Anticipated acquisition by South Eastern Railways Limited (a joint venture between DSB and Stagecoach Group plc) of the Integrated Kent Rail Franchise

The OFT's decision on reference under section 33 given on 31 March 2005. Full text of decision published 11 April 2005

PARTIES

1. **DSB** is part of **DSB Group**, which operates the Danish State railway system and is an independent public corporation wholly owned by the Danish Ministry of Transport. The DSB Group operates urban, intercity, regional and international passenger rail services within Denmark and other European countries including Sweden. The DSB Group achieved turnover of DKK8.9 billion (approximately £835 million) for the year ended 31 December 2003.

2. **Stagecoach Group plc (Stagecoach)** is an international transportation group active in the UK, the USA, Canada and New Zealand. Its UK bus division comprises16 regional companies. In 2003, Stagecoach launched megabus.com, a long-distance inter-city bus transport service that operates a similar business model to a budget airline (with web-ticketing etc.). Stagecoach's rail division in the UK operates two wholly-owned passenger rail franchises: South West Trains (from Waterloo) and the Island Line (Isle of Wight). It also operates the Sheffield supertram system. Stagecoach also holds a 49 per cent shareholding in Virgin Rail Group Holdings Limited, which operates the West Coast Mainline and Cross Country franchises.

3. **Integrated Kent Rail Franchise (IKF)** will include passenger rail services on the network currently operated by South Eastern Trains (SET), a subsidiary of the Strategic Rail Authority (SRA). The IKF is a commuter network serving several areas around South East England, parts of Greater London and several London termini. The IKF will also include new high-speed services from St Pancras making use of the Channel Tunnel Rail Link (CTLR). Reported turnover for the

period 9 November 2003 (when SET took over the franchise from Connex) to 31 March 2004 was approximately £195 million[1].

TRANSACTION

4. DSB and Stagecoach have formed a joint venture company, South Eastern Railways Limited (SER), in which they hold shareholdings of 70.1 per cent and 29.9 per cent respectively, in order to participate in the tender let by the SRA for the IKF. If the parties are successful in their bid, SER will be the IKF franchise operator.

5. The parties notified the transaction on 3 February 2005 and the 40-working day administrative deadline expires on 4 April 2005.

JURISDICTION

6. By virtue of section 66(3) of The Railways Act 1993 the award of a rail franchise constitutes acquisition of control of an enterprise and therefore South Eastern Railways Limited and the IKF will cease to be distinct. Turnover generated by the IKF in the last financial year was in excess of £70 million. Accordingly, a relevant merger situation will be created for the purposes of section 23 of the Enterprise Act 2002 (the Act).

RELEVANT MARKET

7. Neither Stagecoach nor DSB operate rail services that overlap with the IKF. Overlaps exist between passenger rail routes provided by the IKF and Stagecoach's bus/coach operations in London and the East Kent region.

Substitutability between bus and rail

Product market

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

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[1] As this is for a period of less than six months, the accounts do not represent the applicable turnover for the relevant business year.

9. As a general matter, it may be said that bus services often serve intra-urban and rural transport needs, while rail services such as IKF tend to serve inter-urban and commuter passengers. For travel between the same two points, the bus service is often cheaper but slower (due to a larger number of stops or congestion delays), and may be more frequent.

10. As noted, as well as varying by route, the degree of substitutability between different transport modes is also dependent upon characteristics of the user. Of particular relevance in the CC's *NEG/Greater Anglia* report, where coach-on-rail overlaps were prevalent, was the distinction between leisure passengers, commuters and business travellers who exhibited different sensitivities to journey times. The evidence collated by the CC in its *First/Scotrail* inquiry also suggested that train and local buses were at least potentially substitutable on some routes in the Glasgow/Edinburgh area.

11. In this case, the focus of inquiry has been East Kent, and the parties have characterised the bus/rail overlaps arising in this transaction as falling into three categories: 'Thanet routes' (local services and Thanet-Canterbury), 'Rural routes' (services to small towns and villages in Kent) and 'Commuter routes' (services between larger towns). The parties submit that rail is a poor substitute for bus services in the first two categories. On the other hand, they consider that on the Commuter routes, bus is more likely to be capable of competing with rail, as journey times (if not frequencies) are relatively comparable, and passengers are more likely to view bus and rail as substitutable. (These issues are considered further under horizontal issues, below.)

