

Anticipated acquisition by Arriva plc of the assets of the Hertfordshire Bus Operations Of Sovereign Bus And Coach Company Ltd

The OFT's decision on reference under section 33 given on 3 August 2004

PARTIES

Arriva the Shires (Arriva) is part of the ARRIVA group, a transport company operating bus and train services across the UK. In the year ending 31 December 2002, Arriva's UK turnover was £42 million. Sovereign Bus and Coach Company Ltd. (Sovereign) is a Hertfordshire-based bus operator and a subsidiary of Blazefield Holding Limited, which also operates buses in Lancashire and Yorkshire. It sold its St Albans operation in 2004 and its Huntingdon operation in 2003. In the year ending 31 December 2003 Sovereign's UK turnover (including the St Albans operation) was £7 million.¹

TRANSACTION

Arriva proposes to acquire the assets owned and/or operated by Sovereign for the purposes of its Hertfordshire bus operations for £[.]² The extended statutory deadline in this case is 5 August 2004.

JURISDICTION

As a result of this transaction enterprises carried on by or under the control of Arriva and Sovereign will cease to be distinct. The parties overlap in the supply of bus services in a substantial part of the UK and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

¹ From turnover figures supplied subsequent to decision.

RELEVANT MARKET

The parties overlap in the supply of bus services in Hertfordshire. Sovereign operates six [commercial] services in and between the towns of Hemel Hempstead, St Albans, Welwyn Garden City, Hatfield, Stevenage and Hitchin. For present purposes, a bus service comprises a number of journeys from point to point covered by that service; a number of connected overlapping point to point journeys form a flow.

Product market

Arriva argues that rail, private car and taxi provide demand-side substitutes for their bus services in the area in question.

- Rail. Unlike the bus, rail travel is ideally suited for inter-urban, rather than municipal travel. However, in previous decisions, the OFT has found that rail travel can be an economic substitute for bus travel on a given flow where factors such as the journey times, frequency, station location and cost are comparable. This will tend to be highly flow-specific.
- Private cars. Although Arriva points to high car ownership in Hertfordshire, its survey evidence suggests 50 per cent of users could not use a car and a further 31 per cent could only do so if a driver was available. This view is also supported by the majority of third party comments. Survey evidence does not reveal whether sufficient bus passengers would switch to car to render a 5-10 per cent increase in bus fares unprofitable. Given the cost of car ownership, parking, congestion and other factors, the OFT doubts whether private cars are an economic substitute for bus travel in the area in question.
- Taxis. Arriva submits that taxis are an economic substitute to bus as multiple passengers bring the journey cost down to a comparable level. The proportion of bus passengers for whom this would be a viable option is likely to be too low to render a 5-10 per cent increase in bus fares unprofitable, especially given the views of third parties.

Accordingly, bus services are considered separately from other forms of transport, except where rail journey characteristics are sufficiently similar on a specific point to point overlap.

The parties run both commercial and tendered bus services, and operators of either type of service can easily provide the other. From a demand-side perspective, however, passengers cannot switch to tendered services as the two types of services tend to run

² Business secret deleted at request of the parties.

at mutually exclusive times of the day and week and the ability to alter both price and service is controlled by the tendering authority. The two services will therefore be considered separately,

Geographic market

As bus passengers seek to travel from a fixed point of origin (A) to a fixed destination (B), demand-side factors warrant separate consideration of the transaction in terms of its impact on a point-to-point basis, i.e. supply of passenger transport services from A to B

On the other hand, the evidence suggests that supply-side substitution between point to point routes is relatively easy for incumbent operators with scale (the position of the parties' smaller rivals is considered under entry, below). Arriva submits it sets prices on a wider (fare-by-fare, route-by-route) basis, observing that the geographic frame of reference could be a route, town, or larger geographic area. The most recent bus merger case examined by the Competition Commission was Arriva's acquisition of Lutonian, whose existing operations were confined to the town of Luton. The CC focused on the town of Luton (effectively aggregating all point to point journeys within Luton) while also considering the merger's implications in Hertfordshire and Bedfordshire counties.³

Arriva has presented its analysis on this transaction's competitive effects in relation to Hertfordshire as a whole and, individually, the six towns served by Sovereign. While the scope of the parties' head-to-head competition is geographically limited, the OFT endorses Arriva's approach, being the appropriate frame to assess the transaction's likely effect on potential competition (discussed below).

