COMPLETED ACQUISITION BY ARRIVA RAIL NORTH LIMITED OF THE NORTHERN RAIL FRANCHISE

Issues Statement

14 June 2016

The reference

1. On 20 May 2016, the Competition and Markets Authority (**CMA**), in the exercise of its duty under section 22(1) of the Enterprise Act 2002 (**the Act**), referred the completed acquisition by Arriva Rail North Limited (**ARN**), a wholly-owned subsidiary of Arriva plc (**Arriva**), of the Northern Rail Franchise (the **Northern Franchise**) (altogether **the Merger**) for further investigation and report by a group of CMA panel members (**Inquiry Group**).

2. In exercise of its duty under section 35(1) of the Act, the CMA must decide:

   (a) whether a relevant merger situation has been created; and

   (b) if so, whether the creation of that situation has resulted or may be expected to result in a substantial lessening of competition (**SLC**) within any market or markets in the United Kingdom (**UK**) for goods or services.

3. In this statement, we set out the main issues that we are likely to consider in reaching our decision on the SLC question (referred to in paragraph 2(b) above), having had regard to the evidence currently available to us, including evidence set out in the CMA phase 1 decision of 12 May 2016 (the **phase 1 decision**). This does not preclude the consideration of any other issues that may be identified during the course of our investigation.

4. Throughout this document, where appropriate, we refer to Arriva, ARN and the Northern Franchise collectively as '**the Parties**'.

Background

5. The Northern Franchise is currently the largest rail franchise in Great Britain serving 526 stations and operating over 15,000 local and regional services per week.

6. The Northern Franchise provides inter-urban, commuter and other services across the whole of Northern England. The Northern Franchise operates over most rail routes in Northern England, from Chathill in the north to Stoke-on-Trent and Nottingham in the south of the region, and from Liverpool in the west to Hull in the east. Services provided by the Northern Franchise include:

   (a) longer-distance regional services that connect major urban centres (eg Nottingham – Leeds; York – Blackpool and Sheffield – Doncaster – Hull);

   (b) urban services (eg commuter services around the main northern cities such as Leeds, Liverpool, Newcastle, Sheffield and Manchester); and

   (c) rural services (eg routes along the Cumbrian coast from Carlisle to Barrow-in-Furness and the route from Hull to Scarborough in the east).

7. On 9 December 2015, the Department for Transport (**DfT**) announced that ARN was the successful bidder for the Northern Franchise. The operation of the Northern Franchise commenced on 1 April 2016 for a term of nine years (subject to a possible extension of up to one year).

8. Arriva UK Bus, which is part of the Arriva Group (owned by Deutsche Bahn AG), is a major bus operator in the UK. It is the third largest operator in the regional bus market, operating around 5,900 buses in London, the North East, North West and South East of England as well as in Yorkshire, The Midlands and Wales.[1]

9. Therefore, overlaps arise between the existing Arriva bus services and the Northern Franchise rail services.

10. Arriva operates the following rail services, in addition to the Northern Franchise:

   (a) Three rail franchises under the following:

      (i) CrossCountry Trains Limited (**CrossCountry**) – services span the UK from Aberdeen in the north to Stansted Airport, Plymouth and Penzance in the south. The franchise agreement is due to expire in October 2016, although discussions regarding a direct award to extend the franchise up to November 2019 are on-going.

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[1] Arriva's UK bus services are operated by individual operating companies.

(ii) Arriva Trains Wales – services are provided predominantly within Wales, with some services in Northern England. The franchise agreement is due to expire in October 2018.

(iii) The Chiltern Railway Company Limited – services are operated between Aylesbury, Birmingham Snow Hill, Kidderminster, Oxford, Stratford-upon-Avon and London. The franchise agreement is due to expire in December 2021.

(b) Two rail concessions under the following:

(i) DB Regio Tyne and Wear Metro Limited (**Tyne and Wear Metro**) – operated under a Concession Agreement with Nexus, the Passenger Transport Executive (**PTE**) for the Tyne and Wear region. The concession agreement is due to expire in March 2017, although it could be extended to 31 March 2019.

