
Completed acquisition by Govia Limited of South Central Passenger Rail Franchise

CR/39/09

The OFT's decision on reference under section 22(2)(a) given on 6 August 2009. Full text of decision published 17 August 2009

Please note that the square brackets indicate figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.

PARTIES

1. **Govia Limited** (Govia) is a joint venture company owned by the **Go-Ahead Group plc** (Go-Ahead) and Keolis (UK) Limited (a wholly owned subsidiary of Keolis SA). Go-Ahead and Keolis own 65 and 35 per cent of Govia respectively.
2. Go-Ahead is a UK based transport group. It operates train services through its joint ownership of Govia, which currently operates the London Midland franchise and the Southeastern franchise. Go-Ahead also operates bus services, primarily in urban locations, including the wholly owned subsidiaries Brighton & Hove, Metrobus and Go-Ahead London.
3. **Southern Railway Limited** is a wholly owned subsidiary of Govia, and was established specifically for the purpose of pre-qualifying for, bidding for, and operating the **South Central franchise** (the Franchise).
4. Govia is the incumbent franchisee. Govia is currently operating the South Central Passenger Rail franchise via its wholly owned subsidiary New Southern Railways Limited. The necessary assets and liabilities will be transferred from New Southern Railway Limited to Southern Railway Limited according to a 'Transfer Scheme' negotiated between Govia and the Department for Transport (DfT) in advancement of the Franchise.

TRANSACTION

5. Govia signed the Franchise agreement on 8 June 2009 and will start operating the Franchise on 20 September 2009. It will continue to operate it until 25 July 2015. If performance targets are achieved, or if the DfT exercises its discretion, the Franchise may be extended to 22 July 2017. The OFT received a satisfactory submission by Govia on 18 June 2009 and the administrative deadline is 13 August 2009. The statutory deadline is 7 October 2009.

JURISDICTION AND PROCESS

6. The award of the Franchise to Govia does not constitute a concentration under the European Merger Control Regulation¹ (ECMR) since Govia is already operating the franchise. The acquisition of the Franchise will not therefore result in a change of control under Article 3 ECMR.
7. The award of the Franchise to Govia constitutes an acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993. Govia and the Franchise have therefore ceased to be distinct. As the anticipated turnover from the first year of operating the Franchise is expected to exceed £70 million (turnover for 2008 on the Franchise was approximately £560 million) the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.
8. During the course of the OFT's investigation, the parties submitted that they would be willing to forego the receipt of an issues paper, in the event that the OFT found that its duty to refer was triggered but that it would exercise its discretion not to refer given that the market is of insufficient importance. Since the OFT did decide that it would exercise its discretion, it did not send an issues paper to the parties. In addition, given that on a 'worst case scenario' analysis the OFT decided that it would exercise its discretion not to refer, the OFT did not consider that survey evidence (in order to determine whether bus and rail compete on particular flows) was necessary.

¹ Council Regulation 139/2004 OJ L24/1.

COUNTERFACTUAL

9. Applying the substantial lessening of competition test involves comparing prospects for competition with and without the merger. In most merger cases, the natural basis for assessing prospects for competition in the absence of the merger – the 'counterfactual' – is given by conditions prevailing pre-merger (the 'status quo ante'). However, transactions involving the award of a rail franchise are an example of where the status quo ante is not the correct counterfactual as the franchise agreement will terminate and there is no expectation that the company previously running the franchise would be awarded the new franchise.
10. As in previous rail franchise cases,² the OFT takes the view that the appropriate counterfactual to the merger is the award of the franchise either to a company that would raise no competition concerns or to one in respect of which any competition concerns would be remedied through structural or behavioural remedies. In this case, therefore, even though Govia is the incumbent, the OFT does not consider the status quo ante as the correct counterfactual such that its inevitable conclusion would be that the merger could have no effect. The OFT will assess the transaction on the basis that, had it not been awarded to Govia, the Franchise would have been awarded to a franchisee with no overlaps or to one in respect of which any competition concerns would be appropriately remedied.³

MARKET DEFINITION

11. The activities of Govia and the Franchise overlap in the provision of passenger transport services. There are a number of point-to-point journey overlaps between rail services operated as part of the Franchise, rail services operated by Govia as part of other rail franchises and bus services operated by Go-Ahead.

² See for example the CC report on *FirstGroup plc and the Greater Western Passenger Rail franchise*, 8 March 2006 (*FirstGroup/GWF report*), OFT Decision *Completed acquisition by Arriva Trains Cross Country Limited of the Cross Country Rail Franchise*, 20 December 2007, OFT Decision *Completed acquisition by National Express Group plc of the Intercity East Coast Rail Franchise*, 20 December 2007 and OFT decision *Completed acquisition by Stagecoach Group plc of the East Midland Rail Franchise*, 4 February 2008.

