Anticipated acquisition by First MTR South Western Trains Limited of the South Western Franchise

Decision on relevant merger situation and substantial lessening of competition

ME/6664/16

The CMA's decision on reference under section 33(1) of the Enterprise Act 2002 given on 11 July 2017. Full text of the decision published on 24 July 2017.

Please note that [✂] indicates figures or text which have been deleted or replaced in ranges at the request of the parties for reasons of commercial confidentiality.

SUMMARY

1. On 27 March 2017, the Department for Transport (**DfT**) announced that First MTR South Western Trains Limited (**FMSWTL**), a joint venture between FirstGroup plc (**First**) and MTR Corporation (**MTR** and together with First, the **Parties**), was the successful bidder for the South Western Franchise. DfT and FMSWTL entered a franchise agreement and associated agreements confirming the award of the South Western Franchise to FMSWTL (the **Franchise Award**). The South Western Franchise is due to commence on 20 August 2017 for an initial term of seven years, expiring on 18 August 2024 (subject to a possible extension of 11 reporting periods[1]).

2. The Competition and Markets Authority (**CMA**) believes that it is or may be the case that the Parties' enterprises have ceased to be distinct. The UK turnover of the South Western Franchise exceeds £70 million, so the turnover test in section 23(1)(b) of the Act is satisfied. The CMA therefore believes that it is or may be the case that a relevant merger situation has been created.

3. The Franchise Award also meets the thresholds under Council Regulation (EC) 139/2004 (the **EU Merger Regulation**) for review by the EU

[1] 44 weeks.

Commission (the **Commission**). On 5 May 2017, the Commission announced its decision to refer the Franchise Award to the CMA for review. The preliminary assessment period for consideration of the Franchise Award under section 34A(2) of the Act started on 5 May 2017. The statutory 45 working day deadline for a decision is 13 July 2017.

4. The Parties will operate public transport services that overlap with the services provided by the South Western Franchise. These include First's rail services on the Great Western Railways Franchise (**GWR**) and its bus operations from various depots in the south west of England. In line with its previous decisional practice, most recently in relation to the acquisition by Arriva of the Northern Rail Franchise (***Arriva / Northern***),[2] the CMA considered public transport as a separate product market to private transport, and considered as the geographic frame of reference the flows on which the Parties' existing rail and bus operations overlap with the rail services on the awarded franchise.

5. The CMA has therefore assessed the impact of the Franchise Award on the operation of public transport services, in relation to all flows where the South Western Franchise services overlap with those of the Parties, on the basis that they are:

   (a) flows between the same two rail stations;

   (b) flows between two rail stations which serve the same urban settlement;[3] or

   (c) flows where the origin/destination bus stop is not more than 1,200 metres from the origin/destination train station.

6. The CMA reviewed 112 rail-on-rail overlaps and 246 bus-on-rail overlaps. The CMA believes there is no realistic prospect of a substantial lessening of competition (SLC) in relation to 111 rail-on-rail overlaps and all bus-on-rail overlaps. However, the CMA believes that the Franchise Award does give rise to a realistic prospect of an SLC as a result of horizontal unilateral effects on the London to Exeter rail-on-rail services overlap.

7. The CMA considers that the closeness of competition between the overlapping rail services, the absence of other rail competitors on the flow, the fact that the Parties have both the ability and incentive to raise fares, and the absence of material constraints from other modes of transport indicate that

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[2] *Arriva Rail North and the Northern rail franchise: A report on the completed acquisition by Arriva Rail North Limited of the Northern rail franchise* (***Arriva / Northern***), paragraphs 6.16-6.26.
[3] Journeys between the same two settlements, even where different stations in the same settlement are used.

the Franchise Award gives rise to a realistic prospect of an SLC on the London to Exeter flow.

8. The CMA is therefore considering whether to accept undertakings under section 73 of the Enterprise Act 2002 (**the Act**). The Parties have until 18 July 2017 to offer an undertaking to the CMA that might be accepted by the CMA. If no such undertaking is offered, then the CMA will refer the Franchise Award pursuant to sections 33(1) and 34ZA(2) of the Act.

ASSESSMENT

Parties

9. The Franchise Award relates to the award of the South Western Franchise to FMSWTL, a joint venture between First and MTR.

10. First is a public limited company listed on the London Stock Exchange. It operates public transport services in Europe (primarily in the UK), India, and North and Latin America. Of relevance in this case, First's rail and bus operations include:

    - the Great Western Franchise, operated by First Greater Western Limited, now trading as GWR; and
    - bus operations in the West of England, Hampshire, Dorset and Berkshire.

11. In the year to 31 March 2016, First's revenues were £5,218 million worldwide and £2,179 million in the UK.

12. MTR is a company listed on the Hong Kong Stock Exchange. In the UK, MTR operates the Liverpool Street to Shenfield rail service under the name TfL Rail. This service will form part of the Elizabeth Line (Crossrail), which opens fully in December 2019, with MTR operating services between Reading and London. In the 2016 calendar year, MTR's revenues were HKD [✂] billion (approximately £[✂]billion) worldwide and HKD [✂] (approximately £[✂] million) in the UK.

13. The South Western Franchise serves routes between London Waterloo, the southwest of London and towns and cities in the south and west of the UK. The predecessor South Western rail franchise (operated by Stagecoach) generated revenues of £1,066 million in the year ending 2 May 2015.

Transaction

14. Pursuant to the Franchise Award, FMSWTL will come to operate and control the South Western Franchise. First has a 70% stake in FMSWTL, while MTR has a 30% stake.

15. FMSWTL's operation of the South Western Franchise will commence on 20 August 2017.

Jurisdiction

16. The Franchise Award constitutes the acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993. FMSWTL and the South Western Franchise will therefore cease to be distinct.

17. The UK turnover of the South Western Franchise exceeds £70 million, so the turnover test in section 23(1)(b) of the Act is satisfied. The CMA therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

18. As noted in paragraph 3, The Franchise Award meets the thresholds under the EU Merger Regulation for review by the Commission. The Parties submitted a reasoned submission to the Commission on 27 March 2017 requesting pre-notification referral to the CMA under Article 4(4) of the EU Merger Regulation. The CMA informed the Commission that it agreed with the referral request and considered the Franchise Award capable of being reviewed in the United Kingdom under the Act. On 5 May 2017, the Commission announced its decision to refer the Franchise Award to the CMA for review.[4]

19. Under the joint venture agreement (**JVA**), MTR will hold one board seat and will have a [certain material veto rights]. In agreeing to the referral request, the Commission confirmed that MTR has joint control over the South Western Franchise within the meaning of Article 3(1)(b) of the EU Merger Regulation. From December 2019, MTR will also operate rail services as part of the Crossrail concession between Reading and London. However, the CMA has previously found MTR will not exercise control over the Crossrail concession and will not benefit from increased passenger numbers using Crossrail.[5] This overlap is therefore not considered further in this Decision.

[4] European Commission Decision: Case M.8441 - *FirstGroup / MTR corporation / South Western Rail Franchise,* 5 May 2017.
[5] *Acquisition by MTR Corporation (Crossrail) Limited of the Crossrail Concession*, paragraph 20.

20. The preliminary assessment period for consideration of the Franchise Award under section 34A(2) of the Act started on 5 May 2017. The statutory 45 working day deadline for a decision is 13 July 2017. The Franchise Award was considered at a Case Review Meeting.[6]

Counterfactual

21. The CMA assesses a merger's impact relative to the situation that would prevail absent the merger (ie the counterfactual). In rail franchises, the pre-merger situation cannot be the appropriate counterfactual, as the existing rail franchise is coming to an end and a new franchise must be awarded to one of the short-listed bidders. The CMA therefore treats the appropriate counterfactual as the award of the franchise to a train operating company (**TOC**) that raises no competition concerns or where any concerns could be remedied through undertakings in lieu (**UILs**) of a reference to Phase II.[7] Accordingly, the CMA believes it appropriate at this stage to assess the Franchise Award against a counterfactual whereby the South Western Franchise is awarded to a TOC raising no competition concerns or with any competition concerns being remedied through UILs.

