Acquisition by Arriva Rail North Limited of the Northern rail franchise

Summary of provisional findings

Notified: 9 September 2016

Background

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

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. This document, together with its appendices, sets out our provisional findings. We are required to produce our report by 3 November 2016.

The rail and bus sectors in Great Britain

4. Franchised train operating companies (franchised TOCs) operate passenger rail franchises and are awarded the right to run specific services within a specified area for a specific period of time, in return for the right to charge fares. Where appropriate, franchised TOCs receive financial support from the franchising authority, which is currently the Rail Group in the Department for

Transport (DfT).[1] There are currently 16 franchises operating in England and Wales and two in Scotland.

5. The rights and obligations of franchised TOCs are specified through a Train Service Requirement (TSR) as part of the franchise agreement negotiated between the franchising authority and the franchisee. The TSR includes obligations on franchised TOCs such as the number of daily calls at stations and the timing of first and last trains. Each franchise has its own specific TSR and the degree of specification by government varies by franchise.

6. Competition 'for' the market, ie for the award of a rail franchise, is currently the principal form of competition in passenger rail services and franchised services cover 99% of passenger rail miles in Great Britain.

7. There is also a degree of competition 'in' the market (known as 'on-rail' competition) on certain parts of the rail network where different franchised TOCs run services on overlapping or parallel routes. The extent of overlapping and parallel franchises has reduced over time.

8. On-rail competition also takes place where open access operators (OAOs) operate passenger rail services on a commercial basis on routes authorised by the Office of Rail and Road (ORR) for a specified time. OAOs compete with franchised TOCs where their services overlap. OAOs currently account for less than 1% of passenger miles in Great Britain.

9. Arriva also operates a wide range of bus services throughout much of the Northern Franchise area. Buses are the most widely used form of public transport in England. There were around 5.2 billion bus journeys made in Great Britain in 2014/15, with over half being in London. This generated a total of £3.3 billion from passenger fares.[2]

10. The provision of local bus services is now largely in private ownership since the industry was deregulated in 1986. The five largest bus operators in England are Stagecoach (19%), Arriva (17%), FirstGroup (13%), Go-Ahead (13%) and National Express (5%). Other large operators of local bus services account for 22% of services in England, with smaller operators accounting for the remaining 12%.[3]

11. Local transport authorities (LTAs) review the network of commercially registered services, identify additional services which they consider to be

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[1] Transport Scotland is the franchising authority for the ScotRail and Caledonian Sleeper franchises. There are also specific arrangements in place for London Overground and Merseyrail.
[2] DfT, *Transport Statistics Great Britain 2015*.
[3] DfT (2014), *Annual bus statistics: England 2013/14*.

socially necessary and then seek providers through a tendering process. Outside London, approximately 20% of bus services are financially supported and tendered by LTAs.

The Parties and the transaction

12. Arriva is part of Deutsche Bahn AG and is one of the largest providers of passenger transport in Europe, operating 2.2 billion passenger journeys per year across 14 European countries.[4] Arriva's revenue in 2015 was €4.8 billion (£3.5 billion).[5] In the UK, Arriva provides passenger rail services (both heavy and light rail), bus services, non-emergency patient transport services and specialist education transport services.

13. Arriva is currently operated through three divisions, each with its own management teams and divisional directors: (a) Arriva UK Trains; (b) Arriva UK Bus; and (c) Mainland Europe.

14. ARN is a wholly-owned subsidiary of Arriva UK Trains Ltd created for the purpose of bidding for, and operating, the Northern Franchise. In addition to operating the Northern Franchise, Arriva UK Trains operates the Arriva Trains Wales (ATW), Chiltern Railway Company Limited (Chiltern Railways) and CrossCountry Trains Limited (CrossCountry) franchises.[6] It also operates open access services through Grand Central Railway.[7]

15. On 9 December 2015, the DfT announced that ARN was the successful bidder for the Northern Franchise. On 22 December 2015, the Secretary of State and ARN entered into a franchise agreement and associated agreements confirming the award of the Northern Franchise to ARN. 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).

16. The franchise agreement associated with the Northern Franchise includes significant improvements in passenger services, including at least 120 new-build carriages for use on non-electrified routes and the modernisation of all remaining Northern Franchise trains, the phasing out of older 'Pacer' units, additional train services, longer trains, investment in stations, the introduction

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[4] Deutsche Bahn AG is 100% owned by the Federal Republic of Germany.
[5] Deutsche Bahn (2015), Integrated Report, p137. All currency conversions from euros are at the average rate for 2015 of €1=£0.72584 (Deutsche Bahn (2015), Integrated Report, p201).
[6] Arriva UK Rail also operates two rail concessions, namely DB Regio Tyne and Wear Metro Limited and London Overground Rail Operations Limited.
[7] Arriva also owns Alliance Rail which has received approval to operate open access passenger rail services between London and Blackpool from December 2017.

of free Wi-Fi and new ‘Northern Connect’ services between a number of northern cities.

