OFFICE OF FAIR TRADING

Completed acquisition by Arriva plc through Arriva Trains Cross Country Limited of the Cross Country Passenger Rail Franchise

No. ME/3294/07

The OFT's decision on reference under section 22(2)(a) given on 20 December 2007. Full text of decision published 31 December 2007.

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

PARTIES

1. **Arriva Trains Cross Country Limited** (**ATCC**) is part of **Arriva plc** (**Arriva**). Arriva is one of the UK's largest transport companies with operations in various locations throughout the UK and elsewhere in Europe.

2. The **Cross Country Passenger Rail Franchise** (**Cross Country**) is the most extensive rail franchise in the UK, and can be characterised as inter-city, cross-country and supra-regional. Arriva expects to achieve a turnover of around £600 million in the first year of operating Cross Country.

TRANSACTION

3. The transaction concerns the award of the Cross Country franchise to ATCC on 9 July 2007. ATCC will run Cross Country from 11 November 2007 to 31 March 2016. Cross Country was taken over from the incumbent operator, Virgin Cross Country.

4. The Office of Fair Trading's (OFT) statutory deadline for deciding whether to refer the merger to the Competition Commission (CC) is 16 January 2008.

JURISDICTION

5. The award of a rail franchise constitutes the acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993. Therefore, Arriva and Cross Country have ceased to be distinct. The anticipated UK turnover from the first year of operating Cross Country exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

COUNTERFACTUAL

6. 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. The main reason for this is that the franchise agreement will terminate (or, in this case, has terminated) and it is not possible to reach an 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.

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

MARKET DEFINITION

8. The activities of Arriva and Cross Country overlap in the provision of passenger transport services. There are a number of point-to-point journey overlaps between rail services operated by Cross Country and both rail and bus services operated by Arriva.

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[1] See for example the CC report on *FirstGroup plc and the Greater Western Passenger Rail franchise* 8 March 2006 (the *FirstGroup/GWF report*), paragraph 4.6.

Product market

9. 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 cost of journey, the journey time, the time spent travelling to the start point of the journey and 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).

10. As regards private transport, the CC[4] and the OFT[5] 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 among other things, the level of car ownership in the particular area and whether the relevant journey is urban or rural. Arriva submitted that private transport and taxis should be taken into consideration in the assessment of this case as they form part of the same relevant product market. Some third parties active in the supply of transport services also expressed the view that public and private transport compete. In the customer survey conducted by Arriva (see below), in respect of certain flows more customers said that they would switch from bus to private transport in response to a ten per cent price increase than to rail. 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.

11. Given the route- and passenger-specific nature of substitutability between different types of passenger transport on flows, the OFT considered the supply of all public passenger transport services for the purpose of assessing the competitive effect of the transaction.

Geographic market

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[2] *FirstGroup/GWF report*, paragraph 13.
[3] Paragraph 5.22.
[4] CC *A report on the acquisition by National Express Group plc of the Greater Anglia franchise* November 2004 (the *NEG/Greater Anglia report*).
[5] *FirstGroup/GWF report*, paragraph 14.

12. In making a journey, passengers travel from a particular point of origin to a specific destination. Past CC reports[6] and OFT decisions[7] 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.

13. In the absence of evidence in the present case suggesting a different approach, and in accordance with Arriva's submission, the OFT assessed the competitive effects of the merger on the basis of frames of reference which relate to the provision of public transport services between specified origin and destination points (flows).

Overlaps

14. Transport services are considered to overlap if they share the same start and end points, or where their start and end points are 'close'[8]. On this basis Arriva identified 29 flows over five areas where the Cross Country franchise overlapped with its operations:

    a) Newcastle corridor (overlaps with Arriva North East buses)
    b) West Yorkshire (overlaps with Arriva Yorkshire buses)
    c) South Manchester Triangle (overlaps with Arriva North West and Wales buses and Arriva Trains Wales (ATW))
    d) West Midlands (overlaps with Arriva Midlands buses and ATW), and
    e) Severn Channel (overlaps with ATW).

