Completed acquisition by National Express of the Greater Anglia Franchise

The OFT's decision on reference under section 22(1) given on 27 May 2004

PARTIES

National Express Group plc (**NEG**) provides a broad range of transport services in a number of countries. In the UK, its principal businesses include: the operation of train operating companies which provide inter-city, urban and rural passenger rail services in various areas across Great Britain; the operation of a network of scheduled express coach services; and the operation of bus services in the West Midlands and Dundee. Prior to the merger, NEG operated eight rail franchises granted by the Strategic Rail Authority (SRA).

London Eastern Railway Limited (LERL) is the newly formed subsidiary of NEG, set up to operate the **Greater Anglia** franchise. Year 1 revenue of the new Greater Anglia franchise was forecast to be £400m.

TRANSACTION

The SRA has selected NEG as the train operator for the new Greater Anglia franchise, which commenced in April 2004. The newly remapped franchise combines the previous Anglia, Great Eastern and West Anglia rail services. The term of the franchise is for a period of seven years, subject to extension for a further three years if specified performance targets are met. The new franchise will operate all regular services out of London Liverpool Street and will do so within a framework of regulation of certain rail fares and service levels stipulated in the franchise agreement. The statutory deadline for a decision on this transaction is 29 May 2004, and the administrative deadline is 27 May 2004.

JURISDICTION

As a result of the transaction, NEG and the Greater Anglia train franchise have ceased to be distinct. The award of a rail franchise constitutes an acquisition of control by virtue of section 66(3) of the Railways Act 1993 as amended. The transaction will create a relevant merger situation under section 23(1)(b) of the Enterprise Act 2002 (the Act) as the turnover test is met. The ECMR does not apply.

RELEVANT MARKET

The activities of NEG and the franchise overlap in the provision of passenger transport services in the Greater Anglia region through their coach and rail services. The acquired franchise overlaps with rail services that were provided by NEG pre-merger, namely: Central Trains, West Anglia Great Northern (WAGN) and C2C. In addition, NEG provides all the major coach services in the franchise area and some of NEG's coach services overlap with some of the franchise rail routes.

Rail/rail

A number of NEG's pre-existing rail services operate between the same origin/destination points as several rail services it acquired as part of the franchise, creating a number of rail/rail overlaps. The two rail/rail overlaps are (i) the routes in the triangle bounded by Norwich, Peterborough and Cambridge, and (ii) the London to Southend route.

Previous cases have not established definitively the extent to which alternative methods of transport are substitutes for rail travel and vice versa, and this appears to be journey-specific. Factors relevant to the degree of substitutability include levels of car ownership in an area, the extent of traffic congestion and the degree to which train stations are conveniently located.

Rail/coach

NEG now operates all the major rail services and all the major coach services in the franchise area. There are 52 coach routes on which there is an overlap between the franchise rail routes and NEG's coach services. Of these by far the largest are the Norwich-London and Lowestoft-London routes.

The Competition Commission (CC) found that NEG's coach service is a substitute for rail in both NEG/Midland Mainline and NEG/ScotRail.[1] Such findings are route specific, as passengers' decisions on a route will depend on such factors as comparative traveling time, price and convenience, particularly for off-peak journeys. However, the Chief Executive of National Express coach division is quoted as follows: 'There is a feeling in the past that we can't market ourselves in competition with the railways – that's rubbish'. The report goes on to state that he ''hopes that many of these [empty seats] can be filled with disgruntled rail passengers, driven away by higher fares, poor performance and service cuts'.[2]

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[1] National Express Group plc and Midland Main Line Limited, Dec 1996; and National Express Group plc and Scotrail Railways Limited, Dec 1997.

[2] Statement of Chief Executive of NEG's coach division in a 2003 government report on multimodal transport in the South East.

Geographic Market

In line with the OFT's analysis in recent cases,[3] the focus of the competitive assessment is on point-to-point overlaps in the Greater Anglia area as passengers want to travel from point A to point B.

