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January 2005

FIRSTGROUP/INTERCITY EAST COAST FRANCHISE MERGER

1. I refer to your letter of 24 December 2004, in relation to the OFT reference on the proposed acquisition by FirstGroup plc of the Intercity East Coast rail franchise. Please find below, ORR's response to your questions. For clarity we have used the same paragraph numbers as used in your letter.

2a) Whether the proposed acquisition may be expected to result in any substantial lessening of competition

2. [REDACTED] it is relevant at this stage to indicate that ORR would (based on initial considerations) see the key relevant markets in this case to be point to point travel between specific origin and destination pairs.

Rail on Rail overlaps

Hull Trains

3. FirstGroup owns three passenger Train Operating Companies (TOCs) that overlap with the ECML. Two of these, ScotRail and Transpennine are franchised passenger services, the other, Hull Trains, is an open access operator. It is the services currently offered by Hull Trains, and the potential effect that FirstGroup's proposed acquisition of the ICEC franchise may have on these competing services, that represents a potential lessening of competition on routes between London and Hull. [REDACTED]

4. In the event of a completed acquisition of the ICEC franchise by FirstGroup, there would be a clear incentive for FirstGroup to reduce the services or increase the prices currently offered by Hull Trains in which case remedial action would be required if the acquisition were approved. The benefits provided to passengers from Hull Trains' services are as follows:





- (a) **Price competition:** As can be seen from the table below Hull Trains competes directly on price with GNER services at stops between Hull and London. Whilst this table is not exhaustive (in terms of routes or fare types), it indicates a number of cases where Hull Trains provides a cheaper service. If FirstGroup were also to operate the ICEC franchise it seems unlikely that the incentive for Hull Trains to provide a discount relative to the current lead operator's price would remain.

Comparison of Hull Trains and GNER prices between Hull, Doncaster and Grantham - London¹

Table [1]

Hull - London	Standard open return	First Class open return	Standard Saver	Super Advance	Apex
GNER	£121	£204	£71	£46	£33
HULL Trains ²	£89	£147	£63.50	£41	£29
GNER price as a % of Hull Trains price	136%	139%	112%	112%	114%

Table [2]

Doncaster - London	Standard open return	First Class open return	Standard Saver	Super Advance
GNER	£117	£191	£59	£44
HULL Trains	£70	£114	58.50	£29
GNER price as a % of Hull Trains price	167%	168%	101%	152%

¹ These tables compare a range of tickets with the same terms and conditions. Mostly these are 'walk on' fares with the exception of Apex and super advance tickets, which need to be purchased in advance and are restricted to a particular service. Additionally both operators offer a number of discounted tickets with various restrictions, mostly for advance purchase.

The standard return and Saver return tickets are 'protected' tickets meaning they are subject to a price cap

² All Hull Trains prices quoted are Hull Trains only dedicated ticket prices



Table [3]

Grantham - London	Standard open return	First Class open return	Standard Saver	Super Advance
GNER	£71	£122	£36.20	£26.00
HULL Trains	£47	£93	£41.50	£23.50
GNER price as a % of Hull Trains price	151%	131%	87%	111%

(b) **Frequency:** Hull Trains has so far made three applications to amend the frequency in its track access contract. In arguing that additional capacity should be allocated to its services Hull Trains has argued both that there remains considerable untapped demand in Hull and the surrounding areas and that one of the most valued aspects of its service by passengers is the frequency of its direct services to London from Humberside. The extent of untapped demand in the Hull area is supported by ORR's analysis of Hull Trains' new-to-rail revenue [REDACTED]

(c) **Service Characteristics:** In discussions surrounding its track access applications Hull Trains has consistently pointed to what it perceives as the passenger benefits it provides in terms of both its punctuality and customer service. [REDACTED]

[REDACTED] The incentive Hull Trains has to develop these price and non-price benefits and to cultivate the reputation of its service would be substantially reduced if it were under the same ownership as the ICEC franchise operator.

5. From analysis conducted by ORR in considering Hull Trains' applications, the evidence indicates significant head-to-head competition. (From a recent application by Hull Trains for a step-up in services, ORR's analysis indicates that [REDACTED] of Hull Trains' revenue from that step-up in services is competed away from franchised passenger services.) Hull Trains' services enter the ECML at Doncaster, and as might be expected the most significant direct competition is at Doncaster and Grantham.

6. At Hull, Brough and Selby, Hull Trains offers the overwhelming majority of direct services to London. Out of six weekday services to London, Hull Trains supplies five. [REDACTED]

7. It would therefore seem that FirstGroup would have three options in terms of minimising the extent to which Hull Trains' competed directly with franchised ICEC services. It could either:

(a) remove the Hull Trains' service entirely;



- (b) reduce the daily number of Hull Trains' services; or
- (c) remove the stops at Doncaster and Grantham from the service.

8. Clearly the trade-off between these options will depend on the relative profitability of each (ie additional revenue gained by FirstGroup against any cost saved). ORR has not seen FirstGroup's detailed business plan which may shed further light on which option is anticipated or most likely.

