
Anticipated acquisition by FirstGroup plc of the ScotRail franchise

The OFT's Decision on reference under section 33 given on 13 January 2004

PARTIES

1. **FirstGroup plc (First)** is a UK-based international transport company which in the year to March 2003 had a turnover (before exceptional items) of £2.3 billion and made pre-tax profits before interest of £190 million. First operates a wide range of bus services in Scotland.
2. The **ScotRail** franchise concerns the operation of approximately 95 per cent of the passenger rail services in Scotland, of which approximately 50 per cent are operated on behalf of the Strathclyde Passenger Transport Executive (SPTEx). ScotRail also operates sleeper services between Scotland and London as well as certain through services to Newcastle. In the year to 31 December 2002, **ScotRail Railways Limited** (the National Express subsidiary currently operating the ScotRail franchise) had turnover of £367.9 million and made a pre-tax loss of £10.5 million.

TRANSACTION

3. The prospective merger situation arises from a competition for the ScotRail franchise. The **Strategic Rail Authority (SRA)** has pre-qualified three bidders to operate the franchise: First, Arriva and National Express. It is understood that the SRA will select its preferred bidder by April 2004, with the franchise commencing in October 2004. First has said to us that its bid is conditional on approval being received from the OFT on terms satisfactory to First. Accordingly, a decision to refer may have the effect of reducing competition to win the ScotRail franchise. Regulation of certain rail fares and service levels will be stipulated in the franchise agreement with the ultimate winner of the competition for the franchise.

JURISDICTION

4. As a result of this anticipated transaction, First and ScotRail 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) of the Enterprise Act 2002 (the Act).

COMPETITION ASSESSMENT

Market Definition

5. The activities of First and ScotRail overlap in the provision of passenger transport services in Scotland. First identified nearly 800 point-to-point overlaps between its bus services and ScotRail's rail services in the regions of (a) Aberdeen, (b) Edinburgh and the Lothians, and (c) Greater Glasgow. Aberdeen is not considered further below since there is only one overlapping route and the bus journey time significantly exceeds that of the train on that route.

Rail on Rail

6. First currently operates 6 of the 25 Train Operating Companies (TOCs) in Great Britain, none of which overlaps on a 'point-to-point' basis with ScotRail. The OFT does not therefore consider that it is or may be the case the merger may be expected to lessen competition substantially as between rail operators.

Bus on Rail

7. Passengers' choice of mode of transport on a point-to-point journey depends on a number of factors including access to a particular means of transport, personal preference, their value of 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, congestion and the greater number of stops.
8. Whether, and the extent to which, prices and/or service on bus or rail services are constrained competitively by one another is not clear. 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 are based on factors specific to the routes considered by the MMC in the cases at issue.
9. First has argued that the different journey characteristics – e.g. journey lengths and location of bus stops in town centres as opposed to railway stations typically on town peripheries – mean that in many cases bus and rail serve different groups of customers and as a result, do not constrain each other. First's evidence, however, indicates that passengers are prepared to travel further to reach a railway station than a bus stop and may indeed use the bus to

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.

travel to the railway station. 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.

10. Third parties generally considered that on point-to-point routes where bus and rail services overlapped, passengers would consider them to be substitutable for each other. One third party commented that competition between the two modes of transport was keenest where journey times are most similar. Several third parties identified routes (into Glasgow and Edinburgh) used by commuters where, they stated, express bus services had been introduced to compete with parallel rail services.

Conclusion

11. 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 Scotland.