Given the nature of rail and coach transport services, and further to the CC's provisional findings in the Firstgroup/Scotrail Merger Inquiry,[4] competition may also take place on sets of routes, especially where these form part of a broader network. We have regard to this below.

Conclusion

The relevant frames of reference for assessing the competitive effects of this merger are considered therefore to be the supply of passenger transport services on point-to-point routes in the Greater Anglia area.

HORIZONTAL ISSUES

Rail/rail overlaps

Prior to the award of the Greater Anglia franchise, NEG operated several other rail franchises in the region. As a result of this merger, the Greater Anglia franchise overlaps with rail services that will continue to be provided by NEG through its operation of the Central Trains, WAGN and c2c franchises. Common ownership of these services may lead to some loss of competition as the closest constraint to one rail service may be expected to be an overlapping rail service. However, the SRA franchising process imposes conditions on successful bidders such that they are not able to alter service levels and fares freely. Such price and service quality regulation does not cover off-peak fares (although excess revenue gained from any increase in those fares is shared with the SRA) nor does it in theory prevent competition leading to a reduction in regulated fares below the permitted maximum. On non-price issues, including competition on quality, service and innovation (e.g. service frequency, punctuality, on-board amenities and comfort, and new or improved rolling stock), it is possible that service and innovation levels might be lower than they would be without the merger, particularly where service levels are currently above minimum regulated levels.[5] In these circumstances, despite the presence of regulation, it is possible that where there are overlapping rail services, these services may provide a competitive constraint and incentive upon each other.

The Norwich-Peterborough-Cambridge 'triangle'

The award of the franchise to NEG creates 17 point-to-point overlaps on two groups of routes within a triangle bounded by Norwich, Peterborough and Cambridge. In 2003, these overlaps accounted for £1.1 million in revenue from unregulated fares. It would

[3] Acquisition by Firstgroup plc of the Scotrail Franchise, 13 January 2004.

[4] Reference Relating to the Anticipated Acquisition by Firstgroup Plc of the Scottish Passenger Rail Franchise Currently Operated by Scotrail Railways Ltd, published by the Competition Commission on 28 April 2004.

[5] If standards were reduced below minimum stipulated levels, this would trigger penalties.

appear that there is no price competition, however, as on all but one of these overlaps there is common pricing as all tickets are interavailable.

There could be a loss of non-price competition through diminished incentives to exceed minimum regulated service levels. However, most of the overlaps involved tend to have relatively short journey times, unlike the commuting routes into London discussed below. There are competing local bus services operating on those routes, such as First and Stagecoach, and car travel would appear to offer an additional choice for many people. The characteristics of these routes and the relatively short journey distances involved would appear to suggest that bus is a comparable alternative to rail for passengers on these routes. The combination of regulation and a competitive public transport service from a major operator suggests that it is unlikely these overlaps will raise any substantial competition concerns. Therefore, this issue is not considered further.

Southend on Sea to London

The second category of rail/rail overlap is on services between London and Southend. Great Eastern services (formerly operated by First Group and now taken over by NEG as part of the franchise) operate between London Liverpool Street and Southend-Victoria. NEG already operates c2c which also runs services between London Fenchurch Street and Southend-Central. The most significant of the overlaps is that between Southend and London, but there are a number of overlaps between the intervening stations, which are considered separately.

The following evidence is available as to whether the two London-Southend routes compete with each other.

- A comparison of journey characteristics suggests that these services have similar features. Both services offer similar journey time, although the c2c service is more frequent and about 5 per cent cheaper on season tickets and off peak fares.[6] The London termini are some 10 minutes apart, although only one is directly connected to the tube and the other is a few minutes walk from underground connections. At Southend, the stations are 300 metres apart. NEG believes 85 per cent of passengers walk to the station and do not see the two stations as alternatives because of the distance between them. Similarly they claim that car parking is limited. In the absence of survey data, it is difficult to determine what proportion of these passengers would travel the extra distance to the other station. At least 5 per cent of passengers on the route appear to regard the services as close substitutes as they have purchased interoperable season tickets.

