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## Anticipated acquisition by National Express Group plc of the Greater Western Franchise

The OFT's decision on reference under section 33 given on 30 September 2005. Full text of decision published 19 October 2005.

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### PARTIES

1. **National Express Group plc (NEG)** is a leading operator of public transport services in the UK with interests in rail, bus and coach operators. Its principal bus interests in the UK are in the West Midlands, with smaller operations in Dundee and London. NEG's coach division comprises three separate brands: National Express (NEL), Airlinks and Eurolines. NEG currently operates eight train operating companies of which Wessex Trains will be absorbed into the new Greater Western Franchise. In addition, NEG currently controls Central Trains (CT), whose operations include services between Hereford and Worcester and between Newport and Cardiff.
2. **Greater Western Rail Franchise (GWF)** will consolidate the existing operations of the First Great Western (FGW), First Great Western Link (FGWL) and Wessex Trains (Wessex) franchises within a single franchise. It will operate long distance, regional and local services in the Thames Valley, Cotswolds, Avon and the West of England and some cross-border services into South Wales. The Strategic Rail Authority's (SRA) Draft Long Form Report for the GWF states that turnover for 2003/2004 across the three current franchises was £601 million.

### TRANSACTION

3. NEG is one of three pre-qualified bidders in the competition for the GWF. FirstGroup plc (First, the parent company of FGW and FGWL) and Stagecoach Group plc (Stagecoach), have also pre-qualified to take part in the competition. The current FGW franchise expires on 5 February 2006 and the FGWL and the Wessex franchises expire on 31 March 2006. The SRA anticipates that a preferred bidder will be selected and a new franchise agreement closed by Winter 2005/2006, following the issue of the Invitation To Tender in June 2005. The term of the new GWF is proposed to run for seven years from 1 April 2006, with an automatic extension of three years if agreed performance targets are met
4. The transaction was notified on 21 June 2005 and, with NEG's agreement, the OFT extended its review beyond the 40 working-day administrative deadline, which expired on 20 September 2005.

## JURISDICTION

5. 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. If NEG's bid for the GWF is successful, NEG and GWF will cease to be distinct. The combined annual UK turnover of the three franchises which will make up the GWF exceeds £70 million, meeting the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act).
6. Accordingly, the OFT believes that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation for the purposes of section 33(1)(a) of the Act.

## COUNTERFACTUAL

7. Applying the substantial lessening of competition (SLC) test involves comparing prospects for competition with and without the merger. For many mergers the natural basis for assessing prospects for competition in the absence of the merger – the 'counterfactual' – is given by conditions prevailing pre-merger. For rail franchise cases, however, that would not be a proper approach. As the Competition Commission (CC) has said, any incumbent operator on all or part of an existing rail franchise is but one of a number of potential bidders for a franchise about to be let or re-let, and 'the position prior to the merger could not therefore be assumed to have carried on' if that particular merger had not gone ahead.<sup>1</sup>
8. The OFT's view is that the appropriate counterfactual for the bid – and hence prospective merger – by each bidder is not continued operation by the incumbent (nor by the SRA) but the most competitive alternative bid in respect of each individual affected relevant market. In nearly all circumstances in this case, the most competitive alternative bid is one with no existing operations on a given market.
9. The basis for considering the counterfactual by reference to each individual relevant market derives from s 33 of the Act, which requires the OFT to consider whether it may be the case that a SLC may be expected to arise 'within a market or markets' in the UK. As discussed below, the relevant markets for the purposes of the OFT's assessment of horizontal competition issues in this case are a large number of individual point-to-point public transport journeys, or flows.
10. In respect of some individual markets, firm A (say) winning the rail franchise might result in more competition than firm B or C because, for example, it would bring an independent rail operator into competition with coach/bus operators on overlapping flows, while a win by B or C might place competing coach/bus and rail operations on those flows under common ownership. In other individual markets, the position might be reversed so that bids by B or C appear more competitive than that of A. However, it has not been feasible in the scope of the

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<sup>1</sup> See e.g., the following CC reports: National Express Group plc and the Greater Anglia Franchise, a report on the acquisition by National Express Group plc of the Greater Anglia franchise) November 2004, at para. 5.1 (*NEG/Greater Anglia*); FirstGroup plc and the Scottish Passenger Rail franchise, a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited, June 2004 (*ScotRail*) at para. 5.2.

first phase of merger review to attempt to weigh any competitive gains against losses across markets, in part because of the large number of markets at issue.