³ Notwithstanding its approach to the counterfactual, the OFT has taken account of any available evidence, in terms of the extent of competitive effects that might result from the merger, that arises from the fact that Govia has been operating the Franchise to date. This is relevant in terms of the OFT's consideration of its *de minimis* discretion.

Product scope

12. Consistent with previous CC and OFT cases,⁴ and in the absence of evidence to depart from its previous approach, the OFT here considered the supply of all public transport services for the purpose of assessing the competitive effect of the transaction. The OFT notes the extent to which different transport services are substitutable will vary between individual routes (as well as between individual passengers) due to different factors on which passenger's choice of mode relies. These include the journey cost, the journey time, the time spent travelling from the final station or stop to the passenger's ultimate destination, the frequency and directness of the service available, the ease of interchange, as well as other factors such as personal preferences (the 'generalised cost' of a journey). For the purposes of its assessment, the OFT does not need to conclude on the precise scope of the market definition but has considered whether bus and rail compete on certain flows, where this has appeared plausible on the basis of generalised costs arguments.⁵

Geographic scope

13. In making a journey, passengers travel from a particular point of origin to a specific destination. Past CC reports and OFT decisions⁶ have concluded that point-to-point public transport journeys are the relevant geographic frames of reference for competition assessment in relation to bus-on-rail and rail-on-rail overlaps.
14. In the absence of evidence in the present case suggesting that a different approach would be appropriate, and in accordance with the parties' submission, the OFT assessed the competitive effects of the merger on the basis of frames of reference that relate to the provision of public transport services between specified origin and destination points (flows).

⁴ *FirstGroup/GWF report*, paragraph 13.

⁵ On the flows where the OFT did not conclude whether bus and rail compete, it took the most conservative view of market definition, that is, either that bus and rail do not compete where there was a rail-on-rail overlap or that they do where there was a rail-on-bus overlap. However, the OFT notes that intra-modal competition is expected to be stronger than inter-modal competition. The OFT has not needed to reach a definitive conclusion as to the market definition issue because even on the most conservative market definition, the OFT is applying its discretion under section 33(2)(a) of the Act not to refer the merger to the Competition Commission.

⁶ See above, footnote 1

15. In considering origin and destinations, Govia used the catchment areas as defined in the First Group/GWF report:
- in rural areas, flows were considered to overlap where bus and rail served the same settlement regardless of the station/stop location, and
 - in urban areas, bus stops and train stations within 400 metres of each other are treated as overlapping. For journeys with one end outside the particular urban area, a catchment area of 1,200 metres was used at both ends.⁷

HORIZONTAL ISSUES

16. The parties identified 63 overlapping flows on the basis of the catchment areas set out above. Of these overlaps, there are 31 rail-on-rail overlaps and 32 bus-on-rail overlaps.

Rail-on-rail overlaps

Introduction to rail-on-rail theory of harm - regulated v unregulated fares

17. In previous cases⁸ the OFT has considered that consumer harm may arise from an increased ability and/or incentive to raise regulated as well as unregulated fares, given the flexibility within the Government's regulated fares price cap.
18. The regulated fares basket for the current franchise is subject to an annual cap in price increase of RPI+ one per cent across the basket of fares, with the ability to increase individual fares by up to RPI+ 6 per cent. Under this type of regulatory framework, the franchisee may be expected to have the ability and incentive to increase regulated fares by more than RPI+ 1 per cent (up to the RPI+ 6 per cent ceiling) where it faces lower competitive constraints. The OFT has therefore, in the past, not been able to rule out the possibility that the award of a rail franchise agreement could result in

⁷ *FirstGroup/GWF*, Appendix E.

⁸ OFT decision *Completed acquisition by Arriva Trains Cross Country Limited of the Cross Country Rail Franchise*, 20 December 2007, OFT decision *Completed acquisition by National Express Group plc of the Intercity East Coast Rail Franchise*, 20 December 2007 and OFT decision *Completed acquisition by Stagecoach Group plc of the East Midland Rail Franchise*, 4 February 2008

higher regulated fares on certain flows, even if this would be balanced by lower fares on flows that still faced competition.

