OFFICE OF FAIR TRADING

Anticipated acquisition by Virgin Group Investments Limited and Stagecoach Group plc of the Intercity East Coast Mainline Franchise

The OFT's decision on reference under section 33 given on 21 December 2004

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PARTIES

1. **Virgin Group Investments Limited (Virgin)** encompasses over 200 companies operating in a range of sectors including transport, financial services and entertainment. Ivanco (No. 1) Limited ('Ivanco') is a wholly-owned subsidiary of Virgin and holds a 51 per cent shareholding in Virgin Rail Group Holdings Ltd (VRG). VRG is the parent of the companies currently operating the West Coast Mainline (WCML) and Cross Country (VXC) passenger rail franchises. The WCML franchise covers the Western arterial rail network operating between London Euston, Glasgow, Manchester, Liverpool, Holyhead and the West Midlands. The VXC franchise, which is to be re-tendered in 2006 (see paragraph 8 below), covers the rail network from Aberdeen-Glasgow-Penzance and Brighton to North Wales.

2. **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 which 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 (from Waterloo) and the Island Line (Isle of Wight). Stagecoach also holds a 49 per cent shareholding in VRG.

3. Mr. Brian Souter and Mrs. Ann Gloag, as directors and shareholders in Stagecoach hold, together with their family interests, more than 25 per cent of Stagecoach's issued share capital. They also hold a controlling interest (95 per cent of the

issued share capital) in **ScotAirways Group (ScotAir)**. They therefore have a controlling interest in ScotAir and also have the ability materially to influence Stagecoach.

4. **InterCity East Coast (ICEC) Franchise** operates long-distance high-speed passenger rail services linking London with parts of East Anglia, East Midlands, Yorkshire, North East of England and Scotland. The franchise is currently operated by Great North Eastern Railways (GNER) and the turnover for the year to 4 January 2004 was around £429 million.

TRANSACTION

5. Ivanco and Stagecoach have established Inter City Railways Limited (ICR) as their bidding vehicle for the ICEC franchise, through which they have submitted a bid to the Strategic Rail Authority (SRA) to be awarded the new ICEC franchise.

6. In May 2004, the SRA announced that four parties, one of which is ICR (via Virgin and Stagecoach), had successfully pre-qualified as a bidder for the new ICEC franchise. The other three pre-qualified bidders are: the incumbent operator, GNER; Danish Railways (DSB); and FirstGroup plc. The SRA issued an Invitation to Tender to the four pre-qualified bidders on 6 October 2004 and is expected to announce its choice of preferred bidder in February 2005. The franchise term (a period of six years and 11 months) is expected to commence on 1 May 2005.

7. The transaction was notified to the OFT by Virgin and Stagecoach on 27 October 2004. The 40-working day administrative deadline is 23 December 2004.

8. The VXC franchise is to be re-tendered in 2006 and the OFT has therefore assessed the competition effects of this transaction including potential remedies on the basis that Virgin may no longer hold that franchise after that date. Should Virgin be awarded the VXC franchise again, the OFT would reassess whether any competition concerns would arise from such an acquisition.

JURISDICTION

9. The award of a rail franchise constitutes an acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993 (as amended). If ICR's bid for the ICEC franchise is successful, the businesses controlled by Virgin and Stagecoach (and Mr. Souter and Mrs Gloag) will cease to be distinct from ICEC. The franchise's turnover in the UK in the last financial year was in excess of £70 million. Therefore, the transaction meets the turnover test in section 23 of the Enterprise Act 2002 (the Act).

10. 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.

RELEVANT MARKET

11. Overlaps exist between the ICEC franchise and Virgin's WCML and VXC franchises in the provision of rail passenger transport services between London and Scotland and the north of England and between the north of England (from Doncaster) and Scotland respectively, as well as between the ICEC franchise and Stagecoach's bus and coach services. The operation of air services between points served by the ICEC franchise will also be considered.

Product market

12. Passengers' choice of mode of transport on any journey depends on a number of different factors including access to a particular means of transport (either at the boarding or disembarkation point), personal preference, value of time and the relative costs of the available alternatives. The prospects for substitution between rail and other forms of transport for a given journey are considered in outline below.

13. Air travel as, compared to rail travel generally, requires additional costs and time in getting to and from the airport as well as additional check-in time, although this is often more than offset by quicker journey times.

14. 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.

15. As regards private transport, evidence collated by the Competition Commission (CC) in its *FirstGroup/ScotRail* and *NEG/Greater Anglia* merger inquiries 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, amongst other things, the level of car ownership in the particular area and whether the relevant journey is urban or rural.[1]

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[1] 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 ScotRailRailways Limited, 28 June 2004; National Express Group plc and the Greater Anglia franchise, A report on the acquisition by National Express Group plc of the Greater Anglia franchise, 4 November 2004.

16. As well as varying by route, the degree of substitutability between different transport modes is also dependent upon characteristics of the user. Of particular relevance in the CC's *NEG/Greater Anglia* report, where coach-on-rail overlaps were prevalent, was the distinction between leisure passengers, commuters and business travellers who exhibited different sensitivities to journey times. The incumbent franchisee, GNER, has estimated that leisure passengers account for [60-80 per cent][2] of all journeys made on the ICEC franchise and [40-60 per cent][3] of overall revenue earned along this route.[4]

17. In this investigation, third party respondents were generally in agreement that passengers are able to substitute between different modes of public transport on point-to-point flows, particularly where journeys are longer. These aspects are considered in more detail below when assessing the specific overlap flows.