- NEG is unable to provide passenger numbers for the two routes before 2002.[7] On the limited data available, however, there is some evidence suggesting

[6] A greater price difference on peak day returns in one direction suggests a different competitive dynamic may apply on journeys starting in London compared to those starting in Southend.

[7] This data would have been particularly interesting as NEG claims common pricing was introduced at privatisation and that differences since 1996 were driven by regulatory penalties, which could have been plotted to passenger numbers.

that there might have been switching between the two routes. In particular, there was a significant increase in c2c's passenger numbers between 2002 and 2003, while Great Eastern's passenger numbers declined over that period. Passenger numbers moved in opposite directions during the following year. NEG believes that strike action in 2001 means that recorded passenger numbers for 2002 are artificially low. The duration of the strike action, however, at only 10 days, would seem too short to account for the shift in passenger numbers.

- The introduction by c2c of new rolling stock and the decrease in c2c prices may be a more credible explanation for the passenger switching as opposed to the relatively brief strike action.

- A c2c promotional campaign aimed at encouraging Great Eastern season-ticket holders to switch route suggests that the management at the time perceived some switching potential. Switching data are not available as the campaign was cancelled after 48 hours for reasons that are unclear.

- NEG claims not to have taken Great Eastern into account when setting c2c's fares and that it has no survey data or business plans relating to the pricing of these services. Internal documentation from Great Eastern suggests that it at least monitored the impact on its revenues of c2c's new rolling stock, lower prices and more flexible tickets.

- Comparing prices on this route with similar prices on similar routes where there is no competition, both within the franchise area and without, suggests that prices per mile on the Southend routes are comparatively low. Moreover, off-peak fares for c2c and Great Eastern have shown similar movements in recent years.

- There is no evidence of competitive pressure from coach services for Southend to London passengers. Congestion and charges for access and parking in London might limit the car as a realistic alternative.

All the above factors suggest that the following may be reasonable conclusions. The overlapping rail services are similar and a number of passengers do switch between the services, although there is a (surprising) lack of data to establish the extent of such switching or the impact on price. Passenger reaction to the introduction by c2c of new rolling stock and the c2c promotional campaign to attract business from Great Eastern passengers does seem to suggest that some degree of competition existed. It therefore appears reasonable to believe that these two services may have been in competition and that, post merger, fares may increase, in particular for unregulated fares (worth around £[i] per annum). In addition, actual and potential non-price competition that may have raised quality of service above the minimum required standards may also have been lost.

Intermediate overlaps between Southend and London

Although the two services stopping at stations between Southend and London chart different geographic routes, the widest distance between them is around 5 miles and the stations are at similar intervals. Accordingly, the two routes are the closest rail choices for the population living between the two lines and the services on the resulting point-to-point overlaps may exert some competitive constraint on each other.

NEG claims that most passengers walk to stations, or use buses which mostly serve one station but not the other, face limited car parking and are reluctant to enter neighbouring areas due to 'demographic differences'. As a result, they believe only 5 per cent of passengers would regard the two services as substitutes. No passenger data exist to confirm this point, nor is it clear that a 5 per cent switch would be sufficient to render a price increase on off-peak fares unprofitable. The distribution of population between the two lines and the configuration of the road and bus networks in the area might mean that the number of passengers that regard the two lines as substitutes could be considerably higher than the 5 per cent figure.

The notion that there is competition between the Great Eastern and c2c services between overlapping and intervening stations is supported by analysis of the fares on the route. First, there are similarities in fare levels between the two services on several of the intermediate overlaps. Second, changes in fares on overlapping intervening flows follow the same general trend as fares on the overall Southend– London route.