(ii) London Overground Rail Operations Limited – a joint venture between Arriva and MTR Corporation (of Hong Kong) which operates the concession on behalf of Transport for London. The concession agreement is due to expire in November 2016.

(c) Open access rail services under the following:

(i) Grand Central Railway Company Limited (**Grand Central**) – provides high speed train services between London and Sunderland and between London and Bradford (calling at various intermediate stops). Grand Central's track access agreement with Network Rail will expire in November 2026.

(ii) Alliance Rail – not currently providing rail services but it intends to become an open access operator providing passenger services between London and Blackpool.[2]

11. A number of these rail services overlap with rail services operated by the Northern Franchise. Furthermore, the Northern Franchise Agreement provided for transfers of certain services from TransPennine Express (**TPE**) and certain planned service changes such as more stops at certain stations and increased frequency. These could result in additional overlaps or increase

[2] Alliance Rail's application is for rights starting during the December 2017 timetable year for 10 years. Alliance Rail confirmed to the Office of Rail and Road that it would not begin the new services until early 2018 because of the time required to procure and ready the new rolling stock. Additional overlaps may arise between Northern Franchise services and Alliance Rail services once Alliance Rail begins operating these services.

the number of overlapping services (because of increased frequency on Northern).

Market definition

12. Market definition is a useful analytical tool, but not an end in itself, and identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of the CMA's analysis of the competitive effects of the Merger in any mechanistic way. In assessing whether a merger may give rise to an SLC the CMA may take into account constraints outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others.[3]

Product market

13. The Parties overlap in the provision of public transport services, including bus services and rail services.

14. Passengers make choices between various modes of transport that are available for a particular journey. Where passengers face multiple travel options, either of the same mode or different modes of transport, their choices are driven by a range of factors, such as travel to/from the station/stop, journey time, service frequency, punctuality, fares and general service quality. A passenger's choice of mode of transport and their ability to substitute between different options (within the same mode or across modes) depends on these factors (which may collectively be described as 'generalised journey costs').[4]

15. The extent to which different travel options are close substitutes may vary between individual 'flows' (ie journeys between start or end points, which may be part of a longer bus or rail route). We expect to consider substitutability between different modes of public transport relevant to this case in particular on a 'flow-by-flow' basis. Given that certain aspects of the offer to passengers are set at the level of the route we will also consider the potential effects of the Merger on routes as well as flows. We will also have regard to wider transport 'network' issues as explained below (paragraph 23).

[3] *Merger Assessment Guidelines*, paragraph 5.2.2.
[4] Passengers trade-off the various factors in their choice of preferred travel option and seek to minimise the overall 'cost' of their journey, which includes the fare and the time elements. For example, passengers may be willing to trade-off a longer journey time on a slow/stopping service if it serves a stop closer to their ultimate destination.

16. We consider a reasonable starting point for analysis is that, other things being equal, a service completes more closely with another service of the same mode of transport on a flow than with a service using a different mode of transport.

17. We expect to consider competition between different modes of public transport. We expect to consider public transport as a separate product market to private transport unless strong evidence of substitutability between public and private transport is received.

18. We may consider whether the market should be further segmented, eg between leisure travel and business travel and commuting.[5]

Geographic market

19. Passengers travel between a specific point of origin to a specific point of destination (ie a point-to-point journey) and, as such, demand is for travel between two points. Previous cases have assessed competition between transport options on a flow-by-flow basis.

20. However, certain aspects of the offer to passengers are set at the level of the route (for example, the bus frequency) and we will therefore consider the possible effects on competition of the Merger on routes as well as flows.

21. We expect to consider the effects of the Merger mainly where the Parties provide:

    (a) journeys between the same two rail stations;

    (b) journeys where the catchment area of a bus service overlaps with the catchment area of the nearest rail station;

    (c) journeys between the same two settlements; and

    (d) journeys to a main commuter city from two alternative stations or bus stops in nearby towns or villages.