Geographic market

18. In making a journey, passengers wish to travel from a particular origin to a specific destination. The CC has most recently concluded in its report on the *FirstGroup/ScotRail* merger that point-to-point public transport journeys are to be considered the relevant geographic frame of reference for competition assessment. Point-to-point frames of reference have consistently been employed in relation to various modal combinations such as bus/coach/rail and rail/rail and coach/rail (see, for example: OFT decision in *FirstGroup/Thames*; Monopoly and Mergers Commission (MMC) reports in *NEG/Midland Mainline, NEG/ScotRail, NEG/Central Trains*; and CC decisions in *FirstGroup/ScotRail* and *NEG/Greater Anglia*).[5]

19. The OFT has not received any evidence in this case that warrants departing from the point-to-point approach. In particular, the collected evidence does not warrant identification of a broad London-Scotland public transport market.

20. 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 (e.g., London to Edinburgh) or may represent a smaller 'flow' that comprises part of a longer route (e.g., the Edinburgh to York flow, which is part of the Edinburgh-London and Edinburgh-Birmingham routes).

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[2] Figures replace with a range at the request of GNER.
[3] Figures replace with a range at the request of GNER
[4] Source: ICEC Market Analysis
[5] National Express Group plc and Midland Mainline Limited: A report on the merger situation, 20 December 1996, Cm 3495; National Express Group and ScotRailRailways Limited: A report on the merger situations, 16 December 1997, Cm 3773; National Express Group plc and Central Trains Limited: A report on the merger situation, 16 December 1997, Cm 3774.

21. Stagecoach operates bus services in some areas which overlap with the ICEC. These operations may form part of broader public transport networks which will also be considered in this assessment.

HORIZONTAL ISSUES

Impact of regulation

22. 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 (that will be used for the ICEC franchise) 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 ICEC franchise in two main ways: via the service level commitment and fare controls.

    - The service level commitment in the franchise agreement is a specification by the SRA of the level, frequency, maximum journey time and stopping pattern of all of the passenger services to be operated by the franchisee. This is now so specific that the SRA's Invitation to Tender for the ICEC franchise identified the precise train timetable to be provided by the franchise winner. Only the SRA can change the service level commitment. The franchisee can propose changes but the SRA may veto them.

    - As to fare regulation, the price of certain fares will be linked to the rate of inflation. At present, the SRA's policy is to allow regulated fares to rise annually by no more than RPI + 1 per cent. Although this allows the winner of a franchise some degree of flexibility in offering and setting unregulated fares, the merging parties and the SRA have said that the price of regulated fares on specific flows in practice constrains to some degree the prices of unregulated fares on the same flows. This proposition was accepted by the CC in its report on the *NEG/Greater Anglia* merger.

23. The proportion of regulated revenue to total revenue for the ICEC (based on the turnover of the current franchisee) is [20-40 per cent].[6] A large majority of the ICEC's revenue is therefore derived from unregulated fares, of which a large number are 'reduced' off-peak fares.

[6] Exact figure replaced by a range at GNER's request.

Analytical framework

The parties' arguments

24. In addition to arguments related to the competitive force of alternative modes of transport on particular overlap routes or flows, Virgin and Stagecoach have argued that the various aspects of the regulatory framework will represent an effective constraint on their post-merger behaviour. In the context of the OFT's competitive assessment of its bid for the ICEC franchise (see CR/173/04), FirstGroup has raised similar arguments.

25. The various arguments advanced by Virgin, Stagecoach and FirstGroup can be synthesised into the following framework which they rely on to say why a bid for the ICEC give rise to no realistic prospect of a substantial lessening of competition in relation to overlaps between rail services on any given route or flow.[7]

- **Competition concerns cannot arise without pre-merger competition on an overlap flow or route.** In order for there to be pre-merger competition on a flow that could be affected by the award of the ICEC franchise, it would be necessary to identify whether, on a particular flow: (i) passenger rail service providers appeared to serve the same passengers; (ii) they operated similar timetables and frequencies; and (iii) a sufficient proportion of fares (60 per cent[8] was advanced as an appropriate level) remained unregulated to leave any room for price competition. If these conditions were met, competition might be said to exist.

- **It is doubtful that the merger would lessen such competition as exists in overlap flows.** Even if there were competition on an overlapping flow, it is limited in scope because: (i) there are no economic incentives for the parties to reorganise entire fare structures to take advantage of any perceived loss of competition on a particular flow, unless the overlap flow accounts for more than 10 per cent of overall revenue on that route (as well as unregulated fares accounting for at least 60 per cent[9] of total fare revenues on that flow); (ii) on many routes, train tickets of various TOCs are interavailable and, as a result, interavailable ticket prices on a flow are

[7] Although certain of the specific points mentioned in this synthesis were advanced by only Virgin/Stagecoach or FirstGroup, it is appropriate to consider them together since they relate to the acquisition of the same franchise in the same regulatory context. Accordingly, the OFT's competitive assessment of each individual transaction – while focusing on the merits of each bid proposal – takes due account of all arguments that have been raised.
[8] The parties wish to highlight that this was not derived from Virgin/Stagecoach material, see footnote 7 above.
[9] See footnotes 6 and 7 above.

identical for each operator;[10] and (iii) the flow could be an 'odd' overlap that would require the parties to reconfigure an entire route to take advantage of a loss of competition on a single flow; and.