12. As regards private transport, evidence collated by the Competition Commission (CC) in its *First/Scotrail and NEG/Greater Anglia*[2] merger inquiries suggests that there is limited substitutability between public and private transport in response to changes in relative price, although the exact extent of substitutability varies depending on, among other things, the level of car ownership in the particular area and whether the relevant journey is urban or rural (which embraces issues of road congestion and parking difficulties). Stagecoach has argued that greater substitution to car exists in the South East region where car ownership is the highest in Great Britain (1.3 per household)[3] and that taxis provide competition to buses. The evidence provided, however, was insufficient foundation to

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[2] FirstGroup plc and the Scottish Passenger Rail franchise, A report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited, 28 June 2004,; National Express Group plc and the Greater Anglia franchise, A report on the acquisition by National Express Group plc of the Greater Anglia franchise, 4 November 2004

[3] Citing Regional Transport Statisitics published by the Department of Transport.

conclude that private transport is an immediate competitive constraint on public transport operators in the IKF area[4].

Geographic market

13. In making a journey, passengers wish to travel from a particular point of origin to a specific destination. The CC concluded in its report on the *First/Scotrail* merger that point-to-point public transport journeys were considered the relevant geographic frames of reference for competition assessment in relation to the bus/rail overlaps in that case. Point-to-point frames of reference have consistently been employed in relation to various modal combinations such as coach/rail and rail/rail (see for example CC report in *NEG/Greater Anglia*, OFT decisions in *First/ICEC, Virgin/ICEC*).[5]

14. The OFT has not received any evidence in this case that warrants departing from the point-to-point approach, which the parties endorse.

15. Accordingly, the principal frames of reference relate to the provision of public transport services between specified origin/destination points (i.e. 'point-to point' frames of reference). A point-to-point journey may represent a complete route (e.g. in the context of this transaction, Canterbury to Margate) or may represent a smaller 'flow' that comprises part of a longer route (e.g. Canterbury to Sturry).

Multi-modal journeys

16. Where passengers use both a bus service and a rail service to complete a 'multi-modal' journey, the two modes may be viewed as complements rather than (as discussed above) potential substitutes, as each covers a different portion of the total journey.[6] The issue of potential foreclosure by Stagecoach of rival bus operators as a result of its ownership of bus and rail businesses in the IKF region is addressed under non-horizontal issues, below.

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4 In other words, the OFT could not reliably conclude that sufficient passengers would switch from public to private transport to render unprofitable a price increase by a monopolist provider of public transport on given routes on the IKF, merely on the basis of higher car ownership in the South East region.

5 National Express Group plc and Midland Mainline Limited: A report on the merger situation, 20 December 1996, Cm 3495; National Express Group and ScotRail Railways Limited: A report on the merger situations, 16 December 1997, Cm 3773; National Express Group plc and Central Trains Limited: A report on the merger situation, 16 December 1997, Cm 3774.

6 Due to the specific features of the region in question, the CC defined public transport network markets in the *First/Scotrail* case.

HORIZONTAL ISSUES

Impact of regulation

17. The highly prescriptive nature of the new rail franchise template has been well documented in previous OFT decisions (see First/ICEC and Virgin/ICEC).[7] This regulatory regime applies equally to the IKF and directly impacts on the commercial freedom to operate the IKF through tight fare and service level regulation. The proportion of regulated revenue to total revenue for the IKF (based on the turnover of the current franchisee), at [around 60 per cent][8], is significantly higher than the national average of regulated revenue (about [40 per cent]) [see note 8].

18. Bus routes operated under contract to London Buses (TfL) are regulated. London Buses plans each route and specifies the service levels and fares that are to apply to each route. A bus operator is contractually bound by such arrangements and has no influence over fares or service levels.

Stagecoach and IKF overlaps

19. Stagecoach operates tendered bus services in South and East London; commuter coach services between London and Kent under contract to National Express; and tendered and commercial local bus services in East Kent.

20. Stagecoach London bus services and the commuter coach services operated on behalf of National Express raise no competition concerns. Stagecoach has no influence over route design, service level or prices on either of these two operations.