22. We will consider the extent to which supply-side substitution by existing operators in the overlapping areas, or entry by new operators, acts as a competitive constraint on a flow-by-flow basis. This is because substitution

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[5] The Competition Commission previously distinguished leisure travel from business travel and commuting due to different sensitivities in price, journey time and duration (*Review of methodologies in transport inquiries*, Competition Commission, paragraphs 16 & 17. See also ME/6506/14 *Intercity Railways Limited/ICEC Franchise*, CMA (2014), paragraph 34).

and entry conditions are likely to vary across the overlap areas, such that a detailed assessment is appropriate.

23. We may also consider whether there are wider transport 'network' markets, such as the geographical areas over which services from particular depots operate or where network or multi-modal tickets are offered.

Assessment of the competitive effects of the merger

Counterfactual

24. The application of the SLC test (referred to in paragraph 2(b) above), involves a comparison of the prospects for competition with the Merger against the competitive situation without the Merger. The latter is called the 'counterfactual'. We will, therefore, assess the possible effects of the Merger on competition compared with the competitive conditions in the counterfactual situation (ie the competitive situation absent the Merger).

25. The counterfactual is an analytical tool used in answering the question of whether the Merger gives rise to an SLC and it is generally not comparable in detail to the analysis of the competitive effects of the Merger.[6]

26. In rail franchises the pre-merger situation cannot be the appropriate counterfactual, as the existing rail franchise is coming to an end and a new franchise must be awarded to one of the short-listed bidders.[7] The CMA therefore treats the appropriate counterfactual to the Merger as the award of the Northern Franchise to a firm, such as a train operating company (**TOC**), that raises no competition concerns or, if there is no alternative bidder that does not raise competition concerns, to a hypothetical bidder, with any competition concerns being remedied, for example, through behavioural remedies.[8] The effect of both alternatives would be the same.[9]

27. Accordingly, in so far as the operation of the Northern Franchise is concerned, the CMA will assess the Merger against a counterfactual whereby the Northern Franchise is awarded to a TOC raising no competition concerns or, to one in respect of which any competition concerns would be remedied.

28. In making our assessment we will decide upon the appropriate counterfactual that is most likely to have existed absent the Merger, based on the facts

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[6] *Merger Assessment Guidelines*, paragraph 4.3.1.
[7] *Merger Assessment Guidelines*, paragraph 4.3.28.
[8] *Merger Assessment Guidelines*, paragraph 4.3.29.
[9] See *Greater Western Passenger Rail Franchise,* Competition Commission, February 2006.

available to us and the extent of foreseeable future events. We will seek to avoid inserting into our assessment any spurious claims to accurate prediction or foresight.[10]

Theories of harm

29. Theories of harm describe the possible ways in which an SLC could arise as a result of a merger and provide the framework for our analysis of the competitive effects of a merger. We have set out below the theories of harm which we intend to investigate. However, we may revise our theories of harm as our inquiry progresses. The identification of a theory of harm does not preclude an SLC being identified on another basis following further work by us, or the receipt of additional evidence. We welcome views on all the theories of harm set out below.

30. When analysing the competitive effects of mergers involving a very large number of local markets, the CMA (and its predecessors, the OFT and the Competition Commission) have applied relevant filters in order to focus analysis on those local markets that are most likely to give rise to competition concerns.[11] In the transport sector, this approach allows for a more manageable number of flows to be considered in detail, and enables the CMA to prioritise analysis on flows which have the greatest likelihood of an SLC. We will consider whether the following filters are appropriate for use in identifying flows on which to focus our analysis:

    (a) **Significance of overlap filter** – the OFT and Competition Commission have previously excluded from further analysis overlaps involving bus services where revenues (or passengers) account for less than 10% of total route revenues (or passengers).

    (b) **Effective competitor filter** – the OFT and Competition Commission have previously excluded flows where there is effective third party competition, such as competitors which offer a comparable frequency of service to those of the parties.

    (c) ***De minimis* filter** – The OFT and Competition Commission have in previous cases prioritised their analysis on flows which generated annual revenues above an absolute threshold (for example £10,000).[12]

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[10] *Merger Assessment Guidelines*, paragraph 4.3.6.
[11] *Review of methodologies in transport inquiries*, Competition Commission, paragraph 26.
[12] See, for example, *Acquisition by FirstGroup plc of the Greater Western Passenger Rail Franchise,* Competition Commission, paragraph 5.59(b).