19. However, earlier this year, the Secretary of State for Transport, Lord Adonis, announced that, from January 2010 onwards, individual fares within the regulated fares basket will also be capped at RPI + one per cent, with no scope for flexing individual fares within the basket.⁹
20. Govia has provided evidence (and this was confirmed by the DfT) which indicates that in general train operating companies (TOCs) price up to the annual price cap across the regulated fares basket each year. The DfT considered that similarly there would be no incentive for TOCs not to price up to the cap each year on individual flows as, at present, TOCs cannot claim the increase from previous years where they have not imposed it in full (see Endnotes).
21. In light of (i) the Government's planned change to the way that price caps operate under the fares basket for regulated services, and (ii) the DfT's view that TOCs price up to the fare cap, the OFT considers that there will be limited scope for consumer harm through increased regulated rail fares as a result of the award of the Franchise. The OFT therefore considers that where individual fares are price capped at RPI + one per cent, the award of a rail franchise is unlikely to result in consumer harm through increased regulated rail fares.¹⁰
22. In addition, the theory of harm has been limited to price concerns given that the Service Level Commitments agreed as part of the Franchise result in limited scope for the franchisee to significantly worsen non-price factors such as frequency and journey times.
23. The theory of harm with respect to the rail-on-rail overlap flows in this case therefore relates to unregulated (as opposed to regulated) fares - that is, that post merger, Govia, either on the Franchise or the other rail franchises

⁹ <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtran/233/233.pdf>, paragraphs 30-31

¹⁰ While the OFT recognises that government policy on fare regulation may change, where markets are partially regulated, it can only conduct its merger review on the basis of known policy statements.

it operates, will have the incentive and ability to increase unregulated rail fares due to the loss of an independent rail constraint.¹¹

24. The award of the franchise results in rail overlaps between Govia and the Franchise on:

- six flows as a result of Govia's ownership of the Southeastern rail franchise, and
- 25 flows as a result of Govia's ownership of the London Midland franchise.

These overlapping flows are dealt with in further detail below.

South Central and Southeastern overlaps

25. Following the award of the Franchise overlaps arise on six flows as a result of Govia's ownership of the Southeastern rail franchise.

London Victoria to Denmark Hill, London Victoria to Peckham Rye and Peckham Rye to Denmark Hill

26. On each of these three flows the South Central and the Southeastern franchise operate two trains per hour, with similar journey times and 100 per cent interavailable fares.

27. On the Peckham Rye to Denmark Hill flow, First Capital Connect also operates a rail service, with the same journey time, frequency and prices as the two Govia services. In line with established CC methodology¹² it is therefore considered that there is an effective competitor¹³ on this flow and that as such no competition concerns would be expected to arise.

28. On the two remaining flows (that is, London Victoria to Denmark Hill and London Victoria to Peckham Rye) there is also a bus service operating. In general, the OFT considers bus services to be a less effective constraint on

¹¹ The OFT recognises that there may also be limited scope for reduction in service levels.

¹² *Review of methodologies in transport inquiries* for a review of the filters used in previous transport cases (*CC Transport Methodology Report*).

¹³ This has previously been defined in various ways, but usually an effective competitor runs at least half the service frequency of the merged entity.

rail than other rail services – that is, the OFT considers competition between the same mode of transport (intra-modal competition) to be stronger than competition between different modes of transport (inter-modal competition).¹⁴ In this case, bus services are more frequent than the rail services, but have a notably longer journey time. In the absence, therefore, of any further evidence, and in particular in the absence of a passenger survey on these flows to assess the constraint between bus and rail, the OFT has taken a cautious approach and considers that competition concerns may arise on these flows, such that its duty to refer is met.

St Leonards to Hastings, Hastings to Ore and St Leonards to Ore

29. On the Hastings to Ore and St Leonards to Ore flows, the Franchise operates two trains per hour but the Southeastern franchise only operates three trains per day. Given the limited competition between the parties due to the significant difference in frequency it is considered that no competition concerns arise on these flows.
30. On the remaining flow, St Leonards to Hastings, South Central and Southeastern operate at a similar frequency and journey time with 100 per cent interavailable fares. Stagecoach operates a competing bus service on this flow, which is more frequent than the rail service but takes slightly longer (ten minutes by bus compared to four minutes by train). Prices on these services are relatively similar. Whilst in general, and as noted above, the OFT would expect the competitive constraints between two rail services to be stronger than between bus and rail, given the similarities in the services offered on this flow, it is possible that the Stagecoach bus service is an effective competitor. However, as its analysis would not change regardless of whether competition concerns arise on this flow (see below on the application of the exceptions to the OFT's duty to refer), the OFT has not needed to conclude on this issue and has proceeded on the basis that the duty to refer is met in relation to this flow.

South Central and London Midland overlaps

¹⁴ Given the planned Government changes to the regulated fares cap after January 2010 (see above paragraph 19), the OFT's focus in this analysis is on the potential effects of the transaction on passengers travelling at off-peak times, for which fares are unregulated. At these times, it might be expected that the interaction between bus and rail would be stronger given that passenger demand would be expected to be more elastic at off-peak times. Nevertheless, even for off-peak hours, the OFT has taken the cautious view that intra-modal competition is stronger than inter-modal competition.