HORIZONTAL ISSUES

RAIL-ON-RAIL OVERLAPS

15. The acquisition resulted in seven rail-on-rail overlaps:

    - Manchester to Crewe
    - Manchester to Stockport

[6] For example the *FirstGroup/GWF report* March 2006, para.5.32.
[7] *FirstGroup/GWF report*, para.22; Anticipated acquisition by South Eastern Railways Limited of the Integrated Kent Rail Franchise of 31 March 2005, para.15.
[8] See *A report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited*, paragraph 5.4.

- Stockport to Wilmslow
- Wolverhampton to Birmingham New Street
- Cardiff to Newport
- Cardiff to Severn Junction
- Cardiff to Gloucester

16. The theory of harm tested with respect to these overlapping flows is that, after the merger, the lead operator may have the ability and the incentive to increase rail fares or to reduce service levels on these flows due to the loss of an independent rail constraint.

Regulation of rail fares and service levels under franchise agreements

17. Arriva asserted that it has limited ability to vary prices and service levels under the franchise agreement. Specifically, in this case ATCC may only increase the total value of the fares basket by up to RPI+one per cent annually.[9] Within the fares basket, individual fares may be increased by up to RPI+six per cent annually, provided the overall cap on the fares basket is not exceeded. Arriva stated that in practice it is difficult to increase fares on flows with high passenger volumes significantly without increasing the total value of the fares basket by more than the permitted indexation.

18. However, the OFT has not been given more detailed evidence about the relative size of each flow vis-à-vis the overall Cross Country fare basket to assess whether a price increase on a given flow would exceed the permitted level and therefore prevent the price increase being introduced. Furthermore, it is possible that a train operating company (TOC) could choose to increase prices on those flows where they face limited competition and offset this by holding fares constant or decreasing fares on other more competitive flows. It may also be the case that fares may decrease less or increase more than they would have absent the merger.

19. In addition to limited fare increases, Arriva is bound to certain Service Level Commitments (SLCs) in respect of the operation of the Cross Country franchise. It is allowed to change the timetable twice a year, but the SLCs within the Cross Country franchise agreement set out the minimum frequency of trains per day and the stations at which the trains must stop during each journey. In addition, Arriva submitted that any changes

[9] Adjustments can be made up to three times per year.

permitted under the SLCs would have a considerable lead time given that ATCC would have to bid for timetable slots.

20. In previous cases it has been noted that franchise agreements place some constraints on the TOC, but that there is still scope for competition, particularly for unregulated fares.[10]

Regulated fares versus unregulated fares

21. Arriva submitted that the price of regulated fares acts as a cap on the price at which a lead operator can set the fares for the next available unregulated lower priced fare on the same flow, and that this is consistent with the CC's findings in the *FirstGroup/GWF report*.

22. The recent CC methodology report[11] said that there are several factors which counteract the incentives to increase unregulated fares and therefore decrease competition concerns, and that unregulated fares are, to varying extents, constrained by regulated fares.

23. However, the OFT believes that where there is a not insignificant difference between the regulated and unregulated fares it may still be possible to increase unregulated fares by five to ten per cent (or more) when other constraints acting on rail fares are reduced.

Low increments

24. Three of the rail-on-rail overlaps identified result in a very limited increment:

    a) **Manchester to Crewe**: pre-merger ATW operated one train per hour, while Cross Country runs one or two trains per day
    b) **Stockport to Wilmslow**: pre-merger ATW operated one train per hour, while Cross Country runs one train per day
    c) **Cardiff to Severn Junction**: pre-merger ATW operated one train every two hours, while Cross Country runs one train per day

25. The evidence before the OFT does not suggest that the one train per day operated by Cross Country places a strong competitive constraint on the

[10] See the *FirstGroup/GWF report*, paragraphs 3.4 and 3.5.

other TOCs operating on each flow before the merger. There is at least one TOC other than Arriva (ATW and Cross Country) operating in each of these flows with services at least as frequent as ATW's. Based on the very limited increment caused by the merger, the OFT does not believe that the merger gives rise to competition concerns on these flows.

