
Completed acquisition by National Express Group plc of the Intercity East Coast Rail franchise

The OFT's decision on reference under section 22(2)(a) given on 20 December 2007. Full text of decision published 10 January 2008.

Please note that square brackets indicate figures or text which have been deleted or replaced at the request of the parties for reasons of commercial confidentiality.

PARTIES

1. **National Express Group plc** (NEG) is a major UK public transport operator with existing rail, bus and coach operations. NEG's subsidiary National Express Limited (NEL) administers and markets a network of express coach services throughout Great Britain. Although NEL owns and operates some coaches, particularly those used on airport services, the majority of vehicles and drivers employed to operate its coach services are contracted in from a large number of third party coach operators.
2. The **Inter City East Coast** (ICEC) franchise involves the running of regular rail services between London Kings Cross, Peterborough, Doncaster, Leeds, York, Newcastle, Edinburgh and Glasgow, and a limited number of services extending to other destinations (including Inverness, Aberdeen and Hull). The annual turnover of the Intercity East Coast (ICEC) franchise in 2006/07 is expected to be around £545 million.

TRANSACTION

3. NEG was the successful bidder for the ICEC franchise awarded by the Department for Transport (DfT) in August 2007. The new franchise commenced on 9 December 2007.

4. The transaction was notified on 25 September 2007. The (extended) 40-working-day administrative deadline expired on 3 December 2007 and the (extended) statutory deadline will expire on 26 December 2007.

JURISDICTION

5. The annual turnover of the ICEC franchise in 2006/07 is expected to be around £545 million which, together with the turnover of NEG, would meet the required turnover thresholds to constitute a community dimension pursuant to Art. 1 of the European Community Merger Regulation (ECMR). However, since both NEG and ICEC achieve more than two-thirds of their community-wide turnover within one and the same Member State, i.e. the UK, the transaction is not considered to have a community dimension (Art. 1(3) ECMR).
6. The award of the ICEC franchise constitutes an acquisition of control of an enterprise by virtue of section 66(3) of the Railways Act 1993. Therefore, NEG and ICEC have ceased to be distinct. The anticipated turnover from the first year of operating the franchise exceeds £70 million, so the turnover test pursuant to section 23 (1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes it is or may be the case that a relevant merger situation has been created.

COUNTERFACTUAL

7. Applying the substantial lessening of competition test involves comparing prospects for competition with and without the merger. In the majority of merger cases, the basis for assessing prospects for competition in the absence of the merger – the 'counterfactual' – is given by conditions prevailing pre-merger (the '*status quo ante*'). However, the Competition Commission (CC) has established in previous reports¹ that transactions involving the award of a rail franchise are an example of where the *status quo ante* is not the correct counterfactual, as the current franchise agreement will terminate and there is no expectation that the current franchise holder will continue to operate the franchise.

¹ See the CC reports in: *NEG/Greater Anglia*, November 2004, paragraph 5.1 (a report on the acquisition by National Express Group plc of the Greater Anglia franchise); *First/ScotRail*, June 2004, para.5.2 (a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise); *First/GWF*, March 2006, para.4.3 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

8. NEG submitted that the appropriate counterfactual in this case would be the award of the ICEC franchise to one of the other short-listed bidders². It argues that they all have significant public transport interests in the ICEC franchise area. Therefore, any of the other bidders are likely to be at least as detrimental to competition as the award of the franchise to NEG. Accordingly, NEG considers that comparing the award of the franchise to a non-overlap bidder is not a realistically possible alternative.
9. However, in line with the CC's findings in its *First/GWF* report³, the OFT considers that the appropriate counterfactual is the award of the franchise either to a company that would raise no competition concerns or to one in respect of which any competition concerns would be remedied through behavioural undertakings.

MARKET DEFINITION

10. The activities of NEG and the ICEC franchise overlap in the provision of passenger transport services. There are a number of point-to-point journey overlaps between coach services operated by NEL and rail services operated under the ICEC franchise.

Geographic scope

11. Point-to-point geographic frames of reference have consistently been employed in relation to various modal pairings such as bus/coach/rail, rail/rail, and coach/rail (see for example *NEG/Greater Anglia*, *First/Scotrail*, and *First/GWF*).
12. Accordingly, the OFT's principal frames of reference relate to the provision of public transport services between specified origin/destination points (flows) as detailed below.

Product scope

13. NEG has identified 50 direct point-to-point overlap flows between coach services operated by NEL and rail services operated under the ICEC

² Arriva, FirstGroup or the 50/50 Joint Venture between Stagecoach and Virgin.

franchise. On a number of flows there are only very limited (or indeed no) other services currently operating in competition with NEG and the ICEC franchise.

