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ARRIVA PLC

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

RESPONSE TO THE CMA'S ISSUES STATEMENT

4 JULY 2016



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1. **INTRODUCTION AND EXECUTIVE SUMMARY**

- 1.1 This is Arriva's response to the CMA's Issues Statement of 14 June (the **Issues Statement**) setting out the main issues which it is likely to consider in reaching its SLC decision in relation to the award of the Northern Franchise (the **Award**).
- 1.2 Arriva has already submitted a significant quantity of evidence relating to these issues and has made an Initial Submission giving some background to the Award and the markets which will be the focus of the CMA's investigation. This Response does not repeat that material but instead engages directly with the Issues Statement, summarising the key issues arising in relation to each stage of the analysis.
- 1.3 Arriva welcomes the opportunity to provide the CMA with its input on the Issues Statement. At the outset, Arriva notes that it is imperative that the CMA's assessment in reaching its SLC decision is restricted only to outcomes which are merger-specific i.e. which can be expected to arise specifically as a result of the Award, and not as a result of general market conditions.
- 1.4 A number of considerations will be relevant to this assessment, in particular:
- 1.4.1 **Market definition and counterfactual:** Arriva broadly agrees with the overall approach to market definition in the Issues Statement. However, Arriva notes that it will be important for the CMA to take appropriate account of constraints from outside the market as well. It is also imperative that the counterfactual adopted by the CMA reflects the competitive reality of the Award, so that the Award can be assessed in its appropriate context.
- 1.4.2 **Filtering:** Arriva welcomes the recognition in the Issues Statement of the important role played by filters in eliminating from consideration flows where there is no realistic possibility of an SLC.
- 1.4.3 **Theories of harm 1 (bus on rail) and 2 (rail on rail):** Arriva welcomes the inclusion in the Issues Statement of a number of factors relevant to the CMA's assessment in respect of its theories of harm. Arriva outlines in this response a number of additional factors that Arriva considers will be important for the CMA to consider in its assessment. All of these factors will require careful examination before any conclusions can be drawn in relation to the likely impact of the Award at a local level.
- 1.4.4 **Theory of harm 3 (transport networks):** Arriva does not consider that this theory of harm applies in respect of the Award. Arriva responds below to the specific theories of harm outlined in the Issues Statement and explains why the Award will not result in a significant reduction in competition at transport network level.
- 1.4.5 **The existence of significant countervailing factors:** Entry and expansion by other operators is a substantial constraining factor in respect of Arriva's bus operations in the Northern Franchise area, and such entry could be expected to be timely, likely and sufficient to prevent any SLC arising. The influence exercised by DfT and local passenger transport authorities also represents a significant factor.
- 1.4.6 **Considerable customer benefits:** The Award will result in the investment of over £1billion by Arriva in the Northern Franchise and a range of other benefits and improvements for passengers travelling on that franchise. Many of these enhancements were proposed by Arriva as part of the bidding process above and beyond the requirements set out by DfT in the ITT.



2. MARKET DEFINITION

2.1 The Issues Statement emphasises that market definition is a useful analytical tool, but that it is not an end in itself, and in particular that the CMA's assessment may take into account constraints from outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others (§12).

2.2 Arriva welcomes this approach. As noted in its Initial Submission, Arriva considers that the Phase II timetable will enable the CMA to carry out a detailed individual analysis of overlaps failing the initial filtering process. It will therefore be unnecessary to reach general conclusions on the scope of the relevant markets (save insofar as such conclusions directly inform the filtering process). Arriva encourages the CMA to avoid drawing such conclusions at the outset, as these may tend to distort those individual assessments, which are central to this investigation.

Product market: conceptual framework

2.3 Arriva broadly agrees with the overall approach set out in the Issues Statement, namely:

2.3.1 To focus on the choice a passenger makes between various ways to travel a given journey (§14). These choices include different providers offering the same mode (bus and bus for example), and different modes (including not only bus and rail, but also taxi, private hire vehicle, private car, bicycle and foot); and

2.3.2 To understand the factors that passengers will take into account when making such a choice, including: (i) travel to/from the station stop; (ii) journey time; (iii) service frequency; (iv) punctuality; (v) fares; and (vi) general service quality (§14).

2.4 Arriva notes that the factors relevant to passenger choice and their relative weights will vary by journey (punctuality may be more critical on commuter routes for example). It also notes that the list of factors set out above is illustrative and not exhaustive – for example the number of interchanges is likely to be an important factor, separately from journey time. For concessionary passengers travelling by bus, price changes will have no direct impact whereas changes in frequency or service quality would have an impact.

Product market: intra- and inter- mode competition

2.5 Arriva has already indicated its agreement to the general proposition put forward by the CMA that, as a reasonable starting point, all other things being equal, a service competes more closely with another service of the same mode of transport than with a service of a different mode, and expects the evidence to bear it out. It notes however that the extent of inter-modal competition will need to be assessed on an individual flow basis.

Product market: public and private transport

2.6 The Issues Statement notes that “[w]e expect to consider public transport as a separate market to private transport unless strong evidence of substitutability between public and private transport is received” (§17).