11. Notwithstanding the analysis set out above, the OFT recognises that the SLC assessment may also need to be conducted on a franchise-wide basis. In a sense, rail franchises are two-sided markets, in which the franchisee provides services to two sets of customers: the government and the passengers.<sup>2</sup> From the government (and taxpayer) perspective, the relevant market may better be viewed as a single bidding market for which the bidders compete to supply the government as the customer. However, the OFT's starting position is, for the reasons set out above, to focus on passengers' competitive choices for particular journeys. This approach has also informed prior OFT and CC investigations into rail franchises. In view of the conclusions reached on that basis in this case and the *Stagecoach/GWF* and *FirstGroup/GWF* decisions, it has not been necessary to consider any impact on the bidding market.

## RELEVANT MARKET

12. Overlaps exist between passenger rail transport services provided by the GWF and NEG's coach services from London and other hubs to points in the West Country, and point-to-point flows within west and south west England and south Wales. NEG also operates CT which offers rail passenger services between Hereford and Worcester, and between Newport and Cardiff.

## Product market

13. Passengers travelling from point-to-point on any journey may have a number of alternative methods of transport available, including rail, coach, bus and air. Their choice will depend upon numerous different factors, including the availability of different modes of transport, fares, and locations of the embarkation and disembarkation points, journey times, journey distance, and the reliability of the different modes of transport.
14. Whether and to what extent rail passenger services and coach passenger services compete on particular flows and routes is an empirical question dependent on the degree of passenger substitutability between the two modes on those flows and routes. No customer survey data or other empirical evidence in relation to coach and rail in the GWF area was available from either NEG or independent sources, and the OFT has been unable to conduct such research on its own account.
15. Previous in-depth inquiries by the CC have led to different conclusions as to the strength of substitutability, and hence competitive constraints, that apply between coach and rail on common flows. In *NEG/Scotrail*, for example, such competition was sufficiently strong that the prospect of coach and rail services under common control on the relevant Scottish flows led to a finding that the merger was against the public interest (under the Fair Trading Act substantive test) and led to the divestment of NEG's Scottish coach operations at the time.<sup>3</sup> Conversely, in the recent *NEG/Greater Anglia* inquiry, empirical evidence on consumer preferences

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<sup>2</sup> See *ScotRail* at para.4.5.

<sup>3</sup> National Express Group plc and ScotRail Railways Ltd, a report on the merger situation, 16 December 1997.

revealed a relatively low degree of substitutability and thus competition between coach and rail for relevant flows in the East Anglia region. In the OFT's most recent inquiry involving overlaps between coach and rail services, i.e., NEG's bid for the Thameslink/Greater Northern (TGN) franchise, even in the absence of empirical data, the OFT was able to rule out a realistic prospect of SLC as regarded the coach/rail overlaps in that area, on the basis that that merger did not give rise to concerns on any reasonable – including 'worst-case' – assumptions as to substitutability.<sup>4</sup>

16. In the absence of empirical data or other evidence suggesting otherwise, the OFT considers it prudent, as a common sense point of departure, to assume that a significant number of passengers might choose between coach and rail for a journey – weighing factors such as travel time, convenience and cash cost – and that those that tend primarily to choose coach are generally more price sensitive and more willing to accept longer journey times in exchange for lower fares (e.g. students and leisure travellers, who may have lower incomes and/or be less time-sensitive than, say, business travellers).
17. Moreover, as discussed below, our own analysis of the flows in this case shows a strong correlation between coach fares and rail fares which may be indicative of substitutability between the two modes, although the main driver of price was found to be distance. Finally, certain third party evidence suggested a degree of competition between coach and rail in parts of the GWF area.
18. As regards private transport, evidence collated by the CC in its *ScotRail* and *Greater Anglia* merger inquiries suggests that there is limited substitutability between public and private transport in response to changes in relative price, although the exact extent of substitutability varies depending on, among other things, the level of car ownership in the particular area and whether the relevant journey is urban or rural.
19. Given both the points made above and the absence of empirical data leading to a different view, the relevant frame of reference adopted for purposes of assessing the competitive effects of this proposed acquisition is the supply of passenger transport services.

### **Geographic market**

20. In making a journey, passengers wish to travel from a particular point of origin to a specific destination. The CC concluded in its report on *ScotRail* that point-to-point public transport journeys were considered the relevant geographic frames of reference for competition assessment in relation to the bus/rail overlaps in that case. Point-to-point frames of reference have consistently been employed in relation to various modal combinations such as coach/rail and rail/rail.<sup>5</sup>
21. The OFT has not received any evidence in this case that warrants departing from the point-to-point approach, which the parties have endorsed.

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<sup>4</sup> Anticipated acquisition by National Express Group plc of the Thameslink/Greater Northern passenger rail franchise, OFT decision of 3 August 2005 (*NEG/TGN*).