31. We would welcome views on these filters and any additional filters which may be appropriate.

Theory of harm 1: Horizontal unilateral effects on bus-on-rail overlaps

32. Horizontal unilateral effects may arise where one firm merges with a competitor that previously provided a competitive constraint, allowing the merged firm to profitably raise prices, degrade quality, reduce the range of services on its own and without needing to coordinate with rivals and/or to prevent/reduce the introduction of additional services.[13] Horizontal unilateral effects are more likely where the merger parties are close competitors.

33. Arriva owns and operates a number of companies providing local bus services in the area of the Northern Franchise, as follows:

    (a) Arriva Durham County Limited

    (b) Arriva North West limited

    (c) Arriva Northumbria Limited

    (d) Arriva Tees & District Limited

    (e) Arriva Yorkshire Limited

    (f) Yorkshire Tiger Limited

34. In some regions, premium services are operated under the Sapphire brand and inter-urban express services are operated under the Max brand.

35. There are a significant number of overlaps between the existing Arriva bus services and the Northern Franchise rail services. At phase 1, Arriva identified 1,041 flows (150 routes) where existing Arriva bus services and Northern Franchise rail services overlapped.

36. The Merger could provide Arriva with the ability and incentive to worsen its offering to passengers on overlapping services and/or to prevent/reduce the introduction of additional services (new flows or expansion to existing routes). For example, the Merger could lead to an increase in fares and/or a reduction in other aspects of its offering (eg journey time, frequency of services, punctuality and service quality) on either Arriva's local bus services (since customers lost as a result could switch to the Northern Franchise) and/or on the Northern Franchise services (as lost customers could switch to Arriva's

[13] *Merger Assessment Guidelines*, paragraph 5.4.1.

local bus services). Likewise, the merger could lead to Arriva not introducing additional services as any additional bus passengers may remain on/now use rail.

37. In examining the competitive effects of the Merger on competition between Arriva's existing bus services and the Northern Franchise rail services, we will consider the extent of competition between bus and rail services including in terms of destinations, access/egress times, fares, frequencies, journey times and other quality aspects of the offer (for example, the level of comfort and cleanliness of services). We will consider whether passengers viewed the Parties' services as close substitutes prior to the award of the Franchise. This could, for example, be if overlapping services are similar in terms of the generalised journey cost.

38. We expect to focus our assessment of this theory of harm in particular on whether the Merger allows the Parties to increase fares, degrade non-price factors (such as service quality) and/or to prevent/reduce the introduction of additional bus services. This is because local bus services are not subject to the same degree of regulation as rail services, affording greater flexibility to bus operators to change their fares and service offerings. Moreover, the Parties could benefit from cost savings by degrading bus services, while incurring only very limited additional costs in carrying passengers on trains diverted from bus services (because a greater proportion are fixed costs).

39. However, we will also consider the extent to which fare increases or reductions in non-price factors on the Northern Franchise are possible as a result of the award of the Merger.

40. The following factors will also be relevant to our assessment, such as:

(a) the extent of local bus regulation and its impact on the ability and incentives of the Parties to increase bus fares and/or weaken other aspects of bus services;

(b) the proportion of individual routes accounted for by the overlapping flows;

(c) the extent to which the overlapping services are particularly close competitors (for example, in terms of generalised journey costs) such that passenger switching[14] between the Parties' services is high;

(d) the extent to which revenue risk sharing arrangements in the Northern Franchise limit the Parties' incentives to increase fares or reduce service

[14] In the event of a fare increase and/or worsening of quality.

quality on the bus services (and recapture revenues on the overlapping rail services); and

(e) the impact of planned changes to bus services.

Theory of harm 2: Horizontal effects under rail-on-rail overlaps

41. The following Arriva rail services overlap with the Northern Franchise:

(a) rail franchises under:

(i) CrossCountry; and

(ii) Arriva Trains Wales;

(b) one rail concession under:

(i) Tyne and Wear Metro; and

(c) two open access rail services, which are:[15]

(i) Grand Central; and

(ii) Alliance Rail (which, as noted in paragraph 10, is not currently providing rail services but has been awarded access rights to operate open access passenger services between London and Blackpool).