14. In various previous reports concerning the provision of passenger transport services, the CC and the OFT have considered transport markets on the basis of substitutability between coach and rail services (or other alternative modes of transport) on point-to-point flows. In *NEG/Greater Anglia* the CC considered that passenger choice between modes of transport is likely to depend on a number of aspects of the journey, such as journey cost, journey time, frequency etc. which is usually referred to as 'generalized cost'.⁴
15. NEG considers that there should be no automatic assumption that NEL's coach services are constrained by rail services in the ICEC franchise area. NEG also submitted that competition from private cars should be considered as a constraint. NEG has also argued that on many of the mid-to long-distance overlap flows in the franchise area air travel will constrain NEG post-merger.
16. However, the OFT believes that these aspects are more appropriately considered on a flow-by-flow basis. This is in line with previous CC investigations where these considerations have consistently been addressed as part of the flow-specific competition assessment rather than as part of the market definition.
17. The CC has usually distinguished leisure travel from business commuting and business travel to the extent that leisure passengers are more price-sensitive and more likely to switch between different modes of transport in response to a price rise. This will be considered, as appropriate, in the flow-specific assessment below.
18. Therefore, as a starting point, the relevant frame of reference is considered to be public passenger transport services. The competitive assessment will be carried out on a flow-by-flow basis, taking into account the individual flow characteristics.

³ CC report in *First/GWF*, March 2006, para.4.6 (a report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise).

⁴ In *NEG/Greater Anglia* the CC found that the relative (generalized) user costs differed significantly from relative fares.

HORIZONTAL ISSUES

Non-coordinated effects

19. NEG submits that, in setting coach fares they generally do not consider rail services to constrain its coach services. It argues that on the flows where its coach services overlap with the ICEC franchise's rail services, the two modes are not close competitors, which is evidenced by the fact that it does not monitor fares, service frequencies or passenger volumes on the overlapping rail services. NEG points to significant differences in the frequency of service, fares, number of passengers carried, revenue, and journey times between the coach and rail services on many of the overlapping flows. NEL's coach turnover from the 50 overlap flows was £8.7 million in 2006, compared with rail revenue derived from those flows of £325 million.
20. NEG has also put forward arguments that private cars should be treated as being in competition with rail services. In this context it is noteworthy that in *NEG/Greater Anglia* the CC had evidence of limited substitutability between public and private transport in response to price changes, but found that the extent of substitutability may vary according to the type of flow. It noted in particular that private transport accounts for a relatively small share of journeys into central London, a particular focus of that case.
21. NEG contends that air travel provides a relevant constraint on many of the long and mid-distance overlap flows in this case. In *Virgin/Stagecoach/ICEC* the OFT identified airlines as competitors to long-distance rail routes from London to Edinburgh, Glasgow and Dundee⁵. NEG submit that by the same token, on the London-Stirling, London-Berwick-upon-Tweed, London-Aviemore and London-Durham flows air travel should be considered to effectively constrain NEG's coach as well as rail services post-acquisition. This will be further considered in the flow-specific assessment below.
22. However, third-party respondents generally agree that while overlapping rail and coach services are characterised by significant differences in terms of fare prices, journey times, and service frequencies, coach and rail may constrain each other on individual flows. On the basis of a flow-specific

⁵ *Virgin/Stagecoach/ICEC*, at paragraph 78.

assessment, the CC noted in *NEG/Greater Anglia*⁶ a number of reasons referred to in its previous reports why rail and coach should be regarded as substitutable:

- that a significant proportion of the increase in coach demand in response to lower prices after coach deregulation resulted from passengers switching from rail
 - that in response to competition from coach travel at that time, lower fare saver and supersaver tickets were introduced for rail travel
 - that coach prices had been set at a discount from rail prices (NEG told the CC that this was no longer the case), and
 - that there was evidence from passenger surveys that relative fares were a significant factor in passenger choice between rail and coach travel.
23. NEG submitted coach passenger survey evidence in relation to three flows^{7, 8}. These stated preferences showed that for that class of passengers who would switch away from coach services in response to changes in the price or service offer, rail was their most frequently preferred alternative.
24. The theory of harm considered by the OFT in this case is that NEG may have an incentive to increase fares or reduce frequencies, services or service quality in relation to its coach services to shift passengers onto rail and the ICEC franchise. In this context, it should be noted that the main concern in previous coach/rail mergers has been the potential effect on coach services. Coach services are not subject to economic regulation (unlike rail where regulated fares exist to varying degree depending on the flow), hence in principle the merged entity could raise fares or reduce service levels on certain coach services, given that it would benefit from additional revenue from those passengers that switch to its rail services.
25. This focus is consistent with prior inter-modal road/rail cases, where the principal concern has been potential merger effects on unregulated coach or bus services rather than rail services, which are regulated with respect to service levels and subject to partial fare regulation. Regulation tends to reduce the risk of merger effects, and therefore concerns, relating to important issues such as rail service frequency and quality, and as to a rise

⁶ Para 6.19

⁷ London-Leeds, London-Bradford and London-York.

⁸ NEG wishes to highlight that the survey only covered NEL passengers and how they would react to a price increase and/or reduction in service quality by NEL's coach services.

in regulated fares (although the OFT notes that it is still possible to increase regulated rail fares: by RPI + one per cent on a fares basket, and RPI + six per cent on individual fares).

