

Completed acquisition by Stagecoach Group plc of the East Midlands passenger rail franchise

ME/3291/07

The OFT's decision on reference under section 22(1) given on 4 February 2008. Full text of decision published on 14 February 2008.

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

PARTIES

1. **Stagecoach Group plc** (Stagecoach) is an international public transport group, with operations in the UK, USA and Canada. Stagecoach is a UK listed public company. Its business includes bus, train, tram and express coach operations. **East Midlands Trains** (EMT) is a wholly owned subsidiary of Stagecoach, and was established specifically for the purpose of pre-qualifying for, bidding for and operating the **East Midlands Franchise** (the Franchise).
2. The Franchise consists of the former Midland Mainline passenger franchise and part of the former Central Trains passenger franchise, operating trains from London St Pancras to South Yorkshire and the East Midlands. It also serves a number of other urban areas including Newark, Lincoln and Grimsby. In addition there are a number of 'cross country' services from Liverpool to Norwich.

TRANSACTION

3. EMT was awarded the Franchise on 21 June 2007 and started operating the Franchise on 11 November 2007. It will continue to operate it until 1 April 2015 provided that preset performance criteria are met.

4. The transaction was notified on 11 September 2007. The Office of Fair Trading's (OFT) (extended) statutory deadline for deciding whether to refer the merger to the Competition Commission (CC) is 21 February 2008.

JURISDICTION

5. The European Community Merger Regulation (ECMR) does not apply because the Community-wide turnover of Stagecoach and that of the Franchise do not reach the turnover thresholds in Article 1 of the ECMR.
6. The award of the Franchise to EMT constitutes an acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993 and therefore Stagecoach and the Franchise ceased to be distinct. As the anticipated turnover from the first year of operating the Franchise is expected to exceed £70 million by some margin (turnover for the financial year 2006/2007 on the Franchise flows was £[]) 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.

COUNTERFACTUAL

7. 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 (or, in this case, has terminated) and there is no expectation that the company running the franchise prior to the takeover by the new franchise holder would continue to operate the franchise in the absence of the merger.
8. As in previous cases,¹ the OFT takes the view that the appropriate counterfactual to the merger is the award of the franchise either to a

¹ See for example the CC report on *FirstGroup plc and the Greater Western Passenger Rail franchise*, 8 March 2006 (*FirstGroup/GWF report*), paragraph 4.6, OFT decision *Completed acquisition by Arriva Trains Cross Country Limited of the Cross Country Rail Franchise*, 20

company that would raise no competition concerns or to one in respect of which any competition concerns would be remedied through behavioural remedies.

MARKET DEFINITION

9. The activities of Stagecoach 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 and rail, tram, coach and bus services operated by Stagecoach.

Product scope

10. As discussed in previous cases,² the prospect of substitution between rail and other forms of public transport for a given journey are specific to the routes and passenger profiles in question. In the *FirstGroup/GWF report*, the CC refers to the different factors upon which passengers' choice of travel mode relies.³ 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).
11. As regards private transport, the CC and the OFT⁴ have indicated previously 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. Stagecoach submitted that travel by company or private car is an option considered by a high proportion of consumers who may do the same journey by rail or bus. However, given the existing decisional practice, Stagecoach did not focus on this issue in their submission. In the customer survey conducted by Stagecoach (see below), on some flows more customers said that they would switch from the relevant bus service to private transport in response to a ten per cent price increase than to rail

December 2007 and OFT decision *Completed acquisition by National Express Group plc of the Intercity East Coast Rail Franchise*, 20 December 2007.

² *FirstGroup/GWF report*, paragraph 13.

³ *Ibid* at paragraph 5.22.

⁴ See the CC's report: *Review of methodologies in transport inquiries* for a review of the filters used in previous transport cases (*CC Transport Methodology Report*).

(or in response to a withdrawal of the bus service). However, this was not the case in all flows surveyed, and the customer survey only covered a small proportion of the overlapping flows. The OFT did not receive any material evidence in this respect in relation to the other flows. The OFT considered there was insufficient evidence presented to depart from its approach in previous cases.

12. Given the route-specific nature of substitutability between different types of passengers, the OFT considered the supply of all public transport services for the purpose of assessing the competitive effect of the transaction.

Geographic scope

13. In making a journey, passengers travel from a particular point of origin to a specific destination. Past CC reports and OFT decisions⁵ 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).
15. In considering origin and destinations, Stagecoach 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.⁶

⁵ See for example, *FirstGroup/GWF report*, para.22; *Anticipated acquisition by South Eastern Railways Limited of the Integrated Kent Rail Franchise* 31 March 2005.

⁶ *FirstGroup/GWF*, Appendix E.

HORIZONTAL ISSUES

16. The parties identified 85 overlapping flows on the basis of the catchment areas set out above. Of these overlaps, there is one rail-on-rail overlap, one rail-on-tram overlap and two coach-on-rail overlaps. The remainder are bus-on-rail overlaps.