2.7 Arriva considers that it would be premature for the CMA to form a view of this nature on the potential role of private transport in these markets prior to the review of all relevant evidence during the course of its investigation. Such a statement risks prejudging the issues upon which the CMA will receive evidence, and establishing a different burden and standard and proof for this individual issue (which would not be open to the CMA). The CMA must investigate all of the relevant issues and satisfy itself on the balance of probabilities whether the SLC test is met.

2.8 Arriva notes that evidence has already been provided about the importance of private and semi-public options in these areas, particularly in the light of:



2.8.1 The high level of churn among bus passengers, suggesting that bus services can only survive if they win passengers away from private transport, and delay their return to it; and

2.8.2 The revolution in how passengers consume transport, encompassing a variety of new models that span the public/private divide, such as car clubs like ZipCar, cycle hire schemes, car pools and of course ride sharing schemes such as Uber.

Please see Arriva's response to questions D4, D5 and D6 of the CMA's Market and Financial Questionnaire ("MFQ") submitted on 24 June 2016 for further explanation of the constraints exercised by modes of private transport on Arriva's bus and rail operations.

2.9 It would be extraordinary if the CMA were to close its eyes to the undoubted impact of these factors and the way that they are transforming transport markets. Indeed these are the kinds of the issues on which the CMA should focus, in order to ensure that its assessment is truly robust and forward looking. In any case, the competitive constraint provided by private transport is likely to vary between flows, so it would be wrong for the CMA to come to a blanket conclusion on whether or not public transport is a separate market.

Geographic market: conceptual framework

2.10 Arriva agrees that the appropriate frame of reference is a flow basis, i.e. assessing competition for transport between two points (§19).

2.11 Arriva also agrees that aspects of the offer to passengers are sometimes set at a route level, and that this should be fully taken into account in the competitive assessment (§§15 and 20). This involves understanding both:

2.11.1 whether and to what extent operators compete at a route level; and also

2.11.2 how route-level decision making limits the ability to vary services at a flow level.

2.12 As explained in Arriva's response to question F6 of the MFQ, many aspects of service quality cannot be flexed on a flow-by-flow basis. Timetables can only be set at a route level, and changes to service quality (e.g. the condition of the vehicle or the facilities on it) would affect the route as a whole, and potentially other services where the relevant vehicles are used to serve more than one route. Other potential changes, e.g. to the environment at train stations and bus stops/terminals, or to the quality of staff training, would also have a broader impact across more than one route.

2.13 Fares on individual flows are either constrained by regulation or, where unregulated, by a number of other factors which are set out in detail in Arriva's response to question F6 of the MFQ. For example, unregulated rail fares are constrained by the prices of regulated fares, inter-available fares, multi-modal products and the fact that changing fares on one flow may have unintended consequences on other flows or parts of the network, while bus fares are constrained by existing fare structures (both flat fares and graduated fare stages), actual or potential competition from other bus operators, the prices of multi-operator tickets and multi-modal products, agreements with local authorities and the constraints imposed by tendered contracts (on which see further below).

Geographic market: catchment areas

2.14 The Issues Statement sets out its approach to defining catchment areas in §21. As passengers travel between a specific point of origin and a specific point of destination (i.e. a point to point journey), passenger demand is for travel between two points. Arriva agrees that it is appropriate to define a geographic range for the purposes of a local overlap analysis, but notes that competition from services outside that range should not be ignored given the extensive constraint which it can exert. It may also be appropriate to define different geographic ranges depending on whether the services operate in urban or rural areas (as explained further below), or based on different journey characteristics (e.g.



length/duration). As such, Arriva considers it important for the CMA to take such factors into account in assessing the competitive situation for individual overlaps.

- 2.15 In the case of rail-rail overlaps, the geographic analysis carried out by Oxera as part of the pro-forma data gathering found that there is no difference in the number of overlaps captured by the four different catchment definitions that the CMA has set out.
- 2.16 In the case of bus-rail overlaps, Oxera's analysis has found that using either a 1200m radius or 1600m walking distance as the catchment for inter-urban flows makes very little difference to the results, with the 1200m radius generally capturing a slightly larger number of overlaps. For intra-urban flows, a 1200m radius is likely to be too large as some of the flow lengths are relatively short. A large catchment area can lead to counterintuitive results in these flows, such as overlaps that involve passengers ending up further away from their destination than they were at the start. In the past the CMA has used a 400m catchment for bus rail overlaps.¹ While Arriva does not have specific information to support a particular catchment area size, it believes that for intra-urban flows a 400m metre catchment is likely to be a good starting point for overlap analysis.

3. COUNTERFACTUAL

- 3.1 The CMA's Merger Assessment Guidelines (2010) set out in detail the approach to the counterfactual in rail franchise cases:

"4.3.28 In rail franchise cases, 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.

4.3.29 The Authorities will therefore treat the appropriate counterfactual to the merger as the award of the franchise either to a firm 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 through behavioural remedies."

- 3.2 The other short-listed bidders, Govia and Abellio, also operate services which overlap with those of the Northern Franchise. Accordingly there was no alternative bidder which would not raise at least some potential competition concerns. In such a case the CMA's Guidance is clear that the appropriate counterfactual is the award of the franchise to: *"a hypothetical bidder, with any competition concerns being remedied through behavioural remedies"*.²
- 3.3 Arriva considers that this Guidance is not correctly applied in the Issues Statement, in two material respects:
- 3.3.1 First, the Guidance (at §4.3.29) sets out two alternative counterfactuals, the second of which should be used where the first is not available on the facts. As none of the bidders were free of potential competition concerns, only the second of the alternative counterfactuals should be applied in this case.