- **In any event the press of rail regulation would prevent post-merger anticompetitive effects.** Even if all the above conditions are met, it has been argued that there is still no realistic prospect that, post-merger, unregulated fares may be increased or service levels reduced because: (i) unregulated fares need to maintain a certain relativity vis-à-vis regulated fares ; (ii) the parties face high own-price elasticity for leisure passengers, which means that any price increase would be unprofitable; and (iii) high service levels are prescribed in detail in the franchise agreement and there is no incentive for TOCs to further improve upon them.

The OFT's view

26. Virgin has a number of pre-existing rail services through its WCML and VXC franchises operating between the same origin/destination points as the ICEC (rail-on-rail overlaps). Before turning to each of the specific overlap routes and flows, some of the general arguments raised above need to be considered.

Competition concerns cannot arise without pre-merger competition on an overlap flow or route.

27. Identification of pre-merger competition between services is a pre-requisite for any finding that the proposed merger might raise competition concerns. At first sight, a comparison of service frequency, journey time and passenger numbers is a reasonable proxy for establishing the existence of some degree of pre-merger competition between two TOCs on the same overlap flow.

28. In relation to the proposition that unregulated fares should account for at least 60 per cent of revenues before there is any incentive to reorganise services, there is no evidence to show that such a level of regulated fares (i.e. 40 per cent) provides a constraint on unregulated fares that make up the balance (at least 60 per cent of fare revenue) on a particular route.[11]

29. In these circumstances, the OFT believes that where unregulated fares account for more than a low proportion of revenues on a particular flow, it is appropriate

[10] On interavailable flows, prices for interavailable tickets for all TOCs operating on the flow are set by a "lead operator" pursuant to the SRA-approved and Office of Rail Regulation (ORR)-approved Ticketing and Settlement Agreement.
[11] The parties wish to highlight that this was not derived from Virgin/Stagecoach material, see footnote 7 above.

to consider further whether in the post-merger situation prices might rise on the flow or service levels deteriorate.

It is doubtful that the merger would lessen such competition as exists on overlap flows.

30. Even where separate TOCs offered services on the same overlap flow pre-merger, it is not necessarily the case that, post-merger, unregulated fares may be expected to rise. However, on such flows (where more than one TOC operates), a merger of them might be expected to give rise to a unilateral (or non-coordinated) price increase in unregulated fares. It has been put to the OFT that, regardless of tight regulatory control for many fares, there remains some scope for direct price competition on unregulated fares.

31. To assess the likelihood of this happening, the OFT has tried to assess the possible impact of competition on unregulated fares by comparing the price per mile of a non-regulated standard open return ticket across a sample of overlapping routes identified by Virgin, as well as on a sample of major monopoly routes. Here, the following points are relevant.

    - These comparisons suggest that fares per mile are generally higher (up to 70 per cent higher) when one TOC operates a route than when two TOCs are active on the same route or flow.

    - The parties have has criticised these comparisons on a variety of grounds including: the limited scope of the selected sample of routes and fares; the fact that fares on routes are not necessarily cost-related making such comparison difficult; and the impact of other factors (such as overcrowding and route-specific investment) on fare-setting for particular flows or routes. There is some weight in these points.

    - However, the results of the OFT analysis are consistent with broad third party concern that the loss of a TOC from a route might lead to increases in non-regulated fares.

32. Although the results of the fare comparisons above are not decisive, the OFT considers that there is sufficient weight in the quantitative and qualitative evidence to consider that, in general, the presence of two TOCs on a given overlap flow may lead to a degree of competition that benefits consumers, despite the surrounding regulatory context.

33. As noted above, it has been argued that, even in this circumstance, post-merger there would be no incentive for a merged entity to seek to increase unregulated

fares on the flow unless the flow itself accounted for more than 10 per cent of total revenues on the whole route. This argument is borrowed from the analysis conducted by the CC in *FirstGroup/ScotRail*. It was used in that case in relation to bus on rail overlaps to identify problematic flows. It is questionable whether the CC's approach can be so simply extended to rail-on-rail overlaps, where TOCs are likely to be each other's closest competitor.

34. The issue of interavailable fares is relevant to the extent of pre-merger competition between TOCs operating on the same flow. Interavailable fares for each flow are set by the 'lead operator' for that flow. The lead operator is normally the TOC with the greatest commercial interest in the flow concerned. Once these fares have been set, the Ticketing and Settlememt Agreement, as approved by the SRA and ORR, requires the other TOCs operating on the flow to honour them. In these circumstances (where the lead operator sets the fare for both TOCs), economics suggests that the fare setter does not face the usual discipline that, if it raises price it loses sales and hence share of supply to its competitor since the competitors price will also rise automatically by the same amount. The lead operator will therefore set the interavailable fare without taking into account the threat of losing passengers to another TOC. So, it is likely to set the fare higher than the competitive level. In other words, where fares are interavailable, it is likely that the presence of a second TOC offering that fare would make little or no difference to the level at which the fare is set by the lead operator. It follows that, removal of the second TOC (through merger or otherwise) would make no difference to the level of the interavailable fare. Accordingly, the OFT accepts that where a lead operator sets interavailable fares, the scope for price competition to exist between operators is muted.

