

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

FIRSTGROUP PLC'S RESPONSE TO THE CMA'S ISSUES STATEMENT

FirstGroup welcomes the opportunity to respond to the CMA's Issues Statement and looks forward to working with the CMA throughout this inquiry.

The last Phase 2 rail franchise merger inquiry took place 10 years ago. The Arriva/Northern Phase 2 inquiry provides an ideal opportunity for the CMA to set out how its thinking has developed over the last decade. This has the potential to help strengthen competition for subsequent franchises by removing a key source of uncertainty that bidders with existing bus and rail operations in the UK currently face: the competition assessment framework that will be applied by the CMA when assessing the resulting franchise merger.

Having reviewed both the CMA's Issues Statement and the Phase 1 Arriva/Northern decision, FirstGroup is concerned that the approach adopted by the CMA to date and its proposed approach for the Phase 2 inquiry does not appear to reflect the realities of how bus and rail markets work.

- **Bus and rail are not generally close substitutes.** Outside of London there are substantial differences in the types of passengers who use each mode and the nature of the journeys that they make on them. FirstGroup's own internal survey evidence collected over two and a half years, using an approach based on that adopted by the CC, shows consistently that the private car is a far more important constraint than the train. FirstGroup considers that the CMA's proposed exclusion of the private car as a competitor is unwarranted.
- **Access and egress time is highly important.** Passengers on the bus do not usually walk substantial distances at either end of their journey. There is no good reason to assume that they would be willing to walk substantially further to access the train.¹ However, implicitly at least, this is exactly what the CMA's approach to defining overlaps does. The net effect of this is that, despite the Issues Statement stating that "[...] a service competes more closely with another service of the same mode of transport on a flow than with a service using a different mode of transport"², the CMA is proposing to use an approach to defining overlaps between the bus and the train that is far broader than they have used in assessing recent bus merger cases.³ FirstGroup considers that the CMA's proposed approach to defining overlaps is excessively broad.
- **There are low barriers to entry and expansion for bus operators.** FirstGroup considers that there is a continuous prospect of entry of other operators across the vast majority of its bus routes. The barriers to entry to a particular route are very low for rivals that already operate in neighbouring areas. Therefore, if an incumbent operator were to increase its fares on any of its routes, including those that currently do not have a direct competitor, FirstGroup would expect other operators to exploit this increase by adjusting their existing routes or competing directly. Within the context of both the TransPennine Express merger inquiry and the SBH undertakings review, FirstGroup has provided the CMA with numerous examples of cases where it has faced entry from rival operators.

¹ Especially given their age profile which means they are more likely to be disabled and/or be unable or unwilling to walk more than a short distance, typical journey purpose which means they are likely to be carrying items with them (e.g. their shopping), and the fact that their overall journeys are typically short minimising the potential to benefit from the fact that rail services are typically faster than buses for the same point-to-point journey.

² Paragraph 16, Issues Statement.

³ See for example the CMA's approach in Stagecoach / First Devon & Cornwall merger inquiry from September 2015 which used 500m catchment to define overlaps (Paragraph 42, Final Decision).

FirstGroup therefore considers that the CMA needs to take full account of the potential for entry and expansion by rival operators when assessing the impact of the Arriva/Northern merger.

- **Rail franchises are time limited, subject to extensive regulation and, crucially, are themselves shaped by the result of a competitive process.** The ability of a franchisee to alter its offer is essentially limited to the setting of the price for unregulated fares, but even here the franchisee's freedom to do as it wishes is far from absolute. This is because the Secretary of State retains substantial backstop powers to regulate fares. In addition, there is a clear commercial imperative to maintain sensible relationships between the (typically) more flexible regulated fares and the (typically) less flexible unregulated fares.

FirstGroup considers that theories of harm around deteriorating aspects of a franchise's offering other than non-regulated fares are simply not credible (even on a Phase 1 standard).

Throughout the inquiry the CMA needs to develop and undertake its assessment with this empirical context in mind. The current Phase 1 approach, which does not adequately take account of these points, unnecessarily raises the regulatory bar for potential bidders.⁴ This runs the consequent risk that potential bidders will be deterred from bidding for certain franchises, so reducing competition for those franchises to the detriment of consumers and the UK taxpayer.