Frame of reference

22. Market definition provides a framework for assessing the competitive effects of a merger and involves an element of judgement. The boundaries of the market do not determine the outcome of the analysis of the competitive effects of the merger, as it is recognised that there can be constraints on merger parties from outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others. The CMA will take these factors into account in its competitive assessment.[8]

23. The Parties operate public transport services that overlap with the services provided by the South Western Franchise. These include First's GWR rail services and its bus operations.

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[6] See *Mergers: Guidance on the CMA's jurisdiction and procedure* (CMA2), January 2014, from paragraph 7.34.
[7] *Merger Assessment Guidelines*, section 4.3.
[8] *Merger Assessment Guidelines*, paragraph 5.2.2.

Product scope

Competition for the market

24. In line with previous decisional practice, most recently *Arriva / Northern*,[9] the CMA considers that the relevant frame of reference for competition for the market is the award of rail franchises.

Competition in the market

25. In previous decisional practice, most recently *Arriva / Northern*, the CMA considered public transport as a separate product market to private transport. The Parties submitted that the constraint from all modes of transport, including the private car, should be taken into account in the CMA's assessment of competition on the overlapping flows.

26. The CMA has not received any evidence to suggest that a departure from its previous decisional practice would be appropriate in the present case.

27. The CMA has therefore adopted as the frame of reference the provision of all public transport services on a particular flow.

Geographic scope

Competition for the market

28. Rail franchises are awarded across the UK. In line with previous decisional practice, the CMA therefore considers that the appropriate geographic frame of reference for competition for the market is national.

Competition in the market

29. Passengers travel between a specific point of origin and a specific point of destination, described as a 'flow'. In previous decisional practice, the CMA adopted as the geographic frame of reference the flow on which the Parties' existing rail and bus operations overlap with the rail services on the awarded franchise.

30. In identifying overlaps between bus and rail services in *Arriva / Northern*, the CMA used a 1,200-metre catchment (based on walking distance and centred on the rail station). This catchment area was determined using data from

[9] *Arriva / Northern*, paragraphs 6.4-6.7.

NTS[10] on walking distances, which were used to determine the distribution of passengers' walking distances to rail stations in the area of the Northern Franchise.

31. To test whether the 1,200-metre catchment area around rail stations was still appropriate in the area of the South Western Franchise, the CMA performed the same analysis conducted in *Arriva / Northern* and determined the distribution of passengers' walking distances to bus and rail station in the area of the South Western Franchise. Results were in line with the findings of the *Arriva / Northern* investigation. As such, the CMA considered appropriate for this investigation a 1,200-metre catchment (based on walking distance).

32. The Parties submitted that a 1,200-metre catchment for bus-on-rail overlaps was likely to overestimate the distance passengers would be willing to walk between a bus stop and rail station, particularly given the highly-urbanised areas in which many of the flows operated. The Parties also submitted that the *Arriva / Northern* catchment area was not appropriate in the present case because the walking distances for shorter rail journeys were smaller. They said that since the bus routes being considered are each less than nine miles in total distance, a corresponding narrower 800-metre catchment was more appropriate.

33. The results of the competitive assessment on bus-on-rail overlaps did not differ based on 1,200-metre or 800-metre catchments and therefore it has not been necessary for the CMA to conclude on whether a narrower 800-metre (or other narrower) catchment area is a closer reflection of the competitive reality. For consistency and on a cautious Phase I basis therefore, the CMA has used the 1,200-metre catchment area adopted in *Arriva / Northern*.

34. The Parties also submitted that assessing a flow in isolation from its route did not accurately reflect competitive conditions, as price or quality changes on an overlapping flow would have knock-on implications for other flows on the bus or rail route. The CMA has also previously acknowledged that certain aspects of the offer to both bus and rail passengers are set at the route rather than flow level. The CMA therefore assesses the possible effects on competition of the Franchise Award on routes as well as flows.

[10] NTS is a national survey run by the DfT. The NTS includes face-to-face interviews and asks respondents to complete a weekly travel diary, providing details of all trips carried out during the survey week. The NTS collects information on how, why, when and where people travel as well as factors affecting travel. It asks respondents to identify journeys they have made, including those using multiple modes. This includes information on journeys preceding or following a bus or rail journey. Therefore, the NTS is useful in identifying the appropriate catchment areas for bus and rail stations.

Conclusion on frame of reference

35. For the reasons set out above, the CMA has considered the impact of the Franchise Award in relation to public transport operators on all flows that overlap with the South Western Franchise services, on the basis that they are:

    (a) flows between the same two rail stations;

    (b) flows between two rail stations which serve the same urban settlement, even where different stations in the same settlement are used; or

    (c) flows where the origin/destination bus stop is not more than 1,200 metres from the origin/destination train station.

Competitive assessment

Competition for the market

36. The CMA considers that competition for the market could be affected by the Franchise Award if it could lead to a reduction in the number of bidders available for future rail franchise bids, or provide the Parties with an incumbency advantage relative to other bidders in future bids for franchises.

37. The Parties submitted that the award of the South Western Franchise will have no impact on competition for the award of future franchises, on the basis that:

    (a) the award of the South Western Franchise to FMSWTL would not reduce the number of bidders for future franchises;

    (b) the Parties would not obtain incumbency advantages for future franchises through the acquisition of the South Western Franchise; and

    (c) the combined share of franchises and the increment obtained through the South Western Franchise are not significant, with the Parties estimating a combined share of [20-30]%, with an increment of [10-20]%.

38. No third parties raised concerns about the impact of the Franchise Award on competition for the market.

39. The CMA therefore believes that there is no realistic prospect of an SLC with respect to competition for the market for rail franchises as a result of the Franchise Award.

Competition in the market

Horizontal unilateral effects

40. Horizontal unilateral effects may arise when one firm merges with a competitor that previously provided a competitive constraint, allowing the merged firm profitably to raise prices or degrade quality on its own and without needing to coordinate with its rivals.[11] Horizontal unilateral effects are more likely when the merger parties are close competitors.

41. The CMA assessed whether it is or may be the case that the Franchise Award has resulted, or may be expected to result, in an SLC in relation to unilateral horizontal effects in relation to the rail-on-rail overlaps and the bus-on-rail overlaps set out in paragraph 35 above. The CMA's analysis with respect to each is set out in turn below. The CMA has carried out a granular analysis of each overlap rather than focusing on the overall level of overlap (which is relatively high in terms of the proportion of the South Western Franchise's revenues on overlapping routes and flows). This is because as demonstrated by the CMA's previous reviews of rail franchise awards, the potential detrimental effects of any reduction in competition can be very localised for passengers.

Rail-on-rail overlaps

42. The concern under this theory of harm is that the common ownership of overlapping rail services could give the Parties or First the ability and incentive to increase fares and/or reduce non-price aspects of rail services (such as service quality, frequency and operational performance) on the overlapping rail flows on their respective franchises. This is on the basis that, after the Franchise Award, it would be less costly for the Parties or First to raise prices (or lower quality) because it would recoup profit on recaptured sales from customers who would have switched to the overlapping rail service.

43. The below discussion focuses on fare-related theories of harm. However, there are non-fare aspects of a flow or route that might be important in the assessment of the merger effects. There are in principle various aspects of rail quality that could be varied (to reduce costs), such as service frequency or the quality of rolling stock. However, it is in most cases difficult to vary quality on an individual flow without affecting the entire route, and most rail-on-rail overlaps only take up a subset of the route; therefore, the incentive to vary quality is reduced. Secondly, in *Arriva / Northern* the CMA found that the

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

franchise contract restricted the ability of the TOC to adjust service quality considerably.[12] Because of the strongly regulated quality, the CMA decided that a service quality-specific theory of harm was unlikely.

Bus-on-rail overlaps

44. The CMA also considered whether common ownership of overlapping bus and rail services could give First the ability and incentive to increase fares and/or reduce non-price aspects of bus services (such as service quality, frequency or operational performance) on the overlapping bus flows. This is on the basis that, after the Franchise Award, it would be less costly for First to raise prices (or lower quality) because it would recoup profit on recaptured sales from customers who would switch to the overlapping rail service.