31. Following the award of the Franchise, overlaps arise on 25 flows as a result of Govia's current operation of the London Midland rail franchise. These overlaps form part of the route between Harrow & Wealdstone and Milton Keynes Central.
32. In 2007, the OFT considered the acquisition of the London Midland franchise by Govia. At this time the only overlap on this route between London Midland and the current South Central franchise was between Harrow & Wealdstone and Watford Junction. The South Central franchise was extended in February 2009 from Watford Junction to Milton Keynes at the request of the DfT. The OFT understands that the DfT decided to increase frequencies on these flows and subsequently requested the South Central franchisee to extend its service (rather than London Midland increasing its frequency) as South Central had available rolling stock. The decision to operate on these flows was not made by South Central independently and does not appear to have been motivated by a strategy of monopolising particular flows.
33. The extension to Milton Keynes on the South Central franchise formed part of the Franchise agreement when it was put out to re-tender, and therefore these flows constitute overlaps that the OFT must consider on the basis of the counterfactual it adopts in rail franchise cases.
34. On each of these flows the Franchise operates one train per hour and the London Midland franchise operates between one and four trains per hour depending on the flow. Journey times are similar and interavailable fares account for 100 per cent of the revenue.
35. There are no other rail services operating on these flows, with the exception of Watford Junction to Harrow & Wealdstone where the London Overground service operates with a similar frequency. Whilst the London Overground journey time is slightly longer than either of the Govia rail services, it does appear to offer an effective constraint. In line with the CC methodology, the OFT therefore considers that there is an effective competitor on this flow and as such no competition concerns would be expected to arise.
36. On nine of the remaining 24 rail-on-rail overlap flows there is also a bus service present. These bus services offer a similar frequency but longer,

and in some cases, considerably longer, journey times. As discussed above, in general, when considering rail-on-rail overlaps, the OFT considers that a competing rail service would exert a stronger competitive constraint than a bus competitor. In light of the absence of evidence to the contrary, the OFT considers that competition concerns arise on these flows, such that its duty to refer is met.

37. On the remaining 15 rail-on-rail flows there are no competing rail or bus services currently in operation. The OFT therefore considers that the acquisition of the Franchise gives rise to prima facie competition concerns on these flows, such that its duty to refer is met.

Conclusion

38. Based on the evidence received, and in particular the lack of information on whether bus services provide a sufficient competitive constraint on the Franchise on these overlap flows, the OFT considers that the acquisition gives rise to competition concerns on 27 rail-on-rail overlap flows.¹⁵ Potential entry on both bus and rail is considered in more detail below.

Bus-on-rail overlaps

39. The merger resulted in a total of 32 bus-on-rail overlap flows. For these overlap flows, the OFT considered three potential theories of harm:

- that Go-Ahead will have the ability and incentive to increase bus fares and/or reduce frequency on a given flow as post merger it will recoup at least some of the revenue lost from passengers switching to rail
- that Go-Ahead/Govia will have the ability and incentive to increase both their bus and unregulated rail fares and/or reduce bus frequencies on a given flow as they will recoup at least some of the revenue lost from passengers switching from bus to rail and vice versa, and/or
- that Govia would have the ability and incentive to increase unregulated rail fares due to the loss of an independent bus constraint.¹⁶

¹⁵ See Annex 1.

¹⁶ See paragraphs 17 to 23 above in respect of regulated fares.

40. The above theories of harm require that pre-merger bus and rail compete (to some extent) against each other on a given flow.

Preliminary analysis

41. On the overlapping flows, the OFT has applied a series of filters, which broadly reflect those used in previous transport cases.¹⁷
42. In previous cases, the OFT has considered that on bus-on-rail overlaps where there is both a bus and a rail competitor operating on the flow with a similar frequency, this was sufficient to prevent competition concerns arising. On the basis of this methodology, four out of the 32 overlaps were considered unproblematic and requiring no further analysis because Govia faces competition from both an effective rail competitor (Arriva Cross Country and/or South West Trains) and an effective bus competitor (First Group). As a consequence, Govia would not be expected to have the incentive to increase rail or bus prices as it would be constrained by a number of competitors.
43. In previous cases, the OFT has also considered that on bus-on-rail overlaps where there is either a bus or a rail competitor operating on the flow with a similar frequency this was sufficient to prevent competition concerns arising. On the basis of such analysis, the OFT would have been able to exclude competition concerns on a further 12 flows (due to the existence of an effective bus or rail competitor). However, in this case the OFT has taken a more cautious approach in identifying prima facie concerns, in recognising the greater strength of intra-modal competition over inter-modal competition. For bus-on-rail overlaps where there is a bus competitor, the OFT has excluded concerns arising in respect of bus fares, but not in respect of rail fares. Similarly, for bus-on-rail overlaps where there is a rail competitor, the OFT has excluded concerns arising in respect of rail fares, but not in respect of bus fares.
44. The OFT therefore considers on a cautious basis that the acquisition may give rise to prima facie competition concerns:
 - in respect of eight bus-on-rail overlaps, where Govia faces competition from a bus competitor. In particular, Go-Ahead (operating as Brighton &

¹⁷ See the *CC Transport Methodology Report*.