Horizontal Issues

12. The merger would combine the two major transport providers in the region – the ScotRail franchise, which provides almost all of passenger rail services, and First's local bus operations, which provide over half of commercial bus services across Scotland.
13. On a point-to-point basis, the parties' services overlap on 621 routes in Glasgow and 159 routes in Edinburgh, and the parties would be the sole provider of public transport on 271 routes in Glasgow and 92 routes in Edinburgh. For the purposes of the following analysis, we have focused on the 108 routes in Glasgow and the 53 routes in Edinburgh (161 in total) where the overlapping rail and bus journey times are broadly comparable and the merged entity would be the sole provider of public transport. It has been difficult to obtain probative evidence as to whether the bus and rail services on each route could be regarded as substitutes. Indeed, there is an argument that, to the extent bus and rail services on particular routes are really complements rather than substitutes, the combination of those complementary services may result in lower prices to customers. In the cases noted above, the then MMC found that similarity in certain route characteristics such as journey time was indicative of a degree of competition on specific overlapping routes. In this case, evidence is mixed. It appears difficult to identify particular point-to-point routes where all of the route characteristics are consistent with rail-bus competition. Nevertheless, a number of third parties have in this case identified a number of routes where they believe such a constraint exists and have suggested that competition between the two modes is keenest where journey times are most similar.
14. Analysis of the competitive effect of this transaction has to take into account the presence of regulation affecting both rail and bus services in Scotland. In regard to rail services, certain rail fares and service levels are regulated through

the Service Level Commitment specified by the SRA and SPTE to ScotRail. Although in this case the Service Level Commitment has yet to be finalized because the franchise has not been awarded, it is unlikely that the successful bidder will have significant latitude to raise prices or alter service levels on the railways.

15. Bus fares and services in much of the area in which First operates are also regulated, in this case by the undertakings given by First in relation to the acquisition of SB Holdings (SBH) (discussed below). However, as these undertakings do not cover the whole area under consideration and do not prevent alterations on specific routes, some flexibility may remain for First to alter, in particular, service levels.
16. Some customers and competitors expressed the concern that First could alter bus prices or reduce service frequencies to induce passengers to switch to its overlapping rail operations to increase overall revenue (as fares and passenger numbers on these routes are generally higher for rail than those for buses) and that the threat of predation by First would deter new entry on the relevant bus routes. First argues that, in practice, it will not have the ability to adopt such a strategy for a number of reasons. Its arguments are set out below, together with alternative views in square brackets:
 - At peak times, rail rolling stock and infrastructure is already at capacity. [However, there may be sufficient off-peak capacity to make the strategy feasible.]
 - Diverting passengers from bus to rail will not lead to lower costs as First would still need to serve the other parts of the bus routes or times of day where bus does not compete with rail. [However, routes may be reorganised to produce savings and to allow a reduction in service on the point-to-point overlaps.]
 - Discriminatory pricing targeting only those fare stages on a bus route where overlap with rail exists would be difficult to achieve. [However, where this could not be achieved, reductions in service may have the same effect.]
 - Undertakings given by First in relation to the acquisition of SBH restrict First's ability to raise a basket of bus fares in the whole of Central and South East Scotland (excluding the city of Edinburgh) by more than the percentage change in RPI, year on year. First is also constrained by the undertakings from reducing levels of service in Stirling, Clackmannanshire, Falkirk, West Lothian, Midlothian, East Lothian and the Scottish borders (which excludes the city of Glasgow). Here, First may not reduce the registered mileage operated by its commercial services to less than 95 per cent of the registered mileage operated by its commercial services as at January 2002 without obtaining the OFT's prior written consent. [However, these undertakings do not cover all of the routes under consideration. In addition, the restrictions on mileage would not prevent First from closing overlap routes and adding extra

services on existing routes or opening new routes, provided that the costs did not exceed the revenue gained.]

