OFFICE OF FAIR TRADING

Anticipated acquisition by Stagecoach Group plc and Brunel Trains Limited of the Greater Western Passenger Rail Franchise

The OFT's decision on reference under section 33(1) given on 30 September 2005. Full text of decision published 19 October 2005.

Please note that square brackets indicate exact figures excised at the parties' request.

PARTIES

1. **Stagecoach Group plc (Stagecoach)** is an international transportation group active in the UK, the USA, Canada and New Zealand. Its UK bus division comprises 16 regional companies. In 2003, Stagecoach launched megabus.com, a long-distance inter-city bus transport service that operates a similar business model to a budget airline (with web-ticketing etc.). Stagecoach's rail division in the UK operates two wholly-owned passenger rail franchises: South West Trains (SWT from Waterloo) and the Island Line (Isle of Wight). It also operates the Sheffield Supertram system. Stagecoach also holds a 49 per cent shareholding in Virgin Rail Group Holdings Limited, which operates the West Coast Mainline and Cross Country franchises (VXC). Stagecoach has also been invited to tender for two other franchises, the Integrated Kent Franchise (IKF) and the Thameslink Greater Northern Franchise (TGN). There is no overlap between either the IKF or TGN franchise and the GWF.

2. **Greater Western Rail Franchise (GWF)** will consolidate the existing operations of the First Great Western (FGW), First Great Western Link (FGWL) and Wessex Trains (Wessex) franchises within a single franchise. It will operate long distance, regional and local services in the Thames Valley, Cotswolds, Avon and the West of England and some cross-border services into South Wales. The Strategic Rail Authority's (SRA) Draft Long Form Report for the GWF states that turnover for 2003/2004 across the three current franchises was £601 million.

TRANSACTION

3. Stagecoach's (wholly-owned) bidding vehicle, Brunel Trains Limited, is one of three pre-qualified bidders in the competition for the GWF. National Express Group plc (NEG) and FirstGroup plc (First), the parent companies of the incumbent Wessex, FGW and FGWL franchisees respectively, have also pre-qualified to take part in the competition. The current FGW franchise expires on 5 February 2006 and the FGWL

and the Wessex franchises expire on 31 March 2006. The SRA anticipates that a preferred bidder will be selected and a new franchise agreement closed by Winter 2005/2006, following the issue of the Invitation To Tender in June 2005. The term of the new GWF is proposed to run for seven years from 1 April 2006, with an automatic extension of three years if agreed performance targets are met.

4. The parties notified the transaction on 21 June 2005 and, with their agreement, the OFT extended its review beyond the 40 working-day administrative deadline, which expired on 16 August 2005.

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. If Stagecoach's bid for the GWF is successful, Stagecoach and GWF will cease to be distinct. The combined annual UK turnover of the three franchises which will make up the GWF exceeds £70 million, meeting the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act).

6. Accordingly, the OFT believes that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation for the purposes of section 33(1)(a) of the Act.

COUNTERFACTUAL

7. Applying the substantial lessening of competition (SLC) test involves comparing prospects for competition with and without the merger. For many mergers the natural basis for assessing prospects for competition in the absence of the merger – the 'counterfactual' – is given by conditions prevailing pre-merger. For rail franchise cases, however, that would not be a proper approach. As the Competition Commission (CC) has said, any incumbent operator on all or part of an existing rail franchise is but one of a number of potential bidders for a franchise about to be let or re-let, and 'the position prior to the merger could not therefore be assumed to have carried on' if that particular merger had not gone ahead.[1]

8. The OFT's view is that the appropriate counterfactual for the bid – and hence prospective merger – by each bidder is not continued operation by the incumbent (nor by the SRA) but the most competitive alternative bid in respect of each individual affected relevant market. In nearly all circumstances in this case, the most competitive alternative bid is one with no existing operations on a given market.

9. The basis for considering the counterfactual by reference to each individual relevant market derives from s 33 of the Act, which requires the OFT to consider whether it may

[1] See the CC's Reports in *NEG/Greater Anglia* (National Express Group plc and the Greater Anglia Franchise, a report on the acquisition by National Express Group plc of the Greater Anglia franchise) November 2004,at para. 5.1; see also *First/Scotrail* (FirstGroup plc and the Scottish Passenger Rail franchise, a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited, 28 June 2004) at para. 5.2 (*ScotRail*).

be the case that a SLC may be expected to arise 'within a market or markets' in the UK. As discussed below, the relevant markets for the purposes of the OFT's assessment of horizontal competition issues in this case are a large number of individual point-to-point public transport journeys, or 'flows'.

10. In respect of some individual markets, firm A (say) winning the rail franchise might result in more competition than firm B or C because, for example, it would bring an independent rail operator into competition with bus operators on overlapping flows, while a win by B or C might place competing bus and rail operations on those flows under common ownership. In other individual markets, the position might be reversed so that bids by B or C appear more competitive than that of A. However, it has not been feasible in the scope of the first-phase of merger review to attempt to weigh any competitive gains against losses across markets, in part because of the large number of markets at issue.

11. Notwithstanding the analysis set out above, the OFT recognises that the SLC assessment may also need to be conducted on a franchise-wide basis. In a sense, rail franchises are two-sided markets, in which the franchisee provides services to two sets of customers: the government and the passengers.[2] From the government (and taxpayer) perspective, the relevant market may better be viewed as a single bidding market for which the bidders compete to supply the government as the customer. However, the OFT's starting position is, for the reasons set out above, to focus on passengers' competitive choices for particular journeys. This approach has also informed prior OFT and CC investigations into rail franchises. In view of the conclusions reached on that basis in this case and the *NEG/GWF* and *FirstGroup/GWF* decisions, it has not been necessary to consider any impact on the bidding market.

