

## **FIRSTGROUP PLC (“FIRST”) / GREATER WESTERN FRANCHISE**

### **Submission to the Competition Commission (“Commission”) on the appropriate scope for the inquiry and the definition of the counterfactual**

**2 December 2005**

#### **Executive summary**

1. In its initial submission to the Commission for the inquiry into its potential acquisition of the Greater Western passenger rail franchise, First claims that:
  - (a) The OFT’s counterfactual of “the most competitive alternative bid in respect of each individual affected relevant market” is inappropriate, and the inquiry should instead be conducted against a counterfactual defined as the current situation, where First controls the Great Western and ex-Thames Trains routes.
  - (b) The only impact of using First’s proposed counterfactual instead of the OFT’s proposed counterfactual would be to eliminate a handful of overlaps in the First Berkshire and First Cymru areas.
2. This submission rebuts these claims.
3. We argue that the inquiry group should adopt the following position on these matters:
  - (a) Section 66(3) of the Railways Act 1993 requires the Commission’s inquiry for each relevant market to be conducted against a counterfactual in which all Greater Western services in that market are controlled by an hypothetical operator that has no other interests in that market.
  - (b) The merger inquiry’s remit does not include any comparisons of the potential bids with each other, and is not constrained by the Department for Transport’s shortlist or its preferred bidder. The Commission needs to analyse and remedy any substantial lessening of competition that would result from the merger if First is selected, irrespective of what might have happened if the Department had selected another bidder.
  - (c) There are likely to be many markets (both flow-specific and network markets) in which the choice of counterfactual could have a significant impact on the assessment of whether the merger would lead to a substantial lessening of competition.

## **Section 66(3) of the Railways Act 1993 defines the scope of merger inquiries into the award of passenger rail franchises**

4. Section 66(3) of the Railways Act 1993, as amended by Paragraph 30(8) of Schedule 25 of the Enterprise Act 2002, provides that:

For the purposes of Part 3 of the Enterprise Act 2002 (merger references), where a person enters into a franchise agreement as a franchisee, there shall be taken to be brought under his control an enterprise engaged in the supply of the railway services to which the agreement relates.

5. In the first round of franchise awards in 1996-1997, the Government caused individual British Rail subsidiaries to be created and to operate the services to be franchised, and franchise awards were structured as sales of the share capital of these companies to the franchisee. Section 66(3) then merely confirmed that merger control applied to that transaction.
6. In subsequent franchise replacements, including in the Greater Western case, the business of operating the services is transferred from the previous operator to the new operator, without any company or business being sold by the Department for Transport (or its predecessor franchising authorities) to the new operator.
7. In the absence of Section 66(3), such a transaction would be seen as the disposal of that business from the previous franchisee to the new franchisee. This would raise the question for a merger inquiry as to whether the counterfactual was the retention of the franchise by the previous franchisee, or its surrender to the State, or something else.
8. Neither the retention of the franchise by the previous franchisee nor its surrender to the State provide counterfactuals that would be considered entirely satisfactory for such a merger inquiry:
  - (a) Retention by the incumbent cannot be said to be what would happen in the absence of the merger, since the essence of franchise replacement is the forced disposal of the business by an incumbent whose bid has been unsuccessful.
  - (b) Operation of otherwise franchised services by the State is only permitted under the Railways Act 1993 (as amended) in certain circumstances, such as on a temporary basis following the default of a franchisee; it cannot be considered to be the default outcome in the absence of the merger.
9. Section 66(3) thus solves what might otherwise be a difficult problem by specifying Parliament's decision as to the appropriate scope of a franchise award merger inquiry. In effect, Section 66(3) is a guide to the relevant counterfactual. The Commission's task is to interpret and apply that provision to each relevant case that comes before it.
10. This submission seeks to assist the Commission with this task in the case of the First / Greater Western inquiry. It does so by reviewing in turn the main relevant precedents, the implications of Section 66(3) for the relationship (if any) between the relevant counterfactual and the bids by other shortlisted bidders, and the impact on the inquiry of using the incorrect counterfactual suggested by First.

## **The Competition Commission has consistently held that the existing situation is not a valid counterfactual in rail franchise merger inquiries**

11. There have been a number of Section 66(3) mergers referred to the Commission since the privatisation of British Rail. The following review is limited to the most recent Commission findings in this area. All cases cited below were under the merger control regime established by the Enterprise Act 2002 and relate to franchise replacement transactions.