<sup>5</sup> See, for example, CC reports in *First/Scotrail* and *NEG/Greater Anglia*; OFT decisions in *First/ICEC* and *Virgin/ICEC*, both dated 21 December 2004.

22. Accordingly, the principal frames of reference relate to the provision of public transport services between specified origin/destination points (i.e. 'point-to point' frames of reference). A point-to-point journey may represent a complete route or may represent a smaller 'flow' that comprises part of a longer route.

## HORIZONTAL ISSUES

### Summary

23. The OFT's approach to horizontal issues has focused on the potential for a SLC to arise on those overlapping flows where NEG would become the sole or principal provider of public transport, which occurs in many instances in relation to both NEG's pre-existing coach and rail operations. The analysis faced two particular challenges: first, an absence of empirical data (such as was available to the CC in its *Scotrail* and *Greater Anglia* inquiries) on the degree of substitutability, and thus competitive constraint, between different transport alternatives on the relevant markets; second, a problem of scale, given over 300 overlap markets that NEG's GWF bid presents. These points are developed below.
24. The horizontal assessment is structured as follows. First, the regulatory context of rail services is noted. The next section examines theories of harm in relation to coach/rail overlaps and concludes that on current evidence there is a realistic prospect of a SLC, which establishes that the OFT has a duty to refer the merger. Rail/rail overlaps are then considered, but given the conclusions on coach/rail, the OFT finds it unnecessary to reach definitive conclusions on whether the rail overlaps themselves give rise to the requisite belief in a SLC.

### Impact of regulation

25. Before considering the impact of the merger on individual overlap routes or flows, it is important to recognise the regulatory context of this transaction. Passenger rail franchises are awarded by the SRA which sets the terms on which services will be provided. More specifically, the SRA has developed a new template franchise agreement which the evidence indicates is highly prescriptive as to the train services covered by the franchise agreement. In particular, this impacts on the commercial freedom to operate the franchise in two main ways: via the service level commitment and fare controls.
26. The prescriptive nature of the new rail franchise template has been extensively documented in previous OFT decisions (see e.g., *First/ICEC* and *Virgin/ICEC*, *South Eastern/IKF*<sup>6</sup> and *Stagecoach/TGN*<sup>7</sup>). This regulatory regime applies equally to the GWF. However, since the level of regulation (i.e. the proportion of regulated revenue to total revenue) applicable to the GWF is likely to be below the national average of 43 per cent, its impact on the commercial freedom of the train

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<sup>6</sup> OFT decision of 31 March 2005. See OFT website: [www.offt.gov.uk/Business/Mergers+EA02/Decisions/Clearances+and+referrals/South+East+ern.htm](http://www.offt.gov.uk/Business/Mergers+EA02/Decisions/Clearances+and+referrals/South+East+ern.htm).

<sup>7</sup> OFT decision of 7 July 2005. See OFT website: [www.offt.gov.uk/Business/Mergers+EA02/Decisions/Clearances+and+referrals/Stagecoach.htm](http://www.offt.gov.uk/Business/Mergers+EA02/Decisions/Clearances+and+referrals/Stagecoach.htm)

operating company (TOC) through tight fare controls and service level commitments will be less acute than as seen in previous OFT decisions.

27. In short, notwithstanding the prescriptive effect of the regulatory regime, the operator of the GWF will still have the ability to change fares and frequencies on services which will represent over 60 per cent of the revenue from running the franchise.

## **Coach/rail issues**

### ***Theory of harm***

28. The OFT has primarily sought to test whether NEG would have the post-merger ability and incentive to raise coach fares or reduce coach frequencies in order to increase profits. NEG operates coach services which overlap with the GWF on 338 flows across 38 routes, and on a large number of such flows, NEG would be the sole or predominant operator of public transport services.
29. The theory of harm presupposes that coach and rail compete to some degree, on the basis that passengers regard the modes as potential substitutes on the overlap flows in question. This may simply mean that the merger combines two unrelated services, if empirical data demonstrated that very few, if any, passengers considered the two services economic substitutes for travelling from A to B on a given flow. Conversely, if the coach and rail services are substitutable for a material number of passengers, then it can be expected that they constrain one another competitively, a constraint that the merger would eliminate.
30. As noted above, the OFT has no empirical data at its disposal and, in light of factors described under product market definition, has proceeded on the cautious basis that coach and rail may be substitutable and thus compete on relevant flows.
31. The OFT conducted two exercises to test the applicability of the theory of harm. First, it undertook preliminary price correlation analysis seeking to test whether coach and rail fares appear to be unrelated, suggesting an absence of substitutability. Second, the OFT modelled the potential profit incentive for NEG to raise prices or reduce frequencies, consistent with the approach first undertaken by the CC in *Scotrail* and employed in subsequent CC inquiries, notably *NEG/Greater Anglia*, and OFT investigations (e.g., *NEG/TGN*).<sup>8</sup> A precursor to this analysis is to identify flows that should form part of the modelling exercise. These steps are addressed in more detail as follows.