RELEVANT MARKET

12. Overlaps exist between passenger rail transport services provided by the GWF and Stagecoach's interest in the VXC and SWT rail franchises, as well as between the GWF and Stagecoach's bus services in Oxfordshire, Gloucestershire, South Wales and Devon.

Product market

13. The prospects of substitution between rail and other forms of transport for a given journey are specific to the routes and passenger profiles in question. Passengers' choice of transport on any journey depends on a number of different factors, including (convenience of) access to a particular means of transport (either at the boarding or

[2] See *ScotRail* at para.4.5.

disembarkation point), personal preference, value of time and relative costs of the available alternatives.[3]

14. As regards private transport, evidence collated by the CC in its *ScotRail* merger inquiry and *NEG/Greater Anglia* merger inquiry suggests 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.

15. As a general matter, bus services tend to be more frequent than rail services. Bus and coach travel tends to be cheaper than travel by train, although journeys are generally longer due to a larger number of stops or congestion delays.

16. In its *ScotRail* inquiry, empirical evidence led the CC to conclude that train and local buses were at least potentially substitutable on some routes in the relevant areas of Scotland. The CC further concluded that common control of bus and rail on a flow on which bus services and train services overlap in the relevant areas were more likely than not to result in a substantial lessening of competition on particular flows, giving rise to remedies to prevent adverse effects on passengers.[4]

17. *ScotRail* was concerned with public transport services in the Edinburgh/Glasgow region and it is debatable, in the absence of empirical evidence on passengers' preferences in the GWF area, what relevance the findings on the extent of substitutability between bus and rail on these Scottish flows have for the flows at issue in this case. Our own analysis of the flows in this case shows a correlation between bus fares and rail fares.

18. Accordingly, on the information available to it and having regard to the CC's findings in *ScotRail*, the OFT has been unable to discount the possibility that on individual flows there might be a considerable degree of substitutability between bus or coach and rail, respectively (see further below under theory of harm).

19. Given the route- and passenger-specific nature of substitutability between different types of passenger transport on flows, for the purposes of assessment here the relevant frame of reference for assessing the competitive effects of this proposed acquisition is considered to be the supply of passenger transport services.

Geographic market

20. In making a journey, passengers wish to travel from a particular point of origin to a specific destination. The CC concluded in its report on *ScotRail* that point-to-point

[3] For example, in the CC's *NEG/Greater Anglia* report, where coach-on-rail overlaps were prevalent, of particular importance was the distinction between leisure passengers, commuters and business travellers who exhibited different sensitivities to journey times.
[4] See *ScotRail*.

public transport journeys were the relevant geographic frames of reference for competition assessment in relation to the bus/rail overlaps in that case. Point-to-point frames of reference have consistently been employed in relation to various modal combinations such as coach/rail and rail/rail.[5]

21. The OFT has not received any evidence in this case that warrants departing from the point-to-point approach, which the parties have endorsed.

22. Accordingly, the principal frames of reference relate to the provision of public transport services between specified origin/destination points (i.e. 'point-to point' frames of reference). A point-to-point journey may represent a complete route or may represent a smaller 'flow' that comprises part of a longer route.

HORIZONTAL ISSUES

Summary

23. The OFT's approach to horizontal issues has focused on the potential for a SLC to arise on those overlapping flows where Stagecoach would become the sole or principal provider of public transport. As detailed below, this does not occur in relation to Stagecoach's coach operations, but does occur in many instances in relation to both Stagecoach's pre-existing bus and rail operations. The analysis faced two particular challenges: first, an absence of empirical data (such as was available to the CC in its *Scotrail* and *NEG/Greater Anglia* inquiries) on the degree of substitutability, and thus competitive constraint, between different transport alternatives on the relevant markets; second, a problem of scale, given the almost 400 overlap markets that Stagecoach's GWF bid presents. These points are developed below.

24. The horizontal assessment is structured as follows. First, the regulatory context of rail services is noted. The next section examines theories of harm in relation to bus/rail overlaps and concludes that on current evidence there is a realistic prospect of a SLC, which establishes that the OFT has a duty to refer the merger. Rail/rail overlaps are then considered, but given the conclusions on bus/rail, the OFT finds it unnecessary to reach definitive conclusions on whether the rail overlaps themselves give rise to the requisite belief in a SLC. The OFT's position on coach/rail overlaps, which raise no concerns, is summarised.

Impact of regulation

25. Before considering the impact of the merger on individual overlap routes or flows, it is important to recognise the regulatory context of this transaction. Passenger rail franchises are awarded by the SRA which sets the terms on which services will be provided. More specifically, the SRA has developed a new template franchise

[5] See, for example, CC report in *NEG/Greater Anglia*, OFT decisions in *First/ICEC* and *Virgin/ICEC* (both cases reported 21 December 2004); *Arriva/Wales and Borders* (reported 16 March 2004); and *South Eastern Railways/IKF* (reported on 31 March 2005). (See OFT web-site www.oft.gov.uk).

agreement which the evidence indicates is highly prescriptive as to the train services covered by the franchise agreement. In particular, this impacts on the commercial freedom to operate the franchise in two main ways: via the service level commitment and fare controls.

26. The prescriptive nature of the new rail franchise template has been extensively documented in previous OFT decisions (see *First/ICEC* and *Virgin/ICEC*, *South Eastern/IKF* and *Stagecoach/TGN* [6]). This regulatory regime applies equally to the GWF. However, since the level of regulation (i.e. the proportion of regulated revenue to total revenue) applicable to the GWF is likely to be below the national average of 43 per cent, its impact on the commercial freedom of the TOC through tight fare controls and service level commitments will be less acute than as seen in previous OFT decisions.