This concern is not hypothetical. FirstGroup has informed the CMA and the DfT that it did not bid for the Northern franchise for exactly this reason. Specifically, the highly cautious approach adopted by the CMA in assessing other franchise bids led FirstGroup to conclude that any successful bid by it for the Northern franchise would have not have been cleared at Phase 1 without substantial remedies. Given the timescales available, designing and implementing such remedies would have been near-impossible. There was therefore a substantial risk of either jeopardising its ability to start the Franchise on time (or at all, in the event of a Phase 2 referral) or ending up with a set of remedies which would have had to be subsequently reviewed and amended at substantial cost to the business (as per FirstGroup's experience with the undertakings agreed in relation to its former ScotRail franchise).

FirstGroup's specific comments on the Issues Statement and the approach adopted to date are set out below.

SPECIFIC COMMENTS ON THE CMA'S APPROACH

Areas of agreement

FirstGroup welcomes a number of aspects of the CMA's proposed approach.

- FirstGroup agrees that, other things being equal, two services of the same mode on a given flow are likely to be seen as closer substitutes by passengers than services of different modes on the same flow.
- FirstGroup agrees with the CMA's proposed counterfactual for assessing the merger.
- FirstGroup agrees with the CMA's decision not to investigate a theory of harm around the impact of the award of the Northern franchise on competition for future franchises.

⁴ As well as the burden on actual bidders.

- FirstGroup welcomes the CMA's decision to use filters to identify problematic flows (although it has some concerns about the exact filters employed, see below). In addition to the filters suggested by the CMA, FirstGroup would suggest that:
 - very short overlaps of less than 2 miles (3.2km) are excluded following the approach adopted by the CC in the Local Bus market investigation. This is because for such journeys, walking will always be a more viable alternative than travelling by train. The use of such a filter would also help to avoid nonsensical cases where switching from the bus to the train would involve a passenger walking for longer than if they undertook their whole journey on foot in the first place; and
 - for rail: rail overlaps, flows with very high shares of regulated fares are filtered out.
- FirstGroup broadly agrees with the list of factors that the CMA plans to review when assessing the closeness of competition on overlap flows. However, for bus: rail overlap flows FirstGroup considers that the CMA should also take into consideration the level of concessionary passengers on the bus service. This is because such passengers are highly unlikely to switch from a service they use for free (i.e. the bus) to one they would (typically⁵) have to pay for (i.e. the train).

Areas of concern

There are a number of areas where FirstGroup has significant concerns with the CMA's proposed approach and/or the approach it has adopted to date.

- **“Relevant overlaps” are defined much too widely.** Notwithstanding the points above, the CMA proposes to employ a definition of a relevant bus-rail overlap that is much too wide to indicate any meaningful competitive interaction between bus and rail. The CMA has continually widened the definition of a relevant overlap since the most recent Phase 2 decisions in First/Great Western and First/ScotRail, in FirstGroup's view substantially beyond a sensible level. There is no justification for this approach in a Phase 2 context under the balance of probabilities test. FirstGroup has provided the CMA with evidence to support this view in response to the CMA's RFI. The key points from this evidence are summarised below:
 - the CMA's definition of overlaps significantly underweights the importance of access and egress time to passengers;
 - the level of overlap in the catchment areas of bus and rail implied by the CMA's approach is at best trivial and at worst non-existent;
 - the approach is non-operational as key concepts are undefined;
 - in dense urban areas the approach has the potential to lead to nonsensical cases where passengers walk past a large number of competing services in order to access the train; and
 - the approach is inconsistent with the CMA's view that two services of the same mode are likely to be seen as closer to substitutes to one another than services of different modes on the same flow.
- **Bus and rail are not generally particularly close substitutes.** There seems to have been an assumption in several previous franchising merger inquiries that bus and rail journeys are close substitutes, perhaps because both are a type of public transport. The Phase 1 decision in the Arriva/Northern case in particular appears to rely heavily on this

⁵ Concessionary passes allow free travel on the train in some area such as Manchester, but such cases are relatively rare.

untested assumption in order to set aside what are often substantial differences in the characteristics of the modes on the overlap flows in questions. This assumption should not be carried through to Phase 2 without being tested against the available evidence.

FirstGroup's experience is that this assumption is simply not correct across the types of areas covered by the Northern franchise.

- FirstGroup's primary strategic focus is on getting customers out of the car and onto either bus or rail (depending on the services that FirstGroup operates in particular areas) rather than getting bus passengers to switch to travelling by train or getting rail passengers to switch to using bus. This is true in areas where FirstGroup operates both bus and rail operations and in areas where FirstGroup only operates one or other type of operation.
- For most passengers on either mode, the other is not a realistic alternative for the journey they are making. However, even where bus and rail journeys are potential substitutes looking at distance alone, bus and train are used by different types of passengers to make different types of journeys, as FirstGroup set out in its TPE Merger Notice and its response to the CMA's RFI using data from the National Travel Survey.