No material change in incentives of lead operator

26. On the flow **Wolverhampton to Birmingham High Street**, Cross Country operates a train every 20 to 30 minutes, whereas ATW operates one train per hour. Also operating on the flow are two independent TOCs – Central Trains (one train every 15 minutes) and Virgin West Coast (one train per hour). Pre-merger there were three independent TOCs: Central Trains, ATW and Virgin, controlling both the Virgin Cross Country and the Virgin West Coast services. The number of competitors has remained the same post-merger, with Virgin West Coast remaining and the Cross Country service transferring from Virgin to Arriva and the Central Trains service now being part of the new West Midlands franchise. The approach to the counterfactual might assume a fourth TOC but even if examined as a 4 to 3 merger of TOCs the OFT considers that this does not raise competition concerns on this flow because it would not materially change the incentive nor the ability for the lead operator (Central Trains/West Midlands) to increase fares or decrease service levels.

Sufficient effective competition remaining

27. The merger reduces the number of competitors on the flow **Manchester to Stockport** from five to four. Cross Country operates one train every 30 minutes and ATW operates one train per hour. Post merger there will remain four independent TOCs (Arriva, Central Trains (now part of the East Midlands franchise), Northern Trains and First TransPennine), each operating one train per hour. Therefore the OFT believes that sufficient competition will remain on this flow and that the merger does not create competition concerns on this flow.

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[11] See the *Review of methodologies in transport enquiries* report (the *CC methodology report*), paragraphs 67 and 68.

Remaining flows

Cardiff to Newport

28. On the **Cardiff to Newport** flow, both ATW and Cross Country operate one train per hour. There is only one alternative rail service, operated by First Great Western, which is more frequent (every 15 minutes) than those operated by Arriva, and there is no alternative bus service. The journey time for all services is similar. Before the merger there were two additional competitors: Virgin Cross Country, with a once-per-day service, and Central Trains, with an hourly service. However, following some re-mapping these two services are now part of the Cross Country franchise.

29. ATW is the lead operator on this flow. However, First Great Western is allocated a larger proportion of the total flow revenue [ ], and, as Arriva noted, any increase in fares will benefit First Great Western more than it benefits Arriva.

30. Arriva also submitted that there was price competition between ATW and First Great Western on this flow. In 2005, First Great Western introduced dedicated walk-up fares on this flow, which were priced between 30 and 50 per cent less than the interavailable fares (that is, fares that can be used for travel on the services of any rail operator on the flow and the fare is set by the lead operator). In 2006, ATW undercut all of First Great Western's dedicated fares on this flow.

31. Therefore, based on the evidence received, the OFT believes that there has been active competition between Arriva and First Great Western on this flow in the past, both of which will remain active on the flow post-merger. We have received no evidence to suggest that this competitive interaction was dependent on the presence of Central and/or Virgin Cross Country.

32. Only 29.3 per cent of this flow's revenue is regulated. The low proportion of regulated fares may indicate that a high proportion of passengers travel at off-peak times. Based on experience from past cases, the OFT believes that these are more likely to be leisure passengers and therefore to have more elastic demand. In this context, given the high fixed costs of rail transport which would give the TOCs the incentive to maximise revenue from unregulated tickets by keeping prices down (to increase demand), it is unlikely that Arriva would have an incentive to increase unregulated fares,

in particular in view of the previous price competition with First Great Western.

33. The OFT therefore concludes that the merger does not lead to competition concerns on this flow.

Cardiff to Gloucester

34. On the **Cardiff to Gloucester** flow, Cross Country operates one train per hour and ATW operates one train once every two hours and hourly at peak times. There are no direct competitors on this flow providing bus or rail services. First Great Western operates an indirect service via Bristol which runs every 30 minutes, but it takes notably longer than the direct services and therefore it is not considered to be an effective competitor to Arriva. The OFT therefore considers that following the merger Arriva is now the sole provider of public transport services on the Cardiff to Gloucester flow.