Jurisdiction

17. We considered whether a ‘relevant merger situation’ under section 23 of the Act has been created. Section 23 of the Act provides that a relevant merger situation has been created if two or more enterprises have ceased to be distinct and either the ‘turnover test’ or ‘share of supply test’ is satisfied.

18. The award of a rail franchise constitutes an acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993. The Northern Franchise and Arriva have therefore ceased to be distinct.

19. The turnover test in section 23(1)b of the Act is satisfied where the value of the turnover in the UK of the enterprise being taken over exceeds £70 million. The turnover of the Northern Franchise was £568 million in the year ended 3 January 2015.[8]

20. We therefore provisionally concluded that a ‘relevant merger situation’ has been created.

Rationale for Arriva’s bid for the Northern Franchise

21. The Parties told us that Arriva’s rationale for bidding for and acquiring the Northern Franchise was to develop its rail operations in Great Britain and to end a period of relatively unsuccessful franchise bidding. The Parties said that in bidding for the Northern Franchise, Arriva had sought to balance its risk portfolio in its rail business.

22. The Parties also told us that the bid aimed to enhance Arriva’s reputation as an operator of and bidder for franchised rail services, and to deliver value through a much improved travelling environment and customer experience for rail passengers. The Parties said that it was not part of Arriva’s strategy in bidding for the Northern Franchise to benefit from reduced competition on existing rail and bus services overlapping with Northern Franchise rail services.

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[8] Statutory accounts for Northern Rail Limited, 3 January 2015.

Counterfactual

23. We considered what would have been the competitive situation in the absence of the Merger (the counterfactual).

24. The counterfactual in rail franchise cases is normally either that the franchisee raises no competition concerns or that such competition concerns as there are have been remedied. We have not identified any reason to depart from this approach in the present case.

25. In so far as the operation of the Northern Franchise is concerned, we have provisionally concluded that the Merger should be assessed against a counterfactual whereby the Northern Franchise is awarded to a TOC that raises no competition problems.

Market definition

26. The purpose of market definition in a merger inquiry is to provide a framework for the analysis of the competitive effects of the merger. The boundaries of the market do not determine the outcome of the analysis of the competitive effects of the merger.[9]

27. In relation to the geographic market, we note that passengers travel between a specific point of origin to a specific point of destination and, as such, demand is for travel between two points. We describe these journeys as 'flows'.

28. We considered competition between different modes of transport. We considered a reasonable starting point for analysis that, other things being equal, 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.[10]

29. We examined evidence regarding the degree of competition between bus and rail services and between public transport and private transport. We noted that these constraints vary by route and flow and therefore considered the evidence as part of the competitive assessment. As a starting point for the analysis we identified overlaps between the Parties' services and assessed competition between transport options on a flow-by-flow basis. We identified overlapping rail services where journeys were provided between the same two settlements. We identified bus and rail overlaps where the catchment

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[9] *Merger Assessment Guidelines*, paragraph 5.2.2.
[10] This could, for example, be because services of the same mode of transport are more likely to offer a similar set of generalised journey costs (GJC).

area of a bus (rail) service contains rail (bus) stations (stops). We used data from the DfT's National Travel Survey to estimate the relevant catchment area.

30. We also considered the possible effects of the Merger on competition on routes as well as flows as certain aspects of the offer to both bus and rail passengers are set at the route rather than flow level.

Competitive assessment

Competition for the award of rail franchises

31. We considered whether the Merger would reduce competition for the award of future rail franchises.

32. Competition for the market, ie the competition for the award of future rail franchises, could be affected by the Merger if it could lead to a reduction in the number of bidders available for future rail franchise tenders or provide the Parties with an incumbency advantage to other bidders in future bids for franchises.

33. We found that the rail franchise tendering process is designed to minimise incumbency advantages such that bidders are not expected to enjoy significant incumbency or scale advantages as a result of previous franchise bids or awards. We reviewed the identity of successful bidders in previous franchise awards, which suggested that incumbency advantages were not material. We found no evidence that the Merger would reduce the number of bidders for rail franchises.