Coach/rail

NEG now operates all the major rail services and all the major coach services in the franchise area. As mentioned above, the CC has established in previous cases that coach service is a substitute for rail although this depended on the characteristics of the area/route as well as such factors as travel time, price and convenience. The question is to what extent the NEG coach and Greater Anglia rail franchise services compete on any of the 52 point-to-point overlaps in the franchise area.

In the absence of any customer research data, business plans or pricing documentation, the OFT has looked at how fares and journey times compare across these overlaps to see whether there is evidence that rail and coach might influence one another. The figures suggest that rail fares (measured in pence per journey mile) tend to be higher the less competitive are coach journey times against rail. This holds for both peak and non-peak services. There is also a significant positive correlation between coach fares per mile and off-peak rail fares per mile (as compared to no correlation for peak fares).

NEG argued that this might be because both rail and coach fares (measured in pence per mile) tend to decline with journey distance. Analysis indicates, however, that the correlations remain even allowing for this effect. One other possible explanation might be that car journey times are likely to be faster where coach journey times are relatively fast. If so, there might be pressure for both rail and coach fares to be lower on the faster flows. Again, however, the correlations hold even when this possible effect is allowed for.

Costs can also often be a common factor in price relationships. In this case, however, it is not clear why this should be, given that the correlation is across individual flows, not across time where cost increases often have a common inflationary component. In the absence of persuasive alternative explanations, therefore, it is difficult to rule out the possibility that these results reflect a degree of competition between rail and coach on these flows.

NEG was unable to provide contemporaneous documentation on its pricing methodology but accepts that it can take into account demand fluctuations in setting fares on individual flows. In practice, however, NEG maintains that it has made no such adjustments in the franchise area over the past five years. NEG argues that the standard for fare increases is calculated by reference to a basket of NEG's [ ][ii] coach routes, [ ][iii]. NEG has also pointed out that pricing and service decisions take into account the effect on interconnecting journeys. While accepting that this is the case, it does not follow that NEG would not have the ability and incentive to alter prices and service levels to its advantage when overlapping rail and coach services are under common ownership, especially given that the majority of passengers do not interconnect and that fare structures and ticket types potentially allow for differentiation between interconnecting and non-interconnecting passengers. Taking the pricing evidence as a whole, a concern remains that bringing NEG's rail and coach services together will change NEG's incentives to adjust prices and service levels on individual routes or on groups of routes.

Although NEG argues that it strives to offer a consistently high standard of service across its network and to offer its customers a consistently attractive service no matter where they travel throughout the UK, it is possible that a lessening of competition may reduce the need to innovate or provide competitive services on overlap routes.

On the basis of the evidence available, there are grounds to believe that NEG's acquisition of the franchise may lead to rail and/or coach fares being higher than they would be compared to the situation without common control of such services; and actual and potential non-price competition on quality of service and on innovation may be diminished.

Barriers to entry and expansion

Entry for operators onto the national rail network is regulated and licensed by the SRA and the Office of the Rail Regulator (ORR). The ORR's policy on Moderation of Competition allows passenger train operators to protect their core business from competitive new entry. This policy was relaxed in April 1998 to reduce the level of protection so that there are increased opportunities for train operators to introduce new services over those routes where the level of protection is reduced. New entrants would have to compete with existing franchisees without the benefit of operating subsidies received by franchise holders. Given these factors, barriers to entry for passenger rail services are considered to be high.

Regarding coach operations, in principle, entry should be possible on high revenue commuter routes where a frequent single route service could be viable. Both Easybus and Megabus are testing point-to-point services on such routes in other locations outside the franchise area. There is no evidence, however, to show that such services are likely to be launched in the franchise area in the near future. This is in line with NEG's own comments on the difficulties of entry in the 2003 government multi-modal study to research transport alternatives in the South East of England.

A relevant factor here is also NEG's strong existing coach network in the area, including substantial London interconnections with its other services. Given the operating advantages that might be expected to flow from operating a substantial network, and the fact that NEG also now controls rail services in the region, it seems unlikely that a challenge from new coach operations would occur on a scale sufficient to offer a major constraint.

