
Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise

The OFT's decision on reference under section 33 given on 26 March 2004

PARTIES

FirstGroup plc (First) is a UK-based international transport company which operates both bus and rail services in the UK, as well as transport services in the USA. It operates four rail franchises in the UK — First Great Western, First Great Eastern, First North Western, and the TransPennine Express. **The Thames Trains franchise** (Thames franchise) operates services between London Paddington and the Thames Valley, Kennet Valley and Cotswolds areas, as well as on the North Downs line between Reading and Gatwick airport. The term of the franchise is 2 years, running from 1 April 2004 to 31 March 2006. The franchise is currently operated by Thames Trains Limited, a subsidiary of the Go-Ahead Group, which in the year to 28 June 2003 had a turnover of £105.36 million.

TRANSACTION

First was selected as the preferred bidder for the franchise by the Strategic Rail Authority (SRA) on 4 November 2003. The SRA intends to combine the Thames franchise on its expiry on 31 March 2006 with the Great Western and Wessex Trains franchises, to become the Greater Western franchise. The parties notified the transaction to the OFT on 23 January 2004; the administrative deadline is 26 March 2004.

JURISDICTION

As a result of the transaction, First and the Thames franchise will cease 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.

RELEVANT MARKET

The activities of First and the Thames franchise overlap in the provision of passenger transport services in the Thames Valley and Worcestershire/ Herefordshire areas.

Rail on Rail

The parties overlap in the provision of rail services on the same routes between London and Newbury, and London and Hereford. The services operated on the two franchises are to an extent complementary, with First offering high speed, inter-urban services making only limited stops at intermediate stations and Thames providing stopping services, as well as some limited stop services using non-high speed rolling stock.

Previous cases have not been able to establish definitively the extent to which alternative methods of transport are substitutes for rail travel and vice versa, though this does appear to be location-specific. Factors of relevance include levels of car ownership in an area, extent of traffic congestion and the degree to which train stations are conveniently located. A cautious approach would suggest that alternative rail providers provide the closest competitive constraint on a train operating company, so it is important to consider closely any route overlaps between Thames and First services.

Bus on Rail

First operates bus services in two of the areas served by the Thames franchise – the Herefordshire/Worcestershire area and the Reading area. Passengers' choice of mode of transport on a point-to-point journey depends on a number of factors including access to bus stops or train stations, personal preference, comparative journey time, and the relative costs of the available alternatives. These factors are likely to be relevant when passengers are choosing between bus and rail options for broadly the same journey. In this respect, bus services tend to be more frequent and cheaper than comparable rail options, although bus journeys tend to be longer because of the often less direct route taken, and the greater number of stops.

Whether, and the extent to which, prices and/or service on bus or rail services are constrained competitively by one another is not clear. The availability of season (and off-peak) tickets makes it difficult to make comparisons between ticketing options. An increase in the price of a ticket may not be sufficient to induce switching (between bus and rail) if other factors, such as journey duration, are of sufficient importance. Monopolies and Mergers Commission (MMC) merger investigations¹ have considered that a degree of competition between bus and rail does exist on specific routes. The conclusions of these studies, are, however, not necessarily relevant to this case, since the last investigation, involving coach/rail issues, was conducted some time ago (in 1997) and the conclusions of those investigations were based on factors specific to the routes under consideration.

Where bus and rail serve the same point-to-point routes, there may be some passengers who consider them to be substitutes for each other. The degree to which this allows bus services to provide a competitive constraint to rail services, or vice versa, is unclear, but would appear to be highly route-specific.

¹ Cm 3774, 16 December 1997, National Express Group plc and Central Trains Ltd;
Cm 3773, 16 December 1997, National Express Group plc and ScotRail Railways Ltd;
Cm 3495, 20 December 1996, National Express Group plc and Midland Main Line Ltd.

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 certain point-to-point routes with point of origin or destination in the Herefordshire / Worcestershire and Reading areas.

HORIZONTAL ISSUES

Rail on rail

It appears that across the franchise the services operated by Thames and First are to some extent complementary, with Thames serving intermediate stations and First being the operator of choice, where available, for journeys involving major stations. On certain relatively short, frequently served routes, e.g. Reading to London Paddington, First and Thames services appear to be substitutes for some point to point journeys. However, many Thames and First tickets are inter-operable (as set out below) throughout the overlap routes and there is very little evidence of single-operator promotional activity, indicating that competition may be limited.

Common ownership of the two operators will, however, lead to some loss of competition. Train operators offering inter-operable services are remunerated based on estimates of the total number of passengers using each of the services, giving each operator the incentive to boost the number of passengers using its services. Fares are universal, but ticket validities are not: for example, discounted tickets such as 'cheap day returns' and 'savers' are not valid on First services leaving London Paddington during the evening peak, but are accepted on Thames services. In addition the 'network card' off-peak discount card is only accepted on those portions of the First network that overlap with Thames routes (which also accepts the card), suggesting that the presence of competition may be relevant to First's acceptance of the card. Finally, there is the possibility that these operators currently compete on factors such as reliability, availability of seating and refreshments, cleanliness, or other factors impacting on the quality of a passenger's journey.

