

Anticipated acquisition by London and South Eastern Railway, a wholly owned subsidiary of Govia Limited, of the Integrated Kent Rail Franchise

The OFT's decision on reference under section 33(1) given on 28 March 2006. Full text of decision published 4 April 2006.

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**PARTIES**

1. **Govia Limited (Govia)** is a rail franchise holding company. It was formed as a joint venture between The Go-Ahead Group Plc (Go-Ahead) and Keolis (UK) Limited (a subsidiary of Keolis SA), which have shareholdings in Govia of 65 per cent and 35 per cent respectively. Govia will acquire the Integrated Kent Rail Franchise through its wholly owned subsidiary, London and South Eastern Railway (LSER).
2. **The Integrated Kent Rail Franchise (IKF)** will include passenger rail services on the network currently operated by South Eastern Trains (SET), a subsidiary of the Strategic Rail Authority (SRA). IKF is a commuter network serving several areas around the South East of England, parts of Greater London and several London termini. IKF will also include new domestic high-speed services from London St Pancras, making use of the Channel Tunnel Rail Link. SET's turnover for the year ended 31 March 2005 was £443.3 million.

**TRANSACTION**

3. Govia (through LSER) was named the preferred bidder for IKF on 30 November 2005. IKF is due to commence on 1 April 2006 and will run for six years, although the contract allows for an extension of two years if performance targets are met. Alternatively, in the event of a delay to the start of the new high speed services using the Channel Tunnel Rail Link, the franchise may be extended by two years.
4. A satisfactory notification was submitted on 2 February 2006. Therefore the administrative deadline is 30 March 2006. This case qualifies for investigation under the ECMR, however the parties requested the Commission to refer the case

to the OFT under Article 4(4) of the ECMR. This was granted by the Commission on 30 January 2006 on the grounds that point-to-point passenger transport markets were local in scope and that none of the overlaps could be considered a substantial part of the common market.

## **JURISDICTION**

5. The award of a rail franchise constitutes an acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993 (as amended). Therefore as a result of this transaction, Govia (through LSER) and IKF will cease to be distinct. The UK turnover of IKF 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.

## **RELEVANT MARKET**

6. This merger gives rise to rail on rail overlaps as Govia currently operates the Southern franchise through New Southern Railway Limited (Southern).<sup>1</sup> The following overlaps have been identified:
  - (a) between Southern and IKF (currently operated by SET) on various overlapping flows between Charing Cross and Horsham; and
  - (b) between Southern and IKF (currently operated by SET) on overlapping flows between St Leonards Warrior Square and Ore.
7. This merger also gives rise to bus on rail overlaps as Govia's parent company, Go-Ahead, has two bus operating subsidiaries, London General Transport Services Limited and Metrobus Limited, which overlap with IKF on a number of flows in London, Sussex and Kent.

## **Product frame of reference**

8. In travelling between two points, passengers have a number of alternative methods of transport, including car, rail, coach, bus and air. Their choice will be a function of, among other factors, length of the journey, access to a particular means of transport (both boarding and disembarkation points), personal preference, the cost of the journey, the journey time (including the time spent getting to and from stations and bus/coach stops), frequency of services and

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<sup>1</sup> Govia also currently operates the Thameslink franchise, however it will cease to do so on 31 March 2006. Therefore any overlaps between IKF and the Thameslink franchise have not been considered in this assessment.

whether there are direct services available. These factors are sometimes included in a wider measure of 'generalised cost'<sup>2</sup> of a journey which passengers try to minimise when travelling.

9. A passenger's ability to substitute between different modes of transport is highly route specific and depends on the availability of different modes of transport and their comparative characteristics.<sup>3</sup> Additionally, the degree of substitutability between different transport modes is dependent upon the characteristics of the user, and in this case it is particularly relevant to draw a distinction between commuters and leisure passengers as IKF is primarily a commuter network.
10. The parties submit that there may be some demand side substitutability between bus and train for some passengers and on certain flows. In general, when compared to train travel, bus services tend to be more frequent and cheaper, although journeys over the same distance generally take longer because they tend to be less direct, have a larger number of stops and/or are held up by congestion. In this respect, the parties submit that a significant number of passenger journeys on IKF are commuter routes, where journey time will be an important consideration and therefore substitution between bus and rail will be lower. For the purposes of the present assessment, the OFT has considered bus and rail services to fall within the same product frame of reference. The extent of the competitive constraint that they may pose on each other was considered on a flow by flow basis.
11. The parties submit that taxis are unlikely to be in the same product market as rail services because even on the smaller flows, the price of taxis is likely to be significantly higher than that of rail services. In addition, evidence collated by the Competition Commission (CC) in two investigations completed in 2004<sup>4</sup> suggests that there is limited substitutability between public and private transport in response to price changes, although the exact extent of substitutability varies depending on, among other things, the level of car ownership in the area and whether the journey made is urban or rural. Some third parties suggested that the main competition faced by bus or rail is the car. However, as many of the

