a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which has or may have resulted from it or may be expected to result from it, accept from such of the parties concerned undertakings as it considers appropriate. In addition, pursuant to section 73(3) of the Act, in considering whether to exercise its discretion to accept such undertakings, the OFT is required, in particular, to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the substantial lessening of competition and any adverse effects resulting from it.
72. The OFT has therefore considered whether there might be undertakings in lieu of reference which would address the competition concerns outlined above. The OFT's *Mergers Substantive Assessment Guidance* (paragraph 8.3) states that, 'In order to accept undertakings in lieu of reference, the OFT must be confident that the competition concerns identified can be resolved by means of undertakings without the need for further investigation. Undertakings in lieu of reference are therefore appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation.' The OFT considers that a proposal that restores competition – in the sense of reversing the increment in the supply of floaters which can be presumed to have operated in the UKCS absent the merger – would be a suitably clear-cut remedy in this case.
73. The parties have indicated that in order to remedy any substantial lessening of competition identified by the OFT and to avoid a reference to the Competition Commission, they would be prepared to offer undertakings in lieu. The parties therefore offered to divest either only the GSF floater that comes available in July 2008 (the GSF Arctic II), or both GSF floaters that will operate in the UKCS if the GSF Arctic III moves away (the GSF Arctic II and GSF Arctic IV).

74. The parties argued that divestment of the GSF Arctic II should be sufficient to address any competition concerns, because by the time the GSF Arctic IV comes available, in September 2010, a number of new floaters will have been delivered that are specifically targeted at NW Europe. However, the OFT notes that these floaters may be more likely to work in Norwegian waters and that any resulting displacement of older floaters to the UKCS is too uncertain to alleviate the competition concerns in a clear-cut manner (see paragraph 40).
75. The parties' offer to divest both the GSF Arctic II and the GSF Arctic IV removes the entire anticipated increase in fleet size resulting from the merger in the UKCS, provided that the GSF Arctic III, as currently expected, relocates away from the UKCS. The OFT will seek verification that this will occur []. [If] the GSF Arctic III is not relocated, the OFT is minded to consider it should form part of the divestiture package for the remedy to qualify as a clear-cut undertaking in lieu.
76. The parties consider that buyers of these floaters will not have difficulties in recruiting crew in the UKCS, but the parties noted that they were also prepared to give buyers access to the floaters' existing crew to give them an opportunity to persuade the crew to change employment. The OFT has suspended the duty to refer on the premise that it will consider representations from candidate purchasers on this issue [].
77. For these reasons, the OFT considers that the undertaking to divest both the GSF Arctic II and the GSF Arctic IV and give buyers access to the floaters' crew is sufficiently clear cut to restore competition and thereby remedy the concerns in as comprehensive a manner as is reasonable and practicable.

DECISION

78. The OFT has therefore decided to refer the anticipated merger between Transocean and GSF to the Competition Commission pursuant to section 33 of the Act. However, the OFT's duty to refer is suspended because the OFT is considering whether to accept undertakings in lieu of reference from Transocean and GSF pursuant to section 73 of the Act.