26. As to unregulated fares, in *NEG/Greater Anglia* the CC considered that effects on rail were unlikely on the relevant overlap coach/rail flows in that case due in part to very low cross-price elasticity of rail leisure demand with respect to coach.⁹ The CC observed that:

It is particularly unlikely in our view that competition from coach services on the overlap flows we are considering would constrain rail fares ... the cross-price elasticity of rail demand to coach fares or aspects of coach services is very low on these routes, given the low share of coach travel. (para 6.41)

27. In practice, in all other inter-modal cases under the Act the CC has to date not found any adverse merger effects on rail, even in *First/Scotrail* where it did find adverse effects and imposed remedies on the bus element of relevant overlaps.
28. While this case, like *NEG/Greater Anglia*, is also characterised by a low share of coach travel (around one per cent or less of total public transport flow revenue), more important for present purposes is that the OFT has no reason on the evidence to conclude that the diversion ratios from rail to coach would be sufficiently high in the event of a price increase on rail to make such action profitable.
29. Therefore, in this case the OFT excludes concerns as to effects on rail and considers further the risk of adverse effects only on coach travel on relevant overlaps as discussed below.

Filters

30. In previous public transport passenger cases a range of 'filters' have been used in order to focus the analysis preliminarily on those areas that are most likely to give rise to competition concerns. The following filters have been used in previous cases to filter out coach overlaps:

⁹ *NEG/Greater Anglia*, paragraph 6.24 and 6.41.

- a. The '10 per cent filter': the relative importance of overlapping flows compared with overall passenger numbers and revenue on a route: in many previous cases, routes for which overlap flows taken together account for less than 10 per cent of passengers and revenue have been excluded
 - b. The 'effective competitor filter': the presence of countervailing competition from third parties (this has previously been variously defined, but usually an effective competitor runs at least half the service frequency of the merged entity)
 - c. The '*de minimis*' filter: relating to the value of revenue on overlap flows (£10,000 has on occasion been used as a threshold for concentrating initial analysis).
31. Filters have consistently been applied as a starting point. The application of filters is not intended to formally 'safe harbour' those flows which are filtered out and they are not dismissed by the OFT as entirely unproblematic. They provide a means of prioritising the competition assessment of a potentially large number of overlap flows. The logic is, as a first step, to focus the analysis on those flows which appear potentially most problematic.
32. As noted above, NEG identified 50 overlap flows, accounted for by 30 NEL coach routes. Annual revenues attributable to specific NEL coach flows range from less than £10¹⁰ (Durham-Darlington) to over [] (London-Leeds). Application of the 10 per cent filter preliminarily removed eight of the flows. Focusing on flows with annual coach revenues in excess of £10,000 removed an additional 14 flows, narrowing the assessment to 28 overlap flows.
33. Intra-modal coach competition between Stagecoach/Megabus and NEL exists on a number of routes in the ICEC franchise area such that the OFT believes, on the available evidence, that the effective competitor filter could apply, based on relative frequencies. In *Virgin/Stagecoach/ICEC* the OFT noted that on all routes where Megabus was present there was at least one other coach service providing a comparable service, and hence that any attempt to increase Megabus' fares or reduce service levels would

¹⁰ There are less than 10 passengers per annum on this flow.

be expected to result in a displacement of passengers onto competitor coach services.¹¹ Effective countervailing competition is also present on certain flows from third party rail competitors (including Virgin West Coast, First Scotrail, and Cross Country services).

34. On the basis of the effective competition and *de minimis* considerations, NEG's submission filters out another 19 flows and identifies nine flows not excluded by the mixture of filters it suggests might be applied. These are all London-related flows with the other end points being Leeds,¹² Bradford, York, Doncaster, Darlington, Durham, Keighley, Berwick-upon-Tweed and Skipton.
35. On the basis of the OFT's preliminary flow analysis, four additional flows may also be of potential concern. In particular, the London-Stirling, London-Aviemore, Glasgow-Newcastle and Glasgow-York flows, where the competing rail services to NEL and ICEC appear to be limited. With regard to London-Stirling and London-Aviemore, only the Scotrail Sleeper service (which runs only daily) provides a coach or direct rail constraint while Cross Country only runs two direct daily rail services each on Glasgow-Newcastle and Glasgow-York.
36. Therefore, a flow-specific assessment has been carried out with regard to the 13 flows listed in the table below.

Flow	NEL coach frequency*	ICEC rail frequency*	Coach competitors frequency*	Rail competitors frequency*
London-Leeds	14	33	Megabus (4) New Bharat ¹³ (1)	Midland Mainline (3)
London-Bradford	10	1	New Bharat (1)	
London-York	4	30		<i>[Grand Central¹⁴ (3)]</i>

¹¹ *Virgin/Stagecoach/ICEC*; at paragraph 70.

¹² London-Leeds accounts for the fourth highest (non-airport) flow revenue in NEL's network, with annual revenue in excess of [].

¹³ New Bharat is a small business operating a limited number of scheduled coach services, mainly between Southall and the Midlands via Slough.

London-Doncaster	3	47		Hull Trains ¹⁵ (7)
London-Darlington	4	26	Megabus (3) to Scotch Corner	[Grand Central (3) ¹⁶]
London-Durham	4	15		
Glasgow-Newcastle	1	7		Cross Country (2)
London-Stirling	1	1		Scotrail Sleeper (1)
London-Keighley	3	1		
London-Berwick	2	11		
London-Skipton	3	1		
London-Aviemore	1	1		Scotrail Sleeper (1)
Glasgow-York	1	7		Cross Country (2)

* Departures per day.