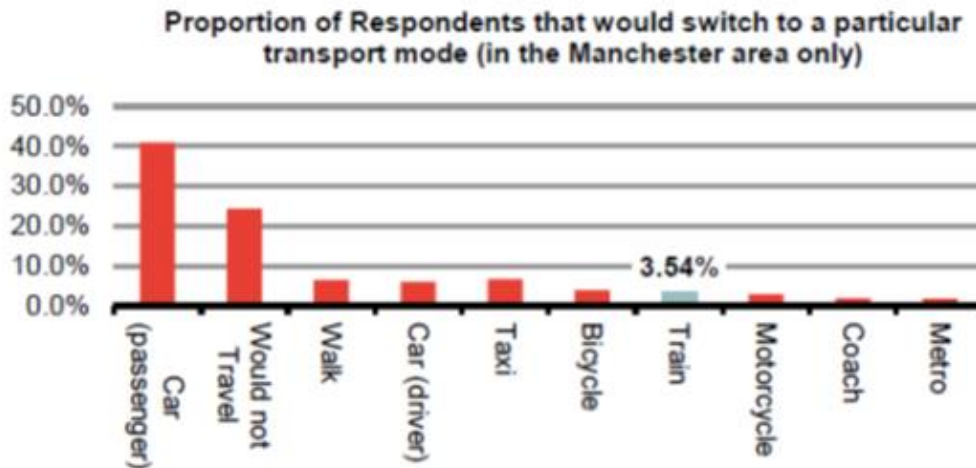
FirstGroup is concerned that this approach is based, at least in part, on an extrapolation of the experience of travelling within London to the rest of country. Such an extrapolation is unwarranted. London's transport market is fundamentally different to other areas across the UK for at least two key reasons:

- car ownership in London is substantially lower than in other parts of the country - in 2013/14 the proportion of households without a car in London was 43%, compared to 21% in the rest of the country;⁶ and
 - the public transport network within London is much denser and more highly integrated across modes than in other parts of the country. This means for passengers within London there are generally multiple options for making a journey by public transport at all times of day and across the week as a whole.
- **The private car is a closer competitor.** FirstGroup has asked Illuma to carry out a regular survey of its bus passengers (the "Illuma survey"), which includes questions on car ownership and on what transport mode (if any) passengers would choose if the bus had not been available. The results show consistently that:
- the car is by far the closest substitute to the bus – whether the passenger would drive the car themselves or be a passenger – with around 40% to 50% typically choosing this option; and
 - rail is at best a limited substitute, with typically less than 5% of customers choosing rail.

The results of this survey for the Manchester area are shown in Figure 1 below. Only 3.54% of the respondents (excluding don't knows) indicated that they would switch to train if the bus was not available for their journey on that day. A greater percentage indicated that they would switch to the private car (as driver) and a far greater proportion would switch to private car (as passenger). This shows that the CMA cannot ignore the constraint from the car, which is clearly the closest substitute to the bus.

⁶ National Travel Survey.

Figure 1. Illuma survey results for Manchester



Source: FirstGroup

Note: Based on passengers surveyed on routes operated out of FirstGroup's depots within the Greater Manchester area.

This finding applies across all routes, across the country as a whole, and even on bus routes which the CMA's overlap exercise would suggest are close substitutes to rail. In particular, it applies across FirstGroup's routes in the North of England. Whilst this does not directly apply to the bus routes of concern in Arriva/Northern, the consistency of the findings from FirstGroup's routes in the area means it is critical that the CMA should properly assess whether in fact bus and rail are close competitors in each specific route and flow in question, rather than relying on untested assumptions.