### ***Relationship between coach and rail fares***

32. A correlation is a measure of the strength of the relationship between two variables. A positive correlation in this case suggests that, on a flow, a high coach

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<sup>8</sup> As already noted above, even without empirical data, this approach allowed the OFT to rule out a realistic prospect of SLC as regarded the coach/rail aspects of NEG's bid for the Thameslink/Great Northern franchise, on the basis that that merger did not give rise to coach/rail concerns on any reasonable – including 'worst-case' – assumptions.

fare (on a per mile basis) is likely to be associated with a high rail fare (on a per mile basis).

33. Correlation analysis in relation to overlap flow fare data showed no meaningful correlation between coach and *peak* rail fares per mile. Yet the same analysis for coach and *off-peak* rail fares per mile produced positive correlation figures – in the range of 0.6 to 0.8 – suggesting that coach competes with off-peak rail, consistent with the proposition that leisure travellers may regard the modes as competitive choices.<sup>9</sup> Nevertheless, the correlation between off-peak rail and coach fares per mile could be due to a variety of other common factors, e.g. common costs, rather than due to a competitive relationship. Regression analysis was used to test whether the common factor of distance (mileage) was creating a misleading effect (e.g., because both coach and rail prices drop on a per mile basis the longer the journey – known as a 'distance taper'), but the coefficients on off-peak rail fare per mile remained high and significant.
34. NEG argued that the correlation is distorted by the historical (and, it argues redundant) practice of coach fares being set at a 70 per cent discount to a specific rail fare when both modes were under public ownership. It also submitted that other factors such as distance tapers could explain the correlation. Finally, it noted that many of the fares in the sample are coded fares which are determined by national pricing policy.
35. In the OFT's view, the fact that NEG's current coach fares continue to reflect historical practice (since terminated, we are told) of linking coach fares to rail fares suggests that NEG regards it as commercially rational to have coach fares at levels that exhibit a relationship with rail fares. Furthermore, the OFT observed correlation across flows where fares are set individually and this remained even when distance was removed as a potentially distorting factor.
36. Overall, the OFT considers that a plausible explanation for the significant price correlation between coach and off-peak rail fares on a per mile basis is a degree of competition between the two modes of transport. As said, no empirical (survey) evidence is currently available that would tend to refute this explanation. Moreover, this explanation is also consistent with certain third party evidence indicating that coach and rail compete in parts of the relevant GWF area.

### ***Filtering of flows***

37. On 100 of the 338 overlapping flows, NEG is already operating both the coach and rail services (as the Wessex franchisee). In the light of the OFT's view of the counterfactual outlined above, the OFT has also considered whether, if NEG wins the GWF, post-merger fares on these 100 overlaps would be higher than they otherwise would have been if an alternative bidder (with no such overlaps) had acquired the GWF (i.e. absent the merger). In other words, the change of

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<sup>9</sup> The correlation coefficient of merely 0.0037 between peak coach and peak rail fares per mile is low. The off-peak correlation figure across all flows of over 50 km in length was at the upper end of the range mentioned, at around 0.8. However, correlation figures across flows for which coach fares are individually determined were found to be 0.6 – these are NEG's so-called 'Top 200' flows by revenue across its entire network, as well as flows for which fare changes are linked to those on a Top 200 flow on the same route.

ownership of the former Wessex (GWF) rail services from NEG to a rival could mean that NEG's pricing and frequency decisions on its coach services would alter to take into account the presence of a now independent rail competitor.

38. NEG has submitted that the OFT should apply a set of filters it derives from the CC's analysis in *NEG/Greater Anglia*. In particular, NEG urged the OFT to exclude from its analysis all overlapping flows that (i) generate revenue less than 10 per cent of the revenue of the route as a whole; (ii) feature coach, bus or rail competition; (iii) generate annual coach revenue of less than £10,000; and (iv) have a service frequency of less than two coaches per day. In applying these filters, NEG suggested excluding from further analysis 318 of the 338 overlap flows, leaving 20.<sup>10</sup>
39. The OFT acknowledges the utility of filters at first phase merger review, especially in a case with well over 300 coach/rail overlaps alone, where sifting the number of flows to be considered to a manageable number is vital.
40. However, such filters are pragmatic, need to be checked for robustness/sensitivity, and could be case-specific (see *FirstGroup/ICEC* Commentary<sup>11</sup>). The validity of these filters should be tested in any given case, rather than simply applied mechanically. In any event, the filters must not be equated with rules which automatically include or exclude flows from the possibility of competition problems.
41. As such, the OFT has carefully considered the impact of adopting NEG's suggested filters. Exclusion of all flows upon which annual revenue was less than £10,000 a year would have filtered out a number of relatively small flows which in aggregate may have resulted in a significant contribution to the calculated profit incentive. Equally, it was also considered inappropriate to filter out flows where the frequency of the coach service is one a day. Overlaps featuring one-a-day coach services were filtered out in the CC's *NEG/Greater Anglia* inquiry, because the investigation revealed that such low frequency coach services were found not to pose a substantial constraint on much higher frequency rail services on the relevant flows in that region. However, in this case relative frequency is much less likely to be important, because these are journeys for which passengers will be allocating a substantial part of the day to travelling – such as between London and Carmarthen, Eversham, Neath or Totnes.<sup>12</sup> NEG has confirmed that for coach services frequency is generally less important than capacity.