45. As noted in *Arriva / Northern*,[13] commercial bus services are subject to relatively few regulatory constraints compared to rail services. Fares on bus services are unregulated, although multi-operator tickets may constrain the level of individual operator bus fares. In contrast to fare changes (which may be implemented through, for example, changes to fare stages), changes to service quality and frequency on a flow are more likely to necessitate changes at the route level. The CMA therefore concluded that a flow would have to account for a significant proportion of a route for First to have an incentive to degrade non-price aspects of a services on a flow.[14]

Framework for assessment

46. The focus of the CMA's assessment is on whether the Franchise Award may result in horizontal unilateral effects in relation to flows on which the South Western Franchise overlaps with First's rail and bus operations.

47. Using the parameters set out in paragraph 35 above, the Parties identified 112 rail-on-rail overlaps and 246 bus-on-rail overlaps. In line with previous decisional practice, the CMA undertook a filtering methodology to exclude from further analysis overlapping flows on which no competition concerns would arise. In this case, the CMA largely adopted the filters used in *Arriva /*

[12] In *Arriva / Northern*, the CMA analysed parts of the Franchise Agreement and discussed issues around quality and the franchise agreement with DfT before coming to the above conclusion: paragraphs 8.35-8.50.
[13] For further details, see paragraphs 8.86-8.92 of the final decision.
[14] In *Arriva / Northern* (paragraph 8.88), the CMA noted that the requirement to notify changes to bus routes to the Traffic Commissioner is unlikely to constrain such behaviour. Operational performance targets may limit the range of actions that the Parties might undertake in response to commercial changes, although the Parties would retain the ability to change their bus timetables on commercial services.

Northern, with a number of minor changes outlined below.[15] The filters (which are based on *Arriva / Northern* unless noted otherwise) are:

(a) In relation to rail-on-rail overlaps:

(i) Filter 1: *Small flows*[16] - Flows where either the South Western Franchise or GWR generated annual revenues of below £20,000 were excluded on the grounds that there was no realistic prospect that competition concerns would arise. The CMA has raised the threshold from £10,000 used in *Arriva / Northern* to £20,000. After reviewing that case and finding that both there and in the present case there is no realistic prospect of an SLC on flows below £20,000, the CMA believes it is appropriate to filter them at an early stage to reduce the number of flows requiring further data collection and assessment.

(ii) Filter 2: *Effective competitor* - Flows where third party TOCs had a share of at least 50% of passenger revenue on the flow were excluded, as there is no realistic prospect that the Parties would have the incentive to increase fares or worsen non-price factors if passengers have alternative rail operators to which they may divert in the event of a fare increase or degradation of the Parties' rail services. This removed two further flows.

(iii) Filter 3: *Inter-available and regulated fares* – The CMA filtered for flows for which (i) fully inter-available fares[17] accounted for 100% of the sum of both TOCs' revenues, and also (ii) regulated fares[18]

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[15] See *Arriva / Northern* for further details on the filtering approach, Chapter 9.

[16] This filter was called the '*de minimis*' filter in *Arriva / Northern* (paragraph 9.5-9.10), but 'small flows' is used here to avoid confusion with the *de minimis* exception to the duty to refer at Phase I.

[17] As in *Arriva / Northern* (paragraph 10.7), the CMA distinguished between two different types of inter-available fares (fully inter-available fares and routed inter-available fares) as well as dedicated fares. The definitions used were:

a) Fully inter-available fares; a fare is fully inter-available if, on a flow, a passenger is allowed to travel on any Train Operating Company (TOC) on any permitted route. These fares are set by the lead operator on the flow.
b) Routed inter-available fare; a fare is routed if, on a flow, a passenger is allowed to travel on any TOC on a specific route. For example, on the flow from A to B, it is possible to go on a direct route or indirect route via C. The routed fare would specify that a passenger has to travel via C, but on any TOC that services the route via C.
c) Dedicated fares; those fares are specific to a TOC. For example, on the flow from A to B, a passenger can only use the TOC issuing the dedicated fare.

Routed inter-available fares can be treated similarly to fully inter-available fares if the overlapping services run on the same route; if they do not, routed inter-available fares can be treated as dedicated fares.

[18] Rail franchises are subject to fare regulation which sets the maximum price that franchised TOCs can charge for certain fares. Regulated fares are set by a formula based on the RPI figure for the previous July. Only certain fares are regulated, but at least one fare available on each flow is generally regulated. All other fares are set commercially by train operators. The CMA acknowledges that, in some circumstances, unregulated fares are constrained by the level of regulated fares. However, the CMA also noted that other unregulated fares, particularly dedicated fares, super-off peak fares and day returns are often priced much below the level of the corresponding regulated fares, thus giving the Parties and First the ability to raise fares. The CMA has

accounted for more than 80% of the sum of both TOCs revenues. Although no flows were excluded using this filter, the CMA noted that on many flows, inter-available fare revenues accounted for a large proportion of GWR and the South Western Franchise revenues, (on average, approximately [90-100]%), although the percentage of regulated fare revenues was only around [50-60]%. As such, as part of its competitive assessment, the CMA has considered in detail whether the level of inter-available fares on the remaining overlapping flows, despite not being high enough to pass the filter, was an indicator of the level of competition between the South Western Franchise and GWR on the overlapping flows pre-award of the Franchise.

(b) In relation to bus-on-rail overlaps:

(i) Filter 1: *Significance of overlap* - The CMA excluded flows where the revenue derived from First's bus service on overlapping flows accounts for less than 10% of the overall bus route revenue. The CMA believes that the Parties are likely to have greater incentives to flex fares or service quality following the Franchise Award if the overlapping flows on the route account for a significant proportion of route revenue. This excluded 44 flows.

(ii) Filter 2: *Small bus flows plus* – The CMA excluded flows with individual bus revenue below £20,000 on the grounds that there is no realistic prospect that competition concerns will arise. The CMA has increased the threshold from £10,000 used in *Arriva / Northern* to £20,000, for the same reasons as the equivalent rail-on-rail filter. Such flows were excluded only if the Parties' combined revenue share for the overlapping flow is below 10% of the bus route revenue (to avoid excluding routes where the combined revenues of flows below £20,000 of annual revenue is high). This removed 52 flows.

(iii) Filter 3: *Small rail flows* – The CMA excluded flows on which the South Western Franchise revenue on a flow is below £20,000. The CMA has increased the threshold from £10,000 used in *Arriva / Northern* to £20,000, as for the corresponding filters above, on the grounds that there is no realistic prospect that competition concerns will arise. This removed 82 flows.

considered on a flow-by-flow basis in the competitive assessment the extent to which unregulated fares are constrained by the level of regulated fares.

(iv) Filter 4: *Revenue increment* – The CMA excluded flows where the increment to the Parties' revenue from the award of the Franchise is 5% or less (comparing revenues from the South Western Franchise rail flows to First's pre-award bus and rail revenue). The CMA believes that where the award of the South Western Franchise does not materially change First's share of bus and rail services on overlapping bus-on-rail flows, competition issues are less likely to arise as there is no realistic prospect that the incentives to increase fares or reduce service quality will change significantly. This removed 4 flows.

(v) Filter 5: *Effective competitor* – The CMA excluded flows where third party bus operators offer at least 50% of the frequency of First's service at peak times.[19] This is because First's incentives to increase fares or reduce service quality will be diluted if a significant proportion of passengers have alternative operators to which they can switch in the event of degradation of First's offer, and the CMA has generally considered transport providers within the same mode to be the closest competitors. This removed 16 flows.