The Issues Statement seeks to assert (at §26) that the effect of the two alternative counterfactuals would be the same. This interpretation of the Guidance appears to be at odds with its content, given that the Guidance identifies two entirely separate alternative counterfactuals and distinguishes the circumstances in which they apply. It is also factually incorrect to conclude that the effect of the two counterfactuals would be the same, as behavioural remedies are subject to a proportionality assessment (see further below) and therefore

¹ See, for example, *FirstGroup/Scotrail*, paragraph 5.4

² Merger Assessment Guidelines para 4.3.29. Arriva notes that the Phase I decision appears to have misstated the appropriate counterfactual.



there can be no certainty that they would lead to an equivalent outcome. The CMA's only basis for its conclusion at the end of §26 of the Issues Statement is a reference to the Competition Commission's reports on the Greater Western Franchises, which were produced some four years before the Guidance was published.

- 3.3.2 Second, the Guidance specifies that the SLCs created by the hypothetical bidder are remedied through behavioural remedies and not "for example" through behavioural remedies, as the Issues Statement suggests (§26). The difference is important as behavioural remedies would be implemented following a proportionality assessment at Phase II, and therefore would not necessarily entirely restore competition to the pre-award state. They do not achieve the same outcome as a (hypothetical) structural remedy.
- 3.4 Arriva notes that these points are not merely technical, but have important substantive implications for the CMA's assessment. The effect of the Guidance is to acknowledge that in some cases the counterfactual cannot be one of perfect competition, but itself involves some degree of compromise to competition on individual flows.
- 3.5 This clearly reflects the reality of the situation in cases such as the present. It is also an approach that recognises the need to balance the protection of competition for the market and competition in the market. As explained in Arriva's Initial Submission, competition for the award of franchises is the primary competitive mechanism for protecting passengers. Holding bidders to unrealistic and artificial counterfactual standards can only discourage future bidding and risks compromising the vitality of the franchising process.
- 3.6 Arriva would encourage the CMA to adopt an approach to the counterfactual that is consistent with its own guidance as well as reflecting the reality of the situation.

4. FILTERING

- 4.1 The Issues Statement recognises the important role that filters play in narrowing down the flows for detailed consideration, by removing those where there is no realistic possibility of an SLC (§30). Arriva welcomes this recognition.

Rail on rail

- 4.2 Oxera's submission of 28 June 2016 identifies five initial filters, designed to take a conservative view, so that the filtering would not eliminate any flows potentially raising competition concerns. These are:
- **A de minimis filter** excluding flows generating revenue for the merged group of less than £5,000 per year. A threshold of £5,000 represents three passenger journeys per day on average, assuming an average fare of £5.00 (which is consistent with the average fare data provided to the CMA in this case). On such flows any benefit from increasing fares or reducing service quality would be insignificant, and almost certainly outweighed by the damage such changes would cause to the remainder of the route and/or the costs involved in making such a change.
 - **An effective competitor filter** excluding flows where third party rail competitors have at least 50% market share on the flow, either by revenue or by frequency of service. On such flows, any benefit from increasing fares or reducing service quality would almost certainly be outweighed by passengers switching to the alternative service(s).
 - **A revenue increment filter** excluding flows where the increase to Arriva's market share is less than 5%. Such a low increment would not materially change the nature or structure of competition on the flow in question.
 - **A regulated fares filter** excluding flows where 90% or more of flow revenue derives



from regulated fares. On such flows there is virtually no scope for price competition given the high proportion of regulated fares, and the effect that this has on the unregulated fares on the flow.

- **An inter-available fares filter** excluding flows where 95% or more of flow revenue derives from inter-available fares and Arriva is not the lead operator. A high proportion of such fares suggests that price competition on the flow pre-Award was either non-existent or extremely limited.

Bus on rail

4.3 The CMA has preliminarily indicated to Arriva that it will accept the following filters in this case, which are intended to exclude flows which are unlikely to raise any substantive competition concerns:

- **A 10% revenue filter** excluding flows which account for a share of less than 10% of total route revenue or passengers.
- **A de minimis filter** excluding flows on which the merging parties generate revenue of less than £10,000 per year and where the revenue share of such flows on a given route is below 10%.

4.4 Arriva welcomes the use of these filters as a pragmatic tool for identifying flows on which an SLC as a result of the award of the Northern franchise is unlikely to arise.

4.5 In addition, the CMA has confirmed that full data need not be provided in respect of flows on which the merging parties would face an effective third party bus competitor. In Arriva's view, for the purposes of the CMA's filtering, an effective competitor can be defined as one which has peak frequency on the flow that is at least half the frequency of the competing Arriva bus service. The existence of such a competitor would give passengers a clear alternative option for bus passengers.

5. BUS ON RAIL – HORIZONTAL UNILATERAL EFFECTS

5.1 Arriva welcomes the CMA's general approach and focus to the first theory of harm described at §§38 and 39 of the Issues Statement and notes that it is critical that the CMA's assessment focuses only on the outcomes that are merger specific, i.e. which can be expected to come about specifically as a result of the award of the Northern franchise to Arriva and not as a result of general market conditions.