27. In short, notwithstanding the prescriptive effect of the regulatory regime, the operator of the GWF will still have the ability to change fares and frequencies on services which will represent over 60 per cent of the revenue from running the franchise.

Bus/rail issues

Theory of harm

28. The OFT has primarily sought to test whether Stagecoach would have the post-merger ability and incentive to raise bus fares or reduce bus frequencies in order to increase profits.[7]

29. This theory of harm presupposes that bus/coach and rail compete to some degree, on the basis that passengers regard the modes as potential substitutes on the overlap flows in question. On a large number of overlapping flows, Stagecoach would be the sole or predominant operator of public transport services. This may simply mean that the merger combines two complementary services, if empirical data demonstrated that very few, if any, passengers considered the two services economic substitutes for travelling from A to B on a given flow. Conversely, if the bus and rail services are substitutable for a material number of passengers, then it can be expected that they constrain one another competitively, a constraint that the merger would eliminate.

30. Stagecoach acknowledges that different modes may sometimes be regarded as substitutes by a proportion of passengers (for example, in relation to medium distance point-to-point journeys), but disputes it in relation to other journeys (see below). Stagecoach has not, however, been able to provide any comprehensive empirical (e.g. customer survey) information, and the OFT has not been able to undertake such research independently.

[6] Reported on 7 July 2005. See OFT website www.oft.gov.uk.

[7] Whilst it is accepted that high levels of price and service regulation on rail may preclude concerns as to switching passengers from rail to bus/coach, the OFT explored whether additional concern may arise should Stagecoach have the ability and incentive to raise unregulated rail fares for the point-to-point flows as well, to increase the returns made on rail as passengers switch from bus. In this regard see *South Eastern/IKF*. See below at paragraph 41.

31. Without empirical evidence on substitutability, the OFT has proceeded on the cautious basis that bus and rail may be substitutable and thus compete on such flows, and conducted two exercises to test the applicability of the theory of harm. First, it undertook preliminary price correlation analysis seeking to test whether bus and rail fares appear to be unrelated, suggesting an absence of substitutability. However, the overlapping flows tested produced a figure of 0.61. Although this is a weaker positive correlation than in some previous cases,[8] such an analysis is consistent with the possibility that on individual flows there might be a considerable degree of substitutability between bus and rail.

32. Secondly the OFT modelled the potential profit incentive for Stagecoach to raise prices or reduce frequencies, consistent with the approach first undertaken by the CC in *Scotrail* and employed in subsequent CC and OFT investigations. Even without empirical data, this approach allowed the OFT to clear Stagecoach's joint venture bid for the IKF franchise, on the basis that that merger did not give rise to bus/rail concerns on any reasonable – including 'worst-case' – assumptions. A precursor to this analysis is to identify flows that should form part of the modelling exercise.

Filtering of flows

33. In the circumstances of previous rail franchise reports, most recently in *ScotRail*, the CC has adopted a series of filters designed to identify a subset of overlaps that may raise competition problems. Stagecoach has presented overlap data and analysis based upon certain of these filters.

34. The OFT acknowledges the utility of filters at first-phase merger review, especially in a case with almost 100 overlaps (400 when rail-on-rail overlaps are included), where sifting the number of flows to be considered to a manageable number is vital.

35. However, such filters are pragmatic, need to be checked for robustness/sensitivity, and could be case-specific (see *FirstGroup/ICEC* Commentary [9]). The validity of these filters should be tested in any given case, rather than simply applied mechanically. In any event, the filters must not be equated with rules which automatically include or exclude flows from the possibility of competition problems.

36. In testing the robustness of filters, the OFT has, as time and evidence reasonably permitted: (i) engaged in a sampling of 'excluded' flows; (ii) undertaken common sense analysis of asymmetries on certain flows, e.g. large disparities in passenger volumes, revenue, journey time, frequency and price or other available data variables; and (iii) sought to solicit from third parties any expression of concerns or other evidence of significant competition to test against the merging party's assertions.

37. Stagecoach has identified 84 flows where their bus services overlap with the GWF. In assessing bus-on-rail overlaps in *ScotRail*, the CC considered that the routes which

[8] In particular *South Eastern/IKF* where the relationship showed a positive coefficient of 0.84.
[9] See CC, *FirstGroup/ICEC* (terminated) merger inquiry: commentary on issues statement, 20 June 2005, (*FirstGroup/ICEC*).

are most likely to give rise to concern are those where the percentage of revenues on a bus route accounted for by all overlap flows on that route exceed 10 per cent.[10]

38. The OFT's assessment has considered the CC's approach of filtering out routes where the share of revenue from overlapping flows is below 10 per cent as a starting point. In order to test the robustness of this filter as applied to the facts of this case we have included in our analysis a sample of flows which would have been filtered out in a strict application of the 10 per cent filter.

39. The CC's next step was to consider other factors relevant to determining the effect of the acquisition on competition on the potentially problematic routes. If an effective competitor[11] is present on a route, Stagecoach would be less likely to have an incentive post-merger to raise bus prices (say) because customers switch in good part to the competing bus operator(s) rather than to rail. The application of the effective competitor filter to this case removes 7 of the 84 overlapping flows.