21. However, Stagecoach operates extensive commercial bus services in the East Kent region. There are a total of 25 routes with 69 point-to-point flows overlapping with IKF rail services. For many such flows, Stagecoach and IKF services appear to be the only or primary means of public transport with no other public transport operators present. This may suggest that Stagecoach and IKF are the only substitutes, at least for those passengers unable or unwilling to rely on private transport means.

Theory of harm

22. In relation to East Kent overlaps, the theory of harm tested by the OFT is informed by the CC's detailed analysis in *First/Scotrail*. In summary, the OFT has

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[7] Both cases reported on 21 December 2004. See oft web-site www.oft.gov.uk

[8] Exact figure excised at the request of the parties

first considered whether Stagecoach has the post-merger incentive to raise bus prices or reduce bus frequencies (relative to their levels absent the merger), because Stagecoach would recoup its share of increased rail revenue deriving from passengers switching from bus to rail. Additional revenue from rail may prompt Stagecoach to engage in such behaviour where it had no incentive or less incentive to do so, pre-merger, when it was independent of the IKF.

23. This theory of harm presupposes that bus and rail compete to some degree, on the basis that passengers regard the two modes as potential substitutes on the overlap flows in question. Stagecoach acknowledges this possibility in relation to Commuter routes in East Kent, but disputes it in relation to other routes (see above). As the OFT has noted, on the majority of these overlapping flows, Stagecoach bus services and IKF rail services are the only or primary means of public transport; accordingly, it is reasonable to suppose a degree of substitutability. The quantitative assessment below proceeds on this basis (see also correlation data, discussed below).

24. Second, whilst it is accepted that price and service regulation on rail tends generally to preclude concerns as to the reverse scenario (i.e. switching passengers from rail to bus), the OFT explored whether additional concern may arise should Stagecoach have the ability and incentive to raise unregulated rail fares for the point-to-point flows as well, to increase the returns made on rail as passengers switch from bus.

Quantitative analysis

25. Before turning to an assessment of whether Stagecoach would have a post-merger incentive to act in the manner posited by the theory of harm, two preliminary issues arose.

- *Identifying overlaps of most potential concern.* In *First/Scotrail*, the CC applied the following screening methodology: bus routes most likely to cause concern are those where the percentage of revenues of the complete bus route accounted for by all overlap flows along the route exceeds 10 per cent. The hypothesis is that it would be economically counterproductive to change the operation of the route as a whole for possible gains on less than10 per cent of route revenue. Application of the 10 per cent threshold in this case would eliminate 9 of the 25 Stagecoach routes that give rise to overlapping flows.

  Stagecoach argued that the 10 per cent threshold should be at least 30 per cent in this case, in proportion to Stagecoach's interest in SER. This would significantly reduce the number of overlapping routes. Profit calculations on rail must of course reflect Stagecoach's lower (29.9 per cent, rather than 100 per cent) economic interest. Arguably, however, this does not provide a basis to depart from the CC's finding that, where increased rail revenue from switching warrants it, the bus operator potentially has sufficient incentive to adjust bus pricing or frequency on a route wherever the overlap flows are significant (i.e. more than10 per cent of total route revenue). In any event, as the OFT concludes that Stagecoach has insufficient incentive to act in the manner posited by the theory of harm applying the 10 per cent threshold, it was not necessary to reach a firm conclusion on whether it might be appropriate to apply a methodology different to the CC's in *First/Scotrail*.

- *Bus/rail price correlation data*. Preliminary price correlation analysis was conducted on the remaining 16 routes showing a strong positive correlation between bus and rail fares charged per mile (train mileage), which may suggest competitive interaction between the two modes. On the other hand, preliminary price correlation analysis conducted by Stagecoach using price per minute of journey time (which it argued was a more accurate indicator of passenger preferences) showed a weak price correlation between the two modes of transport. For the purposes of its inquiry, the OFT proceeded on the basis that correlation data could support the view that bus and rail are substitutable on the overlaps in question. Ultimately, because the OFT concludes that Stagecoach has insufficient incentive to act in the manner posited by the theory of harm, it was not, however, necessary to reach a firm conclusion on the probative value of the correlation studies undertaken, or to conduct further econometric analysis.