The SRA franchising process imposes conditions on successful bidders such that they are not able to alter service levels and fares freely. First will be obliged to meet the passenger service requirement (PSR) set down for the Thames franchise, as well as providing a number of improvements to services.

In addition to setting out service requirements, the SRA continues to regulate fares for the standard class return saver fares and the weekly season ticket (see note 1) throughout the franchise area — regulated fares account for 49 per cent of revenues on Thames services. First argues that a further 33 per cent of Thames revenues are indirectly regulated as prices are constrained by regulated fares. The SRA does not regulate the validities of tickets (see note 2) and has no power to force operators to continue to offer the network discount card benefits. However, this is an off-peak fare and all train operating companies have spare capacity for off-peak journeys. First plans to increase off-peak promotions, suggesting that it may not prove optimal for First to limit the validity of promotional off-peak fares post-acquisition.

The amalgamation of the franchises in question in this transaction, along with the Wessex franchise, to form a new 'Greater Western' franchise is due to take place in April 2006; the combined franchise will then be re-tendered by the SRA. This limits the potential for adverse effects of the current transaction on rail on rail competition to a two year duration. Given that it takes time for any changes to timetables, fares or other competitive conditions to come into effect, as many of these require an onerous (see note 3) consultation process involving the SRA, First is limited in its ability to make any changes; the timetable from December 2004 to December 2005 is, for example, already agreed. First has little incentive to make detrimental changes to the service offered as it is in competition for the much more substantial contract to run the new Greater Western franchise from April 2006.

This conclusion is consistent with previous cases involving rail/rail overlaps of relatively limited duration: in the First/ GB Railways² case where a franchise amalgamation was due to follow nine months after the acquisition the OFT concluded that there was not sufficient time for the transaction to result in a substantial lessening of competition; a similar conclusion was reached in the Connex/ Govia³ case where the period of overlap was two and a half years.

First and the SRA have further argued that the consumer benefits of amalgamating the franchises will outweigh any detrimental effects on competition. The SRA has put to us the following as claimed benefits of the merger: (i) First will be able to alter timetables (by taking advantage of synergistic running of services) to increase seats in the morning peak by [] (see note 4), and in the evening peak by [] (see note 4); (ii) a net benefit estimated at [] (see note 5.) will accrue from the amalgamation of the franchises two years earlier than originally planned; and (iii) increased service frequency and reliability and other factors will make rail services more attractive to the public than previously, leading to increased receipts and a [] (see note 5) franchise payment saving.

Rail on bus

If bus and rail are substitutable modes of passenger transport on certain point-to-point routes within the franchise area, the acquisition of the rail franchise (whose primary fares are regulated) may permit First to raise prices and/or reduce service levels on the bus and enjoy increased overall revenue as its bus passengers switched to rail. For the purposes of this analysis, we have focussed on point-to-point bus and rail overlaps where journey times were broadly comparable, and where the merged entity would be the sole provider of transport, since overlapping routes that meet these criteria would be those most likely to raise concerns. In doing so, we have focussed on commercial rather than tendered bus routes, as the latter are regulated by the tendering body. Adopting this methodology, we have identified three overlaps between a commercial bus service operated by First and a train service within the franchise, as follows:

² Anticipated acquisition by First Group plc of GB Railways plc, OFT decision of 30 September 2003.

³ Proposed acquisition by Govia Limited of Connex South Central Limited, OFT decision of 23 August 2003.

Bus route	Point-to-point overlap with a train service	Distance
191	Slough-Windsor	4 miles
702	Slough-Windsor	4 miles
55/75	Burnham-Slough	2.6 miles

The competition concerns raised by these overlaps appear limited for several reasons. First, third parties had no apparent concerns (unlike in some previous cases). Second, First has explained that some of the bus passengers benefit from local authority schemes for free old age pensioner (OAP) travel on buses, and would therefore not use the train, for which these schemes are not valid. Third, the overlaps compiled by First included fare stages with stops up to 800m from the train station, and therefore probably include customers for whom the train is not likely to be a viable alternative. Fourth, while there are no competing operators on the point-to-point routes in question, there are potential entrants in the form of other operators of commercial as well as tendered bus routes in adjacent areas.

Barriers to Entry

Rail

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 flows 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.

Bus

Local bus operators are licensed, under the Transport Act 1985, by the Traffic Commissioner. Buses may be bought outright, or leased. Bus depots (and out-stations) may be leased. An existing operator, with a local depot is unlikely to face significant barriers to expansion — there are no First depots in the areas of overlap that do not have competitor depots of some size within a 20 mile radius. Where a route is unprofitable (wholly or at certain times) local councils may invite tenders from operators to run the route on a subsidised basis, in which case there is competition for, rather than on, these routes.