### ***First / Scotrail***

12. The Commission’s report on First / Scotrail was published in June 2004, shortly after First had been selected as the preferred bidder. The other short listed candidates were Arriva, National Express, and a fourth bidder who withdrew during the process.
13. The discussion of the counterfactual is limited to the following:

5.2. Our normal method in these cases is to assess the likely effects of a merger in relation to what is likely to happen in the absence of the merger. In this case, either of the two remaining bidders—National Express or Arriva—would obtain the franchise. In the case of the former there would be no change on the current situation: in the case of the latter, there would be far fewer overlaps than result from the FirstGroup acquisition. In either case, the rail and bus network in the Edinburgh area and in most of Glasgow would remain in separate hands, and there would be no increase in FirstGroup’s current share of the public transport market in these areas, or in Scotland as a whole.

14. The analysis of lessening of competition appears to have been conducted against a counterfactual in which the bus and rail services that would come under common control as a result of the merger remained under separate control.

### ***National Express / Greater Anglia***

15. The Commission’s report on National Express / Greater Anglia was published in November 2004. The inquiry had started after National Express had been declared the preferred bidder for the franchise on 22 December 2003, and the transaction was completed on 1 April 2004. National Express was the incumbent operator for a small proportion of the services included in the amalgamated Greater Anglia franchise.
16. The discussion of the counterfactual in the Commission’s report is as follows:

5.1. In considering the counterfactual of what might happen in the absence of the merger, the CC would normally look at the position before the merger. In this case, three former franchises have been amalgamated into one, but this is not part of the terms of reference since it would have occurred regardless of who won the franchise. The position prior to the merger could not therefore be assumed to have carried on, since FirstGroup, the existing operator of most of the services, was only one of nine bidders for the franchise. Of the nine bidders, the three that we ought to consider with regard to the counterfactual are the shortlisted bidders—FirstGroup, Arriva and NEG.

5.2. The particular overlaps that arise from the merger—between NEG’s rail and coach operation, and between its separate rail operations—would not have arisen in the case of any other successful bidder. NEG, however, argued that the award of the Greater Anglia franchise to NEG would nonetheless create new competition—between bus and rail services—within a significant part of the region which would not have occurred had it been awarded to other likely winners.

5.3. Of the nine companies regarded by the SRA as 'pre-qualified' to be considered for the franchise, we are aware of possible competition considerations only in the cases of the three short-listed bidders: NEG, for its coach:rail overlaps and rail:rail overlaps which we are currently considering; FirstGroup; and Arriva.

5.4. FirstGroup operates extensive local and express bus services in the Greater Anglia area, many of which overlap with the Greater Anglia rail services. Many of the overlaps would be with the former Great Eastern services. However, FirstGroup was itself already the operator of those Great Eastern services. There would be many other overlaps between FirstGroup bus services and the Anglia services. But these rail services were previously operated by GB Railways, which was subsequently acquired by FirstGroup. The OFT did not refer that acquisition to the CC. Very few additional overlaps would have arisen had FirstGroup been awarded the franchise (these would have resulted from its acquiring those parts of the former WAGN operations which are now part of Greater Anglia).

5.5. Arriva operates local bus services in north-east London and south-west Essex, a much smaller part of the Greater Anglia area than First Group's operation. Overlaps between Greater Anglia and Arriva would be much more limited than in the case of FirstGroup and even less likely to affect competition.

5.6. In our view, therefore, and given in particular that FirstGroup's previous operation of bus and rail services in this area had not been regarded as of concern by the OFT, we think that it is unlikely that any other competition concerns would have arisen had the franchise been awarded to any other bidder.

17. The analysis of lessening of competition also appears to have been conducted against a counterfactual in which the bus and rail services that would come under common control as a result of the merger remained under separate control.

#### ***National Express / Thameslink Great Northern***

18. The Thameslink Great Northern franchise replacement process is running to a similar timetable as the Greater Western one. National Express was the incumbent operator for some of the services included in the amalgamated franchise.
19. The Commission's provisional findings report in November 2005 includes the following discussion of the counterfactual:

6.1. In applying the SLC test, the CC evaluates the competitive constraints on firms in the event that the merger were to proceed compared with the constraints on them that would have been expected to prevail in the absence of the merger. This is referred to as the 'counterfactual'. Very often, the counterfactual will be the position immediately prior to the merger (having regard to any expected changes in the market). This would be inappropriate in the present case for two reasons: first, the existing Thameslink operator has not been invited to tender and cannot therefore be the operator of the new franchise; and second, the existing Thameslink and Great Northern franchises are to be combined into the new TGN franchise; the competitive position after the amalgamation of these franchises cannot be assumed to be the same as that which prevailed when they operated as separate franchises.