Rail-on-rail and rail-on-tram overlaps

17. The theory of harm with respect to the rail-on-rail overlap flow is that post merger, either the Franchise or the lead rail operator⁷ on the flow has the incentive and ability to increase rail fares or reduce service levels on these flows due to the loss of an independent rail constraint. The theory of harm on the rail-on-tram overlap is similar to those set out in relation to bus-on-rail overlaps (see paragraph 25 below) and is dependent on rail and tram competing on the flow. However, for the reasons set out below, the OFT does not believe that any of these overlaps raise competition concerns.

Manchester Piccadilly – Stockport

18. Following the award of the Franchise an overlap arises on this flow as a result of Stagecoach's 49 per cent shareholding in Virgin West Coast Trains Limited (VWC), operator of the West Coast Main Line rail franchise (WCF). However, Stagecoach considers that they have no independent capacity to change the nature of the rail service provided on the WCF. The OFT did not consider it necessary to conclude on Stagecoach's ability to control WCF given that, for the reasons set out below, competition concerns can in any event be ruled out on this flow.
19. VWC operates 32 services a day between Manchester Piccadilly and Stockport, but only 2 are available to passengers as the rest only pick up and do not set down passengers in Stockport. Similarly in the opposite direction only 1 out of the 33 services sets passengers down in Manchester Piccadilly. On this basis, the OFT considers that the WCF provides only a weak competitive constraint on this flow.
20. Furthermore there are four additional train operating companies (TOCs) who provide the majority of the services on the flow: Arriva Trains Wales,

⁷ The lead operator is the train operator that sets the interavailable fare for the flow.

Northern, TransPennine Express and Arriva Cross Country. These four TOCs operate 172 services a day between them on this flow, compared to just 15 operated by the Franchise and 32 by VWC (albeit with the restrictions discussed above).

21. On the basis of the limited constraint VWC places on the flow and the number of additional TOCs operating on the flow, the OFT does not consider that the merger will result in a substantial lessening of competition on the Manchester Piccadilly to Stockport flow in relation to the rail-on-rail part of the overlap. However, this flow is considered in more detail as part of the consideration of bus-on-rail overlaps below.

Meadowhall – Sheffield

22. Stagecoach operates the Sheffield Supertram service, which offers an indirect service from Sheffield to Meadowhall. However the increment on this overlap is minimal. The Franchise only operates one train per day on this flow, compared to 136 Northern train services and over 100 buses a day by various bus operators as well as 109 Supertram services. Furthermore the overlap is for a limited duration as the Franchise will cease serving this flow in December 2008. As a result, the OFT does not consider that the merger will result in a substantial lessening of competition in relation to this flow.

Coach-on-rail

23. The merger results in two coach-on-rail overlaps between London and Sheffield and London and Leeds.⁸ On these flows Stagecoach operates its megabus coach services. However, on each of these flows there is an effective coach competitor as National Express operates a more frequent coach service than megabus.
24. On the basis that there is an effective competitor Stagecoach would not be expected to have the incentive to increase coach prices as customers would be more likely to switch to the same mode of transport (i.e. the other coach operator) than to rail. Therefore given the constraint provided by National Express, the OFT does not consider that the merger will result in a substantial lessening of competition in relation to either of these flows.

⁸ Both rail services operate from London St Pancras and both coach services from London Victoria.

Bus-on-rail

25. The merger resulted in a total of 82 bus-on-rail overlap flows. For these overlap flows, we considered three potential theories of harm:
- that Stagecoach will have the ability and incentive to increase bus fares or reduce frequency on a given flow as post merger they will recoup at least some of the revenue lost from passengers switching to rail
 - that Stagecoach will have the ability and incentive to increase both their bus and rail fares or reduce frequencies on a given flow, and/or
 - that the lead operator would have the ability and incentive to increase rail fares or decrease frequency due to the loss of an independent bus constraint.
26. All of these theories require that pre-merger bus and rail compete against each other on a given flow.

Preliminary analysis

27. The OFT carried out a preliminary analysis of the overlap flows, applying a combination of the filters applied in previous transport cases⁹ and general features of the flows which indicated the extent of competition between bus and rail. Of the 82 flows there were there were a large proportion where it was not considered necessary to conduct further detailed analysis:
- Competition from effective bus competitor: on 24 flows Stagecoach faced competition from an effective bus competitor.¹⁰ As such, Stagecoach would not be expected to have the incentive to increase bus prices as customers would be more likely to switch to the same mode (i.e. the effective bus competitor) than to switch to rail. The incentives to increase rail fares would also be diluted as, of those customers that would switch to bus in response to a rail fare increase, Stagecoach would only capture a proportion of them. Furthermore, it is likely that the constraint is to some extent asymmetric with rail constraining bus more than bus constrains rail.

⁹ See the *CC Transport Methodology Report*.

¹⁰ This has previously been variously defined, but usually an effective competitor runs at least half the service frequency of the merged entity.