48. Following the application of these filters*,* 38 rail-on-rail overlaps and 48 bus-on-rail overlaps remained for further assessment. The CMA then undertook an initial assessment of the remaining flows looking at certain factors, the presence of which the CMA considered would mean that there was no realistic prospect that competition concerns would arise on these flows. These factors were:

(a) Where information gathered during the filtering process indicated that a flow would not raise competition issues. This included where the flows had very different frequencies (less than daily), where a bus service was tendered or is a school bus service, or where the flow narrowly missed more than one filter but the combination of results from the filtering analysis was sufficient to judge that there is no realistic prospect of competition concerns arising;

(b) An assessment of closeness of pre-award competition which involved calculation of Generalised Journey Cost (GJC) to compare services on the basis of frequency, journey time and fares[20]. Furthermore, for rail-on-

[19] Where multiple bus services from the same bus company were operating on the same flow, the CMA combined the frequency of those buses and applied the filter.
[20] The GJC is a measure of the overall cost of a journey and is made up of a number of component costs including fares, journey time and frequency. Consistent with Arriva/Northern, the CMA adopted a threshold of 25%, above which the CMA consider that rail services of GWR and the South Western Franchise are less likely to be close competitors.

rail overlaps, this step involved analysis of whether dedicated fares on the flows were constraining current and future behaviour of the Parties;

(c) On rail-on-rail flows where GWR (operated by First) was competing with South Western (operated by Stagecoach pre-merger) and revenue from dedicated fares was small but revenue from unregulated fares was large, the CMA was able to use internal documents from both GWR and Stagecoach to examine whether the limited use of dedicated fares was constraining inter-available fares, and whether either had considered introducing more extensive dedicated fares. These documents suggested that dedicated fares did not play an important role in competition on those flows; and

(d) As assessment of the Parties' ability and incentive to increase fares and/or degrade quality, which involved:

(i) for rail-on-rail overlaps, calculation of the 'headroom' between unregulated and regulated fares (which would act as a constraint to any potential fare rise) and the upper limit revenue gain for the Parties from increasing unregulated fares to this headroom limit; and

(ii) for bus-on-rail overlaps, calculation of the 'headroom' between current bus fares and single or multi-operator zonal tickets (which would act as a constraint to any potential fare rise)[21] and the upper limit revenue gain for the Parties from increasing current fares to this headroom limit.

49. After these steps, seven rail-on-rail overlaps and 33 bus-on-rail overlaps routes remained for further assessment. The CMA then undertook an "in the round" assessment of the remaining flows taking account of all previous analysis.

50. Following this more detailed assessment of the remaining flows, only one rail-on-rail overlap and 29 bus-on-rail overlaps (across four bus routes) continued to raise competition concerns and were considered in more depth. These are:

(a) the flow between London and Exeter, on which the South Western Franchise overlaps with First's existing GWR services; and

(b) a number of flows on Routes 3, X4, 6 and 10, on which the South Western Franchise overlaps with First's existing bus operations.

[21] Zonal fares are fares which are set based upon how many 'zones' a passenger travels through, as opposed to being specific to the point of origin and destination.

Rail-on-rail overlap: London to Exeter flow

51. The London to Exeter flow is an important and significant flow which connects travellers between London and the South West of England, with 480,782 journeys taken on the flow in the 2015/16 financial year. Due to its location, the flow is important for travellers to popular holiday destinations in the South West, as well as students at Exeter University. The revenues on the flow are significant, and in the 2015/16 financial year the total revenue for all operators was £[✂].

52. In order to assess the likelihood of the Franchise Award resulting in unilateral effects on the London to Exeter flow, the CMA has considered the following factors:

    (a) the Parties' share of services and revenues on the flow;

    (b) the closeness of pre-Franchise Award competition;

    (c) the Parties' ability to increase fares;

    (d) the Parties' incentive to increase fares; and

    (e) competition from other transport services.

Shares of supply

53. Following the Franchise Award, the Parties will operate 100% of rail services on this flow. Further, the increment to First's share of rail services on this flow is significant: [10-20]% by revenue and [20-30]% by number of journeys.

54. Where all public transport is considered, the CMA estimated that rail services (ie the combined market share) would account for 53.7% of average daily passengers (GWR: [40-50]%; South Western Franchise:[10-20]%). However, the CMA notes there is some uncertainty on the destination of passengers, in particular for those travelling by coach.

Closeness of competition

55. The Parties submitted that GWR and the South Western Franchise services on the London to Exeter flow are not close competitors. In support of this, the Parties submitted that:

    (a) although the GWR and South Western Franchise services are comparable in terms of frequency, South Western Franchise services take significantly longer (up to 57% longer) than the GWR services. GWR

claims that it does not consider [✂], although it did not provide any evidence to substantiate this claim;

(b) the fact the two services terminate at different London stations (the South Western Franchise at Waterloo and GWR at Paddington) is an important point of differentiation. To support their view, the Parties cited a TfL study from 2011 on travel patterns of all passengers travelling in to Paddington and Waterloo.[22] The Parties submitted that this study showed that there were important differences between the passengers who used the two stations, in terms of their final destination,[23] mode of onward transport[24] and journey purpose;[25] and

(c) there are few customers who use the South Western Franchise to travel the full distance between London and Exeter relative to all passengers on the route. While GWR and South Western Franchise may not be close competitors for all customers, the CMA believes that there remain a sub-set of passengers who would use the South Western Franchise for the full journey. For this customer group, the Parties' services would be close competitors. The CMA therefore does not consider this argument further.

- *Journey times and journey cost*

56. The CMA notes that journey times are shorter on the GWR services than the South Western Franchise (166 and 203 minutes on average respectively). However, fares are also more expensive on GWR (£250 for anytime return fares, compared to £145.60 on the South Western Franchise), and passengers may be willing to trade off these factors. Frequencies are similar at 15 and 12 peak daily direct services respectively from Exeter to London, and 17 and 13 peak daily direct services from London to Exeter.[26]

57. In order to assess the overall closeness of competition between the two services, the CMA has calculated the GJC on the basis of anytime fares and off-peak fares. Using calculations based on off-peak fares, which the CMA understands to be the most commonly used tickets on the flow,[27] the GJC for

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22 TfL (2011), Central London Rail Termini: Analysing passengers' travel patterns.
23 With a larger number of passengers arriving at Waterloo travelling to the City of London compared to those arriving at Paddington, which more frequently travelled to destinations in West London.
24 With 21% of passengers arriving at Waterloo (compared to 12% at Paddington) able to reach their final destinations on foot.
25 With 70% of passengers arriving at Waterloo being commuters, compared to 52% at Paddington.
26 Frequencies are based on *GWR.com* website and are slightly different from the Parties' submission which is based on the ATOC timetable.
27 The Parties submitted that GWR revenues on the flow are split as follows: [✂]% from Standard Anytime tickets (£[✂]), [✂]% from Standard Off-Peak and Super-Off peak tickets (£[✂]), [✂]% from Standard Advanced tickets (£[✂]) and [✂]% from season tickets (£[✂]). The rest of the revenues come from First class tickets (mainly Advanced).

the two operators is relatively similar, the difference being under 25%. In *Arriva / Northern*, the CMA considered that where the difference in GJC was greater than 25%, the two services are less likely to be close competitors.

58. Further, the CMA requested that the Parties calculate the Revenue Retention (**RR**) ratio on this flow using MOIRA modelling.[28] This showed that the RR ratio was above 90% under various assumptions involving a degradation of either the South Western Franchise or GWR services. The CMA believes that this again indicates that the GWR and South Western Franchise services are likely to be close alternatives.

59. The Parties submitted that the RR ratio was not an appropriate way to measure closeness of competition, and that MOIRA is not a good indicator either of closeness of competition or incentive to increase fares because it allocates passengers, in response to the degradation simulation, on the basis of journey time and frequency but not fares.

60. The CMA acknowledges that the MOIRA model does not include fares and assigns passengers after degradation on the basis of journey time and frequency only. However, the CMA continues to believe that the RR ratio is one of several appropriate tools for measuring closeness of competition.

- *London terminus stations*

61. Regarding the distinction made by the Parties as to the London terminus stations of the two services, the journey time between Paddington and Waterloo is short relative to the overall journey time on this flow. The TfL study considered all passengers to these stations rather than passengers travelling from Exeter and may not be representative of the specific flow under consideration. For instance, the CMA expects that most passengers arriving at these stations would be commuters who would take the destination station into account, whereas fewer passengers to/from Exeter would be commuters. Finally, the TfL study shows a significant proportion of passengers using both stations have final destinations which lie between Waterloo and Paddington. The CMA therefore does not consider the geographic location of the London terminus stations to be a major differentiating factor.

The Parties submitted that South Western Franchise revenues on the flow are split as follows: [✂]% (£[✂]) from Standard Advanced tickets, [✂]% (£[✂]) from Standard Anytime tickets and [✂]% (£[✂]) from Standard Off-peak and Super-Off-peak tickets. The rest of the revenues come from First class tickets (mainly Advanced).