35. However, even where fares are interavailable and set by lead pricing, there remains a possibility that TOCs may compete in relation to the mix of ticket types that they offer. TOCs are not required to offer fares on all services and can change either the type of tickets valid for a particular service or can vary the proportion of cheaper fares on each flow. There is evidence that TOCs compete in this way where they serve the same flow, and this competition might be lost following a merger. In particular, it appears that the average ticket price for an operator on a given flow could be affected by the quantities of different types of tickets offered, for example, by altering the availability of cheap 'saver' tickets. This occurred in *NEG/Greater Anglia* where certain cheap unregulated ticket types were withdrawn post-merger.

In any event the press of rail regulation would prevent post-merger anticompetitive effects.

36. As to whether the press of rail regulation would nonetheless act as a sufficient constraint to prevent price increases in the circumstances described above, it seems clear that regulated fares constrain to some degree the ability of TOCs to raise the price of unregulated fares. There is little evidence however to gauge the extent of this constraint or whether it would eliminate incentives for post-merger price rises. Similarly, the available evidence provides little indication of the own-price elasticities faced by Virgin and Stagecoach in respect of their unregulated fares pricing.[12] As to service levels, the SRA and TOCs consulted all agreed that the new SRA template franchise agreement was highly prescriptive as to the services to be provided by the franchisee. This is likely to act as a significant constraint on a TOC's ability to reduce or indeed increase service levels materially.

Overlaps between Virgin/Stagecoach and ICEC rail services

37. The OFT's competitive assessment of individual rail-rail overlaps has proceeded in light of the above analysis. It has focused on point-to-point rail journeys that are currently served by both a Virgin/Stagecoach-controlled TOC and ICEC in circumstances where dedicated fares (i.e., fares for use only on trains owned by a particular TOC, which are therefore not interavailable) and unregulated fares on an individual flow represent a material proportion of total revenues on a route. Although the available evidence does not suggest that concerns arise on any overlap point-to-point rail route presently served by more than two TOCs, the OFT has also considered the impact of the transaction on certain other Scottish rail flows where post-merger two TOCs would remain: however, this is because of the presence of Stagecoach in the route too.[13]

Long distance routes

London-Edinburgh

38. The OFT does not consider that Virgin's WCML service from London to Edinburgh represents a significant competitive constraint on GNER's London to Edinburgh service. Currently, WCML only operates one train per day from London Euston to Edinburgh as compared to 17 trains operated by GNER on the ICEC from London Kings Cross. The WCML service accounts for something less than 0.1 per cent of

[12] This question is difficult to gauge. The CC in its *NEG/Greater Anglia* decision focused on the price elasticity exhibited by leisure passengers. While some unregulated fares are targeted at leisure passengers, some unregulated fares apply to business passengers. Furthermore, off-peak fares are not necessarily unregulated.

[13] There are a variety of other flows where, post-merger, at least two TOCs would provide rail services on that flow. Third parties did not raise any specific concerns in relation to these routes: namely, York–Darlington; Edinburgh-Aberdeen (and several interim stations); Darlington-Durham; and Durham-Newcastle.

total rail passengers on this route. It therefore seems to offer no substantial competitive constraint on the ICEC franchise rail services.

39. ScotAir and Megabus also provide London-Edinburgh public transport services. However, neither need be considered in any detail. To the extent that passengers would switch to air alternatives to the ICEC franchise on this route, ScotAir accounts for only a small proportion of daily flights and passengers from London to Edinburgh. While ScotAir operates 9 daily flights on this route, 36 daily flights are operated by competing airlines. Megabus also runs coach services from London to Edinburgh, but these are not considered a realistic material constraint on rail services on this route pre-merger. To the extent that Stagecoach's Megabus service competes with the ICEC franchise service, it provides only a limited service compared with National Express. Accordingly, the merger would not appear to eliminate an important constraint on the ICEC franchise.

London-Glasgow

40. WCML, VXC and GNER currently offer rail services on this flow. While VXC only operates indirect services, which are rarely used to travel from London to Glasgow, the ICEC services and WCML services both operate direct London to Glasgow rail services. In this sense, they might be seen as close competitors. The number of rail passengers carried by each service is significant (WCML: [...]; GNER: [...])[14], and they offer comparable daily service frequencies (10 and 6, respectively).

41. However, the parties have submitted that competition from airlines is particularly strong on this flow. The table below identifies the principal operators along this flow together with details of the number of services provided per day, number of passengers annually, and the range return fares each offers.

Operator	No, of daily services	Annual passengers[15]	Return fares[16]
WCML	10	[...]	£54-£206
ICEC	6	[...]	£27-£206
British Airways	17	[...]	£63-£337
British Midland	8	[...]	£51.40-£335.40
Easyjet	5	[...]	£35.98-£260
Ryanair	5	[...]	£38-£278
Megabus	3	[...]	£4-£26
National Express	3	[...]	£29-£37

[14] Information excised at the parties' request.
[15] Information excised at the parties' request.
[16] These fares show a representative range of standard class fares that are available from each operator. They may not, however, reflect in detail the complete fare range.