- Low increment: there are six flows¹¹ where the merger results in a low increment of one or two services a day compared to a significantly higher number of services on the overlapping mode. The OFT does not consider therefore that the merger will result in a substantial lessening of competition on these flows.
- Generalised cost/convenience: the parties have argued that there is limited competition between rail and bus on most flows based on generalised cost arguments and that the strongest constraint comes from the car. However, 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 this case, however, there are eight flows where we considered that the evidence presented relating to generalised cost arguments was sufficiently strong to conclude that there is limited competition between the modes and therefore that the merger will not raise competition concerns.¹²
- Low revenue and council involvement: on a number of flows, Stagecoach identified very small bus revenues, combined with either tendered services or a high proportion of concessionary fares. On these eight flows, the low bus revenue involved, and the prospect of council intervention in the event of a fare increase, mean that competition concerns could be ruled out on these flows.¹³

28. The OFT does not consider that competition concerns arise on the flows discussed above, and they will not be considered further. In addition, the OFT also applied the '10 per cent filter', consistent with previous OFT and the CC decisions, measuring the relative importance of the flow compared with overall passenger numbers and revenue on a route. In this case, the OFT applied the filter and excluded 18 flows on which the sum of all overlapping flows on a single route account for less than 10 per cent of the route's passengers and revenue. The rationale behind this filter is that the incentives for parties to adjust fares or services on flows which constitute only a small proportion of a route's overall revenue is low and that, if no competition concerns are identified on the relatively larger flows, it is unlikely that the merger will result in competition concerns on these smaller

¹¹ []
¹² []
¹³ []

flows. If competition concerns are identified on the relatively larger flows it may be necessary to conduct a more detailed competitive assessment across all flows.

29. Following this preliminary analysis, a number of flows remained which neither fell within the 10 per cent filter, nor could the OFT dismiss competition concerns on the basis of a preliminary analysis. On these flows, the OFT invited Stagecoach to provide further evidence of the lack of substitution between rail and bus services in the form of a survey of bus customers. Stagecoach submitted, and the OFT agreed, that on seven of the remaining flows the passenger numbers were so low that a survey was unlikely to produce sufficiently robust data from which to draw any meaningful conclusions. Stagecoach therefore agreed to undertake a survey of the following flows:

- Manchester Piccadilly/Manchester Oxford Road to Stockport¹⁴
- Luton to Bedford
- Wellingborough to Kettering
- Lincoln Central to Hykeham
- Worksop to Whitwell
- Worksop to Creswell
- Shirebrook to Mansfield
- Mansfield to Nottingham¹⁵
- Chesterfield to Sheffield
- Mansfield Woodhouse to Mansfield.

Survey results and further analysis

30. Stagecoach and the OFT agreed on the methodology of the survey, which asked bus passengers a number of questions relating to, amongst other things, why they used the bus service, whether they had any knowledge of an alternative rail service, and whether they would switch to an alternative mode of transport in the event of a bus price increase or service decrease.

¹⁴ The bus overlap is the same for both the Manchester Piccadilly – Stockport and Manchester Oxford Road – Stockport rail flows. Therefore, the surveying of these two overlaps required the survey of only one flow.

¹⁵ Stagecoach agreed to survey this flow, even though it faces competition from an effective bus competitor, as part of a 'sense check' to ensure that our preliminary conclusions on such flows were correct. The OFT originally requested surveys on a small number of flows which passed the 10 per cent filter and a small number of larger flows in terms of revenue that had an effective competitor. However, it was agreed between Stagecoach and the OFT that a survey on all of these flows would be disproportionate in this case.

31. The OFT used the survey to measure the degree to which passengers consider rail as a substitute for bus by considering the diversion ratio between the two i.e. out of those passengers who would switch away from using the bus in response to a 10 per cent bus fare rise, or to an equivalent decrease in frequency in bus services, the proportion that would switch to using rail. The diversion ratio on all of the surveyed flows was relatively high – ranging from []. While such figures are based on stated preferences, rather than revealed preferences, and therefore may be subject to a margin of error, [].¹⁶
32. Stagecoach submitted that, despite the high diversion ratios, a profitability analysis on the surveyed flows based on the survey results suggested that it would be profitable to increase bus fares (by 10 per cent) on only six of the 10 flows. Even on these flows, the small profit gained on any one flow (the maximum net annual profit on any one flow was £2,913), and the small total net profit from the six profitable flows was such that Stagecoach would be unlikely to increase fares on any of the flows surveyed as a result of the merger.
33. However, the profitability analysis submitted by Stagecoach assumed a zero marginal cost for both bus and rail passengers alongside relatively high estimates of the price elasticity of demand derived from the survey. In the absence of reasons to the contrary, this combination of assumptions would suggest that, pre-merger, Stagecoach would have incentives to reduce prices that it had not acted upon. If this was correct, this would call into question the very basis for using profitability analysis to examine merger incentives. During the course of its investigation, the OFT therefore challenged Stagecoach on the assumptions used to derive the profitability estimates. As a result, Stagecoach submitted revised calculations based upon zero marginal costs alongside a very low elasticity of demand of -0.3. This indicated that a ten per cent price increase in prices would result in only a small increase in net profit on each of the ten flows. This combination of assumptions, however, also implies that Stagecoach is not acting on potentially large incentives to increase its profits pre-merger.

¹⁶ OFT decision *Completed acquisition by Arriva Trains Cross Country Limited of the Cross Country Rail Franchise*, 20 December 2007 and OFT decision *Completed acquisition by National Express Group plc of the Intercity East Coast Rail Franchise*, 20 December 2007.