[28] The 'MOIRA' model is used in the rail industry, and by DfT, to estimate passenger allocation in response to changes to services, such as timetable changes. It is used by the CMA to test the similarity of overlapping rail services. Specifically, the output of the MOIRA simulations is used to calculate the RR ratio. The RR ratio is defined as the total revenue gain to a TOC relative to the total revenue gains of all TOCs in response to a hypothetical degradation of the service on a flow.

- *Internal documents*

62. The closeness of competition between the overlapping services is further supported by the Parties' internal documents. A GWR internal document indicates that the behaviour of the previous operator, Stagecoach, on this flow affected First's revenue.[29] First said that they did not routinely monitor the South Western Franchise when operated by Stagecoach, but acknowledged that this was in part because Stagecoach's pricing did not frequently change.

- *Third party comments*

63. Views received from a passenger interest body and from various members of the public support the proposition that the services are close competitors. One submission noted that many users have a choice of which service to use. These submissions expressed concern that a loss of competition would mean that, following the Franchise Award, fares on the South Western Franchise services would rise to the level of the GWR services, and the quality of services would drop.

- *Conclusion on closeness of competition*

64. Based on the evidence set out above, the CMA believes that the South Western Franchise and GWR services on this flow are close competitors.

The Parties' ability to increase fares

65. The Parties submitted that the Franchise Award will not give the Parties the ability to increase fares on the London to Exeter flow. The Parties submitted that:

(a) fare regulation has the effect of constraining the Parties from raising prices; and

(b) the JVA between First and MTR significantly reduced First's ability to degrade services on the South Western Franchise (which is jointly owned) to divert passengers to GWR (which is solely owned by First), and internal protocols around fare-setting would not allow the interests of First to be taken into consideration in setting fares for the South Western Franchise.

66. The CMA believes that the Parties would have the ability to increase unregulated rail fares on this flow for the reasons set out below.

[29] See FGWL Board Papers P6 2016, page 114, which states, [✂].

- *Constraints as a result of fare regulation*

67. Both the South Western Franchise and GWR set routed inter-available fares (as described in footnote 17) which allow travel on services via Honiton (for the South Western Franchise) and via Taunton (for the GWR Franchise). All inter-available revenues on this flow are derived from these routed inter-available fares. As such, all tickets are valid on only one operator's service and passengers must choose between them.

68. While certain of these routed inter-available fares are regulated,[30] the majority of revenue comes from unregulated fares, and there is headroom for the Parties to increase the level of the unregulated fares towards the level of the regulated fares. There is headroom for the Parties to increase the following fares:

    (a) on the GWR services, the routed inter-available off-peak single and super off-peak single fares, by 30% and 75% respectively, up to the level of the regulated super off-peak return fare;[31] and

    (a) on the South Western Franchise services, the routed inter-available super off-peak (both single and return) fares by 9%, up to the level of the regulated routed inter-available off-peak return fare.

69. Furthermore, both the South Western Franchise and the GWR services also offer dedicated advance fares, both in Standard and First class.[32] The South Western Franchise's dedicated fares (including both First Class and Standard class) account for more than [✂]% of the South Western Franchise's revenue on this flow and the GWR Franchise's dedicated fares account for c. [✂]% of GWR's revenue on this flow. These fares are significantly cheaper than the routed inter-available fares. For instance, the average standard class advanced single fare on GWR is c. £39 and c. £20 on South Western Franchise services.[33] For instance, the average GWR dedicated fare is much lower that a GWR off peak single ticket (£65.4) and lower than a GWR super off-peak single (£48.8). The quantity of advance dedicated fare tickets available could be reduced, the fares could be removed entirely, or increased to the level of, or close to, inter-available fares.

[30] On the South Western Franchise, the anytime single and day return fare, the off- peak return and the seven-day season ticket are regulated; on GWR, the Super Off-Peak return fare and the seven day season ticket are regulated. Regulated fares account for [✂]% of GWR revenues and [✂]% of the South Western Franchise revenues.
[31] The Parties also have the ability to increase weekly season tickets.
[32] GWR offers Advanced single tickets, with fares ranging from £18.5 to £118. The South Western Franchise offers Advanced single tickets, with fares ranging from £14.2 to £60.2. Restrictions apply to this ticket types.
[33] The Parties submitted that 139,054 journeys were made on GWR advanced tickets in the last year (standard and first class) and 73,830 journeys were made on South Western advanced tickets (standard and first class).

70. Therefore, the CMA does not believe that the terms of the franchise agreements are sufficiently prescriptive such as to remove any ability to increase fares or degrade quality on the London to Exeter route.

- *JV arrangements / internal governance*

71. The Parties have argued that the terms of the JVA allow MTR to block any decision which would lead to revenue loss for FMSWTL, and therefore First would not be able to push through fare increases which would lead to revenue losses which would be recouped by diversion to First. The Parties told the CMA that all decisions about fare levels are taken at [✄] within FMSWTL.

72. The CMA notes that the JVA provides for all decisions taken by the [✄] to be taken [detail on governance arrangements and MTR's position in the JV]. However, the CMA notes that in relation to [reasons based on governance documentation why the CMA does not accept Parties' submissions].

73. In addition, the Parties told the CMA that [details of internal protocols relating to fare setting]. While this may be the case, the CMA considers this is an internal protocol around process only and the Parties have not provided evidence that First, as 70% owner of the South Western Franchise, would not be able to give direction to the pricing team.

74. Therefore, the CMA does not consider that the joint venture arrangements materially affect the Parties' ability to raise fares. The CMA has however taken the joint-venture arrangements into account in its analysis of the Parties' incentive to increase fares.

The Parties' incentive to increase fares

75. The CMA notes that the total revenue on the flow for both operators is about £[✄]. Both First and the current South Western Franchise have pricing teams in place doing sophisticated dynamic pricing of train tickets. Pre-Franchise Award, if either GWR or the South Western Franchise (or both) were to increase unregulated fares, some passengers would have diverted to the other service, resulting in a loss of revenue for the operator increasing its fares. Post-Franchise Award, some of this lost revenue is recaptured by the Parties. The Parties would therefore have an incentive to increase both GWR and South Western Franchise's unregulated fares post-Franchise Award.

76. The CMA has calculated the maximum annual revenue that the Parties would gain if GWR or the South Western Franchise inter-available fares were increased by the maximum headroom available (ie up to or close to the level of regulated fares as indicated in paragraph 86). The results indicate that the

additional annual revenue would be significant, with the maximum potential revenue gain upwards of £[✂] million in the case of the GWR services. For the South Western Franchise services, there is a more modest potential revenue gain of upwards of £[✂].

77. Further, a substantial proportion of passengers (particularly on the South Western Franchise) travel on dedicated fares. While it is not possible for the CMA to quantify the maximum gain for the Parties if all dedicated fares were removed, the CMA believes that, given the price differential between the dedicated and inter-available fares, the potential gains from such action is also likely to be significant, beyond those listed in paragraph 76.

78. The Parties submitted that even if First had the ability to raise fares or deteriorate service for either GWR or the South Western Franchise, they would not have sufficient incentive to do so. The Parties submitted that:

(a) the profitability analysis undertaken by the CMA overestimates the potential gains that the Parties could obtain by increasing fares up to the headroom available;

(b) related to (a), the true headroom available is reduced because of the need for a coherent pricing policy, therefore the potential gains are also reduced;

(c) the JV structure and profit-sharing arrangements with DfT dilute First's incentives; and

(d) increasing fares would compromise the Parties' ability to meet their commitments to DfT in relation to overcrowding.

- *Diversion to the South Western Franchise*

79. The Parties submitted that the profitability analysis undertaken by the CMA overestimates the potential gains that the Parties could obtain by increasing fares up to the headroom available. The Parties noted that the analysis does not take account of the level of passenger diversions to the South Western Franchise services (or to other modes) following the hypothetical fare rise, which they consider to be essential to make the fare rise profitable. Furthermore, the Parties consider that, given that there are significant differences in customer types between GWR and the South Western Franchise, there would be low diversion between the South Western Franchise and GWR, thus reducing the incentive to increase prices.