42. These data show broadly comparable ranges of daily frequencies and fares between the airlines and the two TOCs. Air travel accounts for [over 90 per cent][17] of total public transport passenger journeys between London and Glasgow whereas merely [around 5 per cent][18] of those journeys were made by train. This would seem to suggest that air services are a competitive alternative to rail. The body of other evidence is consistent with that suggestion.

- Virgin's internal business planning documents show consistently that it expects airlines to exercise a strong competitive constraint on its operation of the WCML services.

- Virgin argued that because of the strength of the constraint from air transport, when ticket prices increased on the entire WCML they did not increase to a similar extent on the London to Glasgow flow. In fact, rail fares on that flow have decreased in real terms by [...][19] since 2000 because of strong competition from airlines.

- A passenger survey submitted by Virgin and Stagecoach shows that [over 50 per cent][20] of rail passengers have considered an alternative mode of transport on this flow.

- This is also consistent with trends in airline and rail passenger numbers over the last four years, which show steadily declining numbers of rail passengers at the same time as airline passenger numbers continue to grow. The growth of airline passenger numbers is most striking in relation to budget airline passengers.

- In addition, Virgin's characterisation of the constraint from air travel was widely supported by third parties, including by airlines, other TOCs and by rail passenger representatives.

43. Megabus also operates coach services from London to Glasgow that might compete with the ICEC rail services. However, it is unrealistic to consider Megabus as a material constraint on rail services on this route pre-merger. The journey duration is considerably longer; the pricing structure and level is very different; and the service propositions are quite distinct. Moreover, it is far more probable that any price increase on Megabus services would benefit National Express, which also operates coach services on this route.

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[17] Information replaced at the parties' request.
[18] Information replaced at the parties' request.
[19] Information excised at the parties' request.
[20] Information replaced at the parties' request.

44. In view of this evidence, the OFT is satisfied that there will not be a substantial lessening of competition on the London-Glasgow flow.

London-Dundee

45. VXC only offers indirect rail services on this flow: 3 services a day compared to GNER's 17. Moreover, VXC transports a minimal number of passengers[21] as compared to GNER's [...][22] annual passengers. It is therefore considered that VXC is not an effective competitor to the ICEC services on this flow. The same applies to the coach services operated by Megabus on this flow (see above on London-Edinburgh and London-Glasgow).

46. ScotAir operates 4-5 daily services between London and Dundee. While ScotAir carries a similar number of passenger to GNER annually on this flow [...][23], it is not realistic to consider ScotAir as a material competitive constraint on the ICEC franchise, because ScotAir offers only limited frequencies compared with GNER. Moreover, the proximity of Edinburgh airport and its more frequent services to London would continue to constrain the parties post-merger.

47. In view of this evidence, the OFT is satisfied that there will not be a substantial lessening of competition on this flow.

Mid-distance routes

48. Acquisition of the ICEC by the parties would result in a reduction from two to one TOC on the following flows between Doncaster and Edinburgh:

    (a) Edinburgh/York;
    (b) Doncaster/York;
    (c) Newcastle/Berwick-upon-Tweed; and
    (d) Berwick-upon-Tweed/Edinburgh.

49. As described above, the OFT considers that there may be scope for effective competition between TOCs on a particular overlap flow where they have broadly similar service frequencies and where unregulated fares account for more than a low proportion of revenues on that particular flow. The following table sets out this information for each of the four overlap flows.

[21] Virgin submits that passenger numbers on this flow are too low to be recorded.
[22] Information excised at the parties' request.
[23] Information excised at the parties' request.

	No. of daily services		No. of annual passengers[24]		% of revenues on flow from unregulated fares[25]	
Route	**ICEC**	**VXC**	**ICEC**	**VXC**	**ICEC**	**VXC**
Edinburgh-York	19	13	[...]	[...]	[...]	[...]
Doncaster-York	18	13	[...]	[...]	[...]	[...]
Newcastle-Berwick	14	7	[...]	[...]	[...]	[...]
Edinburgh-Berwick	14	7	[...]	[...]	[...]	[...]

50. These data show that the service frequencies and passenger numbers of the ICEC franchise and VXC franchise on these overlap flows are comparable. In these circumstances, for the reasons set out above, it might be the case that there is some degree of competition between ICEC and VXC services that would be lost as a result of the merger. Only minimal public transport alternatives to rail exist on these flows. There is no competition from airlines. National Express only offers a very limited coach service which is not comparable with the parties' rail services in terms of service frequency and is therefore not considered to be a material competitive constraint on these routes pre-merger.

51. In all four instances, unregulated fares account for more than a low proportion of revenues on the flow. In relation to Edinburgh-York, the unregulated fares account for a very significant proportion of fare revenues.

52. Virgin and Stagecoach have argued that there is no scope for any substantial lessening of competition on the latter three flows (Doncaster-York, Newcastle-Berwick, Edinburgh-Berwick) because all fares on these flows (whether regulated or unregulated) are interavailable. As noted above, in circumstances where all fares on a route are presently interavailable, the OFT considers that the scope for price competition to exist between operators is muted. Accordingly, the merger may make no difference to overall price levels.

