
Completed acquisition by Arriva Plc of the Wales and Borders Rail franchise

The OFT's decision on reference under section 22 given on 16 March 2004

PARTIES

Arriva plc (Arriva) operates an extensive range of public transport services, including buses, trains, commuter coaches and water buses. Its wholly owned subsidiary, **Arriva Passenger Services Limited** (APS), is the holding company for a number of bus subsidiaries, including **Arriva Cymru Limited**, **Arriva Midlands North Limited**, **Arriva North West Limited**, and **Arriva Merseyside Limited**. **Arriva Trains Northern** rail franchise provides inter-urban, rural and commuter passenger rail services across the North of England.

Arriva Trains Wales (ATW) is a new subsidiary, set up to operate the **Wales and Borders** rail franchise. ATW anticipates that its annual turnover will be in the region of [] (see note 1) per annum, of which approximately [] [see note 1] would derive from a Strategic Rail Authority (SRA) subsidy.

TRANSACTION

In August 2003, Arriva was selected by the SRA as the preferred bidder for the new Wales and Borders franchise, with responsibility for operating all local and regional train services in Wales and the Border counties. The SRA had undertaken a competitive tender to appoint a new franchisee and short-listed Arriva, National Express Group, GB Railways/Connex Transport UK and Serco Rail/ NS Dutch Railways (see note 2).

Arriva took over the franchise on 7 December 2003 for a period of 15 years, subject to five-year Performance Review assessments. Under the franchise agreement, Arriva is committed to a profit share agreement with the SRA (see note 3). The SRA will also continue to regulate rail fares for standard class passengers on a national basis (this is currently set at RPI + 1 per cent) (see note 4). The franchise agreement commits Arriva to operating all existing 74 integrated transport initiatives of the previous franchise operator (most of which are in South Wales) and to introduce 30 new integrated transport initiatives, mainly in North Wales.

The statutory deadline, which has been extended under section 25(1) of the Enterprise Act (the Act), is 16 March 2004.

JURISDICTION

As a result of the transaction, Arriva and the Wales and Borders rail franchise will cease to be distinct. The award of a rail franchise constitutes an acquisition of control by virtue of section 66(3) of the Railways Act 1993 as amended. The transaction will create a relevant merger situation under section 23(1)(b) of the Act as the turnover test is met.

COMPETITION ASSESSMENT

Market definition

The activities of Arriva and the franchise overlap in the provision of passenger transport services in North Wales and the Borders. Arriva operates a number of commercial bus services in North Wales as well as part-subsidised or fully-subsidised services on behalf of local authorities from six depots in Aberystwyth, Bangor, Chester, Llandudno Junction, Rhyl and Chester (and eight out-stations at various other locations). These bus services operate between a number of the same journey origin and destination points, i.e. common 'point-to-point' routes, as rail lines within the Wales and Borders franchise, which operate along the North and West coasts, as well as inland to Blaenau Ffestiniog and Shrewsbury, thus creating a series of overlaps.

Rail on rail

Arriva currently operates one Train Operating Company (TOC) in Great Britain, Arriva Trains Northern, which does not overlap on a point-to-point basis with the Wales and Borders franchise. The OFT does not therefore believe that it is or may be the case that the merger may be expected to lessen competition substantially between rail operators.

Bus on rail

Passengers' choice of mode of transport on a point-to-point journey depends on a number of factors including access to bus stops or train stations, personal preference, comparative journey time, and the relative costs of the available alternatives. These factors are likely to be relevant when passengers are choosing between bus and rail options for broadly the same journey. In this respect, bus services tend to be more frequent and cheaper than comparable rail options, although bus journeys tend to be longer because of the often less direct route taken, and the greater number of stops.

Whether, and the extent to which, prices and/or service on bus or rail services are constrained competitively by one another is not clear. The availability of season (and off-peak) tickets makes it difficult to make comparisons between ticketing options. An increase in the price of a ticket may not be sufficient to induce switching (between bus and rail) if other factors, such as journey duration, are of sufficient importance. Monopolies and Mergers Commission (MMC) merger investigations¹ have considered

¹ Cm 3774, 16 December 1997, National Express Group plc and Central Trains Ltd; Cm 3773, 16 December 1997, National Express Group plc and ScotRail Railways Ltd; Cm 3495, 20 December 1996, National Express Group plc and Midland Main Line Ltd.

that a degree of competition between bus and rail does exist on specific routes. The conclusions of these studies, are, however, not necessarily relevant to this case, since the last investigation, involving coach/rail issues, was conducted some time ago (in 1997) and the conclusions of those investigations were based on factors specific to the routes under consideration.