40. It has then been tested whether post-merger Stagecoach would have the incentive to switch passengers from bus to rail (through price rises and/or frequency reductions). We have done this by running the 'scenario analysis'[12] conducted by the CC in *ScotRail*, which simulates the increase in profit (and revenue) that Stagecoach could achieve on overlapping flows from implementing the theory of harm (increased fares on the overlapping bus routes or reduced frequency of its bus operations in order to divert passengers from bus to rail).

41. A related theory of harm on overlaps where Stagecoach provides the rail and bus service on a flow (and no effective competition exists) is that it might be able to raise both unregulated rail and bus fares simultaneously. In previous decisions the OFT has relied on several factors which constrain the ability of the rail company to raise fares post-merger.[13] Despite the regulatory regime to which the GWF will be subject, given the expected low proportions of regulated fares, the operator will still have the ability to change fares and frequencies on services which will represent over 60 per cent of the revenue from running the franchise.[14]

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[10] It was reasoned that if the number of passengers on a bus route who start and end their journeys in places within the catchment areas of rail stations is a small fraction of the total number of passengers on the bus route it would be difficult or even counterproductive to change the operation of a service between the overlap flow points without impacting on the operation of the route as a whole: lower frequency for example, could result in some passengers not making a journey at all. The CC therefore initially eliminated all routes where the share of revenue from overlap flows was below 10 per cent (the '10 per cent filter').

[11] See *ScotRail* at Appendix G paragraph 21.

[12] This analysis has also been conducted by the OFT in its assessments of the sale of the *South Eastern/IKF* and *Stagecoach/TGN*.

[13] These have, inter alia, included: a high level of regulated fares which constrain the unregulated fares from being raised (*Connex/Govia*); whether or not the incremental incentive from operating the bus service on a flow is significant to motivate a price rise on both bus and rail; and the extent of the overlap (cases cited above).

[14] See paras. 25-27 above.

Incentives to increase bus prices

42. The OFT modelled the potential profit incentive for Stagecoach to raise bus fares post-merger. Should bus fares rise,[15] some of the resulting switching away from bus would be captured by GWF's train operations and hence retained within the merged entity, unlike the situation without the merger. It would also enable the bus service to extract more revenue from those passengers who continue using the bus. The question is to gauge the quantitative importance of this theory of competitive harm. If, like in *South Eastern/IKF*, it appeared insubstantial on the range of reasonable assumptions, the theory would not be the basis for the belief in a realistic prospect of a SLC.

43. In conducting the analysis a series of assumptions need to be made on the own price elasticity demand of bus travel[16] and the extent to which a price increase would cause passengers to switch from Stagecoach bus to GWF rail.[17] These aspects vary by route and flow, and the extent to which the CC's assumptions in *ScotRail* are relevant to the demographics of the area under investigation in this case is subject to debate.

44. In our view, using a range of reasonable assumptions is appropriate when no empirical data are available. Under arguably relatively conservative assumptions[18] there is a merger-specific to-rail revenue gain across all overlapping flows that appears substantial. Even using the assumptions advocated by the parties and those used by the CC in *ScotRail*, the modelling still generates revenue uplifts that suggest that Stagecoach may be incentivised to behave anti-competitively.

45. Of the 85[19] flows on which the analysis was run, five routes (Oxford-Bicester, Gloucester-Stroud, Paignton-Newton Abbot, Torquay-Newton Abbot and Exeter-Exmouth) make up 42 per cent of the simulated revenue uplift. On the flows within these routes, the non-merger-specific on-bus effect is small, a significant proportion of the revenue uplift being driven by the merger-specific to-rail effect, hence the acquisition may generate the incentive for Stagecoach to behave anti-competitively.

46. Looking in more detail at these five routes, Oxford-Bicester has a large disparity between the frequency of bus and rail services.[20] It would therefore seem unlikely that on the overlapping flows within this particular route Stagecoach would have the

[15] The model considered price increases on bus of 3 per cent, 10 per cent, 20 per cent and 50 per cent, with rail fares remaining constant.

[16] The own price elasticity of demand measures how responsive bus passengers are to changes in price.

[17] Known as the 'diversion ratio' which measures the extent to which, in the event of a price increase, passengers who switch away from bus do so to rail. For example, if as a result of the fare increase ten passengers switch away from bus to rail and the diversion ratio is 70 per cent, seven of the ten passengers that switch do so to rail. The remaining three lost passengers do not travel by rail, they may not travel at all or they may use an alternative mode of transport.

[18] A price increase of 3 per cent, an elasticity of -1 (which assumes that Stagecoach is currently profit-maximizing with zero marginal cost - as long as capacity remains constant - on rail), and a diversion ratio of 50 per cent.

[19] A number which includes 6 flows taken as a sample of those that 'passed' the 10 per cent filter.

[20] The FGW franchise currently operates 7 trains per day along this flow (the parties maintain that this will be further reduced to 2 morning services and 2 afternoon services under the new franchise agreement). This compares with nearly 50 buses per day.

incentive to attempt to shift passengers onto train by raising prices across the whole route when the rail service is so limited.

47. Gloucester-Stroud, Paignton-Newton Abbot, and Torquay-Newton Abbot are broadly symmetric in terms of their service levels (i.e., the comparative frequency, price, journey time and passenger numbers of bus and rail services). Symmetry in service levels may indicate that here bus and rail are more substitutable. Conversely, given the fact that on all three flows the off-peak return fare on bus is actually higher than the corresponding rail fare, we examined the hypothesis that passengers who are likely to switch from bus to rail because of higher prices have already done so, i.e. there is no ability for Stagecoach to implement a profitable price increase.

48. On the basis of more detailed examination of the fares this was discounted as despite off-peak fares being higher on bus than rail, the peak fares on all three routes were higher on rail than bus. As a result, Stagecoach may have the ability to implement a peak price increase.

