

Completed acquisition by Govia Limited of the West Midlands passenger rail franchise

No. ME/3319/07

The OFT's decision on reference under section 22(1) given on 29 November 2007. Full text of decision published 10 December 2007.

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## PARTIES

1. **Govia Limited** ('Govia') is a joint-venture company owned by the Go-Ahead Group Plc and by Keolis (UK) Limited (a wholly owned subsidiary of Keolis SA). Go-Ahead and Keolis own 65 and 35 per cent of Govia respectively.
2. Go-Ahead is a UK based transport group. It operates train services through its joint ownership of Govia, which is currently running the South-Eastern Franchise and the New Southern Railway Franchise. Go-Ahead also operates bus services, primarily in urban locations such as in and around Birmingham *via* its wholly owned subsidiary **Go West Midlands Limited** ('Go West Midlands').
3. Keolis SA is a leading European multimodal transport operator. It is active primarily in France and also has interests in the UK rail industry,<sup>1</sup> Scandinavia, Germany and Canada.
4. Govia is a shell joint-venture company whose purpose is to own **train operating companies** ('TOC's: companies which run train companies in the UK) on behalf of its parent companies.
5. **The West Midlands Passenger Rail Franchise** (the 'WM Franchise') has been created by the **UK Department for Transport** ('DfT') by amalgamating parts of the Silverlink and the Central Trains passenger rail Franchises. The WM Franchise area is primarily centred around Birmingham and the London commuter market, but also includes some routes north to Liverpool.

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<sup>1</sup> Through Govia and through First/Keolis Holdings Limited, a joint venture between FirstGroup plc and Keolis (UK) Limited, running the Transpennine Express.

## **TRANSACTION**

6. The transaction concerns the award of the WM Franchise to London & Birmingham Railway Limited ('LBR'), a TOC owned by Govia. The franchise agreement was signed on 20 June 2007 and commenced on 11 November 2007. LBR has gained sole control over the WM Franchise.
7. The transaction qualifies for review under the EC Merger Regulation. However, by way of a reasoned submission filed with the European Commission on 16 August 2007, the parties have obtained agreement for the transaction to be examined in its entirety by the UK competition authorities. The European Commission announced its decision to refer the case to the OFT on 20 September 2007 on the basis that the transaction may significantly affect competition in distinct markets in the UK. The extended 45 working-day statutory deadline pursuant to section 34A of the Enterprise Act 2002 (the Act) expires on 29 November 2007.

## **JURISDICTION**

8. The award of a rail franchise constitutes the acquisition of control of an enterprise by virtue of section 66(3) of the Railways act 1993. Therefore, LBR and the WM Franchise have ceased to be distinct. The parts of the Silverlink County and Central Trains Passenger Rail Franchises which form the WM Franchise have generated a turnover in excess of £70 million over the last financial year. Accordingly, a relevant merger situation has been created for the purpose of section 23 (1)(b) of the Act.

## **COUNTERFACTUAL**

9. Applying the substantial lessening of competition test involves comparing prospects for competition with and without the merger. In the majority of merger cases, the natural basis for assessing prospects for competition in the absence of the merger - the 'counterfactual' - is given by conditions prevailing pre-merger (the '*status quo ante*'). However, the CC has established in previous reports<sup>2</sup> that transactions involving the award of a rail franchise are an example of where the *status quo ante* is not the correct counterfactual. The main reason being that the franchise agreement will terminate and it is not possible to reach an expectation that the current franchise holder would continue to operate the franchise.
10. The parties submit that incumbent franchisees for Silverlink County and Central Trains (parts of which now make up the WM Franchise) were

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<sup>2</sup> See the CC Reports in: *NEG/Greater Anglia*, November 2004, para.5.1 (a report on the acquisition by National Express Group plc of the Greater Anglia franchise); *First/ScotRail*, June 2004, para.5.2 (a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise); *First/GWF*, March 2006, para.4.3 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

owned by National Express Group plc ('National Express'), which also operates an estimated 85 per cent of bus services in Birmingham through its subsidiary Travel West Midlands ('TWM'). In this respect, third parties also indicate that the transaction will significantly improve the overall competition conditions compared with the previous situation where the leading bus operator in the WM Franchise area, TWM and the incumbent franchisees (Silverlink County and Central Trains) were both owned by the same company, National Express.