53. There is nonetheless some possibility that post-merger Virgin and Stagecoach might be able: first, to vary the mix of ticket/fare types they offer even where fares are interavailable; and, second, to increase the number of dedicated tickets (i.e., those which are not interavailable) it offers on these flows. It therefore seems possible, post-merger, that Virgin and Stagecoach would have an incentive to vary the fare mix on VXC or ICEC services so as to reduce the quantity of less expensive 'saver' type tickets, thus increasing the average cost of rail travel for passengers on these flows.

[24] Information excised at the parties' request.
[25] Information excised at the parties' request.

54. In relation to the Edinburgh-York flow, however, unregulated fares on this route account for a substantial proportion of fare revenue. Here, the very substantial proportion of unregulated fares suggests that both the ICEC franchise and VXC compete for passengers on this flow via differing fare propositions for passengers. This competition would be lost as a result of the merger.

55. As to the effect of continued regulation on operation of these flows, the reasoning set out above indicated that the OFT considers regulation to have an important effect in muting incentives to engage in unilateral conduct to raise unregulated fares or reduce service levels. However, the extent to which this might operate is difficult to gauge. It is notable that some rail passenger groups have raised concerns about the potential loss of competition on the four routes.

56. The OFT has also considered whether there is any prospect of new entry to these flows by other public transport operators that might be sufficient in scope, timeliness and likelihood to constrain the merged entity's competitive behaviour, However, for the following reasons, the OFT does not consider that there is sufficient evidence to reach this conclusion.

- New rail entry, would have to be by way of an open access agreement with the SRA and the ORR. Open access operators compete with existing franchisees without the benefit of operating subsidies received by franchisees. Virgin and Stagecoach have identified the 'Grand Central Railway Company', which plans to launch a new train service across the Pennines and from the North East to London as from December 2005. This would overlap with the Doncaster-York overlap considered here. However, doubts have been expressed by other TOCs as to the viability of such a service. It is as yet uncertain whether Grand Central will begin operating and whether any such operations would be on a sufficient scale to constrain the merged entity. The OFT has therefore come to the view that the possibility of such entry on the relevant routes is not sufficiently likely to remove the identified competition concerns.

- As to competition from air, it is possible that entry of (low-cost) airlines may act to constrain train companies operating on longer distance routes. Entry would require the necessary investment to lease or buy planes as well as appropriate slots at airports. One third party put to us that new entry would be unlikely given capacity constraint at airports. However, the parties have submitted that the low-cost airlines VLM and jet2.com are considering entering on routes between London and the North of England and Scotland. On balance, the OFT does not believe that barriers to entry in the supply of passenger services are low enough to remove competition concerns on these mid-distance monopoly rail routes.

57. In light of the above evidence, the OFT believes that the merger would result in a substantial lessening of competition on the mid-distance flows relating to Edinburgh-York, Doncaster-York, Newcastle-Berwick, and Berwick-Edinburgh.

Overlaps between Stagecoach bus services and ICEC rail services

58. Stagecoach has a number of bus passenger services operating between the same origin/destination points as certain ICEC services.

59. For its assessment of these overlaps, the OFT has adopted the approach of the CC in its *FirstGroup/ScotRail* merger decision. According to this methodology, the routes most likely to give rise to concern are those where the percentage of revenues on a complete bus route accounted for by all overlap flows along that route exceeds 10 per cent. It might also be necessary to consider additional routes where concerns are raised because of reconfiguration issues (see network effects below) or third party concerns.

60. Applying the 10 per cent rule produced three potentially problematic routes listed below. However, as explained for each route, the OFT does not believe that any of these routes would raise competition concerns because sufficient competition from other passenger transport services would remain.

Glasgow–Edinburgh

61. The table below identifies the various providers of Glasgow-Edinburgh public transport services, their respective daily service frequencies and annual passenger numbers.

Operator	**No. of daily services, unless indicated otherwise**	**Annual passengers[26]**	**Offpeak adult return fare**
ICEC franchise	9	[...]	£5.30
VXC	1	[...]	£7.90
ScotRail	76	[...]	£7.90
Motivator	2-3[27]	[...]	£4.50
Citylink	2-4[28]	[...]	£4.00

[26] Information excised at the parties' request.
[27] The coach service frequencies are hourly frequencies.
[28] The coach service frequencies are hourly frequencies.

62. As noted above, there is a minor rail-rail overlap between VXC and the ICEC franchise rail services between Glasgow and Edinburgh. More substantial competition however, is offered by the Motorvator bus services offered by Stagecoach between Glasgow and Edinburgh.

63. However, the data suggest that the main engine of competition on this flow is ScotRail, which accounts for the majority of daily service frequencies and around [...][29] of passengers on the flow. In contrast, the ICEC franchise, VXC and Motivator services together account for only around [...][30] of passengers. Citylink accounts for all remaining Glasgow-Edinburgh public transport passengers.

64. In light of this evidence, the OFT believes that there is sufficient third party competition on this flow that, post-merger, there is no realistic prospect of a substantial lessening of competition.

Perth-Pitlochry

65. Along this route Stagecoach runs an hourly service and the addition of one train per day from the ICEC rail franchise is minimal. In any event, the principal competition will remain in the shape of Citylink (which is comparable with Stagecoach's services in terms of frequency) and ScotRail which has substantially more rail services than the ICEC franchise. Accordingly, there are no reasons to think that a competition concern arises in this context.