9. An important corollary to the fact that FirstGroup, by virtue of owning Hull Trains, would be in a unique position to reduce (or eliminate) the competitive constraint imposed by Hull Trains on the ICEC franchise, is that FirstGroup would therefore value the franchise higher than other bidders (who would not be able to remove such direct rail competition). For example, while Virgin/Stagecoach would also have other overlapping rail services, these are franchised services with various fares subject to price controls. As a result, the scope for removing competitive constraints would be lower.

10. In its consultation document on the East Coast Franchise in May 2004, the SRA identified that one of the options it was expecting bidders to submit alongside their base case was as an option for incorporating Hull Trains services into the franchise from 2010 - when Hull Trains' current access agreement expires. While this would 'level the playing field' among bidders post-2010, clearly during the intervening period, FirstGroup would retain the advantage described above. However, the SRA's 'Stakeholder Briefing Document' of October 2004 states that Hull Trains' operations, as well as franchised passenger operations (such as Transpennine Express, Northern, etc), should be 'assumed to remain at current levels' (Chapter 4, p.25). The previously identified option of incorporating the Hull Trains service post 2010 within the ICEC franchise appears to have been dropped. This is something that ORR welcomes, given the clear benefits the open access competition from Hull Trains has delivered.

Transpennine Express

11. Transpennine Express (TPE), jointly operated by FirstGroup and Keolis, operates intercity/regional services mainly on East-West routes across the Pennines, from Newcastle/Sunderland via York and Leeds to Liverpool/Manchester. There are service overlaps on north-south routes along the ECML principally between Leeds, York and Newcastle. [REDACTED]

[REDACTED] Overall, ORR does not consider that the overlap of this franchise with the ICEC franchise would result in a substantial lessening of competition.

Scotrail

12. ORR has identified some competition between the ICEC franchise and ScotRail services, but considers it likely that it will be limited, with the former primarily serving passengers making through journeys to and from England [REDACTED].

Interaction between Rail and Bus operations

13. FirstGroup is one of the UK's three largest bus/coach companies and operates bus services in regions and cities in England including, Doncaster, York and Leeds. Bus services in these areas therefore serve stations in the ICEC franchise. ORR would refer to the recent Competition



Commission's (CC) Inquiry into FirstGroup's acquisition of the ScotRail franchise, for details of similar problems identified and the remedies arising from that case.

14. Potential benefits arising where bus/coach services are complementary to rail services could include through ticketing and greater co-ordination between connecting bus and train services than currently exists. Set against this, if FirstGroup introduced an operator-specific inter-modal discount scheme, depending on the circumstances, this could potentially restrict competition in bus services (i.e. market power in passenger rail services could potentially be leveraged into bus services). Further, a multi-modal operator could exclusively promote its own bus services at railway stations, thereby restricting competition in local bus transport markets.

2b) What action should be taken to remedy such a substantial lessening of competition, or any other adverse effects resulting from it?

Rail on Rail overlaps (Hull Trains)

Structural remedies (divestment)

15. As stated above, Hull Trains currently provides competition to the ICEC services on routes between London and Hull. If FirstGroup were successful in acquiring the ICEC franchise, then it would have a clear incentive to make adjustments to the current services and prices offered by Hull Trains, especially, given that ICEC services will be relatively fixed in the franchise specification.

16. The divestment of Hull Trains to a third party without an overlapping rail operation would, in ORR's opinion, ensure the continuation of competition from the closest substitute to the ICEC franchisee on relevant origin-destination pairs – a situation which has to date provided clear benefits to rail users along the Hull–London route.

Behavioural remedies

17. An alternative to the divestment of Hull Trains by FirstGroup would be to seek behavioural undertakings. However, careful consideration would need to be given to behavioural remedies. A minimum requirement would be to seek assurances that the current level of services were not reduced and that the fares for such services were capped to ensure that Hull Trains' services remained attractive to consumers and therefore a competitive constraint to the ICEC franchise.

18. Although the possibility of maintaining the current level of services and fares might serve to protect the existing level of competition, further expansion or innovation which might materialise under separate ownership of the two directly competing operators in question would be lost as might other non-price and non-frequency related benefits. Any remedies should avoid stifling incentives for the provision of competing services which have yielded clear benefits to passengers.

19. Under the current situation where Hull Trains and the ICEC franchise are under separate ownership it has been shown that the former has been innovative in meeting untapped consumer demand and is consistently seeking to increase the number of services on the Hull –London route to the benefit of consumers. ORR is aware that Hull Trains is at present considering adding further trains on this route. In a situation where the franchisee and open access operator are jointly owned it is not clear how this development of the relevant markets could continue.



20. In this particular case, and given the risk that behavioural remedies would mute future competitive interaction, ORR would strongly favour divestment over behavioural remedies if FirstGroup were to be awarded the ICEC franchise.

Rail on Bus overlaps

Behavioural remedies

21. ORR notes that in the CC's inquiry into FirstGroup's acquisition of the Scotrail franchise, it agreed behavioural remedies to counter adverse effects on local bus operations with regard to fares, frequencies, multi-modal tickets and information at railway stations on other bus operators' services. Following the FirstGroup/ScotRail inquiry, the CC required the appointment of an independent monitor to assess and ensure compliance with the behavioural remedies. Such remedies would seem relevant if the bus/rail interactions noted above were sufficient to produce a substantial lessening of competition.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Yours sincerely

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]