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<sup>10</sup> NEG has also argued for an exclusion from detailed analysis of the 8 indirect overlap flows to London and Gatwick, because rail passengers would need to allow excessive time margins to change trains. However, the assessment demonstrated that train services have a significant time advantage on these flows compared to coach. The fact that the rail service is indirect might merit a diversion ratio lower than 70 per cent, as used in the OFT's model.

<sup>11</sup> See CC, *FirstGroup/ICEC* (terminated) merger inquiry: commentary on issues statement, 20 June 2005 (*FirstGroup/ICEC*).

<sup>12</sup> Passengers who will be prepared to switch between coach and rail will be those who attach a lower value to time compared to others and they will not be making the return journey in a day. Also, coach services will be scheduled at times most convenient for customers.

42. The OFT has applied a series of filters based on those employed by the CC in *ScotRail* and *NEG/Greater Anglia* inquiries:

- '10 per cent filter' – excludes flows on routes for which the coach revenue across all overlap flows is less than 10 per cent of the relevant route revenue
- a so-called 'effective competitor' filter – filters out flows on which a rival coach or bus operator(s), either individually or in sum, have 50 per cent of the frequency of the NEG coach services.

In addition, the OFT excluded:

- a large number of flows where annual coach revenue was truly minimal, i.e., less than £500.

43. The application of these filters eliminated 194 flows – well over half the total of 338 flows – from the next phase of scrutiny. This left 144 flows which have been the subject of more detailed profitability analysis. In any event, the application of filters only provides a first screen, i.e. for many of the flows (that would have been excluded under NEG's arguments) the subsequent profitability analysis suggested that there was in any event no realistic post-merger incentive to increase prices or reduce frequency. This applied, among others, to overlaps in the current Wessex franchise area.

#### ***Incentives to increase coach fares***

44. The OFT modelled the potential profit incentive for NEG to raise coach fares post-merger. Should coach prices increase,<sup>13</sup> some of the customers switching away from coach would use GWF's train operations. It would also enable the coach service to extract more revenue from those passengers who continue to use coaches. The model assumed the own price elasticity of demand<sup>14</sup> of coach travel to be -1 on the assumption that NEG would currently act in a profit-maximising manner. NEG has suggested the use of an elasticity of -1.1 for fare increases of up to 10 per cent and that an unspecified higher elasticity should be used for larger fares increases. However, the calculations show that even using an elasticity of -1.1 would still result in a considerable up-lift that would indicate post-merger incentives to raise prices.

45. The model estimated the impact of raising fares on coach revenues using information provided on the average fare paid by coach passengers on each of the overlap flows. It assumed that the rail fare paid by a coach passenger who switched from coach to rail, in response to an increase in coach fares, would be the average coach fare for the relevant flow divided by 0.7. This assumption was based on information provided by NEG that historically coach fares had been set at 70 per cent of the relevant rail fare (see paragraph 34).

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<sup>13</sup> The model considered coach price increases of 3 per cent, 10 per cent, 20 per cent and 50 per cent with rail fares remaining constant.

<sup>14</sup> The own price elasticity of demand measures how responsive coach passengers are to changes in price.