34. To provide an analysis that would be more consistent with Stagecoach's actual pre-merger behaviour, the OFT therefore used the so-called 'Lerner Equation' to provide an estimate of elasticity of demand that would be consistent with pre-merger profit-maximisation.
35. The Lerner Equation requires that the (percentage) gross margin of a firm is equal to the inverse of the own price elasticity of demand faced by that firm. In simple terms the reasoning behind this is as follows: a very high gross margin implies, for example, that a firm would need to increase sales by only a small percentage to earn substantial additional profit; the reason it would not do so, pre-merger, must be because it believes this price reduction would not generate many extra sales, i.e. it perceives a low price elasticity of demand. Gross margins and elasticities are not therefore independent of one another and estimates of each need to be consistent with one another in assessing profitability effects.
36. Having regard to this and the information supplied by Stagecoach, the OFT considered that it was appropriate to examine two scenarios. One used the price elasticity estimates derived from the survey in combination with the gross margins that would be implied by the Lerner Equation. The second took the parties' assumption of zero marginal costs (i.e. 100% gross margins) and combined this with a corresponding price elasticity of -1. Both scenarios indicated that it would be profitable for Stagecoach to increase prices by at least ten per cent on all 10 flows.
37. The size of the estimated effect on net profits is inevitably sensitive to the assumptions used. There was, however, broad consistency between the results derived from both scenarios in the ranking of the flows by size of impact. The ranking therefore provides a useful starting point in identifying those flows on which competition concerns are most likely to arise.
38. In addition to the profitability analysis, Stagecoach submitted that, even if bus fare increases on the individual surveyed flows could, in theory, be considered profitable on the basis of the survey data, there were a number of reasons (on both a general and route-specific basis) why Stagecoach would not have the ability and/or incentive to increase fares on these flows. These related, amongst others things, to the negative impact such an action would have on Stagecoach's public image in the local area; the quality of the rail journey on the individual flow and related flows given the resultant increase in the number of rail passengers; and pricing decisions

for related bus flows, including network or season tickets. Stagecoach also argued that the franchise agreement provides for the Department for Transport (DfT) to make payments to Stagecoach when actual revenue falls below a specified percentage of forecast revenue. As such, Stagecoach submitted that where DfT is making revenue support payments Stagecoach has a reduced incentive to grow rail revenues, particularly if it results in costs or losses elsewhere in its business.

39. Stagecoach also submitted that barriers to entry were low, and that there were a number of potential entrants in relation to the overlapping flows who would prevent Stagecoach from carrying out the theory of harm. However, in this case, no potential entrants have expressed an interest in entering any of these flows. Furthermore the OFT has little evidence of actual entry on existing Stagecoach 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 Stagecoach.
40. The OFT analysed each of the surveyed flows, taking into account the features of the flow that make up the generalised cost for each mode of transport, the results of the profitability analyses under the different assumptions described above, other qualitative factors arising from the survey and the arguments made by Stagecoach as to its ability and incentive to increase fares on the individual flows even in the event of an increase in profit on that flow. The overall balance of these factors, rather than any one individual feature of the flow, formed the basis for the OFT's decision on the merger effect on each of the overlaps. This combination of factors is discussed below as part of a flow by flow analysis.

Flow by flow analysis

41. Manchester Oxford Road – Stockport: the Manchester Passenger Transport Executive sets rail fares on this flow, hence the only relevant theory of harm would be to increase bus fares or reduce frequency. There is a large disparity between rail and bus revenue and reasonably large differences in fares, journey times and frequencies, although the survey indicated a high diversion ratio in the event of a bus price increase. The profitability analysis also suggested a small profit uplift from a 10 per cent fare increase, on all models except Stagecoach's first profitability analysis. However, Stagecoach provided evidence to suggest that rail capacity constraints on this flow meant that Stagecoach would not have an incentive to increase

bus fares, as this would encourage passengers to switch to rail in circumstances where the Franchise already had difficulty with existing passenger volumes. In addition, there are 'station dwell time'¹⁷ targets in relation to Stockport and Manchester Piccadilly station which are not currently being met by Stagecoach, such that switching passengers from bus to rail would make it increasingly difficult for Stagecoach to meet these targets. Given these factors, the OFT does not consider that competition concerns arise on this flow or the related Manchester Piccadilly – Stockport flow.