17. First stresses that, in any event, it would have no incentive to engage in a strategy of inducing passengers to switch from bus to rail by raising bus fares as this would not lead to higher overall revenues for the reasons set out below:
- The rail fare is lower than the bus fare on some of the overlap routes identified. [However, standard fares do not necessarily translate into revenue due to the differences in the fare structure of bus and rail and the varying proportion of subsidised passengers. Accordingly, it is difficult to say precisely what effect fare differentials would have.]
 - Bus passengers are more likely to be discretionary, off-peak travellers, so raising bus fares would likely risk these passengers either not travelling at all or making fewer journeys. Passenger numbers on parts of the route where there is no overlap would be reduced if there was any interruption in the overall service (route or frequency). The revenue lost may offset any gains First could potentially generate from switching passengers on the overlap flows onto its rail services. [However, in both cases it has not been possible to determine the scale of these effects.]
 - Any extra revenue would be marginal as, on each overlap route identified, the percentage of the overall route revenue accounted for by passengers travelling between railway stations is never more than [] per cent [see note 1] and is less than [] per cent [see note 1] of total route revenue for over [] (see note 1) of the routes in question. [However, it has not been possible to determine what the increase in revenue is likely to be on the routes under consideration.]
 - Under the current Service Level Commitment with the SRA and the SPTE, revenue risk is divided between the current franchisee, the SRA and the SPTE. This may considerably reduce any incentive to undertake the hypothetical strategy described by the third parties. [However, the sharing arrangements under this franchise has not yet been determined by the SRA.]
18. There appears to be considerable weight to the arguments advanced by First. The constraints First identifies (in particular the SBH undertakings and the need to rearrange bus services to escape them) would seem largely to frustrate a hypothetical strategy of inducing bus passengers to switch to rail. It is probable that the number of routes that would escape these constraints would be small. As a result, any extra revenue gained would be relatively low, thus weakening the incentive to adopt such a strategy. On the other hand, the alternative views advanced by certain third parties as to the adverse effects of this merger are difficult to dismiss with confidence.

19. Third party customers and competitors also expressed concerns about the threat of predation. This was identified by the MMC as feasible in Scotland¹ in 1996 and the OFT has received complaints under the Competition Act 1998 about anti-competitive predation in this area. First argues that post merger it would have no incentive to engage in a strategy of predation as:
- it would damage its corporate reputation and local relations, including relations with the SPTE, and First is anyway constrained by the provisions of the Competition Act 1998;
 - First currently faces competition from large and small bus operators on most routes in Glasgow, where it is the leading operator;
 - competitors have been expanding, including recent entry on to one of the overlap routes identified by the OFT;
 - there are a number of bus operators with depots in the vicinity of the routes under consideration that could potentially begin services if First were to abandon or reduce bus services; and
 - in Stirling, Clackmannanshire, Falkirk, West Lothian, Midlothian, East Lothian and the Scottish Borders, First is subject to behavioural undertakings (given as part of the SBH undertakings referred to above) that require any reduction in bus fares following the entry of a competitor to be kept in place for a minimum of three years. [Again, these undertakings do not cover Glasgow.]
20. It is important to note that a number of the 161 overlap routes identified generate little revenue and therefore may not attract any potential new entrants in the event that First abandoned the routes. However, even if pure commercial entry is unattractive, it is possible that the relevant local council might subsidize some of these bus routes in order to retain a desired service level on the route(s).

Zonecard

21. One third party expressed a concern that First could undermine to its advantage the Zonecard scheme operated by the SPTE. If First were to win the ScotRail franchise it would then be the dominant partner within the multi-modal and multi-operator scheme, giving it an increased ability to influence pricing of the Zonecard. The same third party expressed concern that First could introduce its own scheme and undermine the effectiveness of the SPTE Zonecard, which in turn would reduce the willingness of passengers to utilise the services of smaller or new-entrant bus operators in the area. First currently offers its own ticketing product promoting daily/weekly travel on any of its buses.
22. First pointed out that the SPTE's influence in choosing the preferred bidder for the franchise would ensure that any bidder would co-operate with the SPTE and

¹ MMC 1996, *FirstBus plc and SBHoldings Limited*, paragraph 2.46 (e)

that First's franchise agreement could include commitments to assuage concerns in respect of the Zonocard.

23. Revenue derived from the Zonocard scheme represents a small proportion of First's total revenue. With that in mind, it seems unlikely that the merged entity would find it worthwhile to engage in such behaviour. Moreover, the Public Transport Ticketing Scheme Block Exemption 2001 provides that the exclusion of an operator from a multi-operator scheme except for objective, transparent or non-discriminatory reasons would result in the scheme losing the benefit of the block exemption from the Chapter I prohibition of the Competition Act 1998.