Hove) faces competition from Stagecoach. The OFT considers that Go-Ahead would not have the incentive to increase bus fares as customers would be more likely to switch to the same mode (that is, the bus competitor) rather than switch to rail. However, the OFT considers that Govia could still potentially have an incentive to increase unregulated rail fares (as Govia - through Go-Ahead - would capture a proportion of those customers that would switch to bus in response to a rail fare increase), and

- in respect of four bus-on-rail overlaps, where Govia faces competition from a rail competitor. In particular, Govia faces competition from First Capital Connect or South West Trains. As discussed above, Govia would not be expected to have the incentive to increase unregulated rail fares as customers would be more likely to switch to the same mode (that is, the rail competitor) rather than switch to bus. However, the OFT considers that Govia could still potentially have an incentive to increase bus fares (as it would capture a proportion of those customers that would switch to rail in response to a bus fare increase).
45. Following this preliminary analysis therefore, a number of further flows remained on which the OFT could not dismiss competition concerns without further analysis. On these flows, the OFT invited Govia to provide further evidence of the lack of substitution between rail and bus services.
46. Govia submitted to the OFT that competition between rail and bus is limited on the basis of generalised cost arguments. In particular, Govia argued that differences in frequency, journey time and/or prices on specific bus and rail flows mean that in reality passengers do not view train and bus services as substitutes and this is reflected in differences in passenger numbers.
47. In line with previous OFT and CC decisions, the OFT considered that generalised cost arguments are not always sufficient to exclude competition concerns as, ultimately, the degree to which different modes of transport are regarded as substitutes by passengers is an empirical question and can vary by geographic area, purpose of journey and other variables. In addition, in this case, given the planned Government changes to the regulated fares cap after January 2010 (see above paragraph 19), the OFT focused on the potential effects of the transaction on passengers travelling at off-peak times, for which fares are unregulated. At these

times, it might be expected that the interaction between bus and rail would be stronger given that passenger demand would be expected to be more elastic at off-peak times.

48. Taking this into account in analysing prices, revenue and passenger numbers, the OFT considered that there are four flows¹⁸ where the evidence presented with respect to generalised cost arguments was sufficiently strong for it to conclude that there is limited competition between the two modes and therefore that the merger does not raise competition concerns.¹⁹

Conclusion

49. Based on the limited evidence available to it, the OFT considers that it is possible that the acquisition could give rise to competition concerns on 24 bus-on-rail overlap flows which are set out in Annex 2. However, the OFT has not needed to reach a definitive conclusion as to whether it is or may be the case that the merger may be expected to result in a substantial lessening of competition because - even if the duty to refer is triggered - the OFT will apply its discretion under section 22(2)(a) of the Act not to refer the merger to the Competition Commission (see paragraphs 64 to 79 below).

Entry

50. Govia submitted that barriers to entry in the relevant bus markets were low, and that there were a number of potential entrants in relation to the overlapping flows who would prevent Govia from raising prices on the bus-on-rail overlaps. However, in this case, no bus operators have expressed an interest in entering on any of these flows. Furthermore the OFT has little evidence of actual entry on the existing Govia/Go-Ahead routes in the Franchise area or that other bus operators have sufficient depot capacity across all of these flows to replace to level of service frequency operated by Go-Ahead.

¹⁸ []

¹⁹ []

THIRD PARTY VIEWS

51. No third parties raised any competition concerns in relation to this merger.

ASSESSMENT

52. Govia will commence the operation of the Franchise on 20 September 2009. The merger resulted in a large number of overlaps between the Franchise and Govia's existing rail franchises and Go-Ahead's existing bus services. As in previous cases, the OFT considered the effect of the transaction on a flow by flow basis, on the basis that the degree of substitutability between different modes can vary from flow to flow.
53. The acquisition results in 31 rail-on-rail overlaps, four of which raise no competition concerns due to the limited pre-merger competition between the Franchise and other Govia services, or due to the presence of effective competitors.
54. The acquisition also resulted in 32 rail-on-bus overlaps, four of which raised no competition concerns due to the continuing presence of effective bus and rail competitors.
55. In line with previous decisions, the OFT considers that generalised cost arguments are not always sufficient to exclude competition concerns. However, for four flows in this case, generalised cost arguments in relation to off-peak journeys, where the OFT would expect bus and rail to compete more vigorously, were sufficiently strong to exclude the possibility of the acquisition giving rise to a substantial lessening of competition.
56. Taking all of the above factors into account, the OFT was not able to exclude the possibility of competition concerns arising on 27 rail-on-rail overlaps and 24 bus-on-rail overlaps. However, the OFT has not needed to reach a definitive conclusion as to whether it is or may be the case that the merger may be expected to result in a substantial lessening of competition because - even if the duty to refer is triggered - the OFT will apply its discretion not to refer the merger to the Competition Commission.
57. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening

of competition within a market or markets in the United Kingdom pursuant to section 22(1) of the Act.