- **The CMA's Phase 1 approach has substantially overestimated the ability and incentive for bus or rail firms to deteriorate their offer post-merger.** In those (limited) cases where the bus and the train are good alternatives for one another, the CMA's Phase 1 approach has overstated the ability and incentive of bus and rail operators to deteriorate the competitive offer of either mode post-merger, whether by increasing prices or by reducing frequency or some quality dimension.
 - With respect to a potential deterioration of the rail offer, the franchise agreement means that undertaking a number of many of the potential deteriorating actions (e.g. reducing frequency or quality – punctuality, etc.) would mean a breach of the terms of the rail franchise contract, as FirstGroup set out in more detail in its response to the CMA's RFI. DfT monitors these metrics on an ongoing basis and has strong enforcement powers including the ability to fine franchisees up to 10% of their turnover and ultimately to enforce early termination⁷. As a result, theories of harm that involve such actions are simply not credible.
 - A significant proportion of rail fares are directly regulated.
 - There is also a wider regulatory landscape that significantly constrains freedom of action, most notably Network Rail's track access conditions and the ORR's enforcement powers.

⁷ As a result, the DfT enforcement powers are a strong deterrent against a franchisee degrading its service. There is, moreover, a track record of franchising authorities exercising such enforcement powers in the event of a franchise breach, either directly or by requiring operators to undertake additional measures or investment and provide compensation

- With respect to bus pricing, as FirstGroup set out in its response to the CMA's RFI, there are significant limits on the ability to target a price rise at passengers travelling on a specific flow. Moreover, in FirstGroup's experience, offering customers a simple, coherent and easy to understand pricing proposition increases the attractiveness of its services, as well as being the most efficient way to operate by helping to speed up boarding times. Generally speaking, it would be unattractive commercially to alter route fares in a way that undermined FirstGroup's ability offer a simple, coherent and easy to understand pricing proposition across the network.
- Finally, even if it were feasible and realistic to engage in the types of deterioration envisaged by the CMA, the likely level of diversion (as indicated by the Illuma survey) is much too low to make it worthwhile to distort route-wide prices (or even flow-level prices) to achieve the hypothetical aim of getting passengers to switch to the train.
- **The CMA has ignored the threat of potential competition.** The CMA has underestimated the constraint on bus operators from expansion of nearby routes in its Phase 1 decisions. Registering a route takes just 56 days (slightly longer in Scotland) and operators, including FirstGroup, are constantly on the lookout for opportunities to exploit. Barriers to entry and expansion in the bus market are minimal.

The evolution of competition between FirstGroup and Stagecoach in Manchester is a good example of low barriers to entry for operators in areas covered by the Northern franchise. Figure 2 and Figure 3 below show FirstGroup's and Stagecoach's networks in and around Greater Manchester in October 2009 and April 2015 respectively. FirstGroup's network is shown in purple; Stagecoach's network is shown in orange the areas where the two networks overlap appear in green. Figure 2 and Figure 3 show that over the six-year period:

- Stagecoach has expanded its services extensively across Greater Manchester, particularly in north Manchester. Stagecoach's network now includes Bury and Radcliffe and it provides a much greater number of services in the area around Wigan;
- over the same period First Manchester has also expanded its network into new areas, principally in south Manchester. For example, First Manchester's network now covers Altrincham and Sale and it provides a greater number of services in and around Stockport; and
- despite these expansions, First Manchester's network is now smaller (in a geographic sense) than it was in 2009. In particular, First Manchester no longer provides services in and around the Wigan area, and has exited from a number of services in north Manchester.

Overall, as a result of these changes, there is now a far greater degree of overlap between FirstGroup's and Stagecoach's networks around Manchester today than six years ago. First Manchester has expanded into south Manchester in competition with existing Stagecoach services, while Stagecoach now operates more services in north Manchester, an area that was previously primarily served by First Manchester.