Barriers to entry and expansion

24. Entry for operators onto the national rail network is regulated and licensed by the SRA and the Office of the Rail Regulator (ORR). Although it is possible to launch new services through Open Access services, these still require approval and are unlikely to be set up by a company not already operating a franchise agreement. Furthermore, the ORR has also noted that new entry is unlikely given that spare capacity primarily exists in areas of low demand. In these areas, new entrants would need to compete with existing franchises without the benefit of the operating subsidies received by franchise holders. Given these factors, barriers to entry into the provision of passenger rail services are considered to be high.
25. Local bus operators are licensed, under the Transport Act 1985, by the Traffic Commissioner. Buses may be bought outright, or leased. Bus depots may be leased. Each depot has a peak-vehicle requirement (PVR), which is a calculation of the maximum number of vehicles that is required to be operational simultaneously to deliver peak time services. Depots are allocated a number of vehicles in excess of their PVR (usually 15 per cent). An existing operator with a local depot is unlikely to face significant barriers to expansion and it is likely that the larger operators would take up profitable routes were First to reduce or cease to provide a service. Where a route is unprofitable (wholly or at certain times of the day), local councils may invite tenders from operators to run the route on a subsidised basis.
26. Previous bus investigations have pointed to the importance of the locations of depots in facilitating entry. In the Scottish region, all the routes identified utilising the methodology stated above had competitors with depots located within 20 miles of a First depot.
27. While it may relatively be easy to set up a bus depot and commence operations, firms may be reluctant to do so if they fear predation. In this case, there appear to be a number of operators who would be able to take over some of the affected routes as they already have depots situated in the vicinity, but the willingness of some of these operators to do so is unclear.

Buyer power

28. Bus and rail passengers are individual consumers and are not considered likely to hold significant buyer power. Local authorities and transport executives that tender council contracts are large customers and as result, may hold significant buyer power. As noted above, regulation will constrain First's freedom to set rail fares and service levels, although the precise extent of this constraint is uncertain as the franchise and Service Level Commitment are yet to be determined. Further, First's commercial freedom in respect of bus operations is constrained to some extent by the SBH undertakings.

Vertical issues

29. No significant concerns were raised.

Third party views

30. Views of third party customers and competitors were mixed: as noted earlier, the key concerns expressed related to commuter routes into Glasgow and Edinburgh.

Undertakings in lieu

31. First has offered to [] (see note 2) where the OFT found substantial competition concerns.

CONCLUSION

32. This anticipated merger situation arises from the current competition for the ScotRail franchise being conducted by the SRA. The successful bidder for that franchise will be subject to regulation by the SRA and SPTE in respect of the fares and service levels of the railways as specified in the Service Level Commitment, and many of First's bus services in Scotland are anyway subject to price and frequency regulation by the SBH undertakings. Within these parameters, is it possible that the merger situation that will result if First wins the franchise competition will lead to a substantial lessening of competition?
33. Whether, and to what extent, there is competition between bus and rail depends on the characteristics of overlapping routes. Certain third parties have put forward views suggesting that the characteristics of certain point-to-point routes indicate competition between bus and rail services on those routes. The analysis above has focused on overlapping routes with no current competing operators and where the bus journey time is no more than double the rail time. First has advanced a number of reasons, discussed above, why it would not have the incentive and/or ability to give poorer value for money to bus passengers as a result of becoming the rail franchise operator. In our view, these arguments have considerable weight. However, third parties have expressed contrary views (and also fears about increased prospects of anticompetitive behaviour) which cannot confidently be rejected on the available

evidence and within the time available for the OFT investigation. In short, we were unable confidently to conclude that if First wins the ScotRail franchise this would not substantially lessen competition on those routes considered.

34. For these reasons, there is therefore a credible view that the merger may be expected to result in a substantial lessening of competition. The evidence currently available is not sufficient for the OFT to be able confidently to reject that view. Therefore, consistent with the recent judgment of the CAT in IBA the OFT has decided to refer this merger to the Competition Commission.
35. The OFT's Substantive Assessment Guidance indicates that undertakings in lieu will only be accepted if they represent a clear cut remedy to a clearly identified competition concern. The timeframe of the OFT investigation has not permitted clear identification of possible detriments to competition. Although the parties have offered [] (see note 2), it would therefore not be appropriate to accept them at this stage.

DECISION

36. This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.

NOTES

1. Actual figures excised at the request of the parties for reasons of commercial confidentiality.
2. Details excised at the request of the parties for reasons of commercial confidentiality