49. When considering the bus/rail overlap on Paignton-Newton Abbot and Torquay-Newton Abbot, it is important to note that Stagecoach already runs SWT and has an interest in VXC, the two rail alternatives to GWF; in other words, pre-acquisition GWF is the only non-Stagecoach operated public transport service on these flows.

50. Both journeys are quicker by train but the frequency of buses (both peak and off-peak) is greater. This may suggest that the expected journey time (a measure of how long the passenger has to wait for a bus or train combined with the actual journey time) is similar when taking either a bus or train. Fares are reasonably comparable. Such symmetries may suggest that bus and rail are substitutable across these flows. Stagecoach itself concedes that these flows are ‘reasonably competitive’.

51. However, there is a large disparity in the number of passengers using each mode of transport, with buses carrying four times as many passengers in the case of Paignton-Newton Abbot and eight times as many passengers on the Torquay-Newton Abbot flow. This may suggest that (regardless of journey time) customer choice of whether to use bus or rail is driven by frequency.

52. However, data provided on aggregate passenger numbers tell us very little about the marginal consumer. For example, it may be the case that leisure passengers, who are more price sensitive, find the two modes substitutable and so would be most likely to switch and thus be the marginal consumers that drive competitive behaviour.

53. Finally, on the Exeter-Exmouth route the peak-time bus service is twice as frequent as the rail service although at off-peak (Sundays and weekdays) the frequency of both rail and bus is the same. The rail journey is up to twice as fast as bus. It is notable that in this instance rail carries at least four times as many bus passengers across the flow.

54. The parties claim that although bus and rail are reasonably competitive, the bus service is operated essentially to ensure that if a passenger misses a rail journey they

will still be able to take a bus and reach their destination faster than if they waited for the next train. No empirical evidence to substantiate this claim was provided. Additionally, it is claimed that at peak times there is no scope to increase bus prices to transfer passengers from bus to rail since rail services already run at maximum capacity.[21] This would, however, not prevent such practices off-peak.

Incentives to reduce bus frequency

55. Having considered the possibility that the merger would create incentives to raise bus prices, we now consider possible incentives to reduce service frequency. As when simulating the price increase, a series of assumptions need to be made on the reduction in bus passengers in response to a reduction in frequency (headway elasticity) and the extent to who, in the event of a reduction in frequency, passengers which switch away from bus do so to rail (diversion ratio).

56. Even under arguably relatively conservative assumptions[22] modelling generates a merger-specific to-rail revenue gain across all overlapping flows, which again appears to be substantial. Again, symmetry in service levels may indicate that here the alternative modes of transport are seen as particularly substitutable.

57. In the OFT's view, the assumptions applied in our frequency modelling are appropriate to examining this highly complex case at first-phase. It should be noted that even modelling on the assumptions advocated by the parties and those used by the CC in *ScotRail*, revenue uplifts arise that may be sufficient to incentivise Stagecoach to behave anti-competitively.

58. Stagecoach has put forward reasons why such frequency reductions are not realistic in practice. Chief among these appears to be the fact that any frequency decrease on an overlapping flow will be felt on the other flows on the route: accordingly, any profit incentive on the individual flow will be outweighed by the decrease in bus revenues on the other (non-overlapping) flows on the route. Although the OFT acknowledges this constraint, there may be circumstances in which it would be feasible to implement frequency reductions on flows consistent with the CC's concerns in Scotrail, e.g. the first and last services of the day, or at the beginning or end of routes.

59. Aside from disputing the assumptions we have applied, Stagecoach has submitted various arguments as to why it would be unable or unwilling to implement the price rises or frequency reductions we have modelled. Primarily it argues that we rely on the incorrect assumption that the strategy for fares and frequencies on particular routes and flows is set at a group level. It claims that, in reality, the management of each regional operating company is responsible for decisions concerning fares and frequencies on specific routes and flows. However, the claim that corporate subdivisions mean that common ownership will not reduce competition (because the acquired unit will be run separately) can be applied to many merger situations, and in

[21] Analysis has been provided to substantiate this claim for only two morning and two evening peak services.

[22] A frequency reduction of 10 per cent, an elasticity of -1 and diversion ratio of 50 per cent.

this case the OFT has not satisfied itself as to the existence of this operational situation nor of its ability to prevent Stagecoach from increasing prices or reducing frequencies on the overlaps in question if it were profit-maximising for Stagecoach as a whole to do so.

60. Stagecoach goes on to argue that the OFT's modelling does not take into account the costs involved in raising fares or changing timetables and that, due to the operating structure of Stagecoach Group plc (outlined above), these costs are multiplied by the number of regional operating companies. The OFT understands that fares and timetables are reviewed on at least an annual basis in any event; thus it cannot conclude that incremental administrative costs would by themselves deter fare increases or frequency reductions.

61. Stagecoach also states that the OFT should take into account a new scheme from HM Treasury that takes effect from April 2006 which will result in free bus fares for people over 60 and disabled people within the area of the local authority where they live in England. [23] It claims that this is particularly pertinent in this case as many of the regions in which Stagecoach's bus operations overlap with the GWF have a high aged population.[24] Although Stagecoach has provided the OFT with internal documents assessing the potential impact of this scheme, without empirical survey data it has not been possible in the time available properly to assess the exact implications of this change on the merger effects identified.