London-Leeds

37. London-Leeds is the fourth biggest flow on NEL's coach network accounting for more than [] annual revenue. On this flow, NEL operates 14 coach services a day, with Megabus operating four services and New Bharat operating one service. While Megabus does not achieve half the number of NEL coach services on this flow (and therefore was not excluded by the effective competitor filter, thereby remaining subject to a more detailed assessment) Megabus' daily capacity is relatively substantial. Megabus operates four 90-seater coaches per day with a total seating capacity of 360 seats, while NEL's daily seating capacity amounts to 405 seats allocated to the flow (out of 686 seats in total¹⁷). Moreover, Megabus' services operate at periods of daily peak demand. Both NEL's and Megabus' services offer a direct service to Leeds and journey times are similar. The parties have submitted that Megabus could easily expand its capacity on this flow, which is supported by the fact that Megabus has on various flows expanded significantly in the recent past.

¹⁴ NEG submits that Grand Central is a new entrant due to start shortly on the East Coast Main Line, however, start of this service seems to have been delayed repeatedly and Grand Central will therefore not be considered as an actual competitor for the purpose of this assessment.

¹⁵ Hull Trains was established in 2000 to offer a direct service between Hull and London.

¹⁶ See footnote 23 above.

¹⁷ The remainder of seats are allocated to other flows on this route.

38. While Megabus started in 2003 as a no-frills coach operator (using very basic coaches and mainly targeting students), it has since brought its business model more in line with that of NEL. For example, it is now targeting the same types of customers (including pensioners and people on lower incomes as well as students). Also, Megabus is now using more comfortable types of coaches, comparable to those of NEG, than when it first started. As a further development of Megabus becoming a more head-to-head competitor of NEL, it has from October 2007 relocated to the same London terminus as NEL, Victoria Coach Station.
39. NEL also submitted internal evidence to demonstrate that it closely monitors and reacts to Megabus' ticket pricing. NEL first introduced so-called 'funfares' in 2003 and NEG argues that this was, inter alia, a response to Megabus' entry. Funfares are low-priced advance purchase tickets which are only available online. They start at £1 from a single journey and their availability varies according to the levels of demand for a specific service. Evidence received from NEG shows that average fares on a flow tend to be lower following the introduction of funfares. NEG also submits that it is currently developing a yield management pricing system, partly as a response to the presence of Megabus.
40. NEG has submitted passenger survey evidence which suggests that an alternative coach operator, such as Megabus, will tend to provide a stronger competitive constraint to NEL on this flow than the alternative rail services.
41. NEG submits and third party evidence received by the OFT confirms that Megabus concentrates its activities on those flows with the highest passenger volumes. It is reasonable to assume that the levels of demand on the London – Leeds flow were considered sufficiently great (and therefore profitable) by Megabus to accommodate its entry, and there is evidence to suggest that it could easily expand its capacity on this flow and run more services if NEG increased coach ticket prices post-merger.
42. In light of the above factors, the OFT believes that no substantive competition concerns are raised by this transaction on the London-Leeds flow.

London-Bradford, London-Keighley, London-Skipton

43. On each of these three flows there is only one direct rail service a day on the ICEC franchise. NEG submits that most rail passengers travelling to these destinations will instead opt for the indirect rail service via Leeds, that is travelling with ICEC from London to Leeds and then take the Northern Rail services from Leeds to Bradford, Keighley or Skipton. For example, there are a total of 27 indirect services daily between London-Leeds-Bradford. Notably, the one direct daily ICEC service takes slightly longer than the fastest indirect service via Leeds.
44. As an alternative to rail (whether direct or indirect), passengers can travel by Megabus coach to Leeds and then use local transport options (such as train – ICEC or Northern Rail – or bus) to reach their final destination.
45. Given that Bradford is only 12 miles from Leeds, NEG argued that Megabus could easily add another stop in Bradford, given that it is the [] largest NEL flow in terms of revenue in the reference area and in light of Megabus' past policy of 'cherry-picking' the highest passenger volume routes. While there is some recent evidence of Megabus reconfiguring its routes, there is no need to conclude on this point as it does not alter the OFT's analysis.
46. On the basis of the evidence available to it, the OFT considers that the merger is not expected to result in a realistic prospect of a substantial lessening of competition in relation to these three flows because of the limited number of overlapping ICEC direct services and the presence of alternative travel options including indirect rail services via Leeds, and Megabus coach to Leeds together with the choice of various local transport options to the final destination.

London-Aviemore, London-Stirling

47. NEG submits that there is significant competition from airlines on both flows which would continue to constrain them going forward. With regard to London-Stirling, a number of airlines fly between London and both Glasgow and Edinburgh airports with Edinburgh Airport being approximately 20 miles from Stirling and Glasgow Airport being approximately 39 miles from Stirling. In relation to London-Aviemore, NEG submits that air travel from London to Inverness which is located approximately 36 miles from Aviemore is a viable alternative for both coach and rail passengers. NEG

has also submitted evidence to support the perception that low-cost air travel is a viable constraint on both coach and rail on long-distance flows from London to Scotland. Between 2001 and 2005, rail's share of leisure passengers between London and Edinburgh (which can reasonably be considered as a proxy for London-Scotland flows) reduced from 42 per cent to 31 per cent and this is largely a result of the inroads of low-cost air travel. With regard to coach passengers, NEG submitted price information showing that ticket prices for low-cost air travel are typically available at prices comparable to coach and rail tickets.