46. The model used diversion ratios<sup>15</sup> of 50 per cent and 70 per cent and tested sensitivity for some flows at a lower rate of 25 per cent. In this context, NEG has submitted that a diversion ratio of 40 per cent as used by the CC in *NEG/Greater Anglia* should have been used. However, the OFT believes that a more cautious approach, using a range of diversion ratios, should be employed at first phase. This is also in line with previous OFT investigations, for example in *NEG/TGN*. As discussed below, the results demonstrate that even a diversion ratio of 40 per cent, generates positive net revenue up-lift.
47. The price simulation on the basis of the model described above provides strong evidence that NEG would have an incentive to increase coach fares on overlap routes, should its bid for the GWF be successful. Of the 144 flows on which the profitability analysis was conducted, 55 flows generate positive up-lift and 19 of these flows account for 90 per cent of the total up-lift.<sup>16</sup> The most problematic flows appear to be to/from London and Gatwick and destinations in the West Country and south Wales.
48. An important factor in the CC's assessment in *NEG/Greater Anglia* was the potential loss of network revenues if NEG raised price on given flows, and so the effect on NEG's network revenues was included in the model. However, even by additionally incorporating other assumptions favourable to NEG, individually and in combination, a positive revenue up-lift, and in turn a merger-specific profit incentive, was identified in respect of between 20 and 55 flows, depending on the assumptions.
49. In addition, the above results may well be conservative estimates as there appears to be potential for greater revenue up-lift for fare increases of between 40-45 per cent. Furthermore, the SRA estimates that unregulated revenue will account for over 60 per cent of the GWF's total revenue. Hence, there may also be scope for unilateral increase in unregulated rail fares.
50. NEG has submitted that it employs a national pricing policy which would prevent it from exploiting coach passengers on individual overlapping flows post-merger. However, NEG has explained that fares are individually determined for the 'Top 200' flows and other flows connected to the 'Top 200'. NEG estimates that these routes account for 80 per cent or more of its coach revenue. [...] <sup>17</sup> Information provided by NEG shows that of the 55 flows which produce a positive up-lift, 20 are 'Top 200 flows'. Of the remainder, for all but four, the fare structure reflects the fares set on a 'Top 200' flow on the same route. It should also be noted that

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<sup>15</sup> The diversion ratio measures the extent to which, in the event of a price increase, passengers who switch away from coach do so to rail. For example, if as a result of the fare increase ten passengers switch away from coach to rail and the diversion ratio is 70 per cent, seven of the ten passengers that switch do so to rail. The remaining three lost passengers do not travel by rail, they may not travel at all or they may use an alternative mode of transport.

<sup>16</sup> Flows where the potential up-lift was estimated to be less than £500 across all price increase scenarios have been excluded from the results. In addition, sensitivity tests were carried out to the diversion ratios and the filters individually and cumulatively. For indirect flows the methodology adopted may overestimate the additional rail revenue generated by switching passengers. However, given that indirect flows account for only 16 per cent of the up-lift, their impact is not considered to be material.

<sup>17</sup> Information deleted at NEG's request.

NEG has recently introduced so-called 'Funfares' on certain flows suggesting further scope for NEG to respond to competitive conditions on a flow-by-flow basis.

51. The OFT therefore believes that should the GWF be awarded to NEG it may have both the ability and the incentive to raise coach prices resulting in a realistic prospect of a SLC on between 20 and 55 flows.

#### ***Incentives to reduce coach frequency***

52. Having considered the possibility that the merger would give rise to incentives to raise coach prices, the OFT considered possible incentives to reduce service frequency. This analysis assesses an increase in revenues (rather than profits), as well as the impact on profits from the cost savings that could be made by a reduction in service on a particular flow. Any losses in coach revenues are set against the decrease in costs likely to be associated with a reduction in service on that route.
53. The OFT modelled frequency reductions using the same assumptions used for the fare increases (i.e., an elasticity of -1, coach to rail diversion ratio of 70 per cent) and on average fares paid by coach passengers and switching rail passengers. The analysis looks at three potential frequency reductions of 10 per cent, 20 per cent and 50 per cent.
54. While there was insufficient data to carry out a full analysis of the impact on cutting service frequency,<sup>18</sup> the results show that NEG could increase profit by cutting frequency on certain coach routes. In particular, additional revenue generated on flows that overlap with rail tends to off-set revenue lost on coach and the profit up-lift is driven by the cost savings. Even if lost network revenue attributable to the specific flow is taken into account, the results suggest that NEG could still profitably reduce frequency.
55. However, since cutting frequency on a route will have an impact on *non-overlap* flows within that route (i.e., flows not also served by GWF rail) a frequency reduction is less likely to be profitable post-merger, because the loss of coach revenue on the route as a whole appears to outweigh (by a considerable margin) the cost savings achieved.. The calculations also show that frequency reductions across the entire *route* would be unprofitable.
56. The OFT therefore believes that whether NEG could post-merger profitably reduce frequency would depend on the scope that there would be for NEG to reconfigure its services so as to reduce frequency on the overlap flows without adversely impacting on service levels on non-overlap flows. However, given that the OFT believes that NEG may post-merger have the incentives to increase coach fares so as to raise a realistic prospect of an SLC, no firm conclusions need to be drawn on the potential profitability of coach frequency reduction.