80. The CMA acknowledges that the figures above are a simplification to illustrate the maximum scope for price rises. The CMA has modelled other scenarios

assuming *(i)* a more moderate price increase[34] *(ii)* that some GWR passengers would switch to the South Western Franchise in response to a fare increase *(iii)* that some GWR passengers would stop travelling or switch to other transport modes in response to a fare increase; and (iv) that First would get only 70% of the revenue of GWR passengers switching to the South Western Franchise.

81. The analysis shows that First can obtain significant extra revenue even under these conditions (for example, up to £[✂] if 10% of affected passengers switch away from GWR – 5% to SWT and 5% to other modes of transport) and very high rates of switching to other modes would be required to make the price increase unprofitable.[35]

82. Furthermore, the CMA notes that the Parties or First can obtain significant additional revenue by increasing the price or reduce the quantity of available advance tickets which are currently priced below the corresponding walk-up fares.

- *Pricing effects on the rest of the line*

83. The Parties submitted that increasing prices between London and Exeter would create fare anomalies for other flows along the service. The Parties submitted that passengers would exploit these fare anomalies by purchasing alternative cheaper tickets, either for destinations past Exeter (so called *travelling short*) or splitting fares at intermediate stations (so called *split ticketing*).[36]

84. The Parties submit that they would therefore not have the incentive to increase fares up to the full headroom.

85. The CMA considers that the Parties have not provided enough evidence to demonstrate whether split ticketing and /or travelling short are common in practice and whether they would constrain the Parties' behaviour. Even if these constraints may limit the incentive to increase fares, they do not remove it completely. For instance, even based on lower potential price increases

[34] Two scenarios were considered: (i) a 37% price increase (ie, a price increase that would make GWR super off-peak single as expensive as SWT super-off single) and (ii) a 20% price increase.
[35] The CMA simulation assumed an increase of GWR super-off peak single fare by the amount specified in footnote 38. It assumed that, following the fare increase, a certain proportion of customers would switch to the South Western Franchise (and GWR could recoup 70% of foregone revenue) and that a certain proportion would stop travelling or switch to another mode of transport (thus representing a lost revenue for GWR). For instance, the CMA simulation shows that in scenario (ii) a diversion rate to other modes above 20% is required to make the price increase unprofitable.
[36] For example, passengers to Exeter would have an incentive to purchase a less expensive ticket to Plymouth despite exiting the train at Exeter. Alternatively, passengers could split their travel at Reading, if the sum of two separate tickets Exeter-Reading and Reading London is cheaper than the Exeter to London fare

which the Parties suggest would be possible, GWR could gain £[✄]from increasing fares on the London to Exeter flow.

- *Diluted incentives due to the JV structure / profit sharing with DfT*

86. First submitted that, even if it could deteriorate the GWR services, its incentive to do so would be significantly reduced on the basis that First would only receive 70% of any incremental profit that resulted from passengers diverting from GWR to the South Western Franchise. The CMA's analysis has taken this into account and its calculations of possible gains to First reflect only 70% of any incremental South Western Franchise revenues.

87. Furthermore, the Parties noted their potential gains are also limited by profit sharing agreements with the Department for Transport (DfT), meaning that the Parties receive a declining share of profits above certain thresholds (with similar profit sharing agreements with the DfT in place for the GWR franchise).

88. Profit sharing agreements with the DfT were considered in *Arriva / Northern*.[37] In particular, the CMA concluded that the profit sharing agreements were only likely to affect the incentives on Arriva to increase passenger numbers on the Northern Franchise over and above its projected levels in circumstances where the franchise is delivering significant passenger growth above the levels included in its plans. [✄]. Therefore, the CMA does not believe it has received sufficient evidence to depart from the conclusions in *Arriva / Northern*.

89. The CMA therefore considers that notwithstanding any dilution of incentives as a result of these factors, the Parties will have the incentive to increase fares.[38]

- *Commitments regarding overcrowding*

90. The Parties noted that as part of its franchise agreement, GWR has committed to reducing overcrowding and increasing capacity, and noted that the route between London and Reading already suffers from overcrowding. The Parties submit that if GWR increases its prices of advance tickets between Exeter and London, it would eliminate the benefit of travelling at off-peak hours, which would worsen crowding between London and Reading,

[37] See paragraphs 8.32-8.34 of the final decision.
[38] Implicit in the CMA's consideration of effects of the Franchise Award is that for passengers who would switch to South Western rail services as a result, pre-Franchise Award First would retain none of the rail revenue from these passengers, and post-Franchise Award First would retain 70% of it. MTR's share may reduce the scale of the change in incentives, but does not remove it.

which all Exeter services pass through. The Parties argue that GWR would therefore not have an incentive to increase advance prices because doing so would put GWR in risk of violating its franchise agreement. The CMA asked the Parties for evidence this type of change on this specific flow would cause overcrowding in practice, but no compelling evidence of this was provided.

91. The CMA notes that the off-peak return ticket is regulated and would act as a constraint to any fare increase at off-peak times. As such, it would be unlikely that many passengers would decide to travel at peak times, which would remain more expensive. Furthermore, the CMA notes that the number of services classified as ‘peak’ from Exeter and/or London is limited – most peak services depart before 7.30am (and between 5pm -6pm from London). As such, the number of passengers shifting from off-peak to peak is likely to be limited. Finally, the CMA notes that the Parties or First can obtain significant revenues by increasing price/reducing number of advanced tickets for each price point without compromising management of demand.

Competition from other transport services

92. The Parties submitted that the overlapping services also compete with both coach and air services.

- *Competition from coach services*

93. In relation to coach services, the Parties indicated that the services provided by Megabus (London Victoria to Exeter; £3-17.50) and National Express (London Victoria to Exeter; £7-27) would be well placed to competitively respond to any deterioration in the Parties’ rail services. The coach terminus is 1.6km from Exeter St David’s train station. The Parties also submitted that South Western Franchise, National Express and Megabus offer comparable services using the GJC analysis. The Parties submitted [internal documents relating to competitive landscape].

94. However, the journey time by coach (4 hours and 30 minutes on average, often close to 5h) is significantly longer than by either of the overlapping rail services (on average, 166 minutes on GWR services and 203 minutes on South Western Franchise services). While the CMA notes that fares are lower, frequency is also lower (4 and 7 peak daily services on Megabus and National Express respectively, compared to 12 and 15 on South Western Franchise and GWR respectively). The CMA considers that these factors

mean that coach services are unlikely to be considered an alternative by a significant number of customers.[39]

95. The CMA contacted both coach operators to get their views on closeness of competition between coach and rail. Coach operators indicated they consider there to be some competition with rail, but that rail services are unlikely to be substitutable with coach services and a change in price of 5% would be unlikely to result in a significant switch from rail to coach. Although rail fares are considered when setting coach fares, this is only one of several considerations (ie price of the rival coach operator).

96. In response to the Issues Letter, the Parties submitted an example of marketing campaign targeted to National Express customers[40] to demonstrate the closeness of competition between the two modes. The CMA considers that the campaign was aimed at increasing awareness of GWR among National Express customers and is not a good indication of competition.

97. In conclusion, for the reasons set out above, the CMA does not believe that competition from coach services on this flow is sufficient to mitigate the effects of the Franchise Award.

- *Competition from air services*

98. In relation to air services, the Parties submitted that [✄] Flybe, which offers a once a day return flight from London City airport to Exeter, at prices that are substantially cheaper than the cost of travelling on GWR at similar times of day.

99. However, the CMA notes that there is only one flight per day, with around 80 seats, compared to approximately 30 daily train services offered by GWR and SWT combined. Therefore, the CMA does not consider that competition from flights from London City airport to Exeter is sufficient to constrain the Parties' services to Paddington and Waterloo.

- *Conclusion: London to Exeter flow*

100. For the reasons set out above, in particular the closeness of competition between the overlapping rail services, the absence of other rail competitors on the flow, the fact that the Parties have both the ability and incentive to raise fares, and the absence of sufficiently strong constraints from other modes of

[39] Coach fares vary greatly which makes it difficult to compare GJC with rail. However, some indicative modelling suggested that the two are not close alternatives for the majority of passengers.
[40] Customer with a National Express ticket affected by road works on the M4 got a free journey on GWR trains.

transport, the CMA believes that the Franchise Award gives rise to a realistic prospect of an SLC on the London to Exeter flow.