35. Arriva submitted that, prior to the merger, 98 per cent of the fares purchased on this flow were interavailable, despite that fact that there were dedicated advance purchase tickets on offer which were cheaper than the interavailable fare. For example, 78.7 per cent of passengers purchase an interavailable saver return ticket for £16.50 rather than a £10 dedicated return ticket which has to be booked in advance and is limited for travel on the ticket issuer's service. In Arriva's view this reflects the fact that most passengers on this flow are leisure passengers who want the flexibility to take any train at their convenience.

36. On this flow 86.5 per cent of fares are regulated. However, as discussed above, regulated fares may still give some flexibility for increasing prices (there is scope for Arriva to increase prices annually on the flow by up to RPI + six per cent within the context of raising the overall fare basket by up to RPI +one per cent), and the OFT has not received any evidence in relation to the relative size of this flow vis-à-vis the overall Cross Country fare basket to dismiss the possibility of prices being increased.

37. Subject to the cap placed by regulated fares, Arriva may also have the ability and incentive to increase unregulated fares on this flow. The OFT does not have information about the price difference between regulated and unregulated fares on this flow to assess the scope for a potential price

increase. However, this may be significant considering that the cap itself might be raised, as discussed above.

38. In addition, a price increase on interavailable fares could have the effect of inducing customers to switch to dedicated fares, and which could in turn be increased or withdrawn by Arriva since there will not be an alternative independent transport operator.

39. Entry barriers regarding the provision of rail services have historically been high due to regulatory barriers. Previous CC reports have found that prospects for entry on train services are very limited given, for example, the lack of track capacity. The evidence before the OFT shows that new rail entry is unlikely to be sufficient in scope to mitigate the competition concerns identified on this flow. In addition, rail passengers do not possess buyer power.

40. The OFT therefore 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 on the Cardiff to Gloucester flow.

RAIL-ON-BUS OVERLAPS

41. The acquisition resulted in 22 bus-on-rail overlaps. The OFT considered three potential theories of harm in relation to bus-on-rail overlaps:

a) That Arriva will have the ability and incentive to increase bus fares or decrease service levels on a given flow in order to induce customers to switch to rail
b) That Arriva will have the ability and incentive to increase both their bus and rail fares on a given flow, or
c) That the lead train operator (that is, the operator setting interavailable fares on a given flow) will have the ability and incentive to increase prices due to the loss of constraint from an independent bus competitor.[12]

42. All these theories of harm require that pre-merger bus and rail compete against each other on a given flow. As discussed above, Arriva argued that there is limited competition between rail and bus based on generalised cost

[12] In each case fare increase could also equate to a reduction in service frequency.

arguments and that the strongest constraint comes from the car. However, in line with previous OFT and CC decisions we have 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, etc.

Non-surveyed flows

43. On three flows, very large differences in journey times and/or frequency led the OFT to conclude that Arriva's bus and rail services were not effective competitors to each other and therefore the merger does not lead to competition concerns. These are:

- Newcastle to Berwick
- Newcastle to Morpeth
- Newcastle to Alnmouth

44. On one flow, the OFT considered that there will continue to be sufficient effective competition post-merger from a bus operator (running three different services that are in total more frequent than Arriva's), and that therefore the merger does not lead to competition concerns. This is:

- Derby to Burton-on-Trent

Surveyed flows

45. Arriva undertook a customer survey in order to assess the degree of competition between rail and bus on the five flows listed below. The methodology and questionnaire used in the survey were designed in close cooperation between Arriva and the OFT.

- Stockport to Macclesfield
- Macclesfield to Congleton
- Leicester to Narborough
- Leicester to South Wigston
- Leicester to Coventry

46. The survey results indicated that on these flows, following a ten per cent price increase in bus fares, between 2.9 and 6.8 per cent of all bus

passengers said that they would switch to rail (the diversion rate). From all passengers who would switch away from bus, between 8.3 and 27.8 per cent said that they would switch to rail (the diversion ratio) in response to a ten per cent price increase.