11. However, as established by the CC in its *First/GWF* report<sup>3</sup>, the OFT is of the view that the appropriate counterfactual is not the continued operation by the incumbent but the award of the franchise either to a company that would raise no competition concerns or to one in respect of which any competition concerns would be remedied through behavioural remedies.

## FRAME OF REFERENCE

12. The parties submit that the transaction at hand results in two types of overlaps: (i) a rail on rail overlap on a single flow (between Watford Junction and Harrow & Wealdstone) operated by the WM Franchise and the New Southern Railway Franchise ('the Southern Franchise') (also owned by Govia) and (ii) rail on bus overlaps concerning 30 flows on which both the WM Franchise and Go West Midlands (owned by Go-Ahead) operate.

### Product market

13. As stated in previous OFT decisions<sup>4</sup>, the prospect of substitution between rail and other forms of transport for a given journey is specific to the routes and passenger profiles in question. In the *FirstGroup/GWF* report, the CC refers to the different factors upon which passengers' choice of travel mode relies. These include the cost of journey, the journey time, the time spent travelling from the final station or stop to the passenger's ultimate destination, the frequency and directness of the service available, the ease of interchange, and finally other factors such as personal preferences.<sup>5</sup> The parties to the present transaction as well as third parties agree that the substitutability of alternative forms of transport depends on the flow in question.

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<sup>3</sup> CC report in *First/GWF*, March 2006, para.4.6 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

<sup>4</sup> Anticipated acquisition by FirstGroup PLC of the Greater Western Passenger Rail Franchise of 30 September 2005, para.13; Anticipated acquisition by South Eastern Railways Limited of the Integrated Kent Rail Franchise of 31 March 2005, para.8.

<sup>5</sup> CC report in *First/GWF*, March 2006, para.5.22 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

14. As regards private transport, the CC<sup>6</sup> and the OFT<sup>7</sup> have indicated previously that there is limited substitutability between public and private transport in response to changes in relative price, although the exact extent of substitutability varies depending on, among other things, the level of car ownership in the particular area and whether the relevant journey is urban or rural. The parties submit and third parties corroborate that in the area concerned by the WM Franchise, private car constitutes a credible alternative to public transport services. However, no material evidence was put to the OFT in this respect.
15. As regards the substitutability between bus and rail services, the CC noted in *First/GWF*<sup>8</sup> that, according to general elasticity evidence, separate markets may exist for bus travel and rail travel. The CC concluded however that trains and local buses at least may be substitutable on some specific flows. The parties to the present transaction submit that on shorter journeys (in contrast to longer journeys such as Birmingham - London or Birmingham - Liverpool) bus services could theoretically be viewed as an alternative to rail. Some third parties report the existence of limited competition between bus and rail operations in the WM Franchise area. They indicate that in this area bus and rail services are more complementary to each other than they are substitutable, given that the rail network offers town-to-town journeys whereas the bus network tends to focus on town networks and to serve the smaller communities in between.
16. Given the route and passenger-specific nature of substitutability between different types of passenger transport on flows and in light of the short distances covered by the specific overlapping flows, the OFT considers the supply of all public transport services for the purpose of assessing the competitive effect of the present transaction.

### **Geographic market**

17. In making a journey, passengers travel from a particular point of origin to a specific destination. Past CC reports<sup>9</sup> and OFT decisions<sup>10</sup> have concluded that point-to-point public transport journeys are the relevant geographic frames of reference for competition assessment in relation to bus on rail

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<sup>6</sup> *NEG/Greater Anglia*, November 2004, para.4.5 (a report on the acquisition by National Express Group plc of the Greater Anglia franchise); *First/ScotRail*, June 2004, para.4.2 (a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise).