Figure 2. FirstGroup's and Stagecoach's Manchester operations in 2009

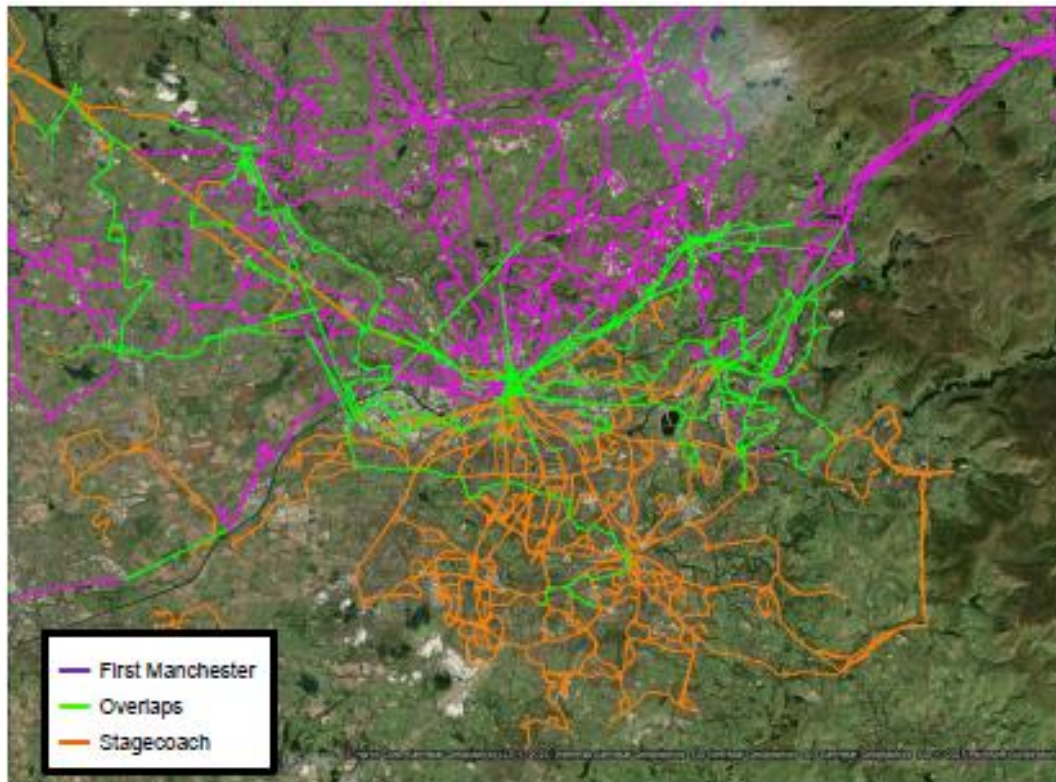
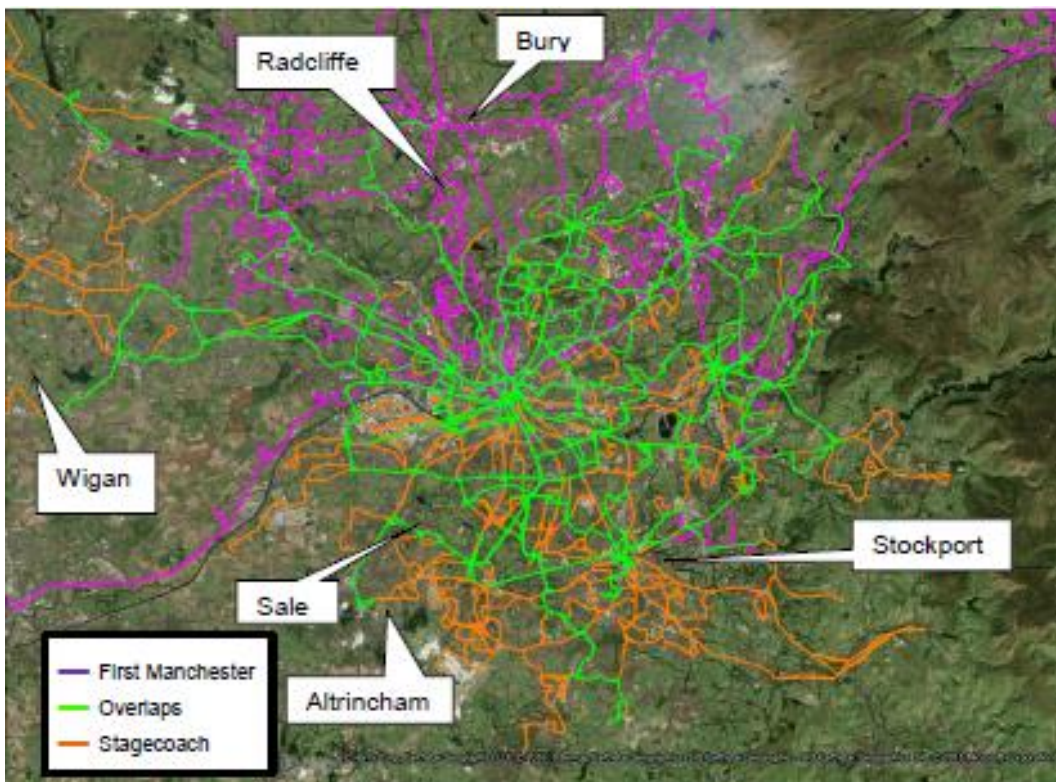


Figure 3. FirstGroup's and Stagecoach's Manchester operations in 2015



Source: Frontier Economics

Note: Based on data from Traveline