48. Given the general high price sensitivity of coach travellers (which has been confirmed by the survey carried out by NEG), the OFT is of the view that, as a general proposition, only low-cost air travel (rather than 'traditional' air travel) can realistically be considered to constrain coach travel. The OFT notes, however, that several low-cost carriers fly between London and Scotland, including Easyjet and Ryanair, as well as a number of scheduled operators such as British Airways and BMI, and this is supported by the evidence provided by NEG showing the considerable growth in leisure passengers using air travel in recent years.
49. On balance, the OFT believes that on the two London – Scotland flows in question low-cost air travel effectively constrains coach (and rail) travel and will continue to do so post-merger.
50. On each flow, ICEC only runs one daily rail service. However, there are another 13 indirect rail services to Stirling via Edinburgh and four indirect services to Aviemore (via Edinburgh and Glasgow). All indirect services are broadly comparable in terms of journey duration. There is also one daily Scotrail sleeper service on each flow. The OFT considers that indirect rail services on the two flows may constrain NEG post-merger although there is no need to conclude on this point as it does not alter the OFT's analysis.
51. In light of the above, the OFT is satisfied that there is no realistic prospect of a substantial lessening of competition on these flows.

London-Darlington

52. NEG submit that while it operates four daily coach services on this flow, Megabus' three services a day to Scotch Corner will continue to effectively constrain it on this flow. Scotch Corner is just seven miles from Darlington

and for all intents and purposes meant to serve the London – Darlington flow; there are frequent local bus services connecting Megabus' stop with Darlington town centre. This has been confirmed by Megabus. Therefore, the OFT considers that Megabus constitutes an effective competitor on this flow, and therefore this flow will not be further considered.

London-York, London-Doncaster, London-Durham

53. This group of flows can be characterised as mid-distance (as compared to the long-distance flows to Scotland, see above). There is no other coach operator active on any of these flows.
54. On London – Durham, NEG will be the only supplier of public passenger transport services post-merger, without any actual competition from another rail or coach operator. NEG submits that there is significant actual competition on the flow from air travel as well as potential competition from Megabus. It argues that the four daily flights from London to Durham Tees Valley and 12 daily flights between Newcastle and London should be considered to sufficiently constrain NEG going forward. Evidence submitted by NEG indicates that rail continues to hold a very high share of the leisure travel market on mid-distance flows,¹⁸ with low-cost air travel playing a much less important role than on long-distance routes to Scotland (see above). Therefore, on the basis of the evidence available to it, the OFT considers that low-cost air travel may not be sufficiently developed to sufficiently constrain coach prices post-merger on the London – Durham flow.
55. With regard to London – York, NEG submits that Grand Central will service the flow with three daily train services. It argues that as an open access operator it may represent a greater competitive constraint than an overlapping fully regulated service. Similarly NEG contends that the presence of another open access operator, Hull Trains, running seven services a day between London and Doncaster would be more attractive than the ICEC for those NEL coach passengers switching from coach to rail, if coach fares increased post-merger. However, given that ICEC runs a much higher service frequency on both London – York (30 daily services) and London – Doncaster (47 daily services) the OFT does not consider the

¹⁸ In particular, the evidence received relates to London – Newcastle but this can be considered as a proxy for other mid-distance routes considered here.

much more limited services of the two open access operators to sufficiently constrain NEG going forward.

56. For all three flows, NEG submits that the threat of entry from Megabus would in any event constrain NEG and prevent the increase of coach ticket prices or the deterioration of its services. However, notwithstanding the evidence indicating that Megabus now competes more closely with NEG than when it first entered, the OFT has not seen sufficient evidence which would allow it to conclude that Megabus' entry on **these particular three flows** would be sufficiently timely and likely to constrain NEG. NEG submits, and third-party evidence confirms, that Megabus focuses on flows with high passenger numbers resulting in high coach revenues. The evidence available suggests that Megabus would not necessarily be prepared to dedicate the required operational resources without the clear prospect of sufficient incremental revenues. Megabus' coach network has been growing for a number of years now and it is not implausible to assume that Megabus' network may already cover the most viable coach routes in the UK. Therefore, in the absence of specific evidence indicating potential entry on these three flows, the OFT believes that it may be the case that a substantial lessening of competition may be created on the London-York, London-Doncaster and London-Durham flows. This is also consistent with the MMC's findings in *NEG/Midland Mainline* where actual rather than potential competition was found to be the main reason for fare reductions.