42. In phase 1, Arriva identified 167 overlapping flows between the Northern Franchise and Arriva.

43. Horizontal effects could arise from the common ownership of overlapping rail services on flows or routes. These horizontal effects arise where this common ownership provides the ability and incentive to raise fares and/or reduce service quality post-Merger (for example reducing frequencies or changing journey times).

44. In relation to rail-on-rail overlaps, the CMA and its predecessors have found that, whilst limited, there is some scope for price competition between rail services, particularly in relation to unregulated fares.[16] Generally, competition in terms of non-price aspects may be more limited because of the restrictions on the franchised TOCs' ability to flex service levels, which are specified in the franchise agreement.[17] We will consider the extent to which there are such

[15] Open access operators are TOCs awarded access rights to provide rail services following an application to the Office of Rail and Road. Open access operators are not subject to franchise specification.
[16] *Review of methodologies in transport inquiries*, Competition Commission, paragraphs 52–54.
[17] This does not apply to the open access services.

restrictions in the existing Arriva franchises and the Northern Franchise and their impact.

45. Horizontal effects are most likely where the overlapping rail services are close substitutes for passengers. This is because pre-Merger, if the operator of one of the overlapping services had increased fares (for example Arriva increased fares on CrossCountry) and/or reduced service quality, then some passengers could have diverted to the overlapping rail service (for example, Northern).

46. However, following the Merger, the joint operator runs both of the overlapping rail services and fare increases or reductions in service quality may become profitable. This is likely to be the case where a significant proportion of passengers switching away from the rail service (eg CrossCountry) following the fare increase or reduction in service quality switched to using the overlapping rail service (eg Northern). For a significant proportion of passengers to switch to the overlapping rail service, the overlapping services must be considered as viable substitutes. This is most likely to be the case where the two services are similar in terms of destinations, access/egress times, fares, frequencies, journey times and other quality aspects of the offer (for example the level of comfort provided on the services).[18]

47. In assessing the competitive effects of the Merger, we will therefore consider various factors, including the closeness of competition between the Parties' and competitors' services, including fares, frequency and average journey times. We will also consider:

(a) the extent to which franchise specification restricts the Parties' ability to degrade their service offering on the overlapping flows and routes and the extent to which franchised TOCs compete on service quality;

(b) the closeness of competition between Arriva's current and planned rail services (including open access services) and the Northern Franchise;

(c) the extent of price competition between TOCs on the overlapping flows and routes, including:

(i) the impact of fare regulation in restricting the ability and incentive of the Parties to change fares, including the ability to flex individual regulated fares;

[18] Rail services may still be substitutes when there are differences in some of these factors, for example lower fares on one service may offset longer journey times on the other service.

(ii) the extent to which regulated fares impose a constraint on unregulated fares;

(iii) the extent to which 'inter-available' fares (ie fares that can be used on the services of any TOC on a flow) limit price competition between the Parties;[19]

(iv) whether the Parties will have the ability and incentive to increase or withdraw operator-specific 'dedicated' fares (ie fares set independently by operators on a flow, which are only valid on that operator's service);[20]

(v) whether the presence of dedicated fares (or the risk of a competitive dedicated fare being introduced) acts as a deterrent to the lead operator increasing the inter-available fares on a given flow;

(d) the impact of planned future changes to rail services, including planned re-mapping of services;[21] and

(e) the extent to which revenue risk sharing arrangements in the Northern Franchise limit the Parties' incentives to increase fares or reduce service quality on the overlapping rail services.

Theory of harm 3: Horizontal effects on transport networks

48. We note that certain features of transport markets may warrant consideration of the broader network of flows and routes in addition to flow-by-flow analysis, including the following:

(a) The presence of PTEs in certain areas, which are responsible for managing the transport network within their areas.