5.2 The Issues Statement describes the factors that it considers will inform its assessment of this theory of harm (§§37 and 40). Arriva considers that all of these factors will be relevant to the CMA's assessment. In particular:

- **Extent and closeness of competition:** It is critical to assess whether the services in question competed in any meaningful way pre-award. As set out in Arriva's Initial Submission³, it cannot be assumed that overlapping services, especially of different modes, necessarily impose a competitive constraint on each other. This will need to be assessed on an individual flow by flow basis, taking into account all relevant factors. Arriva supports the use of a generalised journey cost approach, along with other evidence of customer preference and switching behaviour.
- **Relationship between overlap flow(s) and wider routes and regions:** In practice, bus operators are very limited in their ability to alter fares or service quality on a flow basis (see Initial Submission §§10.18 to 10.20). Any such changes will have an impact on the relevant route and across the region more generally. Unless the

³ Initial Submission §§ 1.13 to 1.15, 6.3 to 6.5 and 9.1 to 9.2



overlap flow is very large relative to its route and region, that impact will make responding to flow level competitive conditions unlikely as any potential gains would be small and the unintended negative consequences hard to predict

- **Impact of regulation of the bus sector:** Arriva has previously described the constraint imposed on bus operators by existing and future regulation of the bus industry.⁴ Local transport authorities have an increasing number of voluntary and mandatory mechanisms by which they can control bus operators' ability and incentives to make independent pricing and service decisions, including by means of voluntary partnership schemes, quality partnership schemes and quality contract schemes. These existing controls will be further enhanced once the Bus Services Bill enters force. The current potential for direct intervention and change by local authorities is a key incentive for Arriva to run its bus services to an appropriate standard, taking account of the interests of passengers and local stakeholders.

Arriva also notes that certain services are operated under contracts with local authorities, awarded following competitive tender processes. Such services enjoy additional protections from any increase in fares or degradation in service, because local authorities typically specify fares and service standards, and or retain the right to retender routes if they are dissatisfied with the operator.

5.3 There are also a number of other factors that will be critical to the assessment which are not expressly included in the Issues Statement, such as:

- **Actual competition from third parties:** it will be essential to take full account of the extent and closeness of competition from third parties, including those within and outside the relevant product and geographic markets as defined. As Arriva has previously explained to the CMA in the Initial Submission and the response to the Market and Financial Questionnaire:
 - Arriva faces vigorous competition in relation to frequencies, fares and quality from both large established bus operators and from mid to smaller operators active within the Northern franchise area.⁵
 - Private transport is already a significant constraint across the Northern franchise area for Arriva's bus and rail operations, [
 - ✂
 -]. For example, within the North West, North East and Humber regions, more than 70% of commuters overall use a car or van as their primary method of travel to work. There is considerable scope for this constraint to grow even stronger in future given the relatively low number of cars per household in the North East and Yorkshire and the Humber regions compared to the rest of the UK.⁶
 - [
 - ✂
 -]⁷
 - It is imperative that the impact of actual competition from third parties (including private transport) must be taken account of in the individual analysis of the flows that remain post-filtering.
 - **Supply side substitution and potential competition:** Section 12 of Arriva's Initial

⁴ Initial Submission §8..1 to 8.5 and 10.27 and response to C.5 of the MFQ

⁵ Initial Submission §9.3, and response to C.2 of the MFQ

⁶ Response to D.4 of the MFQ

⁷ Response to D.4 of the MFQ



Submission describes in detail how easy it is for rival bus operators to alter existing services, or introduce new ones, in response to changes in competitive conditions, and how this threat of itself operates to ensure fares and service quality are maintained. In particular:

- Bus services are fluid and change regularly to meet shifts in local services and demand. Only minimal investment is required for entry and expansion by existing operators – all that is required is access to vehicles, access to a suitable depot/operating facilities and regulatory licences;
 - Amendments to services or entry can be implemented quickly. Changes to services (e.g. timetable changes, alterations of frequencies, or route amendments and introductions) can be made on only 56 days' notice;
 - Given passenger demand for point to point journeys, smaller scale entry can provide significant competitive constraint on existing operators. Entry on more profitable or popular routes, or even just part of a route, or only at times of high demand is sufficient to create actual competition;
 - Multi-operator tickets schemes make it even easier for small-scale operators with more limited services to enter and compete sustainably with larger scale operators; and
 - There are a number of third party bus operators within the area of the Northern franchise which could easily enter onto or expand its services on a bus route or flow currently operated by Arriva.
- **The need and opportunity to win new passengers:** bus passengers exhibit high churn rates and against the backdrop of declining patronage, bus operators must work hard to win new passengers in order to survive (Issues Statement, §9.1). This places pressure on fares and service quality.
 - **The impact of multi-operator tickets and concessionary fares:** the existence of multi-operator ticket schemes and the concessionary fare scheme are influential in terms of Arriva's pricing decisions⁸:
 - Arriva has previously explained to the CMA that multi-operator schemes impose various restrictions on the way in which Arriva operates its business (depending on the terms of the scheme).⁹ In practical terms, multi-operator tickets (which offer greater flexibility to passengers than an own-operator fare and which are typically open to all operators to join) generally act as a constraint on the price of own-operator fares. Moreover, given that participating operators only receive a share of revenue from multi-operator tickets, operators are incentivised to price their own individual fares below the price of a multi-operator tickets in order to attract passengers where they can keep the entirety of the revenue.
 - In respect of flows with a high proportion of concessionary passengers, there is little incentive in practice for Arriva to increase fares or degrade service quality/frequency as a result of the Award. Concessionary passengers are unaffected by fare changes during the period in which the scheme operates and would be unlikely to switch modes if service quality or frequencies reduced (a position that already existed pre-Award and is unaffected by the Award). In addition, price rises may result in the remaining lower proportion of fare-paying passengers switching away.