26. The OFT then sought to test whether, post-merger, Stagecoach would have the incentive to switch passengers from bus to rail on those routes identified as of most potential concern using the *First/Scotrail* methodology, and on the assumption that bus and rail are substitutable in the view of passengers, and thus compete. The analysis simulates the increase in profit Stagecoach could achieve by raising bus fares or reducing bus frequencies. In conducting the analysis a series of assumptions were made on the own price elasticity of demand of bus travel (elasticity ranges used for price increases from –0.3 to –1 and headway elasticity ranges for reductions in frequency from –0.25 to –0.8). In addition, it was assumed that 50 per cent of passengers that switch away from bus do so to rail.[9] Using the range of elasticity and switching assumptions the impact on profitability was considered across a range of price increases and frequency reductions (10 per cent to 50 per cent).

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[9] The figure is consistent with similar analysis undertaken by the CC in the First/Scotrail inquiry.

27. The effect of the analysis was twofold: the primary effect was an increase in bus profits across the range of assumptions.[10] However, these additional profits in bus generated from a price increase or reduction in frequencies are non-merger specific and could be achieved by Stagecoach absent the merger.[11] The secondary effect was a small increase in rail profit for Stagecoach on the majority of point-to-point flows.[12] Stagecoach argued that the profit increase in rail is too low to provide any incentive to increase bus price and/or reduce frequencies. On the majority of flows the additional rail profit was [a minimal amount per annum][13].

28. In taking the analysis a step further the OFT sought to test the impact on profitability using aggressive assumptions such as an own price elasticity of −1 with a 75 per cent switching rate to rail services and a 20 per cent increase in the price of bus fares. The results show a loss in Stagecoach's bus operations (around £[see note 13] per annum) with pro rata rail profit gains of around £[see note 13], thus leaving a net profit gain of around £[an insignificant amount-see note 13]. Using these aggressive assumptions – which represent the worst case against Stagecoach in terms of its post-merger incentives – there still appears little incentive to increase bus fares or reduce frequencies.

29. Stagecoach also argued that post-merger it would lack the ability, as the minority shareholder, to raise unregulated rail fares unilaterally; any such increase would require the full co-operation of DSB, the majority shareholder of SER, which would not share Stagecoach's incentives given that it has no bus operations and the high elasticity of unregulated fares could mean that DSB would lose revenue from such action. In addition to this obstacle faced by Stagecoach, it is questionable whether any increase in unregulated fares would have any meaningful effect on Stagecoach's profitability given its minority share. An examination of regulated and unregulated rail fares on the IKF reveals that, with few exceptions, there is no price differential between regulated and unregulated fares. Stagecoach submits that regulated fares also operate as a 'ceiling' on unregulated fares because the IKF profile does not allow unregulated fares to be set above regulated fares. In light of the evidence presented, the OFT does not believe that Stagecoach has the ability to increase unregulated rail fares to any material extent and therefore its conclusions on Stagecoach's lack of incentive to shift bus passengers to rail remain valid.

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[10] At the highest elasticity bus revenue falls.

[11] Assuming Stagecoach seeks to maximise bus profits, the finding that Stagecoach could profitably raise bus prices absent the merger suggests that the assumptions contain inaccuracies and/or may not fully reflect all competitive constraints upon it on the overlaps in question.

[12] Stagecoach's 29.9 per cent share of IKF reflected in the profit share.

[13] Exact figure excised at the request of the parties.

Qualitative analysis

30. In addition to the quantitative analysis Stagecoach has put forward a number of qualitative, route-specific arguments to rebut any potential competition concerns raised.

31. Whilst many of the submissions put forward appear plausible, given the extent of overlapping routes it has not been possible for the OFT, within the time frame available, to test the accuracy of these submissions with third parties or verify the facts. As the quantitative analysis suggests no substantial horizontal concerns, however, the reliability of this evidence is not material to the outcome.

Barriers to entry and expansion

32. Whilst there may be some scope for entry to the rail sector via open access agreements the likelihood of such entry appears low and no evidence of such entry has been put forward by Stagecoach.

33. Stagecoach has strongly advocated the prospect of bus entry as a countervailing factor in this case. Currently, there appear to be few bus competitors on overlapping routes. However, the OFT notes that there are national operators such as Arriva, with depots in the region that could potentially have the capability and incentive to move into Stagecoach routes in the event of service reductions (or perhaps fare increases) implemented by Stagecoach, thus acting as a constraint.

NON-HORIZONTAL ISSUES

34. Stagecoach is one of the largest bus operators in the East Kent region with services intersecting with the IKF territory beyond the bus/rail overlaps discussed above. Stagecoach participates in a long-standing bus-rail through ticketing scheme that applies at principal stations on the IKF network.