Buyer power

Individual passengers do not have buyer power. To the extent that the SRA tenders for franchises it considers that it has buyer power with regard to competition for the franchise. Regulation by the SRA and ORR will constrain NEG's freedom to set certain rail fares and certain parameters of service levels.

VERTICAL ISSUES

There were no vertical issues raised in this transaction.

THIRD PARTY VIEWS

On certain overlapping rail routes, the ORR identified a potential lessening of competition arising from the acquisition. The SRA and other third parties generally had no concerns about this merger.

CONCLUSION

The merger makes NEG the main provider of inter urban public passenger transport in the franchise region. Actual competition between public transport services will depend on factors specific to the area in question. Economic analysis of the available data points to competition between coach and off-peak rail, and between the London-Southend rail services.

NEG has asserted that an expectation of competition on these specific overlap routes is wrong, for reasons that vary from overlap to overlap but in many cases are plausible. However, NEG has not been able to provide sufficient evidence, despite a prolonged investigation, to support its view that there is little or no competition between the London-Southend rail services, nor between coach and rail services. Notwithstanding extensive regulation of rail services, off peak fares are unregulated and there is a degree of flexibility with regard to service levels. No competing coach or rail service may be expected to enter on the routes under consideration in the foreseeable future. On balance the evidence presented, although not always unambiguous, suggests that at least a degree of competition existed on some overlaps and that this was sufficient to induce some competition both on price and non-price parameters.

It is therefore reasonable to believe that competition may be expected to be reduced, in particular where NEG offers virtually the only long distance public transport on the overlaps under consideration. 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.

Exceptions to refer

The parties cited exceptions to the OFT's duty to refer, namely that the markets are of insufficient importance to warrant reference, that customer benefits outweigh any detriments created by the merger, and that undertakings offered in lieu of reference remedy any detriments created.

The markets at issue are of sufficient importance to warrant reference.[8] The annual revenue of the London to Southend overlap on off-peak alone is £[iv] and total offpeak revenues from all stations on the route are £4 million. The two largest coach and rail overlaps have combined coach and train revenue of £910,000 and £653,000 respectively. Coach revenues for all 52 overlap routes amount to at least £1.2 million.[9]

Customer benefits, in terms of improved rail services, must be clear, quantifiable and merger-specific for the OFT to rely on them.[10] On the basis of the evidence presented to us, it was not clear that the customer benefits were derived from the merger, rather than the creation of the new franchise.

NEG offered undertakings in lieu of reference.

- As to the London/Southend rail concerns, the undertaking in essence proposed to cap the price of the (unregulated) cheap day return fare between any stations between London and Southend to the current discount level off the (peak, regulated) standard day return fare for the same journey. There are two concerns with this proposed remedy. First, it is not clear that a price cap would in this case be sufficient to restore pre-merger incentives to compete on unregulated fares. Second, it does not address concerns related to non-price competition. For these reasons, the rail/rail undertaking cannot be described as a clear-cut remedy capable of ready implementation.

- In relation to the coach/rail overlaps, NEG in essence offered a price cap and guarantee of service quality. Again, this proposal does not appear to restore any pre-merger competitive relationship between coach and rail.

Accordingly, the remedies proposed cannot be accepted as undertakings in lieu of reference.

DECISION

This merger will therefore **be referred** to the Competition Commission under section 22(1) of the Act.

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8 OFT Mergers Guidelines: Substantive Assessment, p44.
9 NEG was unable to provide accurate revenue figures for return journeys.

10 OFT Mergers Guidelines: Substantive Assessment, p44.

[i] Actual figures excised at the request of the parties for reasons of commercial confidentiality.

[ii] Details excised at the request of the parties for reasons of commercial confidentiality.

[iii] Details excised at the request of the parties for reasons of commercial confidentiality.

[iv] Actual figures excised at the request of the parties for reasons of commercial confidentiality.