

FirstGroup Absorbs Thames Trains' Franchise Following OFT Decision

by Gavin Murphy*

Introduction

It was no April Fool's Day joke when morning commuters woke on April 1, 2004 to discover that FirstGroup plc, ("FirstGroup") Britain's largest bus and rail operator, had replaced Thames Trains Limited¹ ("Thames") as the operator of the Thames Valley rail franchise. The new franchise, which was granted for two years, is known as First Great Western Link. FirstGroup also operates four other rail franchises in the United Kingdom² and the First Great Western Link is the initial spoke in a system that will lead to the creation of an integrated regional rail network in 2006. Five days before the takeover, the Office of Fair Trading, ("OFT") the United Kingdom's competition authority, issued a decision³ ("the OFT decision") clearing FirstGroup's acquisition of the Thames franchise. The transaction was not referred to the Competition Commission⁴ for further review.

Background

The Strategic Rail Authority⁵ ("SRA") named FirstGroup as the preferred bidder for the Thames Valley franchise on November 4, 2003. The franchise covers rail services at 71 stations between London Paddington and the Thames Valley, Kennet Valley and the Cotswolds, as well as the North Downs line from the city of Reading to Gatwick Airport.

* Gavin Murphy, Legal Counsel, International Cooperation Group, Department of Justice of Canada. From 1998–99 he was on assignment at the Office of Fair Trading. Mr Murphy is also an associate member of the Durham European Law Institute at the University of Durham, England. The views expressed in this article are strictly those of the author and in no way necessarily reflect the policy or opinions of the Department of Justice or the Office of Fair Trading. This article was completed in May 2004.

¹ Thames was a subsidiary of the Go-Ahead Group, which had a turnover of £105.36 million for the year ended June 28, 2003.

² The four rail franchises operated by FirstGroup are First Great Western, First Great Eastern, First North Western and the TransPennine Express.

³ *Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise* (March 26, 2004). Available: www.offt.gov.uk/Business/Mergers+EA02/Decisions/Clearances+and+referrals/Firstgroup+Plc.htm

⁴ The Competition Commission is an independent public body established by the Competition Act 1998. It replaced the Monopolies and Mergers Commission on April 1, 1999. The Commission conducts inquiries into mergers, markets and the regulation of major regulated industries. Inquiries are conducted in response to references made to the Commission by another authority, which is usually, but not always, the OFT. The Commission has no power to conduct inquiries on its own initiative.

⁵ The SRA was established on February 1, 2001. It provides overall strategic direction and leadership for Britain's railways. The SRA also lets and manages passenger rail franchises, develops and sponsors major infrastructure projects, manages freight grants, publishes an annual strategic plan and is responsible for some aspects of consumer protection.

At the expiration of the franchise in 2006, the SRA intends to join it with the First Great Western and Wessex Trains franchises to create the Greater Western rail system.

The First Great Western and Thames franchises would cease to be distinct companies as a result of this transaction. The award of the Thames franchise also constitutes the acquisition of a business enterprise within the meaning of s. 66(3) of the Railways Act 1993, as amended by the Transport Act 2000. Furthermore, the transaction will create a relevant merger situation under s. 23(1)(b) of the Enterprise Act 2002 (the "Act") since the threshold turnover test is met.⁶ The parties therefore notified the OFT of the proposed merger on January 23, 2004.

OFT Decision

1. Relevant Market

The OFT decision found that the business activities of FirstGroup and Thames overlapped in the provision of passenger transportation services in both the Thames Valley and the Worcestershire/Herefordshire regions, and concluded that the relevant market for its analysis would be the supply of passenger transportation services on specific point-to-point routes with either origins or destinations in Reading or Worcestershire/Herefordshire.

a) Rail on Rail Competition

The parties both offered passenger train services on the same routes between London and Newbury and London and Hereford. Nevertheless, there is also a distinction between the two systems. As the OFT decision stated:

The services operated on the two franchises are to an extent complementary, with First offering high speed, inter-urban services making only limited stops at intermediate stations and Thames providing stopping services, as well as some limited stop services using non-high speed rolling stock.⁷

The OFT decision also confirmed that previous cases have been unable to conclusively determine the extent to which alternative modes of transportation are substitutes for rail travel, adding that substitutability appears to be a location-specific phenomenon. Particular factors of relevance noted by the OFT included car ownership levels, extent of road traffic congestion and the location of train stations.⁸ Nevertheless:

⁶ Under s. 23(1)(b) of the Act, a relevant merger situation is created if the value of the turnover in the United Kingdom of the enterprise being taken over exceeds £70 million.

⁷ *Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise*. See n.3 above, p. 2.

⁸ This list of factors is not exhaustive. Other factors to consider could include petrol and maintenance costs for private automobiles, availability of parking and costs associated with parking, punctuality of trains and services offered on board trains.