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<sup>18</sup> NEG routes overlap to an extent that allows for numerous combinations which makes it difficult to predict on which route(s) a reduction in service frequency on a particular flow would impact. Also, many of the potentially problematic flows are into London and frequency reduction might therefore be achieved by terminating the service in a regions hub such as Bristol.

### ***Constraints posed by other coach and air services***

57. NEG has argued that any attempt to exploit their position post-merger, would be frustrated by the expansion or entry of rival coach operators, in particular Megabus. NEG has also submitted that air travel would impose a competitive constraint on certain flows between the West Country and London.
58. The CC has in *NEG/Greater Anglia* identified considerable natural and strategic barriers to entry to the provision of scheduled coach services. These barriers appear to apply equally to the expansion of services by existing operators. Barriers to entry are, however, expected to be higher for a coach operator entering new routes/flows as compared with increasing capacity and/or frequency on routes/flows where the operator already has a presence.
59. **Megabus** currently operates services in the GWF area and, in particular, on some of the potentially problematic flows. The OFT therefore considered the extent to which the threat that Megabus might increase capacity on these existing services or enter new routes could pose a competitive constraint on NEG. This we did largely by looking at how NEG has, in practice, responded to actual competition from Megabus.
60. The internal business documents provided appear to show that Megabus is considered to be a competitor by NEG at least in terms of overall strategy. Notwithstanding these documents, it appears from the available evidence that Megabus's presence has had only a limited impact on NEG's fares policy. NEG's pricing response has been limited to increasing the number of so-called 'Funfare' tickets. However, these tickets have been targeted towards specific services, while fares for other ticket types had not been reduced.<sup>19</sup> The OFT also notes from NEG's submissions that Megabus employs a different business model and aims to specifically target only very particular coach user groups such as students. On balance, the OFT believes that NEG may be competing with Megabus for only part of its customer base, and that competition may be confined to particular point-to-point flows.
61. NEG has provided data showing large passenger volumes by **air** between London and Newquay relative to other transport modes. However, much of the evidence provided by NEG relates to competition between air and rail rather than air and coach. Competition between air and rail is particularly pronounced for business passengers, whereas the OFT assumes that coach is generally not competing for those customers. On the basis of the limited evidence available, it appears that air fares may be considerably higher than coach fares depending on the departure date. In addition, the costs of travelling to and from the airport are likely to be higher than those of travelling to or from coach drop-off/pick-up points. In the absence of any convincing data on passenger switching, air travel is not considered to pose a substantive constraint on coach fares between the West Country and London.

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<sup>19</sup> The regression analysis for evidence of whether the presence of Megabus would, in practice, operate as a competitive constraint on NEG fare-setting resulted in a coefficient that was insignificant.

## **Conclusion**

62. The OFT therefore believes that should the GWF be awarded to NEG it may have both the ability and the incentive to raise coach prices resulting in a realistic prospect of a SLC on between 20 and 55 flows; the issue of corresponding incentives to reduce frequency is left open.

## **Undertakings in lieu – coach/rail**

63. Having concluded that the transaction should be referred to the CC, the OFT has considered whether there might be undertakings in lieu (UIL) of reference, pursuant to section 73 of the Act, which would address the concerns outlined above.
64. NEG has offered a set of behavioural undertakings in relation to coach/rail concerns, including price caps and service regulation, informed in part by those accepted by the CC in the *ScotRail* inquiry.
65. In order to accept UIL, the OFT must be confident that the competition concerns identified can be resolved by means of undertakings without the need for further investigation. Consistent with its stage of investigation, UIL are appropriate only where both the concerns and the remedies proposed to address them are clear cut. In this case, the number of overlaps involved and the dispute surrounding the appropriateness of assumptions used in our assessment mean the precise identification of the scope of the SLC is not clear-cut.<sup>20</sup>
66. This doubt means that the OFT cannot confidently define the competition concerns we have in a clear-cut manner. Even if such concerns could be clearly-defined, the complex regulatory package of price caps and service regulation at issue raise important questions as to its restorative effect on competition, and cannot be reconciled with the OFT's standard that a first-phase remedy be clear-cut. The OFT therefore concludes that this is not an appropriate case to accept UIL.

## **Rail/rail issues**

67. If NEG were awarded the GWF, 16 rail/rail overlaps with Central Train (CT) services between Cardiff and Newport on the stretch of line between Hereford and Worcester would result.
68. NEG submitted that the CT franchise is due to expire on 31 March 2006 and would subsequently most likely be subject to a management contract determined by the SRA. Moreover, these overlaps would not raise any competition issues because no dedicated fares<sup>21</sup> were offered; competition from rival local bus/coach services would remain and the overlapping services would to a large extent be differentiated by their service frequency.