⁸ Response to F.1 of the MFQ

⁹ Response to C.8 and C.11 of the MFQ



- **A full assessment of Arriva's incentives:** To the extent that any residual concerns remain on particular flows once the filters and other considerations have been taken into account, the CMA will need to consider in detail Arriva's incentives to increase fares or reduce service quality post-award of the Northern franchise bearing in mind¹⁰:
 - Passengers that are diverted away from Arriva's bus services can in many cases switch to competitor services or private transport. The low barriers to entry in the bus industry and the competitive nature of the industry mean that any service gaps can be fulfilled quickly. Further, there could be no guarantee that a passenger switched from bus to rail would switch to a Northern rail service, rather than a competitor rail service. These effects would limit any revenue increase that Arriva could experience in rail as a result of any such strategy;
 - [redacted];
 - Changes to individual bus flows are likely to have wider consequences for other flows on the route or across the Arriva bus network. For example, it would be difficult to change frequencies and fares on an individual flow without distorting the pricing structure and timetable across a wider area. Sub-optimal changes to other flows along the route or to the efficient running of the wider network may lead to reduced profits; and
 - Arriva has operated overlapping bus and rail services in the UK for some time as a result of previous rail franchise awards, and has established a divisional structure involving: (i) separate management of bus and rail services; and (ii) [redacted] (Issues Statement, §1.14.1 and 2.3). At no stage following previous rail franchise awards has Arriva sought to take advantage of its overlapping bus and rail services by degrading service quality or raising fares of its bus services to move passengers to its rail services.¹¹ This reflects the lack of any realistic ability or incentive to do so. There is no reason for the CMA to consider that Arriva would deviate from this approach as a result of the award of the Northern franchise, or that the Award will impact on Arriva's incentives to do so. [redacted]

5.4 In the circumstances, the CMA should not assume that:

- 5.4.1 any overlapping bus and rail services necessarily compete, or
- 5.4.2 that such competition is material given the range of other constraints operating on the bus business, or
- 5.4.3 that Arriva would have any incentive to coordinate its strategy across those bus and rail services.

Each of these steps will need careful examination before any conclusions can be drawn as to the likely impact of the Award at a local level, if any.

6. RAIL ON RAIL – HORIZONTAL UNILATERAL EFFECTS

6.1 Arriva welcomes the CMA's recognition of, and commitment to investigate, the limited

¹⁰ Initial Submission, §10.24 and 10.26

¹¹ See response to C.7 of the MFQ which confirms that Arriva is not aware of any significant changes being made to the bus services within the Northern Franchise area within the first two years of Arriva commencing operations on any overlapping rail franchise.



scope for price competition and even more limited scope for non-price competition as a result of restrictions in franchise agreements (§44). These limits are likely to be even tighter in the context of this case than in previous decisions (as referred to in §44) because:

- 6.1.1 Fare regulation has become more restrictive since the date of most of those decisions, with a cap of RPI+0% set for five years, and the indefinite removal of the flex mechanism across a basket¹²; and
 - 6.1.2 Northern's obligation to simplify its fare structure places further restrictions on its ability to alter fares which were not a feature of previous franchises.¹³
- 6.2 In its assessment of this theory of harm, the CMA indicates that it will focus on closeness of competition between the overlapping flows (§§45 to 46). Arriva agrees that this is an essential step in the analysis. Further, any assessment of unilateral effects must take into account all of the following:
- 6.2.1 The ability of Arriva to bring about an increase in prices or reduction in service quality on one service (Service A);
 - 6.2.2 The cost of doing so, including the numbers and profitability of passengers lost from Service A and also from other flows affected;
 - 6.2.3 The proportion of those lost passengers that would switch to the overlapping service (Service B), relative those who would switch to third party services (whether rail or bus), other modes of transport, or not travel at all; and
 - 6.2.4 The profitability of such switching passengers as they use Service B.
- 6.3 The Issues Statement describes the factors that it considers will inform its assessment of this theory of harm (§47). Arriva agrees that these factors will be relevant to the CMA's assessment. In particular:
- 6.3.1 **Ability to flex service quality:** Arriva has extremely limited ability to alter its Northern rail service offering, or the offering of its other franchised TOCs. Arriva described in its Initial Submission¹⁴ the extent of service regulation under the Northern and other franchise agreements. These agreements specify detailed standards for almost every conceivable aspect of the service, including journey time, timetable, routes, staff levels, staff training, cleanliness, etc.).¹⁵ Failure to meet these standards would lead to significant financial and reputational consequences.¹⁶ This is not just a minimum standard: the franchise process requires bidders to compete also on service quality (as described at section 10 below, Arriva proposed service improvements over and above the requirements of the ITT as part of its bid for the Northern franchise), and the winning bidder is held to its promises in the form of Committed Obligations in the Franchise Agreement.¹⁷ Consequently, the franchise agreement captures anticipated efficiencies and investments, and the CMA can be confident that those service standards are set at a fully competitive level.¹⁸