62. Finally Stagecoach argues that on a number of the overlapping flows Stagecoach bus services are subsidised by the local council and that this limits their ability to either raise prices or reduce frequency. The OFT accepts that if a service is fully-subsidised then during the life of the subsidy Stagecoach will have limited ability to make substantial changes to the service levels. However, an examination of the evidence received during the OFT's investigation from both Stagecoach and third parties shows that the impact of tendering and subsidies (whether full or partial) on both the ability and incentive for Stagecoach to increase prices and/or reduce frequency varies greatly.[25]

Barriers to entry and expansion

63. Stagecoach has strongly advocated the prospect of bus entry as a countervailing factor in this case. Currently, there appear to be few bus competitors on overlapping routes. However, the OFT notes that there are national operators such as First and Arriva, with depots in the region, that could potentially have the capability and incentive to move into Stagecoach routes in the event of service reductions or fare increases implemented by Stagecoach, thus acting as a constraint.

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[23] Currently these people receive fares at half price.

[24] Compared with the national average which Stagecoach claim is 19 per cent, 24 per cent of the population in the South West, 23 per cent of the population in Wales and even higher – 34 per cent - in regions such as Dawlish, of the population are over 60 years of age.

[25] In terms of this variety see, for example, Appendix M, paragraph 19 of *ScotRail* which explains the distinction between minimum-subsidy and minimum-cost tendering contracts.

64. Stagecoach claims that any anti-competitive revision of routes, fares or frequencies would only increase the potential for market entry or competitor expansion by other bus operators. The OFT has received submissions from third parties who state that not only is there no incidence of recent entry in the relevant areas, but also that they would not be able to compete against such a large organisation as Stagecoach.

65. Third parties have also cited network issues as a potential barrier to entry and expansion as well as new vehicles, meeting higher costs of insurance and petrol, lack of driver availability and a reluctance to change timetables and routes owing to passenger resistance.[26]

66. In this case, the available evidence is insufficient to show that entry or expansion onto flows can be relied on to prevent a SLC.

Conclusion

67. Without better evidence on actual substitutability between bus and rail on the relevant overlap flows, the OFT has tested whether Stagecoach might have the post-merger incentive to raise prices or reduce frequencies on a range of assumptions as to bus passengers' price sensitivity and propensity to switch to rail. Assumptions that appear not to be unreasonable, including ones advocated by the parties, give rise to profit gain figures that may be sufficient to incentivise price increases or frequency reductions. At this stage of inquiry, the OFT believes that there is a realistic prospect of a SLC on overlap flows. What is less clear, however, is whether in reality these incentives apply to each overlap flow that features in the model, or only a (potentially very limited) subset. Finally, it is equally conceivable that, as was the case in the *NEG/Greater Anglia* inquiry, actual substitutability between bus and rail modes of transport is low on the flows at issue, and that the model significantly overstates the degree of competition between these modes. So while the OFT cannot dismiss as unrealistic the prospect of a SLC, the scope of the concerns cannot be precisely demarcated, and there is a risk that many flows that appear problematic might prove not to be so on further inquiry, and with the benefit of better evidence.

Undertakings in Lieu – bus/rail

68. Having concluded that the transaction should be referred to the CC, the OFT has considered whether there might be undertakings in lieu (UIL) of reference, pursuant to section 73 of the Act, which would address the concerns outlined above.

69. Stagecoach has offered a set of behavioural undertakings in relation to bus/rail concerns based on those accepted by the CC in the *ScotRail*.

[26] Entry was an important consideration in the CC *ScotRail* inquiry and in a small number of cases the threat of entry on specific routes where an existing operator was operating services that could be easily diverted or extended to serve the same flows was considered sufficient to alleviate concerns on these routes. The main barriers to entry identified in this report were the threat of retaliation and the existence of network operators.

70. In order to accept UIL, the OFT must be confident that the competition concerns identified can be resolved by means of undertakings without the need for further investigation. Consistent with its stage of investigation, UIL are appropriate only where both the concerns and the remedies proposed to address them are clear-cut. In this case, the number of overlaps involved and the dispute surrounding the appropriateness of assumptions used in our assessment mean the precise identification of the scope of the SLC is not clear-cut.[27]

71. This doubt means that the OFT cannot confidently define the competition concerns we have in a clear-cut manner. Even if such concerns could be clearly defined, the complex regulatory package of price caps and service regulation proposed raise important questions as to its restorative effect on competition, and cannot be reconciled with the OFT's standard that a first-phase remedy must be clear-cut. The OFT therefore concludes that this is not an appropriate case to accept UIL.

Rail/rail issues

72. Stagecoach has identified 299 flows on which there is a rail/rail overlap with the GWF: 161 on the VXC franchise; 126 on the SWT franchise; and 12 which overlap with both the VXC and the SWT (triple rail/rail overlaps).

73. The removal of a TOC on a flow such that the remaining TOC becomes the monopoly rail operator (or faces no effective rail competition) on that flow generates a situation where the average fare could be higher than it would be absent the merger. This is because the removal of a competing TOC(s) eliminates the possibility or threat of lower dedicated fares[28] being introduced on this flow and hence the main competitive constraint on monopoly price setting.

74. Stagecoach argues that despite this large number of overlaps, several factors support the conclusion that this transaction would not result in a SLC, primarily: (i) the prescriptive nature of the franchising arrangements; (ii) the overlaps in question representing very minimal revenue; and (iii) the absence of existing fare competition on the overlapping flows.

75. The prescriptive nature of the franchising arrangements: Stagecoach has argued that the letter agreement[29] which governs the running of the VXC, contains terms that are less flexible than other franchise agreements and that as a result it faces more restrictions on its conduct and does not have the same commercial incentives as in other rail franchise situations.