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<sup>2</sup> The generalised cost of a journey includes in-vehicle time; the time spent travelling between stations/stops at each end of the journey, and any additional cost in doing so (e.g. fares); any interchange penalty reflecting the need to change services or modes to complete a journey; the fare paid for the journey; and sometimes other aspects of the journey such as convenience, reliability or 'image' of the mode of transport used.

<sup>3</sup> This includes factors such as the availability of a direct service, waiting times (depending on relative frequencies), relative locations of the embarkation/disembarkation points, journey times, journey distance, the reliability of different modes and fares.

<sup>4</sup> Report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited, June 2004; Report on the acquisition by National Express Group plc of the Greater Anglia franchise, November 2004.

overlaps are on routes coming into London, the congestion charge and parking problems may limit the extent to which cars are seen as substitutes.

12. Given the route and passenger specific nature of substitutability between different types of passenger transport on flows, the relevant product frame of reference for assessing the competitive effects of the proposed acquisition is considered to be the supply of passenger transport services, in particular rail and bus services, on point-to-point routes.

### **Geographic frame of reference**

#### Point-to-point routes

13. In making a journey, passengers wish to travel from a particular origin to a particular destination. The competitive assessment in past cases has therefore considered point-to-point transport journeys to be the relevant frame of reference and it is considered appropriate to apply this approach to the proposed acquisition in this case.
14. In its report on FirstGroup/Scotrail,<sup>5</sup> the CC defined the relevant geographic proximity of train and bus stops that should be considered to give rise to an overlapping flow. In that case, different catchment areas were used depending on the population density of the area in question, and these differed between Edinburgh, Glasgow and the rural areas on the outskirts of Edinburgh. Within the more rural areas (which are most like the areas where the majority of the bus-on-rail overlaps in this case occur) the CC considered that where a rail station is located within 800 metres of its nearest bus stop, the flow is considered to be overlapping. The OFT has followed the same approach in this case.

#### Network markets

15. As well as providing passenger transport along point-to-point flows which are potentially substitutable, bus and rail operations are to some extent complementary.
16. Complementary public transport operations may form broader public transport networks where the transport provider has scope to develop interrelationships, for example by supplying multi-modal tickets valid only on commonly owned transport or by co-ordinating the timing of services to ensure convenient connections. Where relevant, regard is also given to broader transport networks in this assessment.

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<sup>5</sup> Report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited, June 2004.

## HORIZONTAL ISSUES

The impact of rail regulation

17. The service level commitment (SLC) is a specification by the Department for Transport of the level, frequency, maximum journey time and stopping pattern of all the passenger services to be operated by the franchisee. Only the Department for Transport has the ability to alter the SLC under the terms of the franchise agreement. Therefore the OFT has assumed that on the whole, train franchisees have only a limited ability to reduce service levels below those standards set out by the SLC.
18. Train services also face fare regulation, the key aspects of which are set out below:
  - Regulated fares within IKF include the commuter fares basket (comprising season tickets to and from London and London travelcards) and the protected fares basket (comprising all weekly season tickets not covered by the commuter fares basket, saver return tickets where a saver ticket fare existed in 2003 and full return fares where no saver return existed in 2003).
  - The weighted fares within both the commuter and protected fares baskets for IKF cannot increase by more than RPI + 3 per cent for the first five years of the franchise or by more than RPI + 1 per cent for any year thereafter. In addition, no individual fare may increase by more than RPI + 6 per cent from one year to the next.
  - The IKF franchisee may charge premium fares for the high-speed rail services from London, although this premium is capped by the franchise agreement.
19. In its investigation of NEG/Greater Anglia<sup>6</sup>, the CC also considered that the price of regulated fares in practice constrains increases in unregulated fares on the same flows. The extent of this constraint will depend on the differential between the two fare types on each flow.