6.2. In cases where multiple bids for a franchise are involved, as here, the counterfactual is normally taken to be the award of the franchise to one of the other pre-qualified bidders. Since the OFT has cleared unconditionally the other four pre-qualified bidders for the TGN franchise, we regard the appropriate counterfactual for each new overlapping flow in this inquiry as being the award of the TGN franchise to one of those four remaining bidders. The OFT found no competition concerns as regards those other bidders.

6.3. NEG already operates the Great Northern part of the TGN franchise where (as already noted—see paragraph 2.9) its services overlap with those provided by three of its other franchises, One, Midland Mainline and Central. NEG put it to us that, in respect of that part of the franchise, it must follow that no change would arise if it were awarded the TGN franchise. We have taken the view, however, that the fact that NEG currently operates part of the franchise may be relevant to the CC’s analysis of the competitive effects of the award of the TGN franchise to NEG. In particular, NEG’s existing and past behaviour when operating the Great Northern part of the franchise could inform our analysis of the future competitive landscape, as it could provide evidence of the incentives and constraints facing another operator of that franchise. We refer to flows where NEG currently operates the Great Northern part of the TGN franchise and another franchise on the same flow as ‘pre-existing flows’ (see section 10).

## **The merger inquiry does not involve any comparisons between bids**

20. First argues as follows in its initial submission to the Commission:

6.8. However, the OFT notes at paragraph 8 of its decision that

“The OFT view is that the appropriate counterfactual for the bid – and hence prospective merger – by each bidder is not continued operation by the incumbent (nor by the SRA) but the most competitive alternative bid in respect of each individual affected relevant market.”

6.9. First does not agree that this is a proper approach to a counterfactual analysis. In particular:

- to analyse the counterfactual on a route by route basis ignores the fact that a passenger rail franchise is not let on this basis (as is recognised, but not addressed, in paragraph 10 of the OFT Decision). A counterfactual therefore cannot be established for an individual flow independently of all other flows;
- A counterfactual analysis requires the merger to be assessed against the situation that is expected to prevail absent the merger whereas the OFT’s approach requires each bidder to be assessed against a hypothetical alternative bidder who represents the ‘least worst’ alternative of the other two bidders; and
- Even once the winning bidder is known, it is unlikely to be possible to determine which of the two unsuccessful bidders would have won the franchise if the winning bidder did not. Equally it may not be possible, without a full analysis of the alternative bid, to determine whether the unsuccessful bidder would have raised greater or lesser competition concerns than the successful bidder.

21. This argument raises a question of consistency between paragraphs 8 and 10 of the OFT decision. First quotes from paragraph 8 above, and paragraph 10 reads:

In respect of some individual markets, firm A (say) winning the rail franchise might result in more competition than firm B or C because, for example, it would bring an independent rail operator into competition with bus operators on overlapping flows, while a win by B or C might place competing bus and rail operations on those flows under common ownership. In other individual markets, the position might be reversed so that bids by B or C appear more competitive than that of A. However, it has not been feasible in the scope of the first phase of merger review to attempt to weigh any competitive gains against losses across markets, in part because of the large number of markets at issue.

22. We agree with First that it would be inappropriate for the Commission to be required to guess which alternative bid was most likely to have been successful in order to establish the counterfactual for a merger inquiry.
23. We also agree that it would be impractical to determine which of the other bidders represents the least lessening of competition: attempting to weigh up different forms of lessening of competition in different markets against each other is unlikely to produce analytically robust outcomes.
24. First correctly argues that paragraph 10 of the OFT's decision appears to envisage such a "least worst" counterfactual but that the OFT fails to address the issues that adopting such a counterfactual raises. The OFT also fails to reconcile the approach put forward in paragraph 10 with the counterfactual it describes earlier in paragraph 8 of its decision (quoted under paragraph 20 above), which it actually uses. These problems are fatal to the OFT's paragraph 10 analysis.
25. However, we are not persuaded by First's claim that the OFT's paragraph 8 counterfactual is not a proper approach because "a passenger rail franchise is not let on this basis". It is inherent in a counterfactual that it assumes things that deviate from reality. The fact that the OFT's paragraph 8 counterfactual is not in line with the method currently used by the Department for Transport to contract for the operation of railway services does not necessarily mean that it is the wrong counterfactual for the Commission to use in its merger inquiry.
26. Indeed, taken to its natural conclusion, First's argument would deny the existence of any counterfactual at all once the Department has announced the preferred bidder or once the transaction has been completed, since assuming that the franchise was awarded to someone else is not consistent with the way in which the Department's franchise replacement process is expected to work.
27. Relying on information and forecasts about the Department of Transport (effectively the seller in the merger transaction) to define the counterfactual would also mean that the relevant counterfactual could be changed during the course of the inquiry by, in effect, ministerial fiat. This cannot be either practical or correct.
28. In our view, the correct counterfactual must be derived from an analysis of Section 66(3) of the Railways Act 1993, as discussed below, and First's argument against the OFT's paragraph 8 counterfactual makes no contribution to that analysis.
29. First proposes to use the pre-award situation as the counterfactual. The precedents noted above show that the Commission has in the past rejected that solution.
30. In previous cases, the Commission has not needed to decide whether the correct counterfactual was similar to the OFT's paragraph 8 counterfactual (i.e. specified separately in each relevant market as a no-overlap hypothesis) or specified globally as the potential franchisee with the least impact of competition (as seems to be envisaged in the OFT's paragraph 10). This is because in all these cases there existed a realistic alternative candidate whose appointment as franchisee would, in the Commission's view, have led to no substantial lessening of competition in any relevant market. This could be therefore used as the counterfactual across the franchise.