58. On this basis, the OFT is under a duty to make a reference to the Competition Commission. However, the OFT has considered whether it would be appropriate to exercise its discretion to apply the exception to the duty to refer pursuant to section 22(2)(a) of the Act to the facts of this case.

EXCEPTIONS TO THE DUTY TO REFER

Introduction

59. The OFT's duty to refer under section 22(1) is subject to the application of certain discretionary exceptions, including the markets of insufficient importance or 'de minimis' exception under section 22(2)(a), and the undertakings in lieu exception under section 73(2).

Undertakings in lieu of reference and 'de minimis'

60. For the reasons explained in full in the OFT's Dunfermline Press/Trinity Mirror decision,²⁰ the OFT believes that it would be proportionate to refer a problematic merger (that is, not to apply the 'de minimis' exception) where the OFT considers that it is 'in principle' clearly open to the party (or parties) to offer a clear-cut undertaking in lieu of reference – but they have in fact chosen not to do so – because the recurring benefits of avoiding consumer harm by means of undertakings in lieu in a given case, and all future like cases, outweighs the one-off costs of a reference.
61. The OFT did not consider, based on its objective evaluation of the transaction, that this case was a clear candidate for resolution by means of undertakings in lieu. The OFT has a strong preference for structural undertakings over behavioural commitments in a problematic horizontal case. Typically, structural undertakings consist of a divestiture of one of the overlapping businesses that have led to the competition concerns. The OFT does not consider the present case clearly to fit this profile, unlike, for

²⁰ OFT Decision *Completed acquisition by Dunfermline Press Limited of the Berkshire regional newspapers business from Trinity Mirror plc* 4 February 2008.

example, divestiture of a stand-alone business that removes the overlap in a local market.²¹

62. Moreover, the OFT does not consider that a package of behavioural remedies would, in principle, clearly be available as a first-phase remedy in this case. In horizontal mergers in particular, behavioural remedies substitute price regulation for competition. Behavioural remedies in this case, therefore, fail the clear-cut standard of undertakings in lieu because, for the OFT's purposes at Phase I, they are costly and yet of questionable effectiveness.
63. The OFT therefore considers that it would not be appropriate to rule out the application of the 'de minimis' exception at this stage of the analysis.

Application of the markets of insufficient importance exception to this case

64. In the absence of any clear-cut undertakings in lieu being, in principle, available to the parties, the OFT has considered in detail whether to apply the markets of insufficient importance exception to this case. The factors that the OFT considers in determining whether it should apply its discretion in respect of the 'de minimis' exception have been set out in detail in a number of recent cases.²² The relevant factors are:

- market size
- strength of the OFT's concern (that is, its judgment as to the probability of the substantial lessening of competition occurring)
- magnitude of competition lost by the merger
- durability of the merger's impact, and
- transaction rationale and the value of deterrence.

65. The OFT has considered each of the above factors in determining whether to exercise its discretion in this case.

66. **Market size** – The OFT considers that the acquisition of the Franchise

²¹ Divestiture of the target business in this case – the South Central Franchise – would be effective but the OFT does not include what would amount to prohibition when considering whether clear-cut undertakings in lieu are available, as it is not the role of the undertakings in lieu process effectively to invite parties to abandon their own transactions

²² See, for example, OFT Decision *Anticipated acquisition by BOC Limited of the packaged chlorine business and assets carried on by Ineos Chlor Limited*, 29 May 2008 and , OFT Decision *Completed acquisition by Capita Group plc of IBS OPENSsystems plc*, 19 November 2008

creates a realistic prospect of a substantial lessening of competition on 27 rail-on-rail overlaps and 24 bus-on-rail overlaps. For the reasons given in paragraphs 17 to 23 above, the OFT considers that any consumer detriment that may arise as a result of the acquisition would be as a result of Govia's increased ability and incentive to increase unregulated rail fares or bus fares. As such the OFT considers it reasonable to exclude regulated rail fares on the potential substantial lessening of competition flows from the market size for the purposes of its de minimis calculation.