London – Berwick-upon-Tweed, Glasgow-Newcastle, Glasgow-York

57. NEG argues that the Glasgow-Newcastle and Glasgow-York mid-distance flows will not raise any competition concerns given that they will post-merger continue to face sufficient constraint from other rail operators. Any post-merger diversion from coach to rail would benefit competing rail operators and thus constrain NEG. On Glasgow-Newcastle and Glasgow – York, Cross Country operates two daily direct rail services, and NEG submits that various significant non-NEG indirect services run on these flows. The OFT notes that the direct rail services on Glasgow-Newcastle and Glasgow-York are not sufficiently frequent to count as 'effective competition' at the filter stage but indirect rail services might, to some extent, constrain NEL's coach services post-merger.

58. With regard to London- Berwick, NEG relies on competition from air travel from London to Edinburgh and Newcastle. The OFT believes that on this flow, the same considerations as on the London- Durham flow may apply to the extent that low-cost air travel may not be sufficiently developed on a mid-distance flow such as London-Newcastle or, alternatively air travel may not in this case be considered viable (Berwick is about 55 miles from Edinburgh) to sufficiently constrain coach prices post-merger.
59. The OFT considered plausible but did not test whether, in this particular case, indirect services (but not air travel) may constitute a sufficient constraint on these three flows on NEG post-merger. The OFT considers that it is not necessary to conclude on this as the outcome of its assessment of the application of the *de minimis* exception to the duty to refer (see below) would not change in any material respect, even if a substantial lessening of competition were found on these flows. In this respect, the OFT notes that the annual coach revenue derived from these three flows amounts to just [] in aggregate.

THIRD PARTY VIEWS

60. Few grounds for concern were identified by local authority bodies and passenger representative groups.
61. Some transport operators thought that there is scope for some competition between rail and coach services for off-peak/leisure passengers. Their views differed on whether the merger might have a detrimental impact on such competition.

ASSESSMENT

62. The parties overlap in the supply of public passenger transport services - that is, the provision of rail services by the ICEC franchise and the provision of coach services by NEL. The transaction gives rise to 50 point-to-point overlapping flows. On some of these flows there will only be very limited or no competition from other coach or rail operators. After an initial assessment which included the application of the usual filters, an in-depth assessment of 13 flows has been carried out.
63. With regard to London – Leeds, the OFT is satisfied that Megabus will effectively constrain NEG post-merger. Megabus is already active on this

flow offering considerable seating capacity. NEG has submitted survey evidence and internal documents which demonstrate that Megabus competes most intensely with NEL on high-passenger and high-revenue flows such as London – Leeds and this has been confirmed by third party evidence. In relation to the three closely linked flows (London – Bradford, London – Keighley and London – Skipton), the OFT considers that the existence of indirect train services via Leeds, and Megabus coach to Leeds combined with various local transport options to the final destination are sufficient to constrain NEG post-merger.

64. The relevant London – Scotland flows (London – Aviemore, London – Sterling) are considered to continue to be constrained by air travel to Glasgow, Edinburgh and Inverness. Evidence before the OFT indicates that low-cost air travel has significantly increased in the last few years and now provides competition to both rail and coach services. Indirect rail services on these flows may also, to some extent, constrain NEG post-merger.
65. London – Darlington is served by Megabus' service to Scotch Corner, which is located just seven miles from Darlington and well connected to Darlington through local bus services.
66. Accordingly, no concerns arise on the above mentioned flows. However, the OFT has identified a group of three mid-distance flows (London-York, London-Doncaster, London-Durham) where there will be no actual competition from another coach operator and only very limited competition from open access rail operators on two of the flows. Evidence provided by NEG suggests that on mid-distance routes competition from low-cost airlines provides a much weaker constraint than on the London-Scotland flows. Megabus is not active on any of these flows and the OFT has not received flow-specific evidence to suggest that potential competition would be strong enough to alleviate its competition concerns. The available evidence suggests that the (threat of) entry by Megabus (or any other coach operator) cannot be considered to be sufficiently timely or likely to deter NEG from exploiting the reduction in rivalry resulting on these flows.
67. On three additional flows (London-Berwick-upon-Tweed, Glasgow-Newcastle, Glasgow-York) on an initial assessment, the OFT considered plausible but did not test whether indirect rail services may constitute a sufficient constraint on NEG post-merger. The OFT did not consider it necessary to conclude on the question of whether or not the realistic

prospect of a substantial lessening of competition would be created. Even if these flows were found to raise competition concerns, it would not have changed the ultimate decision in this case.

68. Consequently, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom pursuant to section 22(1) of the Act.
69. On this basis the OFT is under a duty to make a reference to the Competition Commission. However, the OFT has considered whether it would be appropriate to exercise its discretion to apply the exception to the duty to refer pursuant to section 22 (2) (a) of the Act to the facts of this case.