42. Luton – Bedford: Stagecoach does not set rail fares on this flow, hence the only relevant theory of harm would be to increase bus fares or reduce frequency. While the services on the different transport modes differ (longer journey time for bus but lower cost), the revenues on the flows are similar, and the survey results suggested a high diversion ratio from bus to rail in the event of a bus price rise or frequency decrease. The profitability analysis suggested a profit uplift from a 10 per cent price increase on all models except Stagecoach's first profitability analysis. While there is another rail operator on the flow (and so any additional passengers, and therefore revenue, in rail would not fall to just Stagecoach), this fact is accounted for in the allocation of revenue in the profitability analysis. In the absence of further route specific evidence and/or reasons as to why Stagecoach would not have the ability and incentive to take advantage of the profit uplift on these flows, the OFT cannot dismiss competition concerns on this flow. Accordingly, the OFT considers that there is a realistic prospect of a substantial lessening of competition in relation to this flow.
43. Wellingborough – Kettering: as a result of the acquisition of the Franchise, Stagecoach will become the only transport operator on this flow. However, bus revenues were significantly higher than rail revenue on the flow, despite the bus journey being more expensive and having a significantly longer journey time. This supports Stagecoach's submission that the two services are not substitutable due to Wellingborough station being some distance outside the town centre. The diversion ratio was the lowest of all the overlap flows, and any profit uplift was relatively small (and negative

¹⁷ This is the length of time for which trains remain stationary at a particular station while passengers board and/or alight. Dwell times in excess of those scheduled contributes to worse punctuality and reduces EMT's ability to achieve the Franchise performance targets.

on Stagecoach's first profitability analysis). The OFT therefore does not consider that competition concerns arise on this flow.

44. Lincoln Central – Hykeham: bus revenue was also significantly larger than rail revenue on this flow, which suggested very limited use of rail despite the bus being more expensive and having a significantly longer journey time. The survey evidence supported Stagecoach's submission that the two services were not substitutable, with a significant majority of bus passengers stating that they did not use rail due to the inconvenient location of the rail station. Only a very small percentage of passengers had ever used rail on this journey. The bus route was also partially tendered on both evenings and weekends, which suggests that at least during these periods the tendering council does not feel that the rail is an adequate substitute for the bus journey. The OFT therefore does not consider that competition concerns arise on this flow.
45. Worksop – Whitwell/Worksop – Creswell: each of these flows exhibited similar features - bus revenues were significantly greater than rail revenues, notwithstanding the bus journey being more expensive and the journey time longer. However, surveys on these flows suggested high diversion ratios, and the profitability analysis also suggested a profit uplift on both flows from a 10 per cent increase, even on the conservative assumptions of Stagecoach's first profitability analysis. On the OFT's profitability analysis the profit uplift on these flows were two of the highest (as a proportion of bus gross profit on the flows). Stagecoach argued that on these routes the ability to increase the price of a single and/or return bus ticket is constrained by the availability of other ticket types, in particular for destinations beyond the point that delineates the flows (but which are valid for those flows). However, the OFT does not consider that these arguments are sufficient to dismiss competition concerns on these flows, and therefore considers that there is a realistic prospect of a substantial lessening of competition in relation to each of these flows.
46. Shirebrook – Mansfield: on this flow bus revenue was again greater than rail revenue, even though the bus journey was significantly longer than the rail. Of those aware of the rail alternative, a significant majority of the surveyed bus passengers suggested that the rail station was inconvenient for them. While the profitability analysis suggested a profit uplift from a 10 per cent price increase on all models (except Stagecoach's first profitability analysis), this amount was particularly small, both in real terms and as a

percentage of Stagecoach's gross bus profit on the flow. The OFT therefore does not consider that competition concerns arise on this flow.

47. Mansfield – Nottingham: as set out above, the OFT found that there was an effective competitor on this flow - Trentbarton operates its own bus service on the flow with a greater frequency than the Stagecoach bus service. The bus service that Stagecoach operates on this flow is also operated jointly with Trentbarton. In addition, National Express operates a service on this flow at slightly greater than half the frequency of Stagecoach's bus service. The profitability analysis suggested only a modest profit uplift from a 10 per cent price increase on all models except Stagecoach's first profitability analysis, which suggested a loss of revenue. The OFT therefore does not consider that competition concerns arise on this flow.

48. Chesterfield – Sheffield: Stagecoach operates three bus services on the flow, with varying journey times that are all, to differing extents, longer than the equivalent rail journey. This is reflected to some degree in the lower price. There is one other bus competitor, and one other coach competitor on the flow, neither of which operate sufficient services to be an effective competitor on the flow, and the OFT did not obtain any evidence to suggest that they would increase their services on the flow in response to a Stagecoach price increase or service decrease. Stagecoach did provide evidence to suggest that rail capacity constraints on this flow meant that Stagecoach would not have an incentive to increase bus fares (and hence encourage passengers to switch to train). However, the survey suggested a relatively high diversion ratio on this flow, and the OFT's profitability analysis suggested that the profit uplift on this flow was one of the more significant of the overlap flows, both in real terms and as a percentage of Stagecoach's gross bus profit. The OFT cannot therefore dismiss competition concerns on this flow, and therefore considers that there is a realistic prospect of a substantial lessening of competition in relation to this flow.

49. Mansfield Woodhouse – Mansfield: This flow attracted significant bus revenue, and very little rail revenue, even though the rail flow is cheaper and significantly quicker. Many bus passengers surveyed suggested that the inconvenient location of the train station was the main reason why they travelled by bus on the flow. Stagecoach submitted that they would have no incentive to divert passengers from bus to rail on the flow, as they

would see little, if any, revenue increase on the rail flow – []. The profitability analysis suggested only a small profit uplift from a 10 per cent increase on all models except Stagecoach's first profitability analysis, which suggested a loss of revenue. On balance, therefore, the OFT does not consider that this flow raises competition concerns.