34. We therefore provisionally concluded that the Merger has not resulted or may not be expected to result in an SLC for the award of rail franchises.

Regulatory constraints on rail and bus operators

35. We considered the extent to which the regulatory framework constrains the commercial behaviour of TOCs.

36. In relation to rail fares, we provisionally found that the Parties do not have the ability to flex regulated fares under the current policy framework. We also examined the extent to which regulated fares constrain unregulated fares and found that regulated fares may act as a constraint on some unregulated fares in some instances. We considered the constraint that regulated fares impose on unregulated fares on a flow-by-flow basis as the mix of regulated and unregulated fares available to passengers varies by flow.

37. In relation to non-price aspects of the rail services, such as service quality, frequency and operational performance, we considered the extent to which TSRs and other obligations constrain the ability of franchised TOCs to adjust their offering. We found that the Parties have limited ability to change non-price aspects of their franchised rail services, including in relation to timetables, rolling stock and service quality.[11]

38. We also considered the extent to which the Parties' commercial behaviour is constrained by the regulation of local bus services. Commercial bus services are subject to relatively few regulatory constraints compared to rail services. The existence of partnership schemes with LTAs, or the potential for such schemes to be introduced, may impose some constraint on the Parties' commercial behaviour, although the constraint will depend on the nature of the schemes in place in different geographic areas. We also note that the Bus Services Bill intends to enhance the powers of LTAs.

39. Bus operators may be constrained by the need to maintain a good reputation with local LTAs and passenger transport executives (PTEs).

40. We took these regulatory factors into account, where relevant, in our competitive assessment.

Filters applied to overlapping flows

41. The Merger creates 167 overlaps between the Northern Franchise and other Arriva TOCs and creates 1,068 overlaps between the Northern Franchise and Arriva UK Bus services. We therefore applied a series of filters for prioritisation purposes in order to focus our analysis on the flows most likely to raise competition concerns.

The effect of the merger on overlapping rail flows

42. We examined whether the Merger would result in an increase in fares on rail flows where services operated by the Northern Franchise overlap with services operated by other Arriva TOCs, namely ATW, CrossCountry and Grand Central.

43. We considered 19 overlapping flows that remained following the application of filters and four additional flows on which internal documents suggested there

[11] We note that the Parties have greater ability to change non-price aspects of their open access services, such as service quality, although track access agreements restrict the timetables of open access services and the rolling stock used.

was pre-Merger competition between Arriva TOCs and Northern Rail (the previous operator of the Northern Franchise).

44. In our initial assessment of these 23 flows, we used the MOIRA industry model to test the closeness of competition between rail services on overlapping flows.

45. We identified 11 flows for further examination where the MOIRA analysis suggested that third party TOCs were not likely to be good alternatives for passengers to Northern Franchise services.

46. In our detailed assessment of these 11 flows, we considered:

(a) the share of services and revenues on the flow held by the Parties and third party TOCs;

(b) the similarity of Northern Franchise and other Arriva and third party TOC services in terms of frequency, hours of operation, journey times and fares;

(c) evidence of pre-Merger competition on fares; and

(d) other constraints on the Parties' ability to increase fares post-Merger, such as fare regulation and the level of flow revenue.

47. We also considered whether entry and expansion would be timely, likely and sufficient to constrain the Parties' commercial behaviour post-Merger.

48. We provisionally concluded that barriers to entry and expansion are high in relation to passenger rail services due to the limited spare capacity on the network and the regulation of track access.

49. Following our detailed assessment of the 11 flows, we provisionally concluded that the Merger has resulted in or may be expected to result in an SLC on four rail flows:

(a) Leeds to Sheffield;

(b) Wakefield to Sheffield;

(c) Chester to Manchester; and

(d) Chester to Stockport.

The effect of the merger on overlapping bus and rail flows

50. We examined whether the Merger may result in an increase in fares and/or a degradation in non-price aspects of the Parties' bus and rail services (such as service quality and frequency) in local areas where Arriva's bus services overlap with the Northern Franchise.

51. We focused our assessment on the competitive effects of the Merger on Arriva's bus fares and services as franchise specification limits the Parties' ability to change non-price aspects of their rail services and fare regulation limits the Parties' ability to adjust certain rail fares in response to competition from bus services.

52. We examined the competitive effects of the Merger on 89 overlapping bus and rail flows prioritised through filtering. We also examined five further bus routes that were surveyed by the Parties.