MARKETS OF INSUFFICIENT IMPORTANCE

70. As demonstrated above, the OFT believes that there is a realistic prospect of a substantial lessening of competition on at least the following three flows:
- London-York
 - London-Doncaster
 - London-Durham
71. However, for the reasons set out below, the OFT considers it appropriate to invoke the markets of insufficient importance or *de minimis* exception to the duty to refer, as recently revised.¹⁹ The purpose of this exception is to avoid reference where the costs are disproportionate to the potential benefits. The revised guidance has raised the previous general threshold ceiling for considering this exception from £400,000 to £10 million.
72. The basis for the OFT's approach is set out in the revised guidance as follows:

Before using this discretion the OFT will exercise its judgement in considering each case on its individual facts. A key issue for the OFT in this regard is the expected impact of the transaction on consumer

¹⁹ OFT 516 b, November 2007.

welfare, considering in particular market size, the magnitude of competition lost by the merger, and the likely duration of that loss, as well as other relevant market features. The OFT is most likely to exercise its discretion not to refer where the relevant market features (which will overlap with those relevant in the assessment of the substantial lessening of competition) indicate that the merger's total impact is likely to be limited. The OFT is generally likely to consider the affected market(s) to be of sufficient importance to justify a reference where their annual value in the UK, in aggregate, is more than £10 million.²⁰

73. As noted above, the aggregate turnover of the coach operations on the relevant problematic flows is less than £1 million. However, the rail revenue on the same flows is in the tens of millions: on London-York alone, for example, the coach revenue, at under [], is less than one per cent of rail revenue on the same flow. The rail revenues on these flows may in part explain why NEG did not seek to rely on the *de minimis* exception. Nevertheless, as the use of this exception is at the discretion of the OFT, it is not necessary for a party to plead the exception in order to benefit from it in an appropriate case.
74. In this context, having considered the individual facts, the OFT consider the following aspects of the current transaction to be particularly relevant to the question of the proportionality of a reference given the issue at stake.
- 1) The special nature of rail franchise awards
 - 2) The rationale for the acquisition and deterrence considerations
 - 3) The issues at stake centre on a small fraction of the relevant market worth less than £1m

Each of these is dealt with in more detail below.

1) The special nature of rail franchise awards

75. The ICEC franchise has been awarded by the Department of Transport (DfT) to NEG on 14 August 2007 through a competitive tendering process.

²⁰ *Ibid.*, at paragraph 7.6 of the revised guidance.

It will commence on 9 December 2007 and run until 31 March 2015, with the last 17 months being subject to meeting set performance targets. The franchise agreement contains revenue risk/share arrangements, in particular a 'cap and collar' revenue share and support mechanism common to all recent rail franchise agreements. It provides for a mechanism to give 50 per cent of the additional revenue above a certain target to DfT. Regulated rail fares are subject to an annual price cap of RPI + one per cent on a basket of fares and RPI + six per cent on individual fares. In practice, the CC has found that even unregulated fares may to a certain extent be constrained by the need to keep a reasonable relationship between regulated and unregulated fares.²¹ The DfT's service level commitment also applies which specifies the level, frequency, maximum journey times and stopping patterns of all rail passenger services.

76. In most cases considered to result in a relevant merger situation under the Act, two or more enterprises – meaning business activities of any kind²² – cease to be distinct and the acquirer gains unfettered commercial control over the target business post-merger. However, rail franchise awards amount to a distinctive medium-term outsourcing agreement by the government of railway services in the franchise area, subject to regulation and potential clawback by the government. The ICEC franchise itself is an example of the government 'taking the franchise back' and re-tendering it quite early during the lifetime of the franchise award in 2005 to GNER. While by no means sufficient to remove any competition concerns in principle, the degree of regulation and other *sui generis* features of rail franchise awards relative to general private mergers and acquisitions activity do place limits on the scale and durability of merger effects on overlap flows – especially with respect to rail services – that are not applicable more generally.

2) Transaction rationale and deterrence considerations

77. Small mergers, or mergers in small markets, can be motivated by the acquisition of market power: for example, a small firm decides to acquire its only competitor active in one or more local markets for the principal purpose of eliminating competition and reaping monopoly profits post-merger. Part of the purpose of any credible merger regime is not only to

²¹ *NEG/Greater Anglia*, Appendix C, paragraph 47.

²² See *Substantive assessment guidance*, at paragraph 2.3.

prohibit a certain class of, say, mergers to monopoly but to deter like transactions from being contemplated or pursued. Recent research commissioned by the OFT confirms that the benefits of competition enforcement in general and the prohibition of anti-competitive mergers in particular go well beyond the direct benefits to customers and consumers achieved in the relevant markets subject to remedial action; in fact, the research suggests as a lower bound a multiple of five times the impact of any remedial intervention by the OFT (undertakings in lieu) or CC (second-phase SLC²³ finding).²⁴ In other words, in considering the costs and benefits of a reference outcome it is often reasonable to assume a 'deterrence multiplier' of any consumer harm prevented if remedial intervention were to result.

78. In contrast, competition concerns may also arise where any potential anti-competitive benefit to the merged firm is incidental to a much larger transaction whose rationale may be benign or even beneficial from a competition perspective. Many of the OFT's undertakings in lieu cases appear to fit this category.
79. In considering the rationale for acquiring the ICEC franchise, the OFT discounts the notion that the acquisition of market power as a result of the problematic coach/rail overlaps formed a material part of NEG's rationale for its winning bid. The overall value of the £545 million franchise clearly lies in the profit potential of operating the franchise on an efficient fixed-term basis subject to various regulatory requirements; the driver for the bid is not the exploitation of any lost competition between coach and rail on a very small number of overlaps. Aside from the ICEC franchise, NEG currently runs three other rail franchises, Greater Anglia ('one'), c2c and Gatwick Express. The latter is due to expire in 2008, while three franchises previously run by NEG expired in 2007.²⁵ Internal documents provided by NEG confirm that its main motivation in bidding for the ICEC franchise was a desire (partly) to compensate for the loss in revenue which had resulted from the expiry of three rail franchises in 2007 and to aim to retain its position as a major UK rail franchise operator.