Where bus and rail serve the same point-to-point routes, there may be some passengers who consider them to be substitutes for each other. The degree to which this allows bus services to provide a competitive constraint to rail services, or vice versa, is unclear, but would appear to be highly route-specific.

Conclusion

The relevant frames of reference for assessing the competitive effects of this merger are considered therefore to be the supply of passenger transport services on certain point-to-point routes in North Wales and the Borders.

HORIZONTAL ISSUES

Bus on rail competition

Arriva is the biggest commercial bus operator in North Wales, with an estimated 70 per cent share of supply. Its post-merger share of supply of rail services in North Wales is estimated to be around 83 per cent.

If bus and rail are substitutable modes of passenger transport on certain point-to-point routes within North Wales and the Borders, the acquisition of the rail franchise (whose primary fares are regulated) may permit Arriva to raise prices and/or reduce service levels on the bus and enjoy increased overall revenue as its bus passengers switched to rail. A corresponding concern was advanced by third parties in *First/Scotrail*.² However, despite Arriva's strong position in both bus and rail services in North Wales and the Borders, third party replies to our investigation generally did not identify specific point-to-point routes on which the one mode of transport was allegedly substitutable for – and so potentially in competition with – the other. The OFT has nevertheless sought to test further the hypothesis of intermodal competition on certain routes, and hence the prospect of competitive harm arising from the transaction.

For the purposes of this analysis, we have focussed on point-to-point overlaps where journey times were broadly comparable, and where the merged entity would be the sole provider of transport, since overlapping routes that meet these criteria would be those most likely to raise concerns. In doing so, we have focussed on commercial rather than tendered bus routes, as the latter are regulated by the tendering body. We have also taken into account the fact that certain rail fares and service levels are regulated through the service level agreement with the SRA, substantially constraining Arriva's latitude to raise prices or alter service levels on the railways.

² *First/Scotrail*, OFT reference decision of 13 January 2004, paras. 10, 16.

Key routes

Adopting this methodology, the following 5 point-to-point overlaps have been identified between commercial bus services operated by Arriva and a train service within the franchise.

Table 1: affected overlaps

Bus route	Point-to-point overlap
5/ 5X	Llandudno Junction to Conwy
5/ 5X	Conwy to Penmaenmawr (off peak only)
5/ 5X	Llandudno Junction to Llandudno
5/ 5X	Llandudno Junction to Bangor
11	Flint to Shotton

Source: Arriva

These are all in a corridor running along the coast between Bangor and Chester which is commonly used by commuters.

As regards North Wales, Arriva submits that bus and rail services are in distinct product markets because an increase in fares or reduction in service levels will not induce substantial switching between the two modes of transport. Arriva suggests that passenger demand for the respective modes of transport in this region is driven not by fare considerations, but rather by factors such as journey time, convenience and location of bus routes and railway stations, and service reliability.

Certainly, there are significant differences in the objective characteristics of bus services and train services in North Wales. The former generally form a network, connecting villages and towns in the region, whereas the train represents an inter-urban shuttle service. For example, the train service in the Bangor to Chester corridor runs along the North Wales coast parallel to the A55. However, few of the local buses in North Wales travel along the A55 since they service towns and villages connected by older roads (such as the A5151 and A547). Bus passengers travelling from Bangor to Chester would need to make several changes by bus and the journey time (244 minutes) would significantly exceed that of the train (56 minutes (fast)/79 minutes (slow)).

Third party views and the limited number of overlaps identified suggest that, for the routes in question, it is likely that bus and rail services do not compete, but are at least partially complementary, with some proportion of rail passengers using bus services to travel to or from the railway station. Furthermore, concessionary fare passengers make up a significant proportion of local bus service passengers, accounting for around 50 per cent of passengers on the overlapping routes identified above. Such passengers cannot travel for free by rail (although they can buy a concessionary card and buy lower priced fares), and therefore are unlikely to transfer to rail if Arriva were to increase price or reduce service on the corresponding bus route.

Arriva further submitted that the market was insufficient to warrant reference, on the basis of evidence suggesting that the combined annual bus and rail revenue of the five routes was less than £50,000 and the number of passenger journeys was approximately 50,000. Had this argument been critical, it would have been difficult to accept based on the scope and quality of information provided to the Office. For instance, the revenue and passenger figures for the overlapping rail routes provide an

average price per rail journey of around 20-25p. This figure seems too low to be reliable. We therefore would not have been able to accept Arriva's argument that the overlaps are of insufficient importance to merit reference based on its figures.