67. As discussed in paragraph 43 above the OFT has considered that on bus-on-rail overlaps, where Govia faces a bus or rail competitor, Govia may still have the incentive to increase prices on that mode where it does not face intra-modal competition. Therefore, for the purposes of determining the size of the market for which there could be an impact on competition (and that would be therefore relevant to the exercise of its discretion in respect of its duty to refer) the OFT has only taken into account (a) the rail revenue on those bus-on-rail overlap flows where there is a bus competitor, and (b) the bus revenue on those bus-on-rail overlaps where there is a rail competitor.
68. The total revenue, therefore, of the 51 flows on which the OFT has found competition concerns in this case amounts to approximately £3.7 million per annum. This is clearly less than the £10 million threshold above which 'de minimis' will not be applicable; as such, it is appropriate to consider the additional 'de minimis' factors in detail.
69. **Strength of OFT's concerns** - in respect of rail-on rail overlaps, the OFT believes, on a balance of probabilities, that the transaction may be expected to result in a substantial lessening of competition. However, in respect of bus-on-rail overlaps, which account for approximately half of the revenue on the problematic flows in this case, the strength of the OFT's concerns would appear lower, given that bus entry (which on bus-on-rail overlaps is more likely to be an effective constraint to Govia than on a rail-on-rail overlap) would be possible. However, even on this lower probability of likelihood of harm, the OFT's overall belief that harm will result from the merger, although not in itself conclusive, tends to point away from the exercise of the 'de minimis' exception in this case.

70. **Magnitude of competition lost** – the OFT has, in past decisions in relation to rail franchises, noted the special nature of rail franchise awards.²³ In most cases considered to result in a relevant merger situation under the Act, two or more enterprises – meaning business activities of any kind – cease to be distinct and the acquirer gains unfettered commercial control over the target business post-merger. However, rail franchise awards amount to a medium-term outsourcing agreement by the government of railway services in the Franchise area, subject to regulation and potential clawback by the government, and qualifying as an 'enterprise' within the meaning of section 23 of the Act pursuant to the express provision in section 66(3) of the Railways Act 1993. While by no means sufficient to remove any competition concerns in principle, the degree of regulation and other generic features of rail franchise awards relative to general private mergers and acquisitions activity do place limits on the scale and durability of merger effects on overlap flows – especially with respect to rail services – that are not applicable more generally.
71. Despite its particular approach to the counterfactual in rail franchise cases the OFT had, in this case, the opportunity to assess the competitive effects of the Franchise acquisition, given that Govia is the incumbent operator and as such some of the bus-on-rail and rail-on-rail overlaps discussed above have been in place for a number of years.²⁴ Where it can be demonstrated that under competitive conditions equivalent to those expected post-merger, the parties have not in fact been able to increase prices significantly, the OFT may lower its expectations of the magnitude of harm resulting from the merger.

Unregulated rail fares

72. In this case, Govia provided evidence that it has been constrained in raising unregulated rail fares under the current franchise agreement and submitted that this constraint may be expected to remain under the new Franchise where competitive conditions will be similar. Whilst it is theoretically

²³ *Completed acquisition by Arriva Trains Cross Country Limited of the Cross Country Rail Franchise*, 20 December 2007, OFT decision *Completed acquisition by National Express Group plc of the Intercity East Coast Rail Franchise*, 20 December 2007 and OFT decision *Completed acquisition by Stagecoach Group plc of the East Midland Rail Franchise*, 4 February 2008.

²⁴ Specifically the majority of the bus-on-rail overlaps have been in place since the start of the current franchise in 2004 and the Southeastern rail-on-rail overlaps have been in place since Govia won the Southeastern franchise in 2007. The relevant rail-on-rail overlaps with London Midland have only been in place since the extension of the South Central Franchise in 2009.

possible for unregulated fares to be increased significantly by TOCs, in practice, the OFT considers for the reasons given below that regulated fares do provide at least some constraint on unregulated fares.

73. In the current franchise period Govia has faced a RPI + one per cent price cap across a basket of regulated fares. Govia provided evidence which shows that the annual price rise across all unregulated fares has been the same as the annual fare increase across the basket of regulated fares, indicating that unregulated fares are to some extent constrained by regulated fares. Govia submitted that this is due to the need to maintain a price differential between peak (usually regulated) and off-peak (usually unregulated) fares, and indeed that the peak fares provide a 'ceiling' price for off-peak fares. This has also been supported by the OFT's market investigation (First Group, the ORR and the DfT have broadly confirmed this) (see Endnotes). The evidence provided suggests that even on overlap flows where there is less competition, price increases on regulated and unregulated fares have been similar (within a percentage point difference on a cumulative increase basis, with unregulated prices sometimes increasing less than regulated prices).
74. Given that from January 2010 each individual fare increase will be capped at RPI + one per cent and that regulated and unregulated fares on the flows examined by the OFT in this case moved in a broadly similar manner, the magnitude of harm will not be expected to be significant as long as the RPI + one cap is in place.

Bus fares

75. Govia also provided some pricing data on the relevant bus flows. [] As the number of flows within its network where Brighton & Hove buses does not face competition from another bus company is relatively small, the OFT considers that the constraints on the majority of flows would constrain City Saver fares across the network as a whole.
76. As a result of the above factors, the strength of the OFT's belief of the magnitude of harm resulting from the merger, although not in itself conclusive, tends to point towards the exercise of the 'de minimis' exception in this case.