47. In **Leicester to Narborough**, **Leicester to South Wigston** and **Leicester to Coventry** the relatively low diversion ratio to bus led the OFT to conclude that the degree of substitution between bus and rail on this flow is too limited for the merger to cause competition concerns. In **Leicester to South Wigston** this is further supported by the difference in frequency between rail and bus services, while in **Leicester to Coventry** this is further supported by a higher diversion ratio to other bus and coach than to rail, implying that passengers consider the notably slower direct coach service as a stronger competitor on the flow than the more frequent, but indirect, rail service.

48. In **Stockport to Macclesfield** the diversion ratio from bus to rail suggested by the survey was 23.1 per cent. However, this flow is tendered by the Greater Manchester Passenger Transport Executive and as such Arriva does not control fares or frequency. Moreover, even if Arriva were able to raise bus prices it may not have the incentive to do so. This is because Arriva receives only [ ] of rail revenue on the flow, the remaining 52 per cent being split with two other TOCs operating on the flow.

49. In **Macclesfield to Congleton** the diversion ratio from bus to rail is 27.8 per cent. The OFT conducted a profitability incentives analysis to assess whether Arriva would have an incentive to flex bus services and/or fares in order to induce customers to switch to rail. The analysis showed that even considering the lowest rail elasticity within the range, the incremental rail revenues would represent less than four per cent of Arriva's revenue on this flow and therefore it is unlikely that it would have a strong incentive to increase prices or decrease service levels.

Filtered out flows

50. In past transport cases where there have been a high number of overlapping flows, filters have been applied to allow the OFT and CC to focus their analysis on those flows most likely to give rise to competition concerns. The use of filters was based on the premise that if no competition concerns were identified on any of the flows that were subject

to more detailed analysis, it would be unlikely that that would be the case for those overlaps filtered out in the initial stage.[13]

51. In this case, the OFT only applied the filter based on the relative importance of the flow compared to the overall route, and excluded from its initial analysis 13 flows in which the sum of all overlapping flows on a single route account for less than ten 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 revenue is low and that, if no competition concerns are identified on the relatively larger flows (in relation to the route), it is unlikely that the merger will result in competition concerns on these smaller 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.

52. Because the revenue filter is not a safe harbour - in other words, the OFT may find competition concerns in a flow which represents less than ten per cent of the total route revenue - and given that in some of the bus-on-rail overlaps the OFT could only conclude that no competition concerns were raised after extensive analysis, in this case the OFT took a cautious approach and by way of a sense check opted to conduct a simplified analysis of those flows filtered out from the initial analysis.

53. The evidence before the OFT shows that these flows do not raise competition concerns due to strong generalised cost arguments, the presence of effective competition and/or significant discrepancy between the revenue obtained by Arriva in bus and rail services in each flow, indicating limited competition between the modes, and the very low percentage of revenue yielded in the flow in comparison with the total route revenue.

THIRD PARTY VIEWS

54. No third party raised any concerns in relation to the merger.

[13] See the *CC methodology report*, paragraph 25.

ASSESSMENT

55. Arriva commenced operation of the Cross Country Franchise on 11 November 2007. The merger resulted in rail-on-rail and bus-on-rail overlaps. As in previous cases, the frame of reference used by the OFT was considered on a flow by flow basis, on the basis that the degree of substitutability between different modes can vary from flow to flow.

56. The merger resulted in seven rail-on-rail overlaps, six of which do not raise any competition concerns due to low increments, no change in the number of independent competitors or sufficient effective competition remaining on the flow. The OFT however believes that the merger may give rise to a substantial lessening of competition on the Cardiff to Gloucester flow, in which Arriva is now the sole provider of public transport and may be able to increase prices or decrease service levels. Entry and/or expansion by competitors onto this flow is not expected to be timely, likely or sufficient to mitigate any competition concerns, and rail customers do not have buyer power.

57. The OFT does not believe that the merger caused competition concerns in any of the 22 rail-on-bus overlapping flows. In the five flows that were subject of a customer survey, either bus and rail do not compete to a significant degree or there would not be a strong profit incentive for Arriva to flex bus services to cause customers to switch to rail or vice-versa. The OFT considered that the merger did not cause competition issues on the other flows because the overlapping services are not effective competitors and/or there will remain sufficient competition post-merger.