In relation to open access operators (e.g. Grand Central), whilst they are not parties to a Franchise Agreement and therefore have some greater flexibility in

¹² Initial Submission §7.4 and Response to C.8 of the MFQ

¹³ Response to C.8 of the MFQ

¹⁴ Initial Submission §§ 7.3 to 7.5 and 10.7

¹⁵ Initial Submission §§ 7.3 to 7.5 and 10.7 and response to C.5 of the MFQ

¹⁶ Initial Submission §10.7

¹⁷ Response to C.5 to C.6 of the MFQ

¹⁸ Initial Submission §10.8



terms of service quality, they remain subject to a raft of Network Rail regulations and limits on non-price aspects of its offer (primarily dictated by the scope of their track and station access rights), such as frequency, journey time and stopping points. Changes to routes would require approval of the ORR.¹⁹ Grand Central, in any event, is primarily a long-distance operator and is unlikely to focus on local issues in the Northern franchise area when most of its revenues and focus related to long-distance flows to/from London.

- 6.3.2 **Closeness of competition:** The CMA will be able to form a view of closeness of competition between Arriva's TOCs, and between Arriva's and competitors' services by comparing aspects of the services concerned such as destination, access / egress times, fares, frequencies, journey times and other quality aspects of the offer (Issues Statement §47). However, it is also critical to assess whether the services in question competed in any meaningful way pre-award. As set out in Arriva's Initial Submission²⁰, it cannot be assumed that overlapping routes necessarily impose a competitive constraint on each other. In many cases, customers will choose on the basis of timetable, which operators cannot alter. Information such as the proportion of tickets sold at regulated or inter-available fares will help to provide insight on this issue.

As part of this factor, it will also be essential to take full account of the extent and closeness of competition from third parties, including those within and outside the relevant product and geographic markets as defined. As set out at paragraph 5.3 above, private transport is a significant constraint on Arriva's bus and rail services across the Northern franchise region, and there is a significant prospect that this will increase even further over time.

- 6.3.3 **Price competition:** Arriva has described in both its Initial Submission and the response to the MFQ the extent to which fares are regulated, the ways in which regulated fares constrain unregulated fares and the significance of finding few dedicated fares on a route.²¹ The result is that there was only limited price competition between competing rail operators pre-award, and that neither Arriva's ability nor incentives to increase rail prices on overlapping flows has increased as a result of the Award.

The Issues Statement also contains reference to the ability of train operators to flex individual regulated fares (§47(c)(i)). However, the DfT informed the CMA at Phase 1 that there will be no such ability in the foreseeable future.

- 6.4 There are also a number of additional factors that Arriva considers are important for the CMA to take account of in its assessment:

- 6.4.1 **The role of competition for the market:** as set out in Arriva's Initial Submission²², the primary means by which passengers benefit from competition is via the franchise bidding process. It is critical that this context informs the entirety of the rail-on-rail analysis.

- 6.4.2 **The duration of the overlap franchises:** a number of Arriva's rail franchises/concessions which overlap with the Northern franchise are due to expire over the course of the next three years, and there is no certainty that Arriva will retain these after the expiry date.²³ This reflects the inherently transitory nature of rail franchises. Consequently, a number of the overlapping

¹⁹ Initial Submission §§7.7 and 10.9 and response to C.5 of the MFQ

²⁰ Initial Submission §§1.10 to 1.12

²¹ Initial Submission §§7.4 and Response to C.8 of the MFQ

²² Initial Submission §§ 1.6 to 1.7 and 7.3

²³ Initial Submission §§14.4 to 14.6 and the response to E.4 of the MFQ



rail flows may be for a time limited period only. The period over which any competitive effect is felt is highly relevant to the significance of that effect.

6.5 Finally, the Tyne & Wear Metro concession will require separate consideration. At Phase 1 the CMA recognised that overlaps between Northern and Tyne & Wear Metro could not give rise to an SLC because Arriva has no material ability to set or influence fares or service quality, and all fare revenues (and revenue risk) were for the account of the owner and manager of the concession, Nexus. Arriva would welcome early confirmation that the CMA intends to take a similar approach in Phase 2.

6.6 In summary, the scope for any competition between rail operators is very limited. In many cases passengers do not choose between operators but on the basis of timetable. Operators have virtually no ability to flex service quality and only limited influence over fares. This reflects the design of the rail industry on privatisation, when a decision was taken to focus on competition for the market rather than competition within it.

7. HORIZONTAL EFFECTS ON TRANSPORT NETWORKS

7.1 The Issues Statement recognises that this theory of harm is predicated on the current existence of strong competition between the Arriva and Northern networks and the prospect that such competition would be reduced significantly as a result of the merger. Arriva welcomes this recognition.