76. The SRA has informed the OFT that although the agreement has no implication for the fares regulation regime, the specific provisions relevant to the final 12 months of the

[27] See, in particular, paragraphs 8.3 and 8.4 of the OFT *Mergers, Substantive Assessment Guidance*.

[28] Dedicated fares are those tickets which can only be used on a specific operator's trains on a flow.

[29] Entered into by the SRA and Virgin Trains in July 2002, it replaces the original VXC Franchise Agreement.

franchise [ ] may have some implications for the franchisee's commercial freedom.

77. The overlaps in question represent very minimal revenue: Stagecoach cites the importance of viewing the overlaps in the context of the affected businesses. As regards the rail overlaps, it notes that in 2003/4:

- [less than 5 per cent] of SWT's total revenue was earned from SWT flows that overlap with the GWF;
- [less than 5 per cent] of VXC's total revenue was earned from VXC flows that overlap with the GWF. Stagecoach's maximum return on that revenue is limited to 49 per cent of the [low] profit margin to which the VXC franchisee is entitled by the letter agreement with the SRA. There is no certainty under that agreement that there will be any additional revenue available for distribution;
- [less than 5 per cent] of the three incumbent GWF franchisees' combined total revenue was earned from flows that overlap with VXC and/or SWT rail operations (some of these flows also overlap with Stagecoach's coach and bus operations).

78. The OFT has received no evidence to demonstrate that an incentive to exploit a post-merger position would not exist simply because the number of passengers and revenue on particular routes was relatively small (both in abstract and in relation to the numbers on the franchise as a whole). Moreover, the number of overlaps in this case means that even if individual routes represent minimal potential gain, in aggregate an incentive could be created for Stagecoach to exploit its position.[30]

79. The absence of existing fare competition on the overlapping flows: Stagecoach argues that there is very little evidence of effective price competition between the VXC or SWT and GWF franchisees on the flows in question and therefore that there is no competition to be lessened. In this regard Stagecoach cites the CC, *FirstGroup/ICEC*.[31]

80. In the Commentary on *FirstGroup/ICEC*[32] the CC stated that effective price competition between operators on the same flow results in part from how operators use the proportions and levels of inter-available fares[33] and dedicated fares[34] in order to attract passengers. A low level of journeys made on dedicated fares on a flow was said to indicate that there is little price competition between operators on that flow. Where more than 90 per cent of revenue on a flow was derived from inter-available tickets, the CC considered that little competition existed for fares, even with the existence of more than one operator on a flow (the 'dedicated fares filter').

[30] See *FirstGroup/ICEC*.
[31] See also *FirstGroup/ICEC*, OFT's decision.
[32] *FirstGroup/ICEC*, at paragraph 12.
[33] Inter-available tickets are those that may be used on any train operator's trains on a flow.
[34] Dedicated fares are those tickets which can only be used on a specific operator's trains on a flow.

81. Since filters are a pragmatic, case-specific device,[35] the OFT has sought to test the appropriateness of the dedicated fares filter to this case. It should be recalled that in *FirstGroup/ICEC*, sensitivity analysis showed that the choice of 90 per cent as the cut-off point had little effect on which flows were included or excluded.[36] However, in this case, since there are numerous flows upon which the proportion of dedicated fares is between 5 and 15 per cent, applying the dedicated fares filter has a significant effect on the number of flows that are included or excluded from analysis. This suggests a degree of caution is appropriate when considering the application of the 10 per cent filter.

82. Furthermore, we have documentary evidence from Stagecoach demonstrating its intention to introduce (dedicated) 'Value' fares on some shorter distance flows such as Exeter-Plymouth and Plymouth-Penzance in September: the rationale being to fill empty seats on off-peak services at the edge of the VXC network. The fact that across both these flows the current level of dedicated fares is zero demonstrates that the existence and importance of dedicated fares on a flow at present is not necessarily a reliable proxy of the level of current or future price competition. In these circumstances, the OFT does not consider that the dedicated fares filter is an appropriate sift on the facts of this case.

83. The OFT has, however, applied the other filter employed by the CC in its *FirstGroup/ICEC* analysis. After the application of this 'effective competitor' filter,[37] over 250 potentially problematic flows remain.[38]

84. Limited duration of the overlaps: Stagecoach states and the SRA has confirmed that the VXC franchise is expected to be terminated alongside the Central franchise by February 2006: it is expected that the VXC will cease operation no later than February 2007. Stagecoach has also indicated (and the SRA and the Department for Transport have confirmed) that the SWT franchise will be re-tendered in 2005-6 and it is expected to terminate in February 2007. On this basis, Stagecoach has argued that the remaining duration of the franchises is insufficient in length for incentives resulting in an SLC to materialise.

85. If the anticipated timetable is correct, the maximum duration of the overlaps between VXC, SWT and the GWF is 10 months from the commencement date of the GWF (anticipated 1 April 2006) to the termination date of the SWT and VXC franchises (anticipated February 2007). Stagecoach argues that in the event that it is awarded either or both of the new VXC or SWT franchises, the OFT would then have the opportunity to assess the competitive effects of that transaction then. In addition, Stagecoach argues that its intention to re-bid for either of these franchises would act as a further disincentive to raise prices in the interim.

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[35] See footnote 2 of the *FirstGroup/ICEC* Commentary.
[36] Ibid at paragraph 12.
[37] Ibid at paragraph 10. This filter excludes flows on which a competitor has at least half the merged entity's service frequency on the mode of transport in question.
[38] Effective competition on both the SWT and VXC overlaps is provided by Southern.