58. 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.

59. On this basis the OFT is under a duty to make a reference to the CC. 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.

MARKETS OF INSUFFICIENT IMPORTANCE

60. As demonstrated above, the OFT believes that there is a realistic prospect of a substantial lessening of competition on the Cardiff to Gloucester rail flow.

61. However, for the reasons set out below, the OFT considers it appropriate to invoke the markets of insufficient importance or *de minimis* exception to the duty to refer, as recently revised.[14] Although Arriva did not seek to rely on the *de minimis* exception, as the use of this exception is at the discretion of the OFT, it is not necessary for a party to plead the exception in order to benefit from it in an appropriate case.

62. The purpose of this 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:

63. 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 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.[15]

64. In this context, having considered the individual facts, the OFT considers the following aspects of the current transaction to be particularly relevant to the question of the proportionality of a reference given the issue at stake.

[14] OFT 516 b, November 2007.
[15] *Ibid.,* at paragraph 7.6 of the revised guidance.

- The special nature of rail franchise awards

- The rationale for the acquisition and deterrence considerations, and

- The issues at stake centre on an affected market worth just above £1m.

65. Each of these is dealt with in more detail below.

The special nature of rail franchises awards

66. The Cross Country franchise has been awarded by the Department for Transport (DfT) to Arriva on 9 July 2007 through a competitive tendering process. It has commenced on 11 November 2007 and will run for eight years and four months. The franchise agreement provides for a mechanism to give 50 per cent of the additional revenue above a certain target to DfT. As discussed above, the regulated fares basket is subject to an annual price cap of RPI +one on fare baskets and to RPI +six 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.[16] The DfT's SLC also applies which specifies the level, frequency, maximum journey times and stopping patterns of all rail passenger services.

67. In most cases considered to result in a relevant merger situation under the Act, two or more enterprises - meaning business activities of any kind[17] - cease to be distinct and the acquirer gains unfettered commercial control over the target business post-merger. However, rail franchise awards amount to a distinctive medium-term outsourcing agreement by the government of railway services in the franchise area, subject to regulation and potential clawback by the government. 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.

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[16] *NEG/Greater Anglia report,* Appendix C, paragraph 47.
[17] See *Substantive assessment guidance*, at paragraph 2.3.

Transaction rationale and deterrence considerations

68. Small mergers, or mergers in small markets, can be motivated by the acquisition of market power: for example, a small firm decides to acquire its only competitor active in one or more local markets for the principal purpose of eliminating competition and reaping monopoly profits post-merger. 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).[18] 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.

69. In contrast, competition concerns may also arise where any potential anti-competitive benefit to the merged firm is incidental to a much larger transaction whose rationale may be benign or even beneficial from a competition perspective. Many of the OFT's undertakings in lieu cases appear to fit this category.

70. In considering the rationale for acquiring the Cross Country franchise, the OFT discounts the notion that the acquisition of market power as a result of the problematic rain-on-rail overlap formed a material part of Arriva's rationale for its winning bid. The expected annual turnover of the franchise (£600 million in the first year) clearly lies in the profit potential of operating the franchise on an efficient fixed-term basis subject to various regulatory requirements; the driver for the bid is not the exploitation of any lost competition between rail and rail on one flow.

71. 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

[18] See OFT press release of 12 November 2007, available at www.oft.gov.uk/advice_and_resources/resource_base/consultations/deterrent

not undermine deterrence by incentivising a similar acquisition whose motive is market power by merger.[19] 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.

The issues at stake centre on an affected market worth just £1.1 million

72. The aggregate rail turnover associated the Cardiff to Gloucester flow is just above £1.1 million. The scale of 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 SLC 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.

Conclusion

73. 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 SLC 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 action. Accordingly, 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.

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[19] See OFT Consultation on this exception, June 2007 (OFT933con) at 4.14 and OFT press release of 15 November 2007, available at www.oft.gov.uk/news/press/2007/156-07

DECISION

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