<sup>7</sup> Anticipated acquisition by FirstGroup PLC of the Greater Western Passenger Rail Franchise of 30 September 2005, para.14.

<sup>8</sup> CC report in *First/GWF*, March 2006, para.5.23 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

<sup>9</sup> For example the CC report in *First/GWF*, March 2006, para.5.32 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

<sup>10</sup> Anticipated acquisition by FirstGroup PLC of the Greater Western Passenger Rail Franchise of 30 September 2005, para.22; Anticipated acquisition by South Eastern Railways Limited of the Integrated Kent Rail Franchise of 31 March 2005, para.15.

overlaps. Additionally, point-to-point frames of reference have consistently been employed in relation to various other modal combinations such as coach on rail and rail on rail overlaps.

18. In the absence of evidence in the present case suggesting a different approach and in accordance with the parties' submission, the OFT assesses the competitive effects of the present transaction on the basis of point to point journeys, also known as 'flows'.
19. Accordingly, the transaction is assessed on the basis of frames of reference which relate to the provision of public transport services between specified origin/destination points (flows).

## **HORIZONTAL ISSUES**

### **Impact of regulation**

20. Before considering the impact of the merger on individual overlap flows, the OFT notes that the rail franchise regulatory regime applies to the WM Franchise and directly impacts on the commercial freedom of the franchise operator through tight fare and service level regulation. Regulated revenue for the WM Franchise accounts for 64 per cent of total revenue and is therefore significantly higher than the national average of regulated revenue (about 40 per cent).

### **Rail on rail overlap**

21. The parties submit that the transaction gives rise to a single rail on rail overlap between the WM Franchise and the Southern Franchise (both Govia-owned franchises) on the Harrow - Watford Junction flow. The flow accounts for a very small proportion of revenues and passengers (below five per cent) on the relevant Govia-operated routes.
22. The information provided by the parties shows that on the identified overlapping flow, Transport for London (TfL - London Overground) runs departures as frequent (three trains per hour) as the combined services operated by the WM Franchise and the Southern Franchise, and that from January 2008, TfL - London Overground will be responsible as the lead operator for setting the fares between Harrow and Watford Junction. The parties also submit that all fares are inter-available so that neither the WM Franchise nor the Southern Franchise will exercise price setting powers.
23. In light of the above, the OFT considers that the transaction does not result in a substantial lessening of competition on the specific flow between Harrow and Watford Junction.

## Rail on bus overlaps

24. The parties identify some 30 flows where Go West Midlands' bus services overlap with the WM Franchise.
25. As identified in past cases,<sup>11</sup> the main concern arising from bus on rail overlaps relates to the possible incentive for the merged entity to raise bus fares or reduce bus frequencies, with a view to shifting passengers from bus to rail. According to such a theory of harm, revenues from passengers responding to a price increase (or a decrease in frequency) by switching away from bus services to rail services are retained by the merged entity as opposed to being lost to another operator under the counterfactual.
26. In the present case, the parties identify 20 overlapping flows on which other bus companies operate credible alternative services for passengers if Go West Midlands were to increase prices or reduce service levels. The OFT and the CC have decided in past cases that the extent to which a given overlapping flow gives rise to a concern depends, among other factors, on the existence of another bus operator on that particular flow. If an effective bus operator is present on the specific flow, passengers are expected to be more likely to switch to the competing bus service than to switch to rail: in the *FirstGroup/GWF* case, the CC considered that competition concerns arose only on those overlapping flows where FirstGroup would become the sole or the principal provider of public transport.
27. Further, other operators in past cases have been considered as providing sufficient competition to prevent the merged entity from increasing fares or reducing frequency when they operated with a frequency of at least half that of the merged entity. In *FirstGroup/GWF*, competition concerns were dismissed on those flows where other competitors operated a service every hour compared to a FirstGroup service every half hour.<sup>12</sup> In the *ScotRail* case, an additional criterion was used for those FirstGroup services which were run with at least one bus every ten minutes, namely that the expected headway of the other operator's service should be no more than ten minutes greater than the expected headway of FirstGroup services.<sup>13</sup>
28. According to the information provided by the parties in relation to these 20 identified flows, TWM and the FirstGroup (First) operate (respectively on