86. In certain previous decisions[39] the OFT has concluded that the relatively limited duration of rail/rail overlaps meant that there was insufficient time for the transactions to result in a SLC. Stagecoach has provided evidence both of the limited duration of the overlaps, suggesting a limited time-span in which any anti-competitive gains could be realised, as well as other impediments to price rises. However, given the OFT's above conclusions that it is bound to refer this case due to bus/rail concerns, it has not been necessary for the OFT to conclude definitively on the degree to which the rail overlaps raise concerns.

87. Finally, while there may be some scope for entry to the rail sector via open access agreements, the likelihood of such entry appears low and no evidence of such entry has been put forward by Stagecoach.

Coach/rail issues

88. There are six coach routes operated by Stagecoach which overlap with GWF rail routes, five operated by Megabus (containing ten flows) and the Oxford Tube which runs between Oxford and London. On all of these flows Megabus and Oxford Tube face extensive coach competition, primarily from National Express. In each case the National Express service[40] more than exceeds that of the effective competitor criterion as defined by the CC in *ScotRail.*[41] These flows are therefore not considered further.

VERTICAL ISSUES (Multi-modal ticketing)

89. In securing the GWF, the potential may exist for Stagecoach to enhance the integration of bus and rail services in the overlapping regions.

90. Stagecoach participates in a number of multi-modal ticketing schemes that are managed either by a TOC (FGW, Wessex or Virgin Trains, in the case of most schemes relevant to the GWF) or by the Association of Train Operating Companies. In roughly half of these schemes, Stagecoach is the only bus operator participating in the scheme, whereas in other schemes Stagecoach participates together with other operators.

91. Here, as in past cases,[42] it has been observed that integrated transport networks have a potential source of competitive advantage against new entry or expansion by existing smaller operators. Stagecoach has not developed multi-modal ticketing schemes that are exclusive to its own operations on its other rail franchises. Stagecoach claims that its policy is to support schemes open to all operators (which is a requirement of Plusbus schemes) so that customers have maximum convenience and use of public transport is encouraged.

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[39] *FirstGroup/GB Railways*; *FirstGroup/Thames Trains*; *Connex/Govia* see OFT website www.oft.gov.uk.
[40] And that of the Oxford Bus Company.
[41] See further above.
[42] See, for e.g., *Arriva/Wales and Borders*, *South Eastern/IKF* and *Virgin/ICEC*.

92. Stagecoach claims that it has no plans to change this policy. Nonetheless, the ability to introduce tickets valid only on its trains and buses, to provide information on only its interconnecting bus services at its stations or to run buses to give convenient connections to its train services, could allow Stagecoach to limit entry and/or expansion on the routes in question. A number of third parties have raised such a concern in this case and are keen to ensure that they would be involved in any through-ticketing schemes.

93. It is possible that the merger may enhance Stagecoach's position as a network operator. If this strengthened position reduces or eliminates the potential for competitors to enter or expand, this would remove or weaken a source of checks on Stagecoach's ability and incentive to change service levels in a manner which may be to the detriment of consumers. Given the level of evidence, these concerns may be too speculative to form the basis for a SLC finding, but it is ultimately unnecessary to conclude on this point given the OFT's duty to refer established above.

THIRD PARTY VIEWS

94. A number of third party views were sought in relation to this transaction. As noted above, third parties have raised concerns about the difficulty of entry and expansion along with possible network effects.

95. In the Office of Rail Regulation's view, rail/rail overlaps between Stagecoach and the GWF may create a potential for a SLC.

96. The SRA's view is that in general buses act as complements rather than substitutes to rail but assessment has to take place on a case-by-case basis.

ASSESSMENT

97. Stagecoach is one of the three competing bidders for the award of the GWF by the SRA. The GWF will be subject to extensive SRA regulation. Assessment of this merger must take account of the surrounding regulatory context.

98. For point-to-point journeys where the GWF rail services overlap with bus services already provided by Stagecoach, in many cases Stagecoach would be the only supplier of public transport services post-merger.

99. As to bus/rail overlaps, the key issue raised by the transaction is whether the combination of these formerly independent public transport alternatives for a given journey would in fact reduce competition such that post-merger Stagecoach would have the incentive to increase bus fares and/or reduce frequencies as a result of the merger. The degree of competition that bus and rail impose upon one another derives from the degree to which passengers would switch between the modes in response to price increases (and/or frequency reductions). On this fundamental question the OFT had no significant empirical evidence in relation to the 84 point-to-point flows at issue. However, preliminary price correlation was consistent with the possibility that on

individual flows there might be a material degree of substitutability between bus and rail. In lieu of direct evidence, the OFT has had regard to CC in *ScotRail* and has sought to test how realistic it is to expect merger-induced bus price increases or frequency reductions by simulation using a range of assumptions.

100. On assumptions that we believe not to be unreasonable there would appear to be a substantial incentive for Stagecoach to raise bus prices (and/or lower frequencies) and perhaps also to raise unregulated rail fares as a result of the merger. The theory of competitive harm therefore cannot be dismissed as incompatible with the facts available at this stage of merger review. Accordingly, the OFT believes there is a realistic prospect of a SLC in relation to bus/rail overlaps. Despite best efforts, it has not, however, been possible during first-phase review and with the limited direct evidence of substitutability to engage in precise segregation of flows between those that do and do not raise such concerns.

101. As the bus/rail undertakings in lieu offered do not represent a clear-cut solution to a clear-cut concern, this exception to the duty to refer could not be applied. Given the OFT's duty to refer in any event, it was unnecessary to reach definitive views on issues raised by the many (nearly 300) rail/rail overlaps, albeit of limited duration, or in relation to multi-modal ticketing.

102. In conclusion, 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.

DECISION

103. This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.