A cautious approach would suggest that alternative rail providers provide the closest competitive constraint on the train operating company, so it is important to consider closely any route overlaps between Thames and First services.⁹

b) Bus on Rail Competition

FirstGroup operates bus services in two geographical areas served by Thames—Reading and Worcestershire/Herefordshire—but customers' choice of transportation depends on a variety of factors: access to bus stops and train stations, personal preferences, comparative journey times and relative costs of available alternatives.¹⁰ Bus services are generally more frequent and cheaper, but these benefits are often offset by longer journey times and less direct routing with repeated stops. It is not clear whether prices and/or service on bus and rail operations are constrained competitively by one another. The OFT acknowledged that the availability of season passes and off-peak tickets makes it difficult to form comparisons. An increase in the price of a ticket may not be enough to induce switching to the other mode of transportation, if factors such as journey times are important. While at least three investigations carried out by the former Monopolies and Mergers Commission ("MMC") in 1996 and 1997 concluded that a degree of competition does exist between rail and bus on specific routes, the OFT suggested that conditions may have changed since then. As well, the MMC conclusions were based on circumstances unique to the routes under examination.

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.¹¹

2. Horizontal Issues

a) Rail on Rail Competition

The train services operated by FirstGroup and Thames appear to some extent to be complementary, according to the OFT decision. Thames served intermediate stations and FirstGroup the major stations. On some short and frequently travelled routes, for example between Paddington and Reading, the two franchises are basically substitutes for point-to-point journeys, and tickets purchased may often be used on both systems.

The OFT admitted that common ownership of the two franchises will result in some loss of competition. But, as already noted, the amalgamation of these franchises together with Wessex Trains to form the Greater Western system will take place in 2006, and the combined network will then be re-tendered by the SRA. The OFT decision said that there is simply not enough time for the transaction to have an adverse effect on

⁹ *Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise*. See n.3 above, p. 2.

¹⁰ To these factors can be added others, such as passenger comfort, safety features, scheduled departure times and ease of ticket purchase.

¹¹ *Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise*. See n.3 above, p. 2.

competition before then. This view is consistent with at least two other cases considered by the OFT that also involved rail on rail overlap of relatively limited duration.¹² The OFT decision stated:

Given that it takes time for any changes to timetables, fares or other competitive conditions to come into effect, as many of these require an onerous...consultation process involving the SRA, First is limited in its ability to make any changes; the timetable from December 2004 to December 2005 is, for example, already agreed. First has little incentive to make detrimental changes to the service offered as it is in competition for the much more substantial contract to run the new Greater Western franchise from April 2006.¹³

It is also the view of both FirstGroup and the SRA that the consumer benefits realised by this merger outweigh any possible lessening of competition. By taking advantage of harmonised services, additional seating will be available in both the morning and evening peak travelling times into and out of London. This increased service and reliability will enhance train travel for the public, resulting in improved passenger levels.

b) Rail on Bus Competition

If, in fact, rail and bus services are substitutable forms of passenger transportation on certain point-to-point routes, it is conceivable that FirstGroup could raise fares and/or reduce service levels on bus routes and still enjoy increased revenues as bus passengers would switch to trains. The OFT decision identified three overlaps between a commercial bus service operated by FirstGroup and train routes within the franchise. Nevertheless, the competition concerns were held to be minimal. There were no third-party concerns with this merger proposal; some passengers have free travel passes on buses that are not valid with rail travel,¹⁴ no fare stages are conveniently located to train stations; and there is always the potential for additional bus companies to enter the market.

¹² *Anticipated acquisition by First Group plc of GB Railways plc* (September 30, 2003). Available: www.of.gov.uk/business/mergers+ea02/decisions/clearances+and+referrals/first+group.htm; *Proposed acquisition by Govia Limited of Connex South Central Limited* (August 23, 2001). Available: www.of.gov.uk/Business/Mergers+FTA/Decisions/Govia+Limited.htm

¹³ *Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise*. See n.3 above, p. 4.

¹⁴ For example, old age pensioners.

c) Barriers to Entry

Rail

Barriers to entry in the provision of passenger rail services are high. Entry is regulated and licensed through the SRA and the Office of the Rail Regulator.¹⁵ Since April 1998 limited competition in the provision of rail services has been possible, but new entrants would have to compete with existing franchise holders without the benefit of the operating subsidies that the current operators receive.

Bus

Local bus firms are licensed under the Transport Act 1985, and buses may be bought outright or leased. An existing operator is unlikely to face serious barriers to expansion as there are no FirstGroup bus depots in the overlap area that do not have competitor depots within a 20-mile radius.

Buyer Power

Individual passengers do not have buyer power, but the SRA could be deemed to have buyer power as it is the tendering body for the rail franchise. Regulation by the SRA and the Office of the Rail Regulator will also constrain FirstGroup's ability to set prices and service levels.