Filtered flows

50. The OFT has found that there is a realistic prospect of a substantial lessening of competition on four of the overlap flows. Consistent with the OFT's view that the 10 per cent filter is not a 'safe harbour', competitive concerns cannot be ruled out on the filtered flows without a more detailed competitive assessment. Similarly, the OFT cannot rule out competition concerns on those flows for which Stagecoach and the OFT agreed that passenger numbers were so low that a survey was unlikely to produce sufficiently robust results from which to draw conclusions on competition between bus and rail. However, the OFT has not undertaken a more detailed competitive assessment in this case, as neither the assessment of the duty to refer, or the use of the *de minimis* discretion, turns on the competitive assessment of the filtered flows.

THIRD PARTY VIEWS

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

ASSESSMENT

52. Stagecoach commenced operations of the Franchise on 11 November 2007. The merger resulted in a large number of overlaps between the Franchise and Stagecoach's existing bus, coach, tram and rail transport interests. 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 merger resulted in two rail-on-rail/tram overlaps and two coach-on-rail, overlaps, none of which raised concern due to the small increment caused by the merger, or the continuing presence of effective competition. There were a number of bus-on-rail overlaps. While many of these overlaps could be dismissed on the basis of a preliminary analysis, and a number fell within certain filters which the OFT considered were appropriate to apply in

this case, the OFT and Stagecoach agreed that ten bus-on-rail flows would be the subject of further analysis by way of a passenger survey.

54. The passenger survey suggested relatively high diversion ratios from bus to rail on all flows in the event of a ten per cent increase in bus prices. Stagecoach and the OFT each produced profitability analyses based on these diversion ratios. Given the different set of assumptions used to construct the profitability analyses, these produced different results on the incentive for Stagecoach to increase bus prices on the overlap flows following the merger. The OFT therefore considered each flow in turn, taking into account the features of the flow that make up the generalised cost for each mode of transport, the different results of the profitability analysis under the different assumptions, other qualitative factors arising from the survey and the arguments made by Stagecoach as to its ability and incentive to increase fares on the individual flows even in the event of an increase in profit on that flow.
55. Taking all of the above factors into account, the OFT considered that the merger could raise competition concerns on four of the overlapping flows: Luton – Bedford, Worksop – Whitwell, Worksop – Creswell, Chesterfield – Sheffield.
56. Given the OFT's conclusion on the above flows, the OFT could not rule out competition concerns on either the filtered flows or the flows that were left out the passenger survey due to the small number of bus passengers travelling on those flows. However, the OFT's decision on its duty to refer does not depend on the competitive assessment of these flows, and therefore the OFT did not consider these flows further.
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).
60. The Act makes clear in section 73(1) that the OFT's discretion to accept undertakings in lieu under section 73(2) applies only once the OFT has already decided not to exercise its *de minimis* discretion under section 22(2) to avoid a reference to the Competition Commission.¹⁸ The question of whether to apply the *de minimis* exception therefore precedes the question of whether (in appropriate cases) to accept undertakings in lieu. This sequence is required under the Act because the question of whether to accept undertakings in lieu of reference that have been offered by the parties arises only once the OFT has decided that it would actually, otherwise, be under a duty to refer the merger to the Competition Commission.
61. However, the sequence of questions that the OFT is required to ask itself under the Act does not limit the scope of the OFT's discretion under section 22(2)(a) to decide not to make a reference to the Competition Commission based on the *de minimis* exception. The Act leaves open to the OFT the considerations it should take into account in exercising that discretion.
62. It is open to the OFT, when exercising its discretion under section 22(2)(a) to have regard to all relevant considerations, including whether the consumer harm in the case in question could have been avoided by the provision of clear-cut undertakings in lieu.¹⁹
63. The OFT considers it proportionate to make a reference, by declining to exercise its *de minimis* discretion, where clear-cut undertakings in lieu are,

¹⁸ Section 73(1) states: 'Subsection (2) applies if the OFT considers that it is under a duty to make a reference under section 22 or 33 (disregarding the operation of section 22(3)(b) or (as the case may be) 33(3)(b) but taking account of the power of the OFT under section 22(2) or (As the case may be) 33(2) to decide not to make such a reference.' (Emphasis added).

in principle, clearly available to the parties to avoid a reference in the case under consideration.²⁰ The OFT will therefore evaluate whether undertakings in lieu are, in principle, clearly available without regard to whether or not undertakings in lieu have in fact been offered in the case in question.

Application of the *de minimis* exception

64. As demonstrated above, the OFT believes that there is a realistic prospect of a substantial lessening of competition on at least the following four flows:

- Luton to Bedford
- Worksop to Whitwell
- Worksop to Creswell, and
- Chesterfield to Sheffield.

