

## Anticipated acquisition by FirstGroup PLC 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.

---

### PARTIES

1. **FirstGroup PLC (First)** is a UK-based international transport company with turnover in year to March 2004 of £2.5 billion. FirstGroup is active in the passenger rail sector and is the parent company of the train operating companies (TOCs) currently running five rail passenger franchises: First Great Western, First Great Western Link, TransPennine Express, Hull Trains, and First ScotRail. FirstGroup also has a number of passenger bus operations in localities throughout the UK, including First Berkshire, First Bristol, First Cymru, First Devon & Cornwall, First Hampshire & Dorset, First Somerset & Avon and First Wyvern, which all operate services in the Greater Western franchise area.
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. First is one of three pre-qualified bidders in the competition for the GWF. National Express Group PLC (NEG the parent company of the other incumbent franchisee, Wessex) and Stagecoach Group plc (Stagecoach), 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 14 June 2005 and, with their agreement, the OFT extended its review beyond the 40 working-day administrative deadline, which expired on 9 September 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 First's bid for the GWF is successful, First 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.<sup>1</sup>
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 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'.

---

<sup>1</sup> 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*).

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.<sup>2</sup> 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 *Stagecoach/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 First's interest in bus services in Bristol, Devon and Cornwall, Hampshire and Dorset, Somerset and Avon, Wyvern, Berkshire and South Wales.

## 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 disembarkation point), personal preference, value of time and relative costs of the available alternatives.<sup>3</sup>
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

---

<sup>2</sup> See *ScotRail* at para.4.5.

<sup>3</sup> 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.

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.
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 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.<sup>4</sup>
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.

---

<sup>4</sup> 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 31 March 2005). (See OFT web-site [www.of.gov.uk](http://www.of.gov.uk)).

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 First would become the sole or principal provider of public transport. As detailed below, this does not occur in relation to First's rail operations, but does occur in many instances in relation to First's pre-existing bus 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 over 400 overlap markets that First'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.

### 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 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*<sup>5</sup>). 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.

---

<sup>5</sup> Reported on 7 July 2005. See OFT web-site [www.of.gov.uk](http://www.of.gov.uk).

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. First operates bus services that overlap with the GWF. There are no rail-on-rail overlaps in this case.
29. The OFT has primarily sought to test whether First would have the post-merger ability and incentive to raise fares or reduce frequencies in order to increase profits.<sup>6</sup>
30. This theory of harm presupposes that bus and rail compete to some degree, on the basis that passengers regard them as potential substitutes on the overlap flows in question. On a large number of overlapping flows, First 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.
31. First acknowledges that different modes may sometimes be regarded as substitutes by a proportion of passengers but disputes it in relation to other journeys. First 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.
32. 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 0.39. Although this is a much weaker positive correlation than in some previous cases,<sup>7</sup> such an analysis is consistent with the possibility that on individual flows there might be a degree of substitutability between bus and rail.
33. Secondly the OFT modelled the potential profit incentive for First to raise prices or reduce frequencies, consistent with the approach first undertaken by the CC in *Scotrail*

---

<sup>6</sup> 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 First 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 para.43.

<sup>7</sup> In particular *South Eastern/IKF* where the relationship showed a positive coefficient of 0.84.

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

34. 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. First has presented overlap data and analysis based upon these filters.
35. The OFT acknowledges the utility of filters at first-phase merger review, especially in a case with over 400 overlaps, where sifting the number of flows to be considered to a manageable number is vital.
36. However, such filters are pragmatic, need to be checked for robustness/sensitivity, and could be case-specific (see *FirstGroup/ICEC* Commentary<sup>8</sup>). 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.
37. 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.
38. Although acknowledging that the 10 per cent 'filter' is not an automatic safe harbour and that each individual case has to be examined on its merits, First has consistently argued that the factual matrix of this case is 'almost identical' to that in *ScotRail* and hence it sees 'no good reason to depart from the [CC]'s approach.'
39. First has identified 403 flows on which there is a bus-on-rail overlap with the GWF. In assessing bus-on-rail overlaps in *ScotRail*, the CC considered that the routes which 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.<sup>9</sup>

---

<sup>8</sup> See CC, *FirstGroup/ICEC* (terminated) merger inquiry: commentary on issues statement, 20 June 2005, (*FirstGroup/ICEC*).

<sup>9</sup> 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').