Stonehaven-Montrose

66. The successful acquisition of the ICEC would result in the merger of Stagecoach's frequent service along the Stonehaven-to-Montrose route with four ICEC services per day, as well as two VXC services. There remains one less frequent alternative bus service operated by Citylink.

67. However, the OFT considers that the prospects of any substantial lessening of competition emerging on this route can be discounted, because ScotRail will provide competitive discipline post-merger. Any theory of harm would be based on Stagecoach making its bus service less attractive and then earning greater profits from customers switching to the ICEC franchise rail services. In reality, any such strategy would more likely benefit ScotRail, which operates 22 services per day on the route compared with the four ICEC services. The merger would not therefore result in any incentive to offer less attractive bus services on this flow.

[29] Information excised at the parties' request.
[30] Information excised at the parties' request.

Overlaps between Stagecoach coach services and ICEC rail services

68. In addition to the flows identified above, Stagecoach's Megabus operates a number of coach passenger services between the same origin/destination points as certain ICEC rail services. However, these overlaps do not raise any competition concern, for two main reasons.

69. First, the service offered by Megabus is highly differentiated from that of trains, particularly over longer distance routes. Journey times are considerably longer and prices are considerably lower, suggesting that this service is targeted at a different type of customer.

70. Second, on all routes where Megabus is present there is at least one other coach service providing a comparable service. Applying the CC's theory of harm to competition developed in *FirstGroup/ScotRail*[31], any attempt to increase Megabus prices or reduce service levels would be expected to result in a displacement of passengers onto competitor coach services. There is therefore not considered to be an incentive post-merger to reduce service levels or increase prices on rail-on-coach overlaps.

Network effects arising from the combined Virgin/Stagecoach/ICEC public transport services

71. In *NEG/Greater Anglia*, the CC concluded that local bus and train networks could be regarded as complementary and that there might be scope to develop interrelationships between them, for example by supplying multi-modal tickets. While such multi-modal ticketing would be *prima facie* pro-competitive and thus pro-consumer, it might adversely impact on other transport operators if they were denied access to the multi-modal ticketing arrangement at all or allowed access only on less favourable terms. In extreme cases, such adverse effects might induce exit.

72. In England, Stagecoach operates local bus services in three regions which overlap with the ICEC: in the North East, East Midlands and East of England. None of these bus services operates on a point-to-point flow along the ICEC franchise. Since the ICEC is a high-speed, long distance service with relatively few stops, it is serving a different need to that met by Stagecoach's local bus services. In addition, Stagecoach does not appear to operate on routes that could be re-

[31] If bus and rail are substitutable modes of transport on certain point-to-point routes within the franchise area, the acquisition of the rail franchise may permit the bus company to raise prices or reduce service levels on the bus and enjoy increased overall revenue as its bus passengers switched to rail.

configured as feeder services[32] for rail services andl post-merger it will continue to face vigorous competition from the ScotRail/FirstGroup train and bus network. Therefore, it is not considered that there would be sufficient incentives for Stagecoach to develop inter-relationships between the ICEC franchise and their existing bus services. As set out above, such network effects might on the face of it be pro-competitive. They can, however, ultimately result in exit and therefore a loss of competition.

THIRD PARTY VIEWS

73. The ORR has raised some concerns about reduced rail-on-rail competition between London and Scotland. However, this might be mitigated by competition from airlines. It also highlighted concerns with the rail overlaps between VXC and the ICEC between Doncaster and Edinburgh.

74. The SRA did not comment on competition issues raised by this transaction. It informed us that the ICEC would be run on a new template franchise agreement which is more prescriptive than the previous one in terms of service levels and transparency of costs and revenues. [...][33]

75. Some rail passenger groups have raised concerns about overlaps in the area between Doncaster and Edinburgh. However, a majority of third parties were unconcerned. With regard to whether rail services compete with other modes of transport, most notably travel by plane, views were mixed. A majority agreed that on long-distance point-to-point flows passengers could chose between various modes of transport.

ASSESSMENT

76. Virgin and Stagecoach's ICR bid vehicle is one of the four competing bidders for the award of the ICEC franchise by the SRA. The ICEC franchise will be subject to extensive SRA regulation. Assessment of this merger must take account of the surrounding regulatory context.

77. Focusing on point-to-point journeys where the ICEC franchise rail services overlap with rail, bus, coach or air services already provided by Virgin and Stagecoach (including Mr. Souter and Mrs. Gloag), it is possible to identify a number of key overlaps where post-merger Virgin/Stagecoach would be the only supplier of rail services, particularly on various London-Scotland routes and in the North-East of England.

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[32] Such bus services are re-directed in order to connect passengers to rail services operated by the same supplier.
[33] Information excised as requested by the SRA.

78. In relation to the rail routes from London to Edinburgh, Glasgow and Dundee, the evidence suggests that even where there is a clear overlap between an ICEC rail service and an existing Virgin rail service, as on London to Glasgow, there is every prospect for continued vigorous competition from airlines which transport the vast majority of passengers on these flows. Any overlaps with Megabus do not raise concerns, in part because of the differentiation in the price and service offering between Megabus and the ICEC franchise and in part because Megabus will also face continued competition from National Express. Similarly, any overlaps with Scotair do not raise concerns because of the limited overlap and proximity of strong airline competition at Edinburgh airport.