Buyer Power

Individual passengers do not have buyer power. To the extent that the SRA is tendering for this franchise it will consider that it has buyer power with regard to competition for the franchise. Regulation by the SRA and ORR will constrain First's freedom to set rail fares and service levels.

VERTICAL ISSUES

Multi-modal issues

Common ownership of local rail and bus services by First would enable it to begin offering a multi-modal ticket, either a 'travelcard' valid on any First services within a given area for a defined period, or individual 'through' tickets incorporating both the rail and bus portions of a passenger's journey. Should First introduce one or both such schemes, it could conceivably capture multi-modal passengers who might otherwise have used a competitor's bus service for parts of their journeys, affecting the viability of existing competitors and opportunity for new entry. To the extent such competitors were eliminated, First would have the opportunity to raise prices for consumers buying bus-only tickets, who would be obliged to use First buses and pay more to travel than they otherwise would have done. This could outweigh the short term benefit to consumers of potentially cheaper First-only multi-modal tickets.

First offers multi-modal schemes elsewhere in the UK and is an important bus operator in the local areas of overlap between the Thames franchise and its bus services. However, First estimates that less than [0-5] per cent (see note 6) of passengers on its buses are travelling to or from train stations and there is little take-up of existing multi-modal schemes in these areas. First estimates that less than [0-5 per cent] (see note 6) of First Midland Red revenue is generated from sales of multi-modal tickets.

The OFT nonetheless sought to test whether First would be likely to engage in successful foreclosure of rivals with reference to the local-specific conditions at the 18 Thames stations served by First bus services. In response to our investigation, First provided detailed evidence on a station-by-station basis. Its evidence and argumentation may be summarized as follows:

- At several stations, other rail operators provide a substantial number if not the majority of services;
- For several other stations, First is bound by agreements set out in the Franchise Agreement to make all reasonable efforts to engage in multi-operator ticketing in these areas;
- At several stations where First operates all proximate bus services, the transaction will not deter new entry otherwise attracted by multi-modal passenger traffic, because a marginal percentage of bus journeys in these areas are part of multi-modal travel, evidenced by the minimal proportion of revenue derived from existing (limited) multi-modal schemes;
- At another station, First has a small share of proximate bus services and its existing multi-modal revenue is negligible.

Our review of this evidence, together with the absence of third party complaint, leads us to conclude that First will lack the ability and/or incentive to foreclose rival bus operators at the stations identified.

THIRD PARTY VIEWS

Third parties were generally unconcerned by the merger.

ASSESSMENT

This case raises three separate issues: (i) loss of rail on rail competition, (ii) loss of competition between bus and rail on point-to-point overlap routes and (iii) the potential

for foreclosure of competing bus operators should First issue multi-modal (bus/rail) tickets valid only on its own services.

With regard to rail-on-rail competition, the parties are each others' closest competitor for point-to-point journeys along the London Paddington to Newbury or Hereford routes, with very limited other sources of rail competition. However, a number of factors give rise to the conclusion that any competition concerns which arise from this transaction are negligible. Most importantly, contractual agreements with the SRA limit the potential for a worsening of service and/ or increase in fares, and the SRA has announced its intention to merge these franchises from April 2006. This restricts the ability of First to make any detrimental changes to services as these take time to enact, as well as limiting the incentive for such changes as it would not be logical for First to jeopardise its bid for the much more important Greater Western franchise.

With regard to rail-on-bus overlaps, the competition issues appear to be minimal. There are three bus and rail point-to-point routes where journey times are broadly comparable and there is no competing operator. Given the absence of third party concern and the presence of local competitors in the vicinity, the creation of these bus/rail overlaps by the merger is unlikely to result in a substantial lessening of competition.

Finally, the possibility appears remote that the merger would foreclose competition from rival bus operators should First introduce exclusive multi-modal ticketing schemes. Various factors – notably the limited take-up of existing schemes in the areas of overlap, the conditions imposed by the SRA in certain areas and the lack of competitor concern – all indicate that a substantial lessening of competition is unlikely to result in this respect.

In light of our finding that any loss of competition arising from the merger is insubstantial, it is unnecessary in this case to assess further the claims that countervailing customer benefits outweigh potential detriments to competition.

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

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

NOTES

1. The SRA notes that it does not regulate Savers tickets in the London Area, as Savers are regulated under Protected Fares regulation. The London area is covered by Commuter regulation which includes peak return fares.
2. The SRA has informed us that it does regulate the restrictions that can be placed on regulated tickets.
3. The SRA says that this process is thorough, but it does not believe it is onerous.
4. Percentages have been excised at First's request.

5. Figures have been excised at First's request.

6. A range replaces the exact estimate at First's request.