40. 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.
41. The CC's next step was to consider other factors relevant to determining the effect of the acquisition on competition on those potentially problematic routes. If an effective competitor<sup>10</sup> is present on a route, First 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 36 of the 403 overlapping flows.
42. It has been tested whether post-merger First 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' conducted by the CC in *ScotRail*,<sup>11</sup> which simulates the increase in profit (and revenue) that First 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).
43. A related theory of harm on overlaps where First 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.<sup>12</sup> 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.<sup>13</sup>

#### Incentives to increase bus prices

44. The OFT modelled the potential profit incentive for First to raise bus fares post-merger. Should bus fares rise,<sup>14</sup> 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, as in *South*

---

<sup>10</sup> See *ScotRail* at Appendix G paragraph 21.

<sup>11</sup> This analysis has also been conducted by the OFT in its assessments of the sale of the *South Eastern/IKF* and *Stagecoach/TGN*.

<sup>12</sup> 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).

<sup>13</sup> See paras. 25-27 above.

<sup>14</sup> 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.

*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.

45. In conducting the analysis a series of assumptions need to be made on the own price elasticity demand of bus travel<sup>15</sup> and the extent to which a price increase would cause passengers to switch from First bus to GWF rail.<sup>16</sup> 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.
46. In the OFT's view, using a range of reasonable assumptions is appropriate when no empirical data are available. Under arguably relatively conservative assumptions<sup>17</sup> 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 First may be incentivised to behave anti-competitively.
47. Of the 174 flows on which the analysis was run, 15 of these<sup>18</sup> make up 50 per cent of the revenue uplift. On these flows 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 First to behave anti-competitively.
48. Looking in more detail at these 15 flows, four of them 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 particularly substitutable. Conversely, given the fact that on two flows, (namely Bristol-Nailsea and Backwell and Falmouth-Truro) the off-peak single 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.
49. This possibility was dismissed on the basis of more detailed examination of the fares. Although the 'walk-on' single fares are higher, the revenue per journey figure<sup>19</sup> is continuously higher on rail than bus. This indicates that a substantial proportion of passengers using these bus flows are not using the 'walk-on' fare. This may indicate

---

<sup>15</sup> The own price elasticity of demand measures how responsive bus passengers are to changes in price.

<sup>16</sup> 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.

<sup>17</sup> A price increase of 3 per cent, an elasticity of -1 (which assumes that First is currently profit-maximising with zero marginal cost - as long as capacity remains constant - on rail) and a diversion ratio of 50 per cent.

<sup>18</sup> The fifteen flows fall within the following bus routes 8, 8A, 9, 9A, 88, 88B, 5, 10, 337, 349, 354, 364, X4, X5, X39, 21, 21A, 921, X1 and X42.

<sup>19</sup> The amount of money First receives from the patronage on a given journey, calculated by dividing total revenue by number of passengers.

that many passengers are using discounted or concessionary fares and would therefore not be likely to switch.<sup>20</sup> However, again in the absence of data concerning passenger profiles, the OFT is not able to satisfy itself that First would be unable to implement the theory of harm in relation to these flows.

50. Furthermore, within these 15 flows there are clear examples of flows which are far less symmetric in terms of their service levels (e.g. Bath Spa to Bristol Temple Meads) and where there would appear to be no real constraint on First's ability to raise prices.
51. First has submitted various arguments as to why it would be unable or unwilling to implement the price rises we have modelled. Aside from disputing the assumptions we apply, First argues that since fare increases on particular flows on a route will have knock-on effects on the other flows on the route and would otherwise cause 'substantial difficulties,' this would outweigh any benefits deriving from profit increases on the overlapping flows. These difficulties are said to arise from the fact that fare stages do not correspond to station catchment areas and are linked along a route, and the amount of management time and effort that would be required to implement specific changes.
52. Although the OFT sees some logic in the argument relating to fare stages, First has failed to provide any consistent evidence demonstrating this constraint in practice. As to management time, since fares are reviewed on at least an annual basis in any event; the OFT can see no incremental administrative costs that would deter fare increases.
53. First also argues that the 'majority of fare increases are general increases in fares at specific prices across all routes in an area.' In addition it states that 'a price increase of around 3 per cent would be significant for many fares and a general 10 per cent price increase would be considered substantial by many customers.' Neither of these assertions is substantiated by firm evidence. In fact, the OFT has received a significant amount of verifiable evidence that shows First increasing fares on numerous individual flows by between 5 per cent and 25 per cent. In addition, we have received examples of First implementing fare stage general price increases of up to 122 per cent.

#### Incentives to reduce bus frequency

54. 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 which, in the event of a reduction in frequency, passengers who switch away from bus do so to rail (diversion ratio).