65. However, for the reasons set out below, the OFT considers it appropriate to invoke the *de minimis* exception to the duty to refer, as recently revised.²¹

66. The purpose of the exception is to avoid reference where the costs are disproportionate to the potential benefits. The revised guidance has raised the previous general threshold ceiling for considering this exception from £400,000 to £10 million. The basis for the OFT's approach is set out in the revised guidance as follows:²²

Before using this discretion the OFT will exercise its judgement in considering each case on its individual facts. A key issue for the OFT in this regard is the expected impact of the transaction on consumer welfare, considering in particular market size, the magnitude of competition lost by the merger, and the likely duration of that loss, as well as other relevant market features. The OFT is most likely to exercise its discretion not to refer where the relevant market features (which will overlap with those relevant in the assessment of the substantial lessening

¹⁹ A clear-cut remedy is one that is both effective and proportionate. See paragraphs 8.1-8.5 of OFT *Mergers Substantive Assessment Guidance*.

²⁰ For more detail on the reasoning for this approach, see OFT decision *Completed acquisition by Dunfermline Press Limited of the Berkshire Regional Newspapers business from Trinity Mirror plc*, dated 4 February 2008.

²¹ OFT 516b, November 2007.

²² *Ibid.*, at paragraph 7.6 of the revised guidance.

of competition) indicate that the merger's total impact is likely to be limited. The OFT is generally likely to consider the affected market(s) to be of sufficient importance to justify a reference where their annual value in the UK, in aggregate, is more than £10 million.

67. As noted above, the OFT will not consider it proportionate to apply the *de minimis* exception under section 22(2)(a) where clear-cut undertakings in lieu are, in principle, clearly available.²³
68. In the current case, the OFT does not consider that clear-cut undertakings in lieu are, in principle, clearly available. The OFT has a strong preference for structural undertakings over behavioural commitments in a problematic horizontal case. Horizontal mergers structurally alter a market by increasing its concentration that a structural solution is best-placed to remedy, preferably by restoring competition lost by the merger. Typically, structural undertakings consist of a divestiture of one of the overlapping businesses that have led to the competition concerns.
69. The OFT does not consider the present case clearly to fit this profile, unlike, for example, divestiture of a stand-alone business that removes the overlap in a local market. Divestiture of the target business in this case – the East Midlands franchise – would be effective but easily disproportionate to the harm identified on just four flows representing a small fraction of franchise turnover. As a matter of the OFT's judgment in principle, it is also not obvious that a divestiture of the bus element of the overlap is clear-cut. Bus routes, let alone flows, are not stand-alone businesses. A removal of the four problematic overlap flows would in all likelihood entail the respective divestitures of one bus route 'carved out' from a wider transport network, raising potential operational and commercial complications for both Stagecoach and potentially the acquirer; conceivably, a wider asset package of depots and other routes and assets might be required to give effect to the remedy, which in turn heightens the question of proportionality. Accordingly, it is not clearly the case that a clear-cut structural undertaking is available in this case.
70. Moreover, the OFT does not consider that a package of behavioural remedies would, in principle, clearly be available as a first-phase remedy in

²³ A clear-cut remedy is one that is both effective and proportionate. See paragraphs 8.1-8.5 of *OFT Mergers Substantive Assessment Guidance*.

this case. While behavioural undertakings in lieu can provide a means of moderating the scope for the merged company to exploit market power created or enhanced by the merger, particularly in non-horizontal cases, they substitute regulation for competition in a horizontal case. In a case such as this where (i) the merger concern is horizontal; (ii) the industry is unregulated, and (iii) the remedy is foreseeably of longer-term duration – the life of the franchise – such remedies raise substantial issues of market distortion and circumvention as well as the de novo public and private costs of monitoring and enforcement not applicable absent the merger undertaking. For these reasons behavioural remedies in this case 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.

71. In making the above in-principle assessment of structural remedies, the OFT has taken, and will continue to take, a conservative approach on the availability of clear-cut remedies that favours further consideration of the de minimis exception to the parties' potential benefit (as in this case). In short, such remedies must be clearly available. In the case that (i) the OFT considers that clear-cut undertakings are not clearly available in principle; and (ii) the OFT then declines to apply either the de minimis exception or the customer benefits exception, therefore leaving actual offers of undertakings in lieu as a live issue, the OFT's in principle judgment in the context of its de minimis discretion is without prejudice to its subsequent consideration, where applicable, of the parties' arguments that their remedies offer is clear-cut.
72. In the absence of any clear-cut undertakings in lieu being, in principle, clearly available to the parties, the OFT has gone on to consider what other factors exist in the present case such that it would be appropriate to apply its *de minimis* discretion.
73. The OFT has recently considered the '*de minimis*' exception in two rail franchise cases.²⁴ In those cases, the OFT considered three aspects of those transactions to be particularly relevant to the question of proportionality of a reference given the issues at stake:
 - the special nature of rail franchise mergers

²⁴ *Completed acquisition by National Express Group plc of the Intercity East Coast Rail franchise* (20 December 2007); *Completed acquisition by Arriva Trains Cross Country Limited of the Cross Country Rail Franchise* (20 December 2007).

- the rationale for the acquisition and deterrence considerations, and
- the value of the affected market at stake.