53. We examined the Parties' ability to increase fares or degrade bus services on overlapping bus and rail flows as a result of the Merger. The Parties told us that their commercial behaviour was constrained by the need to maintain graduated fare structures on routes, the price of Arriva area tickets and multi-operator tickets and by partnerships between Arriva and local authorities. We considered these potential constraints, where relevant, on a flow-by-flow basis.

54. We examined the Parties' incentives to raise bus fares or degrade bus services post-Merger. In our assessment of overlapping flows, we considered a number of factors including:

    (a) the proportion of route revenue accounted for by a flow on which Arriva bus services and Northern Franchise services overlap;

    (b) the closeness of competition between bus and rail services pre-Merger;

    (c) the extent of competition from other bus and rail operators; and

    (d) local geographic factors or market conditions that might affect competition between bus and rail services on individual flows.

55. We noted that, in contrast to fare changes (which may be implemented through, for example, changes to fare stages), any changes to Arriva's service quality and frequency on a flow would necessitate changes at the route level. We therefore provisionally concluded that a flow would have to account for a significant proportion of a route in order for Arriva to have an incentive to degrade bus services on a flow.

56. The Parties commissioned a survey of bus passengers on 18 flows that they identified through their own filtering process. We monitored the survey fieldwork and identified a number of issues with the conduct of the survey. We also identified a number of methodological issues in the design of the survey. We therefore considered the results of the survey 'in the round' with other evidence at an aggregate, rather than flow-specific, level.

57. The Parties told us that, under its current organisational structure, Arriva saw no potential advantage in coordinating strategy between its bus and rail divisions, and in any event was not set up to do so with each train and bus operating company having its own board and management structures, [✂]. However, we noted that Arriva is a commercial organisation and therefore has incentives to ensure that it profit maximises post-Merger, which may include facilitating a degree of coordination between its bus and rail services post-Merger.

58. We examined barriers to entry and expansion in relation to bus services. We provisionally concluded that whilst *de novo* entry by new operators is unlikely to be timely, likely and sufficient to constrain the Parties' commercial behaviour, expansion by existing operators may act as a competitive constraint in certain areas, particularly where existing operators have a sizeable presence in the local area.

59. We found that the likelihood of entry or expansion by existing bus operators may vary according to local competitive conditions. We therefore considered the level of barriers to entry and expansion on a flow-by-flow basis as part of the competitive assessment.

60. Following our detailed assessment of the overlapping flows, we provisionally concluded that the Merger has resulted in or may be expected to result in an SLC on the following routes:

(a) routes 3, X3/X3A and X4 in the Redcar area;

(b) routes 83 and 84 in the Huddersfield area;

(c) routes X14, X15 and X18 in the Ashington area; and

(d) route 12 in the Darlington area.

The effect of the merger on transport networks

61. Some passengers purchase network tickets rather than route or flow-specific tickets. For these passengers, the relevant market may be the network rather than the route or flow. On the supply side, bus operators organise their

services around hubs and depots and may switch their services to or from the overlapping bus and rail flows and routes. We therefore considered the effect of the Merger on transport networks.

62. We found that bus and rail network tickets in the Northern Franchise area serve different market segments and that most passengers are unlikely to substitute between them. We also found that the wide availability of alternative bus network tickets offered by Arriva's competitors are likely to exert a competitive constraint on Arriva post-Merger and restrict its ability and incentive to flex its commercial offer on bus network tickets.

63. We therefore provisionally concluded that the Merger has not resulted or may not be expected to result in an SLC in relation to transport networks.

Provisional conclusion

64. The Merger creates 167 overlaps between the Northern Franchise and other Arriva TOCs and 1,068 overlaps between the Northern Franchise and Arriva UK Bus services.

65. As a result of our assessment, we provisionally concluded that:

(a) the award of the Northern Franchise to ARN has created a relevant merger situation;

(b) the creation of that situation has not resulted in or may not be expected to result in an SLC for the award of rail franchises;

(c) the creation of that situation has not resulted in or may not be expected to result in an SLC in relation to transport networks;

(d) the creation of that situation has resulted in or may be expected to result in an SLC on the following overlapping rail flows:

(i) Leeds to Sheffield;

(ii) Wakefield to Sheffield;

(iii) Chester to Manchester; and

(iv) Chester to Stockport.

(e) the creation of that situation has resulted in or may be expected to result in an SLC on the following overlapping bus and rail routes:

(i) routes 3, X3/X3A and X4 in the Redcar area;

(ii) routes 83 and 84 in the Huddersfield area;

(iii) routes X14, X15 and X18 in the Ashington area; and

(iv) route 12 in the Darlington area.