---

<sup>20</sup> This also corresponds to the passenger demographics of the area which First has provided us with, i.e, a high proportion of old people and others eligible for discounted tickets.

55. Even under arguably relatively conservative assumptions<sup>21</sup> 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.
56. 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 First to behave anti-competitively.
57. First has put forward various reasons why such frequency reductions are not realistic in practice. Chief among these appear 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.
58. First argues that on a number of the overlapping flows First bus services are tendered and that this limits their ability to either raise prices or reduce frequency. The OFT accepts that if a service is fully-tendered then during the life of the contract First will have limited ability to make substantial changes to the service levels. However, an examination of the evidence we have received during the investigation from both First and third parties alike shows that the impact of tendering (be it full or partial) on both the ability and incentive for First to increase prices and/or reduce frequency varies greatly.<sup>22</sup>
59. First argues its commercial freedom is constrained by concerns over local authorities reacting to adverse service level alteration by encouraging First's competitors to expand on to the affected routes. The tendering agreements that the OFT has examined show no evidence of this in response to First changing its services. Furthermore, none of the contracts submitted to the OFT contain penalty clauses, and third parties have explained that there is little they can do in the event of a default by the tenderer as they are often the only operator who can viably provide this service.
60. Finally, the OFT's assessment shows that on the majority of flows where the service is partially tendered, revenue from non-tendered services represents more than 90 per cent of the overall route revenue. In short, the presence of some tendering on the route does not appear to constrain First's ability or incentive to change fares and frequencies.

---

<sup>21</sup> A frequency reduction of 10 per cent, an elasticity of -1 and diversion ratio of 50 per cent.

<sup>22</sup> In terms of this variety see, for e.g., Appendix M, paragraph 19 of *ScotRail* which explains the distinction between minimum-subsidy and minimum-cost tendering contracts.

## Barriers to entry and expansion

61. First 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. On the routes First has identified where it sees competitor expansion as most likely, the OFT has contacted the potential entrants 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 First.
62. Third parties have also cited network issues as a potential barrier to entry and expansion as well as predation by First, 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.<sup>23</sup>
63. In this case insufficient evidence has been supplied to show that entry or expansion onto flows can be relied on to prevent a SLC.

## Conclusion

64. Without better evidence on actual substitutability between bus and rail on the relevant overlap flows, the OFT has tested whether First might have the 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

65. 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.

---

<sup>23</sup> 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.

66. First has offered a set of behavioural undertakings based on those accepted by the CC in the *ScotRail*.
67. 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 this 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.<sup>24</sup>
68. 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.

#### **VERTICAL ISSUES (Multi-modal ticketing)**

69. In securing GWF, the potential may exist for First to enhance the integration of bus and rail services in the overlapping regions.
70. First is already active in a number of First-only multi-modal ticketing schemes in the franchise area. First maintains that it has little incentive to engage in anti-competitive behaviour given the public authority interest in these schemes and the limited revenue that they generate. First also participates in multi-operator schemes within the franchise area which it claims will be continued (wherever practical) if it acquires the GWF.
71. Here, as in past cases,<sup>25</sup> it has been observed that integrated transport networks generate a potential source of competitive advantage against new entry or expansion by existing smaller operators. By introducing tickets valid only on its trains and buses, by providing information on only its interconnecting bus services at its stations or by running buses to give convenient connections to its train services, First may 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.
72. It is possible that the merger may enhance First'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 First'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

---

<sup>24</sup> See, in particular, paragraphs 8.3 and 8.4 of the OFT *Mergers, Substantive Assessment Guidance*.

<sup>25</sup> See, for e.g., *Arriva/Wales and Borders, South Eastern/IKF* and *Virgin/ICEC*.

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

73. A number of third party views were sought in relation to transaction. As noted above, third parties have raised concerns about the difficulty of entry and expansion along with possible network effects and First-only multi-modal ticketing schemes. [ <sup>26</sup>].
74. 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

75. First 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.
76. For point-to-point journeys where the GWF rail services overlap with bus services already provided by First, in many cases First would be the only supplier of public transport services post-merger.
77. As to bus/rail overlaps, the key issue raised by the transaction is whether the combination of these otherwise independent public transport alternatives for a given journey would in fact reduce competition such that post-merger First 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 174 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 the 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.
78. On assumptions that the OFT believe not to be unreasonable there would appear to be a substantial incentive for First 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

---

<sup>26</sup> Information excised at the request of FirstGroup.

evidence of substitutability to engage in precise segregation of flows between those that do and do not raise such concerns.

79. 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.
80. 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**

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