74. These issues, discussed in more detail below, are also equally relevant to the current case.

The special nature of rail franchise awards

75. The Franchise has been awarded by the DfT to Stagecoach on 21 June 2007 through a competitive tendering process and commenced on 11 November 2007. The Franchise will run for 7 years and 4 months, the last 16 months being dependent on meeting DfT performance targets. The franchise agreement provides for a mechanism to give 50 per cent of the additional revenue above a certain target to DfT. The regulated fares basket is subject to an annual price cap of RPI + 1 and to RPI + 6 on individual fares. In practice, the CC has found that even unregulated fares may to a certain extent be constrained by the need to keep a reasonable relationship between regulated and unregulated fares.²⁵ The DfT's Service Level Commitment also specifies the level, frequency, maximum journey times and stopping patterns of all rail passenger services.
76. In most cases considered to result in a relevant merger situation under the Act, two or more enterprises – meaning business activities of any kind²⁶ – 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 *sui generis* 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.

²⁵ *NEG/Greater Anglia report*, Appendix C, paragraph 47.

²⁶ See *Substantive assessment guidance*, at paragraph 2.3.

Transaction rationale and deterrence considerations

77. Part of the purpose of any credible merger regime is not only to prohibit a certain class of, say, mergers to monopoly but to deter like transactions from being contemplated or pursued. Recent research commissioned by the OFT confirms that the benefits of competition enforcement in general and the prohibition of anti-competitive mergers in particular go well beyond the direct benefits to customers and consumers achieved in the relevant markets subject to remedial action; in fact, the research suggests as a lower bound a multiple of five times the impact of any remedial intervention by the OFT (undertakings in lieu) or CC (second-phase substantial lessening of competition finding).²⁷ In other words, in considering the costs and benefits of a reference outcome it is often reasonable to assume a 'deterrence multiplier' of any consumer harm prevented if remedial intervention were to result.
78. In considering the rationale for acquiring the Franchise, the OFT discounts the notion that the acquisition of market power as a result of the problematic overlaps formed a material part of Stagecoach'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; it is clear that the driver for the bid is not the exploitation of any lost competition on any one flow.
79. 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.²⁸ In other words, it is unreasonable to assume that a decision by the OFT to apply the exception in this case would materially lessen deterrence of supposed anti-competitive bids for UK passenger rail franchises.

²⁷ On the deterrent effect or precedent value of intervention by the OFT or CC affecting private mergers and acquisitions activity, the best estimates, from a survey of relevant legal practitioners, is that the ratio of proposed mergers abandoned or modified on competition grounds (before the OFT becomes of them) to those in which there was a finding of SLC (by the CC) or undertakings in lieu is approximately five to one: see *The deterrent effect of competition enforcement by the OFT: a report prepared for the OFT by Deloitte* (OFT962, November 2007), at 4.6, page 29.

²⁸ See OFT Consultation on this exception, June 2007 (OFT933con) at 4.14 and OFT press release of 15 November 2007, available at <http://www.of.gov.uk/news/press/2007/156-07>.

The value of the affected market at stake

80. The total revenue of the four markets on which the OFT has found competition concerns in this case amount to approximately £1.4 million per annum. This includes Stagecoach's bus and rail revenue,²⁹ and revenue of other operators on the relevant flows.³⁰ If the OFT also includes revenues from the flows filtered out by the 10 per cent filter and those flows which were not surveyed due to the small number of bus passengers, this would increase the aggregated bus and rail revenues of the relevant flows to less than £3 million per annum.
81. The relevant revenue at stake implies merger effects only in relation to a proportion of a sum which is at most £3 million.³¹ The scale of conceivable merger effect is therefore low. Moreover, the OFT's belief that the merger will result in such effect is not one on the balance of probabilities; rather, its belief is of a 'realistic prospect' of a substantial lessening of competition under the 'may be the case' standard below a 50 per cent likelihood. It is by no means a foregone conclusion, therefore, that the CC would reach a balance of probabilities belief on further inquiry that adverse merger effects can be expected at all. Taken together, this suggests that the likelihood of CC intervention to resolve competition concerns is low, and that such concerns are in any event unusually small in scale, and without any 'multiplier effect' for deterrence. These considerations make it appropriate to rely on the *de minimis* exception.
82. Overall, given the cumulative weight of (1) the peculiar issues raised by rail franchise awards cases, (2) the lack of a deterrence multiplier, (3) the small scale of the issues at stake, and (4) the lower 'realistic prospect' standard of belief the OFT has in relation to its substantial lessening of competition findings, 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 CC inquiry are disproportionate to the prospect of benefits from such

²⁹ Based on historical revenue figures provided by Stagecoach.

³⁰ Stagecoach submitted that this case was similar to *National Express/ICEC* in that any merger effect was only likely to take place in respect of Stagecoach's bus operations, and hence rail revenues should be omitted from the revenue calculation for the purposes of *de minimis* considerations. However, the OFT has not concluded on this point, as the OFT considers that even combining bus and rail revenue in this case, total revenue is sufficiently low to make the case appropriate for the *de minimis* exception.

³¹ This is a worst case scenario, as it assumes that the OFT will find a substantial lessening of competition on all of the flows which were either filtered out by the 10 per cent filter or not surveyed due to the small number of bus passengers.

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

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