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<sup>11</sup>Anticipated acquisition by FirstGroup PLC of the Greater Western Passenger Rail Franchise of 30 September 2005, para.29; Anticipated acquisition by South Eastern Railways Limited of the Integrated Kent Rail Franchise of 31 March 2005, para.22; CC report in *First/GWF*, March 2006, para.5.45 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

<sup>12</sup> CC report in *First/GWF*, March 2006, para.5.38 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

<sup>13</sup> CC report in *First/ScotRail*, June 2004, para.6.12 (a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise).

17 and 3 flows) comparable or even more frequent services than those provided by Go West Midlands. In this respect, the OFT notes that TWM forms part of the UK Bus Division of National Express and is regarded by third parties to the transaction as operating the leading local bus network in the WM Franchise area. According to its website, TWM is one of the largest bus operators in Europe operating over 500 bus routes. It runs the UK's largest urban bus network outside London, with a fleet of 1,600 buses. According to the parties' estimate, TWM operates 85 per cent of bus services in Birmingham.

29. In view of the above, the OFT considers that the competitive constraint provided by other bus companies on each of the 20 flows significantly reduces the incentive for Go West Midlands to raise prices or to lower service levels, so that no credible theory of harm arises on these specified frames of reference.
30. Finally, the parties submit that the remaining overlapping flows (ten out of the 30 identified) belong to partially tendered routes on which Go West Midlands operates tendered services only, while other bus operators, namely TWM and First operate additional services commercially. In this context and given the information provided by the parties in relation to GO West Midlands's tendered services,<sup>14</sup> the OFT considers that the latter is not in a position to adjust fares or service levels on any of these 10 specific flows.

## **Conclusion**

31. In light of the above and in the absence of any evidence or third party comments pointing to the contrary, the OFT believes that the transaction does not give rise to a substantial lessening of competition on any of the identified bus on rail overlapping flows.

## **Barriers to entry and expansion**

32. The parties submit that barriers to entry and expansion in the rail sector within the WM Franchise area are high given the regulated nature of rail services in general, the absence of any anticipated new franchise and severe capacity limitations for track access in the WM Franchise area.
33. However, the parties submit and third parties corroborate that in the bus sector barriers to entry and expansion are low, as illustrated by the substantial numbers of small independent bus operators across the West Midlands.

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<sup>14</sup> Tender documents which are binding upon Go West Midlands specify the route, the frequency, the vehicle type and the maximum fare for the route.

34. In any event, it is not necessary for the OFT to conclude on the nature of barriers to entry and expansion for the purposes of the present analysis, given the absence of competitive concerns raised by the transaction at hand.

## **THIRD PARTY VIEWS**

35. A number of third party comments have been sought in relation to this transaction. None of them expressed any concern. Some of them believe that the transaction will improve competition in the WM Franchise area as Go-Ahead only has a small foothold in the local bus services in comparison to National Express, who is the leading operator in the area.

## **ASSESSMENT**

36. The impact of the present transaction is assessed on the basis of the provision of public transport services between specified origin/destination points.
37. The parties identify a single rail on rail overlapping flow on which the merged entity, they submit, will not have any price setting powers. Indeed, another operator, TfL is responsible for setting the fares and runs departures as frequent as those supplied by the merged entity. The OFT therefore believes that the transaction does not give rise to any competition concern on the rail on rail overlapping flow.
38. The parties also identify a number of rail on bus overlapping flows on the majority of which the leading bus operator TWM operates services at comparable or even higher frequency than the services run by the merged entity. Additionally, a number of overlapping flows are covered by routes on which the merged entity operates under tender only. Consequently, the OFT considers that the merged entity is not in a position to profitably increase bus prices or lower service levels on these flows.
39. Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

## **DECISION**

40. This merger will therefore not be referred to the Competition Commission under section 22(1) of the Act.