²³ Substantial lessening of competition.

²⁴ See OFT press release of 12 November 2007, available at www.of.gov.uk/advice_and_resources/resource_base/consultations/deterrent

²⁵ These are the Central, Silverlink and Midland Mainline franchises.

80. In this context, the OFT believes that this case is particularly amenable to the application of the *de minimis* exception because such a finding would not undermine deterrence by incentivising a similar acquisition whose motive is market power by merger.²⁶ In other words, it is unreasonable to assume that a decision by the OFT to apply the exception in this case would materially lessen deterrence of supposed anti-competitive bids for UK passenger rail franchises.

3) The issues at stake centre on a small fraction of the relevant 'market' worth less than £1m

81. Although a simple calculation of market size of the SLC flows lead to figures far in excess of the general threshold, the OFT believes such calculation to be inappropriate given the actual issues at stake.

82. The relevant markets used for the purposes of the assessment encompass both coach and rail (and any other) modes of public passenger transport on the flow. However, market definition is simply a means to an end:²⁷ the real question in considering an inter-modal overlap is the degree to which substitutability and therefore competition between the different modes of public transport constrains price and other variables on each mode.

83. As noted above in the section on horizontal issues, the theory of harm in this case is the potential merger effects on coach services, and not also on rail. Therefore, for the purposes of exercising its discretion in relation to road/rail overlaps, the OFT considers it appropriate to conclude that the conceivable benefits of a CC reference are unlikely to include any remedial action flowing from a SLC finding in relation to adverse merger effects on rail service quality or fares. Accordingly, the OFT discounts the rail revenue on the overlap flows and for purposes of its cost/benefit assessment and limits the assessment of merger effects, and total impact on consumer welfare, to the coach element of the flows.

84. Coach revenues on the three flows raising the realistic prospect of a substantial lessening of competition account for under [] per annum. If the revenues from the London-Berwick-upon-Tweed, Glasgow-Newcastle and

²⁶ See OFT Consultation on this exception, June 2007 (OFT933con) at 4.14 and OFT press release of 15 November 2007, available at www.of.gov.uk/news/press/2007/156-07.

²⁷ Substantive assessment guidance, at paragraph 3.11.

Glasgow-York flows were also included in the assessment, the revenue in question would increase to under [] per annum. Nothing has therefore turned on whether these flows are subject to SLC findings or not.

85. As a sense check and in line with the OFT's policy that the application of filters in public passenger transport cases is an analytical tool rather than a means of 'safe harbouring' certain flows, if for the sake of argument those flows back filtered out by the so-called 10 per cent and *de minimis* filters were included, this would increase the aggregated coach revenues of the relevant flows to less than [] per annum; again, this does not alter the result.
86. Accordingly, the relevant revenue at stake implies merger effects only in relation to a proportion of a sum which, in any event, is below £1 million. The scale of conceivable merger effects is therefore low. Moreover, the OFT's belief that the merger will result in such effect is not one on the balance of probabilities; rather, its belief is of a 'realistic prospect' of SLC under the 'may be the case' standard below a 50 per cent likelihood. It is by no means a foregone conclusion, therefore, that the CC would reach a balance of probabilities belief on further inquiry that adverse merger effects can be expected at all. Taken together, this suggests that the likelihood of CC intervention to resolve competition concerns is low, and that such concerns are in any event unusually small in scale, and without any 'multiplier effect' for deterrence. These considerations make it appropriate to rely on the *de minimis* exception.
87. In considering costs and benefits, the OFT further notes that, even if the CC were to reach an expectation of anti-competitive outcome, it is far from clear that prohibition or structural remedies would be considered proportionate given the scale of the issue relative to the size of the franchise and the detrimental impact on customers of requiring any divestment of part of NEG's nationwide coach network. Behavioural remedies, meanwhile, would impose significant public and private costs beyond the costs of the reference itself, are not capable of restoring lost competition, and raise the potential for market distortion.²⁸

²⁸ See for example the OFT's experience in relation to *National Express Group/Prism*, undertakings review decision of 3 August 2006.

Conclusion

88. Overall, given the cumulative weight of (1) the peculiar issues raised by rail franchise awards cases, (2) the lack of a deterrence multiplier, (3) the small scale of the issues at stake, and (4) the lower 'realistic prospect' standard of belief the OFT has in relation to its SLC findings, the OFT considers that the total impact of the merger on consumer welfare is likely to be limited, and that the costs associated with a CC inquiry are disproportionate to the prospect of benefits from such action. Accordingly, taking into account all the relevant facts specific to rail franchise awards and this award in particular, the OFT exercise its discretion not to refer because the markets are of insufficient importance to warrant a reference.

DECISION

89. This merger will therefore not be referred to the Competition Commission pursuant to section 22(2)(a) of the Act.