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<sup>6</sup> Report on the acquisition by National Express Group plc of the Greater Anglia franchise, November 2004

## Rail on rail overlaps

### London Charing Cross to Horsham

20. Govia has identified 22 overlapping flows on the route between London Charing Cross and Horsham. In addition, there are 3 further overlapping flows which branch off this route: Peckham Rye to Victoria, Peckham Rye to Denmark Hill and Denmark Hill to Victoria.
21. The OFT has found no evidence of pre-merger competition between Southern and SET on any of the flows along this route. This is primarily because inter-available fares account for 100 per cent of the revenues along these flows. Govia has stated that the introduction of dedicated fares on these flows would not be commercially beneficial due to the relatively low yields and capacity constraints on the Southern and South Eastern networks. Govia has further submitted that it has never considered the introduction of dedicated fares or, where it is the lead operator,<sup>7</sup> it has never considered the potential for a follower operator to introduce dedicated fares.
22. Govia submits that rail services between Three Bridges and Horsham are currently operated jointly by SET and Southern, with all revenue accruing to Southern. This has been confirmed by the Department for Transport. Therefore the proposed acquisition will not change the pre-merger position in relation to these flows and they have not been considered any further.

### St Leonards Warrior Square to Ore

23. SET and Southern rail services also overlap on 3 flows between St Leonards Warrior Square and Ore. However, the OFT has found no evidence of pre-merger competition between Southern and SET on these flows. SET only operates a limited service between Ore and Hastings and between Ore and St Leonards Warrior Square. Therefore it is likely that SET poses a relatively weak constraint on Southern's services on these flows. Furthermore, inter-available fares account for 100 per cent of the revenues along these flows. Govia submits that it has never considered the introduction of dedicated fares or, where it is the lead operator,<sup>8</sup> it has never considered the potential for a follower operator to introduce dedicated fares.

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<sup>7</sup> Southern is the lead operator on all of the flows except for Peckham Rye to Denmark Hill, and Charing Cross to Waterloo East, on which flows SET sets the inter-available fares.

<sup>8</sup> Southern is the lead operator on the Ore to Hastings and the Ore to St Leonards Warrior Square flows and SET is the lead operator on the Hastings to St Leonards Warrior Square flow.

## **Bus on rail overlaps**

24. Govia has identified a number of bus services, operated by Go-Ahead, which overlap with IKF routes. However these overlaps do not raise any competition concerns for the following reasons:
- (a) London routes: a number of overlaps between Go-Ahead's bus routes and IKF rail routes occur within the London area, where bus services are regulated by Transport for London (TfL). Within the TfL area, bus operators contract with TfL to provide services. The terms of the contract cover the setting of fares, bus frequency and capacity, and service quality (for example punctuality and cleanliness). Therefore, there is no scope for bus operators on these routes to increase fares or reduce service levels.
  - (b) Contracted bus services: Go-Ahead operates certain bus services on a contracted basis, for example the provision of school journeys and free bus services to a supermarket. Go-Ahead is remunerated on a gross cost basis for these services and the local authority is responsible for setting service frequencies on these routes. Therefore Go-Ahead does not have the ability to set service levels or fares on these flows.
  - (c) Overlap services on the Three Bridges to Horsham route: as mentioned above, the Department for Transport has confirmed that rail services between Three Bridges and Horsham are currently operated jointly by SET and Southern, with all revenue accruing to Southern. Therefore the proposed acquisition will not change the pre-merger situation in which a bus-on-rail overlap currently exists on this route.
  - (d) Kent supported services: Govia submitted that certain of Go-Ahead's bus routes are fully supported by Kent county council. Therefore Go-Ahead does not have the ability to set fares or frequency of services on these routes. Furthermore, Govia has stated that in any event Go-Ahead will cease to operate these routes from 28 April 2006.

## **Barriers to entry and expansion**

25. Given the highly regulated nature of the rail network, expansion by existing train operating companies is highly unlikely. In addition, entry by new train operators is also unlikely (although theoretically possible under the open access arrangements) due to the need for Department for Transport approval and the difficulties of running a profitable service that overlaps with existing train operating companies.

### **THIRD PARTY VIEWS**

26. None of the third parties who were contacted during the course of the investigation raised any concerns about this merger.

### **ASSESSMENT**

27. This merger gives rise a number of rail-on-rail and bus-on-rail overlaps as Govia currently operates Southern and its parent company Go-Ahead owns two bus operating subsidiaries. However, in relation to the rail on rail overlaps, the OFT has found no evidence of pre-merger competition between Southern and SET, particularly because inter-available fares account for 100 per cent of revenue on these flows. The OFT does not believe that any of the bus-on-rail overlaps raise competition concerns, as Go-Ahead does not have the ability to set fares or frequency of services in relation to most of the overlapping flows where there will be a change to the pre-merger position.
28. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

### **DECISION**

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