79. There are four flows between Edinburgh and Doncaster however where there is a realistic prospect that the merger would result in a substantial lessening of competition. On these flows, the available evidence indicates real scope for adverse effects from the merger. On the one flow (Edinburgh-York) where there are substantial unregulated, dedicated fares, competition will be eliminated by the merger. On other routes where fares are interavailable or unregulated fares are only a low proportion of total fare revenue on the route, there may still be some prospect of a substantial lessening of competition emerging from changes in the availability or mix of ticket types. The risk of these adverse effects is not mitigated by the prospects of air or rail new entry.

80. The OFT does not believe that the merger would lead to adverse effects on competition in bus and/or coach services. The CC's 10 per cent rule produced three routes in this case that have been assessed in more detail, none of which raises serious concerns because sufficient competition, especially from National Express, bus services and ScotRail, will remain post-merger. As to network effects, there is no evidence that Virgin and Stagecoach would have an incentive to develop favourable inter-relationships with their own local bus services. Such effects would in any not raise competition concerns, unless they result in other operators being excluded from the network.

81. Consequently, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom in particular on the flows between Edinburgh to York, Doncaster to York, Newcastle to Berwick and Berwick to Edinburgh.

UNDERTAKINGS IN LIEU

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

83. The parties offered a range of undertakings to address the potential concerns identified above. Specifically, Virgin and Stagecoach offered:

(a) not to bid again for the VXC franchise when it is re-tendered in 2006;[34]
(b) to continue to offer all current GNER/ICEC fares on the flow from [London via][35] Edinburgh to Glasgow;[36] and
(c) a behavioural undertaking to maintain the particular ticket mix currently offered by the ICEC franchise and, in addition, [on certain flows][37] to introduce a price cap for [certain][38] ICEC standard class fares that would be directly linked to the SRA's regulatory framework.[39]

84. The OFT has considered these undertakings proposals carefully. In doing so, the OFT has taken into account the extensive regulatory framework already in place in this the sector and the fact that the VXC franchise is itself due for re-award in 2006. In these circumstances, given that the OFT has identified a competition concern that relates primarily to the four flows around the Edinburgh-York line and to the ability of the successful bidder for the ICEC franchise to raise prices for unregulated ticket fares, the proposed behavioural undertaking offered by Virgin and Stagecoach might be appropriate. More specifically, the following considerations are relevant.

- The VXC franchise will be re-tendered in 2006 and it is possible that Virgin might no longer hold this franchise after that date. Any remedy in respect of the overlap between the ICEC franchise service and VXC might therefore be in place for only a short time. In the event that Virgin/Stagecoach were to be a preferred bidder for the VXC franchise again, the OFT at that stage could re-assess the competitive situation on these overlap flows.

- TOCs are already subject to close regulatory scrutiny when operating passenger rail transport franchises.

85. In view of their very limited duration and the close regulatory scrutiny to which TOCs are already subject, the OFT considers it appropriate to consider the behavioural undertakings offered.

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[34] The parties wish to highlight that this structural undertaking is not required, see paragraph 87.
[35] Included for clarification at the parties' request.
[36] The parties whish to highlight that this structural undertaking is not required, see paragraph 44.
[37] Included for clarification at the parties' request.
[38] Included for clarification at the parties' request.
[39] The parties whish to highlight that this undertaking will only be relevant for the period of overlap, see further paragraph 87.

- The parties have offered to ensure that the current fare offerings and ticket mix on the four ICEC franchise services are maintained. This proposal is a clear-cut response to the identified competition concern taking into account the period of time for which this undertaking would be in place.

- They have also offered to introduce a price cap for ICEC standard class fares. This is a straightforward proposal that links directly into existing SRA fare regulation mechanisms. This will make compliance monitoring extremely easy.

86. Although the OFT has a strong preference for structural as opposed to behavioural undertakings, the behavioural proposals in this case warrant more detailed consideration given their very limited duration and the regulatory context of the merger. In this circumstance, concerns about the cost and burden commonly associated with behavioural undertakings appear less acute than usual.

87. As noted above, Virgin and Stagecoach have offered a structural undertaking (i.e., not to bid again for the VXC franchise) which is akin to a divestment remedy. However, this undertaking could not be implemented prior to the re-tendering of the VXC franchise. The behavioural undertakings described above address the interim period. If Virgin does bid for the VXC franchise again, the OFT will have a further opportunity to consider the competition issues at that stage. Accordingly, it is not necessary to accept this structural undertaking now, as the competition issues arising on the four identified flows from the overlaps between VXC and ICEC can be reconsidered in the near future.

88. In light of the above, the OFT believes that the proposed behavioural undertaking represents a clear-cut remedy to the competition concern identified. The OFT therefore concludes that this is an appropriate case in which to exercise its discretion not to refer a merger to the CC since it is considering whether to accept an undertaking in lieu.

DECISION

89. The OFT is not referring the anticipated acquisition by Virgin and Stagecoach of the ICEC to the CC on the information currently available to it because it is considering whether, instead of making a reference, to accept appropriate undertakings from Virgin and Stagecoach to address the competition concerns arising from the merger.