It is therefore appropriate in this case to take as the frame of reference both (i) commercial and (ii) tendered bus services on point to points, individually and in aggregate, corresponding to Sovereign's actual and potential scope of operations within Hertfordshire.

HORIZONTAL ISSUES

The parties appear to constrain each other's competitive behaviour in two respects. First, where their bus routes overlap, serving common origin and destination points, they may directly place pressure on each other's prices and services as passengers can compare these variables on the respective services and switch between them. Non-price factors identified by Arriva as valuable to passengers include frequency,

³ Monopolies and Mergers Commission, Arriva plc and Lutonian Buses Ltd – A report on the merger situation, 18 November 1998, paras. 2.22-2.23.

punctuality, reliability and journey experience factors such as the quality of drivers and on-board cleanliness and safety.

Second, even where the one party does not run a parallel service to the other, it has the ability quickly and easily to switch buses on to that route. Such threat of entry by the absent party may place substantial or equivalent pressure on the incumbent's prices and service levels (identified above) as head-to-head competition, and thus represent an important competitive constraint. The CC similarly considered both actual and potential facets of competition in the Arriva/Lutonian report.⁴

Actual competition

Five of Sovereign's six services overlap with flows on fifteen Arriva services. None of these services completely overlap but do so for flows varying from one or two kilometres within town to several kilometres on the inter-urban flows.⁵ Comparative frequency of the service also varies from flow to flow. As such, the degree of head-to-head rivalry and the impact on price and non-price competition may well be limited. However, on several flows there are no other competing bus services and on others other competitors are limited to one other bus or rail service. Such a lessening of competition, particularly where Sovereign is the closest or only competitor, could be characterised as substantial.

Both parties bid for tendered bus operations and have competed for such contracts. Tendering bodies have not, however, expressed the view that the merger would substantially lessen bid competition in this area.

Potential competition

The parties' data suggests Arriva's post-merger share of commercial bus services in the Hertfordshire region is [around 60 per cent] with an increment of [around 10 per cent]; post-merger share in [four of] the six towns served by Sovereign are [over 65 per cent], with increments [around 5-15 per cent].⁶

As the second largest bus operator in Hertfordshire Sovereign appears to be Arriva's closest competitor in terms of scale and scope of operations relative to smaller rivals, as well as having a fleet of a similar age or newer than Arriva's. It covers more towns and has a less concentrated network compared to rivals, and has both twice the number of licences and depots compared to the next nearest rival.⁷

⁴ Ibid, para. 2.62.

⁵ Clarification at request of parties. Of 49 overlaps they identify one is 410m.

⁶ Business secret deleted at request of the parties.

⁷ Clarification at the request of the parties. From figures supplied subsequent to decision University bus has almost as many licences.

A prime example of Sovereign's apparent potential to expand is within and from Stevenage, where it has bus depot, Arriva has {around half}⁸ of commercial bus services, and the merger would reduce the number of significant bus operators from three to two.

The weight of evidence available to the OFT therefore suggests that Sovereign's potential to expand on to Arriva's routes (and vice versa) represents an important existing constraint on each other's activities lost through the merger.

Barriers to Entry and Expansion

The loss of actual and potential competition between the parties would be offset (and therefore be insubstantial) if barriers to entry for new operators or expansion by existing operators can be shown to be low.

Ability to enter or expand

Small-scale entry on individual routes has low cost but is unlikely to replace the competitive constraint posed by the scale of Sovereign's operations. Larger rivals such as Centrebus or Universitybus would have to at least double in size (measured in annual commercial mileage) to replicate the scale of Sovereign. Views were expressed that their single depots mean they are generally limited in the geographical scope of their operations.

There is no evidence of recent entry (as opposed to acquisition of existing services) on a significant scale in this geographic area. [].⁹

Third party responses indicate that entry on a larger scale is considerably more difficult, requiring newer vehicles, an operating depot and sufficient number of licences to operate and compete effectively on a larger scale.

Incentives to enter or expand

It is clear from previous consideration of bus markets and from third party comment that major bus operators tend not to enter each other's core markets.¹⁰ Therefore entry by another major is considered unlikely.