7.2 Arriva considers that this theory of harm can and should be easily dismissed. As Arriva has explained in previous submissions to the CMA, Arriva and Northern network tickets are not currently close competitors. Therefore the merger will not result in a significant reduction in competition at a transport network level. In particular:

7.2.1 Arriva does not currently offer on a permanent basis any Arriva rail network tickets in the Northern Franchise area²⁴. Although Arriva offers bus network tickets within the Northern Franchise area, it cannot be assumed that Arriva's bus and Northern's rail network tickets necessarily impose a cross-modal competitive constraint on each other.

7.2.2 Arriva has previously outlined to the CMA that there is in fact a significant disparity in price between Northern and Arriva day and 7 day tickets within the Northern Franchise Area. Northern's cheapest adult day ticket (for a range/rover style ticket without railcard) is £19.50 while Arriva's most expensive bus day ticket is £7.70. Northern's cheapest adult 7 day ticket (without railcard) is £88.00, while Arriva's most expensive 7 day adult ticket is £27.20.

7.2.3 Generally speaking, and in particular on longer journeys, bus journey times will be longer than rail journey times.

7.3 The scope of the Northern Franchise network is determined by the Northern Franchise award and the routes contained therein. Arriva's bus network tickets operate on a zonal basis and while they incorporate additional intermediate destinations compared to the Northern Franchise, they do not extend to all destinations covered by Northern network tickets.

7.4 The Issues Statement also describes at §50 specific theories of harm which the CMA intends to consider in relation to transport networks. Arriva addresses each in turn:

- **Ability to worsen offer on transport networks if networks are close alternatives for passengers:** As discussed above, the Arriva and Northern networks do not represent close alternatives for passengers. In any event, Arriva has no realistic ability or incentive to worsen existing network ticket offerings.

²⁴ Response to B.8 of the MFQ



- As outlined at Section 5 above, the separate management of Arriva bus and rail services, and the separate incentives and performance targets for its bus and rail divisions preclude any realistic ability or incentive for coordination across Arriva's bus and rail network tickets.
- Arriva notes that its network tickets face competition from similar bus network tickets offered by competitors (such as Stagecoach's dayrider and megarider tickets). Existing demand for Northern Network tickets is already limited (representing less than [X] % of revenue on the Northern Franchise²⁵) and may be affected further by any potential price increases. A number of alternative network tickets and multi-operator tickets may also be available to passengers.
- **Integration of bus and rail services:** It is unclear to Arriva whether this theory of harm relates to the integration of bus and rail services, or the integration of bus and rail network tickets. In any event, Arriva has no ability or incentive to integrate either bus and rail services or bus and rail network tickets post-merger:
 - As previously outlined to the CMA, Arriva is contractually obliged under the Northern Franchise Agreement to hold the Northern Franchise business separately from other Arriva businesses, to ensure the clean transfer of the Northern Franchise business at the end of the Franchise Term.
 - The terms of the Northern Franchise Agreement would preclude any attempts by Arriva to alter existing Northern Franchise service quality with a view to integrating services with Arriva's bus services²⁶.
 - Any integration of bus and rail services would represent a significant departure for Arriva from its current operational structure which separates the management of Arriva bus and rail services²⁷. Further, it would involve a fundamental shift in Arriva's strategic and cultural approach to its bus and rail businesses. [X]
 - Currently in the Northern Franchise area, Arriva does not offer any Arriva-only multi-modal network tickets [X]
 - [X] if it were to do so, it is by no means clear that this would be harmful to consumers. In fact it may well be the case that such integration would provide a net benefit to passengers. The CMA appears to recognise this fact to some extent in §50 (b).
- **Extent of incumbency advantages with PTE:** Arriva has previously explained to the CMA that it does not consider that the scale of an operator has any discernible effect on negotiations with individual PTEs²⁸. In particular, the fact that an operator is a larger scale operator has no relevance with respect to the bargaining position of that operator with the PTE. By way of example:
 - Arriva's bus operators regularly deal with PTEs in respect of services which PTEs put out to tender, which are generally awarded on a set of criteria based on service specification and price. In those circumstances, the PTE's primary

²⁵ Response to D.1 of the MFQ.

²⁶ Response to F.2 of the MFQ.

²⁷ Initial Submission, §1.14.1 and 2.3.

²⁸ Response to C.12 of the MFQ.



concern is achieving the highest quality services in respect of those routes for the least cost to the public and contracts may often be awarded to smaller operators. These considerations are likely to only increase further in importance with the anticipated introduction in early 2017 of franchising powers for local authorities under the Bus Services Bill²⁹.

- In Arriva's experience, multi-modal schemes are open to all operators who would like to participate and scheme administrators may encourage or invite additional operators to join their schemes. In Arriva's experience, the scale of an operator does not influence how PTEs treat operators in relation to access to schemes, or the distribution of profits from such schemes. In Arriva's experience it is also relatively straightforward for new entrants to enter such schemes. While the precise manner of entry to a scheme will depend on the particular scheme rules, the timing for new entrants is likely to be in the region of two to three months.
- Even if any incumbency advantages based on scale did exist, the acquisition of the Northern Franchise does not materially improve Arriva's position as it represents a minimal (less than [\gg])% increment to Arriva's existing network ticket sales in the Northern Franchise area³⁰. Arriva therefore will not enjoy an incumbency advantage when dealing with PTEs as a result of the merger.