Barriers to entry and expansion

Entry for operators onto the national rail network is regulated and licensed by the SRA and the Office of the Rail Regulator (ORR). The ORR's policy on Moderation of Competition allows passenger train operators to protect their core business from competitive new entry. This policy was relaxed in April 1998 to reduce the level of protection so that there are increased opportunities for train operators to introduce new services over those flows where the level of protection is reduced. New entrants would have to compete with existing franchisees without the benefit of operating subsidies received by franchise holders, which would be especially difficult in rural Wales which has never been profitable. Given these factors, barriers to entry for passenger rail services are considered to be high.

Local bus operators are licensed, under the Transport Act 1985, by the Traffic Commissioner.³ Buses may be bought outright, or leased. Bus depots (and out-stations⁴) may be leased. Each depot has a peak-vehicle requirement (PVR) which is a calculation of the maximum number of vehicles it requires to be operational simultaneously to deliver peak time services. Depots are allocated a number of vehicles in excess of their PVR (usually 15 per cent). An existing operator, with a local depot is unlikely to face significant barriers to expansion and it is likely that larger operators would take up any profitable routes abandoned (wholly or partially) by Arriva. Where a route is unprofitable (wholly or at certain times) local councils may invite tenders from operators to run the route on a subsidised basis, in which case there is competition for, rather than on, these routes.

Buyer power

Individual customers are unlikely to have buyer power. Local authorities tender contracts for bus services, and the SRA award rail franchises for rail services, and both appear to hold significant buyer power by virtue of competition for these contracts, given the number of bidders. Regulation will constrain Arriva's freedom to set rail fares and service levels.

VERTICAL ISSUES

Joint ticketing schemes

Arriva, as the successful rail franchisee, will administer a number of joint ticketing schemes, including thirty new integrated tickets required under the terms of the rail

³ The Traffic Commissioner licenses public sector vehicles (buses) and requires that commercial routes must be registered 56 days before the service commences and that the service is operated in accordance with the registered details.

⁴ Out-stations are secure areas for overnight parking.

franchise, several of which will operate in North Wales. Such schemes are multi-operator multi-modal schemes to which third parties have a right of access.

Arriva is also party to the PlusBus scheme — a nationwide multi-modal scheme run by Journey Solutions (a company independent of Arriva). Arriva has entered into an agreement with Journey Solutions to introduce PlusBus schemes at Aberystwyth, Bangor, Colwyn Bay, Flint, Llandudno Junction, Rhyl, Prestatyn and Wrexham. Arriva has invited numerous other bus operators in the region to join such schemes, and many have indicated their intention to join.

Foreclosure concerns

Several third parties have raised concerns about the possibility of Arriva introducing an Arriva-only multi-modal ticketing scheme, thus foreclosing them from providing bus feeder services to and from railway stations. Should Arriva introduce such a scheme, it could conceivably capture multi-modal passengers who might otherwise have used a competitor's bus service for parts of their journeys, affecting the viability of existing competitors and opportunity for new entry. The adverse impact on competitors from losing multi-modal passengers could be relatively swift, as Arriva's bus rivals in the region tend to be small-scale operators. The elimination of these competitors would give Arriva the opportunity to raise prices for consumers buying bus-only tickets, who would be obliged to use Arriva buses and pay more to travel than they otherwise would have done. This could outweigh the short term benefit to consumers of potentially cheaper Arriva-only multi-modal tickets.

Arriva currently has no Arriva-only multi-modal tickets in North Wales, and points to its commitment to multi-operator schemes as evidence supporting its contention that it has no plans to introduce tickets for use exclusively on its own trains and buses. It has also pointed out that it does not operate such tickets elsewhere. However, there are no current barriers (e.g. in the franchise agreement, contracts with local authorities for bus services, or the PlusBus multi-operator multi-modal ticket scheme) to Arriva introducing its own multi-modal ticket scheme, if it had an incentive to do so.

Arriva points out that it received only £11,928 from current multi-modal ticketing schemes in Wales in 2003, and that these schemes are not a significant source of revenue. Acquisition of the rail franchise would of course potentially significantly increase the revenue received by Arriva for multi-modal tickets. The introduction of the thirty planned new integrated tickets would also raise revenue, by an unknown amount. In order to address its incentives to introduce Arriva-only tickets, Arriva has been asked to provide information on numbers of customers travelling on its buses to and from railway stations in the franchise area, as an indication of the proportion of passengers that might buy such integrated tickets should Arriva introduce them. If such data showed, for example, that multi-modal revenues were a small percentage of total bus revenues associated with stops in the vicinity of railway stations, Arriva's incentive to engage in foreclosure is likely to be negligible. To date, however, Arriva has been unable to provide this information from its origination and destination data.