77. **Durability** – while the duration of harm for a rail franchise would normally be expected to be over the whole duration of the Franchise (that is, six to eight years) a closer examination of the facts reveals that this is not necessarily the case. Firstly, as far as the London Victoria to Denmark Hill and the London Victoria to Peckham Rye flows are concerned, the Franchise will cease to operate these flows by May 2012 as part of the Thameslink redevelopment programme so the overlap will cease to exist.²⁵ In addition, the London Midlands franchise will be retendered in six years and the Southeastern franchise in five years, so South Central overlaps with these franchises may cease to exist at that point. In addition, bus entry on routes where Govia would be able to charge higher prices due to lack of competition may be possible within the short term. The OFT therefore notes that the duration of harm could well vary for different flows and while in some cases duration of harm may point against exercising the discretion, in others, duration of harm will be limited, which may support the exercise of the 'de minimis' discretion.
78. **Transaction rationale and value of deterrence** - part of the purpose of any credible merger regime is not only to prohibit a certain class of anticompetitive mergers but to deter like transactions from being contemplated or pursued. In considering the rationale for acquiring the Franchise, the OFT discounted the notion that the acquisition of market power as a result of the problematic overlaps formed a part of Govia's rationale for its winning bid. The expected annual turnover of the Franchise clearly lies in the profit potential of operating the Franchise on an efficient fixed-term basis subject to various regulatory requirements and not in the exploitation of any lost competition on any one flow. In this context, the OFT believes that this case is particularly amenable to the application of the 'de minimis' exception because such a finding would not undermine deterrence by incentivising a similar acquisition whose motive is market power by merger.

²⁵ This is consistent with the OFT's approach to the counterfactual, that is, that it should not be assumed that an incumbent franchisee will be awarded the franchise when it comes up for renewal.

79. **Conclusion** - overall, given the above, the OFT considers that the total impact of the merger on consumer welfare is likely to be limited, and that the costs associated with a Competition Commission inquiry are disproportionate to the prospect of benefits from such action. Accordingly, given that the OFT does not consider that undertakings in lieu are, in principle, clearly available, and taking into account all the relevant facts specific to rail franchise awards and this award in particular, the OFT exercises its discretion not to refer because the markets are of insufficient importance to warrant a reference.

DECISION

80. This merger will therefore **not be referred** to the Competition Commission pursuant to section 22(2)(a) of the Act.

ENDNOTES

81. By way of clarification in respect of paragraph 20, the OFT notes that TOCs cannot impose the increase in fares retrospectively on individual flows.
82. By way of clarification, the OFT notes that comments submitted by First Group, the ORR and the DfT in paragraph 73 only related to the relationship between regulated and unregulated rail fares.

Annex 1 – rail-on-rail overlaps

1. London Victoria to Denmark Hill
2. London Victoria to Peckham Rye
3. St Leonards to Hastings
4. Watford Junction to Hemel Hempstead
5. Watford Junction to Berkhamstead
6. Watford Junction to Tring
7. Watford Junction to Leighton Buzzard
8. Watford Junction to Bletchley
9. Watford Junction to Milton Keynes Central
10. Harrow & Wealdstone to Hemel Hempstead
11. Harrow & Wealdstone to Berkhamstead
12. Harrow & Wealdstone to Tring
13. Hemel Hempstead to Berkhamstead
14. Hemel Hempstead to Tring
15. Hemel Hempstead to Bletchley
16. Hemel Hempstead to Leighton Buzzard
17. Hemel Hempstead to Milton Keynes Central
18. Berkhamstead to Tring
19. Berkhamstead to Leighton Buzzard
20. Berkhamstead to Bletchley
21. Berkhamstead to Milton Keynes Central
22. Tring to Leighton Buzzard
23. Tring to Bletchley
24. Tring to Milton Keynes Central
25. Leighton Buzzard to Bletchley
26. Leighton Buzzard to Milton Keynes Central
27. Bletchley to Milton Keynes Central

Annex 2 – bus-on-rail overlaps

1. Shoreham by Sea to Hove
2. Shoreham by Sea to Brighton
3. Southwick to Portslade
4. Southwick to Hove
5. Southwick to Brighton
6. Portslade to Hove
7. Portslade to Brighton
8. Hove to Brighton
9. Brighton to Farmer
10. Brighton to Lewes
11. Brighton to Eastbourne
12. Ifield to Crawley
13. Three Bridges to Crawley
14. Gatwick Airport to Crawley
15. Three Bridges to Horley
16. Three Bridges to Haywards Heath
17. Redhill to Three Bridges
18. East Croydon to East Grinstead
19. Caterham to Whyteleafe
20. Redhill to Reigate
21. Tattenham Corner to Tadworth
22. Oxted to Hurst Green
23. Eastleigh to Southampton Central
24. Eastleigh to St Deny's