35. While being potentially substitutable on some routes, Stagecoach's bus network may be regarded as complementary to IKF rail services, particularly by way of bus feeder routes to and from railway stations. Thus, potential exists for Stagecoach to enhance the integration of bus and rail services in the East Kent region through the development of inter-relationships such as multi-modal tickets, valid only on Stagecoach bus and IKF trains. Such actions may be advantageous for passengers through a greater integrated transport network, but may also adversely impact on other bus operators, potentially reducing rival's passenger volumes, forcing exit of smaller bus operators and foreclosing the

market to new bus entrants. This may lead to medium-long term harm to consumers that may outweigh short-term benefits of integrated ticketing.[14] One market participant expressed such concerns to the OFT, although it appears that the primary concern for that operator was inability to fund the equipment necessary to facilitate its participation in multi-modal ticketing schemes. The merger would not affect this particular issue. The Office of the Rail Regulator (ORR) also raised concerns that Stagecoach could introduce operator-specific schemes that, while offering potential passenger benefits, could also potentially restrict competition in bus services.

36. Stagecoach has submitted that the schemes currently in place are open to all bus operators in the region who wish to participate and this will continue even if successful in acquiring the IKF and extending such schemes across the network. In addition, Stagecoach has provided evidence to show that revenues gained from the through ticketing and multi-modal schemes are minimal because very few passengers use such schemes, tending to suggest insufficient incentive to engage in foreclosure strategies.

37. The weight of evidence is insufficient for the OFT to conclude that the merger raises a realistic prospect of foreclosure of rivals through exclusionary multi-modal ticketing schemes.

THIRD PARTY VIEWS

38. A number of third party views were sought in relation to transaction. As noted above, one market participant raised a concern regarding connection with possible network effects but generally third parties raised no concerns.

39. As noted above, although the ORR identified potential benefits arising from merging complementary bus and rail services, it also raised concerns that Stagecoach might use complementary rail and bus services to develop multi-modal schemes to the disadvantage of other bus operators. The SRA raised no concerns.

ASSESSMENT

40. SER, a JV between DSB and Stagecoach, is seeking to win a bid for the IKF. There are three other pre-qualified bidders. Neither Stagecoach nor DSB operate rail services that overlap with the IKF network. However, as one of the largest bus operators in the East Kent region, Stagecoach operates bus routes that overlap with IKF rail services on a number of point-to-point flows. On the

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[14] See further the discussion in the OFT's decision, Completed acquisition by Arriva Plc of the Wales and Borders Rail franchise, 16 March 2004.

majority of these overlapping flows, Stagecoach bus services and IKF rail services are the only or primary means of public transport.

41. The key competition issue raised by the transaction is whether post-merger Stagecoach would have the incentive to increase bus fares and/or reduce frequencies in order to switch bus passengers to rail; a secondary issue was whether it might also increase unregulated rail fares to increase the profitability of such a strategy. In addition, the potential for Stagecoach to pursue foreclosure strategies was also considered given Stagecoach's presence as the major bus operator in the region covered by the IKF network.

42. As regards Stagecoach's incentive to switch its bus passengers onto rail, profitability analysis suggests that little or no incentive exists for Stagecoach to take such action. Even testing with aggressive assumptions on elasticity, switching, price increase and frequency reductions; this demonstrated minimal gain on rail profit.

43. The evidence also suggests that Stagecoach, as minority shareholder in SER, would lack the ability unilaterally to increase unregulated rail fares on the IKF. Furthermore, the majority of revenue on the IKF is derived from regulated fares, which sets a 'ceiling' on the price of unregulated fares. Price differentials between regulated and unregulated fares are minimal. Given the above factors, it is difficult to envisage any meaningful effect on the profitability of taking such action, if indeed such action were open to Stagecoach.

44. The potential for foreclosure of rivals through multi-modal ticketing does not give rise to concern. The evidence available to the OFT suggests that very few passengers make use of bus-rail network tickets and the resulting revenue earned by Stagecoach is minimal. There appears little or no incentive for Stagecoach to exclude other bus operators from participating in any future scheme. The through-ticketing schemes currently in place are open to all bus operators in the East Kent region.

45. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

46. This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.