Bus-on-rail overlaps

101. Following the initial steps outlined at paragraphs 47-48 above, the CMA identified bus-on-rail flows on four bus routes for detailed assessment. Although a number of flows on these routes were identified at earlier stages of the CMA's investigation as unlikely to individually create competition concerns, the CMA has taken a route-level view where a significant number of flows remain for analysis. The routes the CMA considered in-depth are:

   (a) Route 3, which runs between Portsmouth City Centre and Fareham: the CMA's filtering had failed to remove concerns for nine of the original 15 overlapping flows on route;[41]

   (b) Route X4, which runs between Southsea Hoverport and Southampton Central: nine of the original 36 overlapping flows;[42]

   (c) Route 6, which runs between Hamble and Southampton: two of the original 10 overlapping flows;[43] and

   (d) Route 10, which runs between Weymouth and Dorchester, and overlaps with the South Western Franchise on flows between Weymouth, Upway and Dorchester: one of the original three overlapping flows.[44]

102. Where First also operates other bus services on the flows of primary interest, the CMA has taken those into account in its assessment. The CMA notes that First operates several services on the flows Cosham-Portsmouth Harbour and Cosham-Portsmouth Southsea, and Route 8 also fails the filters on these flows only.[45]

103. To assess the likelihood of the Franchise Award resulting in unilateral effects on this flow, the CMA considered the following factors in the round:

[41] Cosham – Fareham, Cosham – Portsmouth & Southsea, Cosham – Portsmouth Harbour, Fareham – Portchester, Portchester – Portsmouth & Southsea, Portchester – Portsmouth Harbour.
[42] Fareham – Portchester, Fareham – Portsmouth & Southsea, Fareham – Portsmouth Harbour, Portchester – Portsmouth & Southsea, Portchester – Portsmouth Harbour, Fareham – Southampton Central, Portchester – Southampton Central, Portsmouth Harbour – Swanwick, Sholing – Swanwick, Portsmouth Harbour – Southampton Central, Fareham – Woolston, Portsmouth & Southsea – Southampton Central, Bursledon – Portsmouth Harbour, Portsmouth & Southsea – Woolston, Portsmouth Harbour – Woolston, Fareham – Sholing, Portsmouth & Southsea – Swanwick, Bursledon – Portsmouth & Southsea, Portsmouth Harbour – Sholing, Portsmouth & Southsea – Sholing.
[43] Hamble – Southampton Central, Netley – Southampton Central.
[44] Weymouth to Dorchester.
[45] The profitability analysis below in relation to incentive to raise fares also applies to Route 8.

(a) The closeness of pre-Franchise Award competition;

(a) First's ability to increase bus fares;

(b) First's incentive to increase bus fares; and

(c) competition from other transport services.

Closeness of pre-Franchise Award competition

104. The Parties submitted that:

(a) for flows within Portsmouth, a 400m catchment area rather than a 1200m catchment area is appropriate. This is because Portsmouth is a small city and because it is very densely populated.

(b) Related to (a), some flows had a GJC differential of greater than 25%, as calculated by the Parties.

(c) A source of survey evidence, the Illuma bus passenger survey (**Illuma Survey**), shows low diversion rates from bus to rail services.[46]

105. In relation to (a), as outlined in paragraph 33 above, in the interests of consistency, the CMA has adopted the 1,200-metre catchment area used in *Arriva / Northern*, but considers the outcome of the analysis would not differ on a narrower, 400m catchment area.

106. In relation to (b), the Parties submitted GJC differentials are 25% or above on some additional flows. The key differences between the Parties' and the CMA's analysis is whether single or return fares are used in the analysis. The CMA has used single fares as these are most frequently used by bus passengers on the routes in question.

107. The CMA's GJC calculations indicate that the differences in GJC between the bus services and the South Western Franchise services are generally low, and that in many cases both fares and journey times are similar. This

[46] The Illuma survey has been used by FirstGroup to measure customer satisfaction with its bus services since September 2009. The survey is conducted monthly and consists of paper questionnaires being given out to a random cross section of passengers at regular intervals over the period 7:30am to 7:30pm across the buses within the survey sample, and collected in by the Illuma representative on board. Across the country, approximately 63,000 customers are surveyed every year covering users of approximately 460 bus routes. Across the area covered by the South Western Franchise, around 13,000 passengers on approximately 50 routes are surveyed each year. In December 2013, FirstGroup added an additional question to the Illuma survey that asked customers about how they would make their current journey if the bus was not available.

suggests that the degree of differentiation between bus and rail services is low and that passengers are likely to view bus and rail services as substitutes.

108. In relation to (c), the Parties have submitted that the Illuma Survey shows low diversion from bus to rail (2.3% on 3, 5.4% on 6, 2.9% on 10 and 1.7% X4). The Parties have argued that as the overlapping flows make up a significant proportion of total route revenue, these results demonstrate that rail is not a close competitor on these routes. The CMA has some concerns on the survey methodology and notes that these diversion rates are significantly lower than the results of the survey in *Arriva / Northern*, where diversion rates on individual flows varied significantly across flows (in certain cases, diversion rates to rail were as high as 50% of bus passengers). The *Arriva / Northern* survey illustrated that diversion may vary greatly between flows, presumably depending on how suitable a substitute rail service is for a particular bus service, and so route level results should be interpreted with caution.

109. The CMA has therefore taken the results of the Illuma Survey into account as one piece of evidence on closeness of competition between the bus routes and rail, but does not place significant weight on the Illuma Survey in reaching its conclusion. The CMA notes that the results of its incentive analysis below do not differ even if the lower diversion figures indicated by the Illuma Survey are used, as the CMA concludes that no sufficient incentive exists, even on the basis of a higher diversion.

Ability to increase fares

110. The Parties submitted that First is constrained from raising bus fares because it would need to ensure that any increases to fares did not lead to fare-inconsistency (eg, that the price of a shorter journey did not exceed the price of a longer journey, or that the price of journeys between the same two points on two different bus routes did not differ).

111. The CMA acknowledges that fares on individual flows may be constrained by the need to keep a consistent fare structure, and that First may not have the incentive to change the structure for the sake of the relatively few flows and routes affected by the merger. However, the CMA considers that First can still increase fares within a range determined by existing fare stages. Further, given that Route 3 and Route X4 are adjacent, at least for some flows, the CMA considers that First would be able to raise fares across both routes with minimal impact on fare consistency.

112. Furthermore, in line with *Arriva / Northern*, the CMA has considered whether First zonal tickets or multi-operator scheme constrain First’s ability to increase

fares.[47] As the fares on all overlapping flows across Routes 3, 6 and X4 are lower than the price of both the First zonal ticket and the SolentGo ticket, the CMA concludes that First would have the ability to raise fares to the level of the fares for these tickets, which would typically represent a price increase of 60-100% on single fares.[48] Route 10 is not covered by a zonal day ticket or multi-operator ticket.

Incentive to increase fares

113. The scale of price rise illustrated above is the theoretical maximum. The CMA then considered the extent to which First would have the incentive to increase price, given passengers willingness to pay (which will capture the constraint imposed by rail, but also by other competing services).

114. In line with a conservative Phase I approach, the CMA has simulated several possible price increases, including increasing bus fares by the maximum headroom available (ie the difference between the current fare and the First Group zonal fare) as well as more moderate increases of 10-30%. In the absence of a fully reliable survey on switching from bus to rail,[49] and consistent with *Arriva / Northern*, the CMA's analysis has assumed that around 20% of non-concessionary bus passengers would switch to another mode of transport or stop travelling following the hypothetical price increase. Of these, around 10% are assumed to switch from bus to rail. Furthermore, the CMA took into account that First would obtain only 70% of the revenue generated by bus passengers switching to rail.

115. Even with a significant price increase of 20-30%, the gains available to First are modest. The CMA's analysis found that an increase of 30% or more would be required for price rises to raise significant revenue on bus routes under plausible switching scenarios.[50] While the maximum headroom available means such a price increase would be theoretically possible, in view of the evidence on closeness of competition between bus and rail outlined above, the CMA does not consider it plausible to suggest that removing the constraint of rail would allow such significant price increases.