8. THEORIES OF HARM THAT THE CMA IS NOT CURRENTLY MINDED TO PURSUE

- 8.1 Arriva welcomes the CMA's confirmation that it is not currently minded to pursue whether the Award would affect competition for rail franchises. As set out in the Initial Submission, Arriva agrees with the CMA's conclusion at Phase 1 that there was no realistic prospect of an SLC for rail franchises as a result of the Award and sees no reason for the CMA to depart from this view at Phase 2.³¹

9. COUNTERVAILING FACTORS

- 9.1 As described in section 12 of Arriva's Initial Submission, the bus industry is characterised by extremely low barriers to entry and expansion:

9.1.1 As explained in paragraph 5.3 above, there are no material barriers to entry or expansion relating to the costs of entry, access to the necessary assets or licensing or other regulatory barriers. Entry or expansion can be effected relatively quickly (within 56 days) at a minimal cost. There are a number of well-established third party bus operators within the areas of overlap with the Northern franchise which could readily enter or expand services on flows or routes currently operated by Arriva if there was a perceived opportunity.

9.1.2 Small-scale operators can and do act as a significant competitive constraint on Arriva without needing to enter on a large scale, given the point-to-point nature of passenger journeys. To the extent that there may be economies of scale and scope, these do not act as a material barrier to entry – and smaller operators may, conversely, benefit from lower operating costs than larger operators. The growth of multi-operator ticket schemes within the area of the Northern franchise has also made it even easier for smaller operators to enter, expand and compete sustainably.

9.1.3 Incumbency advantages in the industry are low and the threat of retaliation does not appear to have deterred third parties from competing on bus routes operated by Arriva.

²⁹ Initial Submission §1.13.5 and 8.2 and Response to C.12 of the MFQ.

³⁰ Response to D.1 of the MFQ.

³¹ Initial Submission §10.5



- 9.2 The threat of entry and expansion by other operators if opportunities arise is therefore a significant constraining factor on Arriva's operations in the Northern franchise area. Arriva considers the threat to be credible as entry can be:
- 9.2.1 Timely, given that services can be started or expanded within a short timeframe on an "opportunistic basis", and that minimal investment is required;
 - 9.2.2 Likely, in the event of any attempt by Arriva to increase prices or degrade services on overlap flows (which would give other operators an opportunity to enter or expand on the relevant routes so as to win passengers away from Arriva, to their commercial benefit); and
 - 9.2.3 Sufficient to prevent any SLC arising, given that entry or expansion onto the relevant flow (even without any broader entry/expansion) would act as a direct competitive constraint on that flow.
- 9.3 Arriva considers that the strong influence exercised by the DfT and local passenger transport authorities is also a significant countervailing factor in respect of Arriva's rail and bus operations:
- 9.3.1 Arriva's relationship with the DfT is of fundamental importance to Arriva, both in terms of current and future rail franchises: the operation of a franchise requires very close and extensive cooperation with the DfT, and Arriva's performance has a crucial bearing on future franchise awards. In practice, there is a very strong disincentive to take any steps which might jeopardise Arriva's relationship with the DfT.
 - 9.3.2 The constraints exercised by local passenger transport authorities as a result of increasing bus regulation have already been described above. In addition, the potential for direct intervention and change by these authorities (e.g. the introduction of a QCS) represents a considerable incentive for Arriva to operate its bus services to an appropriate standard. Local authorities are a key stakeholder in Arriva's bus business, and are also customers of Arriva (e.g. where services are subsidised or tendered, or concessionary arrangements are in place). Senior management of Arriva's UK bus operators invest a significant proportion of their time managing relationships with these authorities. These relationships are of paramount importance and, again, there is a very strong disincentive to take any steps which might jeopardise them.
10. **POSSIBLE REMEDIES AND RELEVANT CUSTOMER BENEFITS**
- 10.1 The Northern franchise was awarded to Arriva following a competitive bidding process. Arriva's bid was chosen as it offered the best outcome from that process.³²
- 10.2 The award of the Northern franchise to Arriva will result in considerable benefits to passengers travelling on that franchise. As part of its bid, Arriva has committed to invest over £1 billion in the Northern franchise and to deliver a host of benefits and improvements for passengers, including the provision of new rolling stock and the refurbishment of the existing Northern fleet, additional services and a more coherent timetable, faster journeys, the extension of platforms to accommodate longer trains, improved station facilities, better customer service, closer community links, enhanced measures to ensure passenger safety and free wi-fi on all trains.
- 10.3 These benefits do not merely reflect the requirements set out by the DfT in the ITT. Arriva proposed as part of the bidding process an ambitious range of service improvements, innovations and performance and satisfaction targets that went beyond the DfT's

³² Initial Submission §10.2 to 10.3 and responses to C.6 and H.1 of the MFQ



requirements. These enhanced commitments are now codified in the final franchise agreement, which contains c.2900 franchise obligations and c.300 committed obligations. This was expressly recognised by the DfT at the time it announced the award of the Northern franchise to Arriva.³³

10.4 [✕]

10.4.1 [✕]

10.4.2 [✕]

10.4.3 [✕]

10.5 Furthermore, any remedies should go no further than is strictly necessary in the circumstances, reflecting the particular legal test for cases referred back by the European Commission to the CMA.³⁴

³³ Response to C.6 and H.1 of the MFQ
³⁴ Initial Submission §13.1.4