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<sup>20</sup> See, in particular, paras. 8.3 and 8.4 of the OFT *Mergers, Substantive Assessment Guidance*.

<sup>21</sup> Dedicated fares are those tickets which can only be used on a specific operator's trains on a flow.

69. On a closer assessment it appears that for 12 of the 16 flows, CT operates a much more frequent, i.e. hourly service as compared to the four times daily GWF irregular service. Therefore, four flows may raise competition concerns: Newport to Cardiff; Great Malvern to Malvern Link; Great Malvern to Worcester; and Malvern Link to Worcester.
70. It remains doubtful as to whether the transaction might give rise to a realistic prospect of a SLC on these flows. This would depend on the exact duration of the CT franchise, i.e. the duration of any overlap between CT and the GWF. The OFT is currently not in a position to specify the duration of the overlaps with any certainty. Moreover, further assessment of the potential introduction of dedicated fares may be required in order to reach a conclusion as to whether or not the award of the GWF would raise a realistic prospect of an SLC on these overlaps.
71. In certain previous decisions<sup>22</sup> the OFT has concluded that the relatively limited duration of rail/rail overlaps meant that there was insufficient time for the transactions to result in a SLC. Given the OFT's above conclusions that it is bound to refer this case due to coach/rail concerns, it has not necessary for the OFT to conclude definitively on the degree to which the rail overlaps raise concerns.

### **THIRD PARTY VIEWS**

72. The OFT has received representations from the SRA and another third party. The SRA said that the CT franchise is currently being remapped and that the structure of the new franchise will be announced in autumn. The SRA is proposing to postpone the end of the franchise to September 2007. An introduction of dedicated fares on the flows serviced by both GWF and CT would be unlikely, but not impossible.

### **ASSESSMENT**

73. NEG is one of the three competing bidders for the award of the GWF franchise by the SRA. The GWF franchise will be subject to extensive SRA regulation. Assessment of this merger must take account of the surrounding regulatory context.
74. For point-to-point journeys where the GWF rail services overlap with coach or rail services already provided by NEG, the merger would result in 338 coach/rail overlaps and 16 rail/rail overlaps. In many cases NEG would be the only supplier of public transport services post-merger.
75. The key issue raised by these coach/rail overlaps is whether the combination of these otherwise independent public transport alternatives for a given journey would in fact reduce competition such that post-merger NEG would have the incentive to increase bus fares and/or reduce frequencies. The degree of competition that coach and rail impose upon one another derives from the degree to which passengers would switch between the modes in response to price increases. On this fundamental question the OFT had no significant empirical evidence in relation to over 300 point-to-point flows at issue. In lieu of direct

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<sup>22</sup> *FirstGroup/GB Railways; FirstGroup/Thames Trains; Connex/Govia*. See [www.of.gov.uk](http://www.of.gov.uk).

evidence, the OFT has sought to test how realistic it is to expect merger-induced price increases or frequency reductions by simulation using a range of assumptions.

76. On assumptions that we believe not to be unreasonable there would appear to be a substantial incentive for NEG to raise coach fares on between 20 and 55 flows. These are mainly flows to/from London and Gatwick and destinations in the West Country and south Wales.
77. Such changed pricing incentives attributable to the merger may be lessened or removed if the presence or threatened entry or expansion by rivals were a sufficient constraint. However, barriers to entry and expansion in coach services appear to be substantial. From the available evidence, at least, it appears that Megabus may currently only compete with NEG on specific flows/routes and for certain customer groups. Competition from air travel is not considered to pose a substantive constraint on coach fares between the West Country and London.
78. Post-merger incentives to reduce coach frequency are less clear. The potential profitability of frequency reductions will depend on whether or not it would be possible for NEG to reduce frequency only on overlapping flows.
79. In sum, the theory of competitive harm in relation to coach fare increases cannot be dismissed as incompatible with the facts available at this stage of merger review. Accordingly, the OFT believes there is a realistic prospect of SLC in relation to a minimum of 20 and a maximum of 55 coach/rail overlaps. Despite best efforts, it has not, however, been possible during first-phase review and with the limited direct evidence of substitutability to conclude more definitively among the flows identified between those that do and do not raise such concerns.
80. As the coach/rail undertakings in lieu offered do not represent a clear-cut solution to a clear-cut concern, this exception to the duty to refer could not be applied.
81. Given the OFT's duty to refer in any event, it was unnecessary to reach definitive views on issues raised by the rail/rail overlaps, albeit of limited duration.
82. In conclusion, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

## **DECISION**

83. This merger will therefore be referred to the Competition Commission under section 33(1) of the Act.