116. In this context, the CMA notes that as discussed above fare increases would need to ensure consistency across bus routes and between flows. While the

[47] First has daily single operator zonal tickets in the Southampton and Portsmouth area. The multi-operator scheme, 'SolentGo', also operates in the area.
[48] On return fares, which on the flows under consideration accounts for a third of bus fares, the typical headroom is 10-30%.
[49] See above for comments on the Illuma Survey.
[50] Implicit in the CMA's consideration of effects of the merger is that for passengers who would switch to South Western rail services as a result, pre-Franchise Award First would retain none of the rail revenue from these passengers, and post-merger First would retain 70% of it.

CMA believes that this would not prevent a fare increase on overlapping flows the CMA notes that it could mitigate the level of fare increase which First may have the incentive to implement.

117. As outlined below, the CMA does not consider the potential competition from existing operators expanding to compete with First on the routes is sufficient to mitigate a moderate price increase. However, the CMA considers the relatively low barriers to adding additional routes is likely to impose some constraint on the incentive to implement a large price increase. The Parties submitted that they face competition from a number of other operators, including Stagecoach, South West Coaches and Xelabus on a number of the flows. As noted in *Arriva / Northern*, expansion is more likely ‘where existing operators have a sizeable presence in the local area’.[51]

118. In view of these factors, the CMA does not believe that First has the incentive to increase bus fares.

Competition from other transport services

119. As for other modes of transport, the Parties submitted that they faced competition from National Express’ coach services (which operate between Southampton and Portsmouth) and Southern’s rail services (which operate between Fareham, Portchester and Cosham). As the CMA does not consider First has the incentive to increase fares, it has not been necessary to consider how closely these services compete with First on the flows.

Conclusion on bus-on-rail overlaps

120. In conclusion, the CMA considers that several flows on Routes 3, X4, 6 and 10 are likely to involve close competition between First’s bus services and the South Western Franchise pre-Franchise Award and that the ability to raise fares may be present. However, the CMA’s analysis suggests that very significant price increases would be necessary for First to make material gains. The CMA does not consider such price increases would be commercially viable, and therefore the CMA believes that First will not have the incentive to increase bus fares on Routes 3, X4, 6 and 10. Accordingly, the CMA found that the Franchise Award does not give rise to a realistic prospect of an SLC as a result of horizontal unilateral effects in relation to any of the bus-on-rail overlaps.

[51] *Arriva / Northern*, paragraph 11.102.

Barriers to entry and expansion

121. Entry, or expansion of existing firms, can mitigate the initial effect of a merger on competition, and in some cases, may mean that there is no SLC. In assessing whether entry or expansion might prevent an SLC, the CMA considers whether such entry or expansion would be timely, likely and sufficient.[52]

122. With respect to entry or expansion on the overlapping rail-on-rail flow, the Parties acknowledged the CMA's finding in *Arriva / Northern* that the prospects for entry or expansion of rail services is very limited due to network capacity, and submitted that the South Western Franchise area was no exception.[53] The CMA has not received any evidence to suggest that it would be appropriate to depart from the position adopted in *Arriva/Northern* in this case. The CMA therefore does not believe that entry or expansion in rail services would be sufficient, timely or likely to prevent a realistic prospect of an SLC as a result of the Franchise Award.

123. With respect to entry or expansion on the overlapping bus-on-rail flows, the Parties suggested that bus and coach operators with local depots or nearby operations could expand their services to compete with the Parties. However, the CMA does not consider that it has received sufficient evidence to conclude that expansion by the Parties' rivals on those flows on which First does not face competition would be timely, likely or sufficient. However, the CMA has noted that while entry or expansion is unlikely to be timely, likely or sufficient to mitigate a small price increase, the prospect of entry or expansion is a factor which the CMA considers relevant in its conclusion that a significant price increase would not be commercially viable.

Third party views

124. The CMA contacted customers and competitors of the Parties. Some customers raised concerns regarding possible price increases and degradation of quality as a result of the Franchise Award.

125. Third party comments have been taken into account where appropriate in the competitive assessment above.

[52] *Merger Assessment Guidelines*, from paragraph 5.8.1.
[53] The Parties did note that an application for an open access contract had been made by Alliance Rail (a subsidiary of Arriva) for services between Southampton and Waterloo. However, as such entry would in any event not impact the degree of competition on the London to Exeter flow, this submission is not considered further.

Conclusion on substantial lessening of competition

126. Based on the evidence set out above, the CMA believes that it is or may be the case that the Franchise Award has resulted, or may be expected to result, in an SLC as a result of horizontal unilateral effects in relation to public transport services between London and Exeter.

Exceptions to the duty to refer

127. Where the CMA's duty to refer is engaged, the CMA may, pursuant to section 33(2)(a) of the Act, decide not to refer the merger under investigation for a Phase II investigation on the basis that the market(s) concerned is/are not of sufficient importance to justify the making of a reference (the ***de minimis* exception**).

128. The Parties submitted that the CMA should exercise its discretion to exercise the *de minimis* exception because the overlaps represent a negligible proportion of revenues in relation to the relevant First and South Western Franchise services, and since the revenue increment from the Franchise Award is only £[✂]million.

129. In considering whether to apply the *de minimis* exception, the CMA will consider, in broad terms, whether the costs involved in a reference would be disproportionate to the size of the market(s) concerned, taking into account also the likelihood that harm will arise, the magnitude of competition potentially lost and the duration of such effects.[54]

130. The CMA considers that the market(s) concerned will generally be of sufficient importance to justify a reference (such that the exception will not be applied) where the annual value in the UK, in aggregate, is more than £15 million.[55] Critically, it is the size of the market(s) and not the size of the revenue increment resulting from the transaction which is relevant. The revenue of all rail operators on the London to Exeter flow was approximately £[✂]million in the 2015-2016 financial year. It is therefore significantly above the £15 million threshold and would be expected to be a market of 'sufficient importance'.

131. In addition, the CMA's general policy, regardless of the size of the affected market, is not to apply the *de minimis* exception where clear-cut undertakings in lieu of a reference could, in principle, be offered by the Parties to resolve

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[54] *Mergers: Exception to the duty to refer in markets of insufficient importance* (CMA64), June 2017, paragraphs 16-17.
[55] *Mergers: Exception to the duty to refer in markets of insufficient importance* (CMA64), June 2017, paragraph 14.

the concerns identified.[56] In this case, the CMA has identified an SLC in relation to a rail-on-rail overlap only. The CMA has previously accepted undertakings in lieu of reference in the form of a price cap as sufficiently clear-cut in *Stagecoach / Eastern Franchise*. Similar undertakings were accepted in Phase II in *Arriva / Northern*. The CMA has not received any evidence to suggest similar undertakings would not be available to resolve the SLC identified in relation to the London to Exeter flow in this case. The CMA therefore considers that undertakings in lieu of reference may in principle be available in this case.

132. For these reasons, the CMA does not believe that it is appropriate for it to exercise its discretion to apply the *de minimis* exception.

Decision

133. Consequently, the CMA believes that it is or may be the case that (i) a relevant merger situation has been created; and (iii) the creation of that situation has resulted, or may be expected to result, in an SLC within a market or markets in the United Kingdom.

134. The CMA therefore believes that it is under a duty to refer under section 33(1) of the Act. However, the duty to refer is not exercised[57] whilst the CMA is considering whether to accept undertakings[58] instead of making such a reference. The Parties have until 18 July 2017[59] to offer an undertaking to the CMA.[60] The CMA will refer the Franchise Award for a Phase II investigation[61] if the Parties do not offer an undertaking by this date; if the Parties indicate before this date that they do not wish to offer an undertaking; or if the CMA decides[62] by 25 July 2017 that there are no reasonable grounds for believing that it might accept the undertaking offered by the Parties, or a modified version of it

Andrea Coscelli
Chief Executive
Competition and Markets Authority

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[56] Mergers: Exception to the duty to refer in markets of insufficient importance (CMA64), June 2017, paragraph 12.
[57] Section 33(3)(b) of the Act.
[58] Section 73 of the Act.
[59] Section 73A(1) of the Act.
[60] Section 73(2) of the Act.
[61] Sections 33(1) and 34ZA(2) of the Act.
[62] Section 73A(2) of the Act.

11 July 2017

Endnote

The approach to GJC described in footnote 20 was also used in relation to bus-on-rail overlaps.