Entry or expansion by non-major rivals, such as those with a lesser or less long-standing presence than Sovereign, can be deterred by a large-scale incumbent's ability to provide strategic responses to small-scale entry. Arriva has submitted that it has no incentive to engage in predation due to its illegality under the Competition Act 1998 (CA98) and its inconsistency with the corporate group's compliance programmes, reputation and brand value.

⁸ Business secret deleted at request of the parties.

⁹ Business secret deleted at request of the parties.

¹⁰ See e.g. Lutonian report, paras. 2.54, 2.69.

The issue in merger control is not whether a rational strategic response by an incumbent is lawful under CA98 or offers short-term benefit to consumers; it is how the prospect of such responses affects third parties' incentives to enter or expand, and thus impacts on consumers beyond the short-term. In *Arriva/Lutonian*, the CC noted the 'prospect of retaliation' as generating a 'reputational effect and so creat[ing] or reinforc[ing] a barrier to entry'.¹¹ In this case, third parties also cited the risk of retaliatory response as a deterrent to expansion and were concerned that the merger would enhance the risk of such responses – and thus further deter entry or expansion – by increasing Arriva's scale advantages over potential rivals.¹² In sum, it cannot be concluded that entry or expansion by the majors or smaller-scale rivals in the area in question will be sufficient to replicate the competitive pressure seemingly eliminated by the merger.

Counterfactual

The parties suggest that Sovereign is unlikely to expand as its parent company has been divesting all its operations in the south of England. However, Sovereign is profitable and even if its parent will inevitably sell (though it did not approach Arriva) and therefore not expand Sovereign's operations in the interim, other conceivable buyers exist that may benefit from increased scale and pose no or fewer competition concerns.

Buyer power

Buyer power of commercial bus passengers is limited.

THIRD PARTY VIEWS

The majority of third parties who commented expressed concern. Respondent competitors were universally concerned, as was one customer. For the reasons discussed above, competitor concern in this case is not deemed to be compelling evidence of consumer benefit.

ASSESSMENT

The transaction qualifies under the share of supply test. Consistent with previous inquiries and third party views, the frame of reference in this case concentrates on

¹¹ Ibid, para 2.69, 2.72; see further paras. 2.54, 2.69-2.75 generally.

¹² While economies of scale may of course be efficiency-enhancing and result in consumer benefit, it is not clear that such benefits will be passed on post-merger absent sufficient competitive pressure. Moreover, such scale advantages are not necessarily merger-specific.

commercial and tendered bus services on a point to point basis and aggregates thereof, in this case, within Hertfordshire.

Arriva is the leading bus operator in Hertfordshire; Sovereign, with significant scope and scale, is second largest. For reasons detailed above, the merger appears to remove the most likely entrant on each other's routes and thereby eliminate a substantial competitive constraint.

Third parties would not appear to be likely to replicate the threat posed by Sovereign through entry or expansion in the area. Majors are unlikely to enter; smaller scale entry or expansion, where not deterred altogether by Arriva's ability to strategically respond, cannot be expected to do so on the scale of Sovereign's operations.

Consequently, 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.

Arriva and Sovereign also compete head-to-head on a number of flows. Although these overlaps are limited in scale, on a number of these flows the merger will eliminate bus competition, or leave one competitor in place. Given the OFT's above concerns, it is not necessary to decide whether the loss of direct competition on these overlaps, individually or in aggregate, itself amounts to a substantial lessening of competition for the purposes of s 33(1) of the Act.

EXCEPTIONS TO THE DUTY TO REFER

The parties cited two exceptions to the duty to refer: markets of insufficient importance and undertakings in lieu. As the OFT's concern is loss of potential competition and Sovereign's services alone represent annual turnover [projected at £3.7 million for 2004], the first exception is inapplicable.

The parties' undertakings in lieu proposals are behavioural undertakings, comprising, in effect, (i) a service frequency undertaking, guaranteed to maintain the existing number of and age of buses; and (ii) a price cap, either by comparison with all other [commercial] services in Hertfordshire (all of which the parties believe are subject to competition) or linked to RPI increases. Both would apply to certain (though not all) overlapping services for a period of two years. The undertakings do not purport to address the OFT's primary concern, the loss of potential competition. Nor is it clear that such mechanisms sufficiently restore pre-merger incentives to compete in areas of actual competition. Accordingly, the remedies proposed cannot be accepted as undertakings in lieu of reference.

DECISION

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