3. *Vertical Issues*

a) Multi-modal Issues

Common ownership of both local rail and bus services would allow FirstGroup to offer a multi-modal ticket for exclusive travel on its routes. This measure could have the potential to attract passengers to FirstGroup at the expense of competing bus services or prospective new entrants.

To the extent such competitors were eliminated, First would have the opportunity to raise prices for consumers buying bus-only tickets, who would be obliged to use First buses and pay more to travel than they otherwise would have done. This could outweigh the short term benefit to consumers of potentially cheaper First-only multi-modal tickets.¹⁶

FirstGroup estimates that no more than five percent of its passengers travel to or from train stations on its buses, and there is only modest interest in its existing multi-modal

¹⁵ The Office of the Rail Regulator is an independent, non-ministerial government department. It is responsible for managing the national railway network, the relationships between the train operators and the network operator, issuing and enforcement of licences, approval of key industry contracts and consideration of some competition law matters.

¹⁶ *Anticipated acquisition by Firstgroup Plc of the Thames Trains franchise.* See n.3 above, p. 6.

ticketing schemes in other parts of Britain. Notwithstanding, the OFT sought to test whether FirstGroup could engage in successful foreclosure of rivals at 18 Thames stations served by FirstGroup bus routes.¹⁷

At some stations other rail companies provide significant levels of service. At several additional stations FirstGroup is bound by terms in the franchise agreement to make all reasonable efforts to engage in multi-operator ticketing. At still other stations where FirstGroup operates all proximate bus services, only a marginal percentage of bus journeys are part of a multi-modal ticketing scheme. Finally, at one station FirstGroup has a small proportion of the proximate bus services, and its existing multi-modal revenue is negligible. On the basis of this review—and the absence of third-party complaint—the OFT determined that the company lacked the ability and/or incentive to foreclose on rival bus operators at the stations identified.

Conclusion

The OFT made a reasoned and thoughtful evaluation of this merger proposal and found that it would not result in a substantial lessening of competition. This is not a surprising conclusion. FirstGroup's rail services and fares are regulated by the SRA. The company is anxious to win the lucrative Greater Western franchise, and it is therefore unlikely to take any anti-competitive action that will prejudice its chances of being selected the successful bidder. Furthermore, with rail and bus overlaps where there is no competing operator, it was evident that third parties were unconcerned about the proposed merger, and local competitors were in the vicinity to constrain any potential erosion of competition. It was also unlikely that the transaction would induce foreclosure of competition from rival bus operators if FirstGroup introduced exclusive multi-modal ticketing arrangements. In light of these observations and its overall assessment that any loss of competition arising from the merger is not substantial, it was unnecessary to assess the claims that countervailing customer benefits outweigh potential detriments to competition. The OFT decided that the merger should not be opposed, and the case was not referred to the Competition Commission.

FirstGroup did not take long to promote its new First Great Western Link. Said Alison Forster, managing director of First Great Western and First Great Western Link:

The improvements started the very minute we took over this morning but it will take time, and the introduction of the new timetable, before we can deliver all the benefits we want to provide. Over the coming days, weeks and months we will be focused on giving our new customers a much brighter future.¹⁸

It is the responsibility of organisations such as the SRA, the OFT and the Office of the Rail Regulator to ensure that Britain's trains are reliable, safe, competitively priced and meet the needs of the travelling public. Privatised passenger rail companies are

¹⁷ FirstGroup provided the OFT with detailed evidence on a station-by-station basis.

¹⁸ April 1, 2004 FirstGroup press release, *Rail Customers Look Forward to a Brighter Future*. Available: www.firstgroup.com/corpfirst/press/pressreleasestory.php?id=156

increasingly under pressure to deliver more efficient services and a number of rail franchises expire in 2004. Future franchise holders will be expected to meet key performance indicators and deliver value for money. For those rail operators that meet these objectives, there is the possibility of franchise extensions.

The OFT has also made it clear that it will ensure the award of rail franchises are in the best interests of competition. Its assessments should never be considered mere formalities. On March 16, 2004 the OFT announced that it will refer the acquisition of the Wales and Borders rail franchise by Arriva plc to the Competition Commission unless Arriva provides appropriate undertakings to address potential competition concerns.¹⁹

The OFT has already examined several rail franchising cases and developed a high degree of expertise in this area. It is hoped that this knowledge can be relied upon to help build a modern, competitive and cost-effective national rail network in the years ahead.

¹⁹ *Completed acquisition by Arriva Plc of the Wales and Borders Rail Franchise* (March 16, 2004). Available: www.of.gov.uk/Business/Mergers+EA02/Decisions/Undertakings+in+lieu/Arriva.htm