(b) Passenger demand for transport services may be at the network level, for example because certain passengers may require multi-flow or multi-modal transport services. For such passengers different services are

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[19] The lead operator is normally the operator with the most commercial interest in the flow and usually sets the fares for all inter-available tickets. Other operators are required to honour these inter-available fares once they have been set by the lead operator. There must be at least one inter-available fare for every flow.
[20] Operators other than the lead operator can set 'dedicated' fares for travel only on their own trains, generally at a lower price than the inter-available fare. The lead operator can also set dedicated fares in certain circumstances. For example, it can set discounted advance fares for travel only on its own services.
[21] From January 2018, TPE will take over some of the services currently provided under the Northern Franchise. Certain services and stations within the current TPE franchise will also be re-mapped into the new Northern Franchise immediately prior to the commencement of the new TPE franchise.

substitutable only to the extent that they offer a similar multi-flow or multi-transport service.

(c) Transport companies organise their services around transport hubs and modifications to services have implications for their existing network.

49. Arriva UK Bus offers a total of 22 network tickets in the geographic area served by the Northern Franchise.

50. We will consider whether the Merger may give rise to horizontal effects at the level of transport networks, by significantly reducing competition between such networks, including through the following:[22]

(a) The joint operator of bus and rail networks having the ability to profitably raise network ticket prices or otherwise worsen its offer on the transport network (for example reducing the coverage of network tickets) if the two networks are close alternatives for passengers.

(b) The joint operator of the bus and rail services integrating bus and rail services. While this could be beneficial to passengers who value integration, it could also reduce the quality of services for those passengers who were using the segregated services.

(c) The joint operator may enjoy significant incumbency advantages when dealing with the relevant PTE. For example, the operator may have significant bargaining power in negotiating with the PTE if it holds a significant proportion of the transport network for that PTE. Alternatively, the PTE may have a preference for awarding contracts to existing operators of networks within their area. We will, therefore, consider the effects of the combined bargaining power of the Parties.

Theories of harm the CMA is not currently minded to pursue

Horizontal effects in the award of franchises

51. We note that the number of credible bidders for franchises is relevant for the strength of competition 'for' the award of franchises. The phase 1 decision considered whether the Merger would affect competition 'for' the market (ie competition for rail franchises) by leading to a reduction in the number of bidders available for future bids, or provide the Parties with an incumbency advantage relative to other bidders in future bids for franchises.

[22] See, for example, *Review of methodologies in transport inquiries*, Competition Commission, paragraphs 8–9.

52. No third parties raised concerns about the impact of the Merger on competition for the market and the CMA considered that there was no realistic prospect of an SLC for rail franchises as a result of the Merger.

53. Subject to any further third party submissions in response to the present Issues Statement and/or further evidence submitted in the course of the investigation, we are not currently minded to investigate this theory of harm further. We do, however, welcome reasoned submissions that third parties may wish to make in this regard.

Countervailing factors

54. We will consider whether there are countervailing factors which are likely to prevent or mitigate any SLC that we may find.

55. In particular, we intend to consider whether entry or expansion by effective competitors in the bus sector could be expected to be timely, likely and sufficient to prevent any SLC on the flows and routes under consideration.[23] To do this, we will:

- *(a)* look at the history of actual entry, expansion and exit by the Parties and their competitors and review any future plans for entry;
- *(b)* look at responses to entry and the extent to which entry acts to disincentivise fare increases or reductions in service quality; and
- *(c)* examine factors which might inhibit entry or the expansion of existing competitors on the routes under consideration, including sunk costs, regulatory barriers, the size of the market and the threat of retaliation by incumbents.

56. We are not currently aware of any other countervailing factors.

Possible remedies and relevant customer benefits

57. Should we conclude that the Merger has resulted or may be expected to result in an SLC in any markets, we will consider whether, and if so what, remedies might be appropriate, and will issue a further statement.

58. In any consideration of possible remedies, we may have regard to their effect on any relevant customer benefits that might be expected to arise as a result

[23] Merger Assessment Guidelines, paragraph 5.8.1. *et seq.*

of the Merger and, if so, what these benefits are likely to be and which customers would benefit.

Responses to the issues statement

59. Any party wishing to respond to this issues statement should do so in writing, by no later than **5pm on 28 June 2016**. Please email arrivanorthern@cma.gsi.gov.uk or write to:

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