The foreclosure concern depends on a number of cumulative factors that require validation. The available evidence demonstrates that Arriva would have the ability to engage in this sort of strategy. The absence of evidence as to lack of incentive from Arriva leaves the OFT unable to dismiss such concerns as unfounded. Indeed, the only available evidence suggests that Arriva may have the incentives. While the available

evidence tends to be circumstantial, it may be noted that (i) Arriva is the principal and in many cases only provider of rail services at each railway station in North Wales, while supplying 70 per cent of bus services in the region; (ii) rival bus companies operate to and from a significant number of railway stations in the region; (iii) the principal routes by value are not unlikely to have a reasonable number of multi-modal passengers that would be attracted to Arriva-only ticketing at the expense of Arriva's rivals. The foreclosure concerns voiced by third parties remain plausible. Moreover, if foreclosure were to happen, it may be on a substantial scale given the number of stations in the region where competition could be affected.

THIRD PARTY VIEWS

Third parties generally did not regard bus and rail services as competing for passengers in the area, or that the award of the rail franchise to Arriva would give it an undue advantage running buses. A few third parties were concerned that Arriva would alter rail fares or services to induce more passengers onto its buses. Several bus competitors raised the concern that they would be adversely affected if Arriva introduced its own multi-modal tickets.

ASSESSMENT

This merger situation arises following a competition for the Wales and Borders franchise conducted by the SRA. In this case the successful bidder overlaps only on existing bus routes, not rail routes. Other bidders for the rail franchise could have raised similar issues in other parts of Wales if they had won the franchise. All successful bidders are subject to regulation by the SRA in respect of fares and service levels. Tendered bus routes are similarly regulated.

Within this framework, Arriva's services overlap on a limited number of commercial bus and rail point-to-point routes where journey times are broadly comparable and there is no competing operator. However, a majority of third parties have supported Arriva's argument that bus and rail do not compete in North Wales, as geography dictates that bus services tend to be local services between villages, while the rail line mainly carries passengers on longer journeys between larger towns. In addition, a significant proportion of local bus passengers travel free on buses.

Therefore, the evidence indicates that there is a lack of substitutability between bus and rail in this area. Accordingly, the OFT does not believe that it is or may be the case that the merger may be expected to lead to a substantial lessening of bus/rail competition in North Wales.

Post-merger, Arriva has the ability to introduce its own multi-modal ticketing arrangements and deny third party bus operators in the region access thereto (thus possibly foreclosing bus routes into rail stations). Although no such schemes yet exist, several third parties have voiced concerns that Arriva might act in this way. While the incentives to adopt any such strategy depend on a number of factors outlined above, including Arriva's ability to capture its competitor's customers and the magnitude of the effect of the introduction Arriva's own multi-modal tickets on competitors, the limited available evidence is on balance consistent with third parties' foreclosure concerns. In particular, Arriva has not contested its ability to introduce its own multi-modal ticket in North Wales, and has not furnished evidence tending to show a lack of incentive to do so and/or that the effect of foreclosure would be minimal.

Accordingly, the OFT believes that the possibility of Arriva successfully pursuing this strategy and thereby harming competition is real. The OFT therefore believes that it may be the case that this merger may be expected to result in a substantial lessening of competition.

UNDERTAKINGS IN LIEU

Having concluded that the acquisition should be referred to the Competition Commission, we have considered whether there might be some undertakings in lieu of reference, pursuant to section 73 of the Act, which would address the concern we have outlined above. Arriva has offered an undertaking that any multi-modal ticketing arrangement introduced would be open to any bus operator on the same terms as Arriva, and that Arriva would invite all local bus operators to participate in any such scheme, in order to allay concerns about multi-modal tickets. The proposed undertaking is a clear cut remedy to the concerns raised.

DECISION

This merger will therefore **be referred** to the Competition Commission under section 22(1) of the Act, unless Arriva gives suitable **undertakings** pursuant to section 73 of the Act to address the potential competition concern outlined above.

NOTES

1. Figures excised at Arriva's request.
2. Two different lists of bidders short-listed for this franchise appear on the SRA website. The SRA have pointed out that this list was the most recent.
3. The SRA has pointed out that this is a profit share rather than revenue share agreement.
4. The SRA has told us that the level of RPI + 1 could change in future.