31. First's argument, as far as it goes, appears to rest on the assumption that the Commission used a paragraph 10 global counterfactual in these cases, and that the impracticality or inappropriateness of a paragraph 10 counterfactual for the Greater Western case justifies falling back on using the current situation as the counterfactual.
32. Our submission is that First's argument rests on a misunderstanding of the Commission's previous decisions. In these precedents, the analysis actually reported by the Commission does not rely on a global counterfactual. Instead, the Commission assesses, within each relevant market, whether control over rail services by the potential franchisee would lead to a lessening of competition compared to the case where rail services are independently managed. The analysis does not rely on the identity of the person (alternative bidder or otherwise) that would be assumed to control these services.
33. Thus, whilst the extracts relating to the Commission's views on counterfactuals quoted above leave open the possibility that the Commission had in mind a paragraph 10 counterfactual, the analysis in the reports does not allow that interpretation. And in any event it would seem extraordinary for First to interpret Commission reports in a way that implies that the Commission used an approach that First considers to be flawed and impractical.
34. In summary, we agree with First that comparisons between the extent of the potential lessening of competition associated with different bidders are not within the proper scope of the merger inquiry, and that the OFT's paragraph 10 analysis must be rejected. But the actual analysis in the Commission precedents does not rely on any fallacious comparisons of this kind, and instead seems in line with the OFT's paragraph 8 counterfactual.

**The counterfactual need not be specified in terms of a foreseeable award of the franchise to another bidder**

35. The wording of Section 66(3) (quoted above at paragraph 4) makes it clear that a franchise award merger inquiry involves consideration of the acquisition of a deemed enterprise, defined as the operation of the services included in the franchise contract.
36. In the case of the Greater Western franchise, that deemed enterprise does not currently exist, either as a legal entity or as an identifiable business within a wider legal entity. It will only come into actual existence at the time where it falls under the control of the successful franchisee.
37. The use of a deemed enterprise in this way means that railway franchise acquisition inquiries are somewhat different from most merger inquiries: there is nothing similar to Section 66(3) to specify the scope of the inquiry or the relevant counterfactual in the general system of merger control under the Enterprise Act 2002.
38. In our view, this specific feature of rail franchise award transactions mergers explains the approach used in previous Commission inquiries and stated at paragraph 8 of the OFT's decision, in particular the fact that the definition of the counterfactual for these inquiries places no reliance on the current situation and little reliance on likely alternative outcomes in the absence of the merger. Because Section 66(3) requires the

Commission to investigate a merger involving a deemed franchise enterprise that does not actually exist prior to the merger, it is unsurprising that the counterfactual should itself be somewhat further removed from foreseeable events than it would be in the case of a merger between enterprises that actually exist before the transaction.

39. Our analysis of the precedents shows that one effect of this special feature of the counterfactual in merger cases governed by Section 66(3) is that it is appropriate to conduct the analysis on a market-by-market basis, choosing an appropriate counterfactual (of independently controlled rail services) in each market, without any attempt at building a global counterfactual covering the whole franchise or at using one of the unsuccessful bidders as a proxy for such a global counterfactual.
40. In fact, we can see nothing in the legal framework, in our understanding of the intent of merger control for franchise award transactions or in the competition analysis relied upon in the precedents to suggest that the counterfactual should be expressed in term of a named alternative franchisee, whether globally or within each market. Whilst thinking of the counterfactual in terms of an award to a particular company that happens to have no overlapping operations in the relevant market may provide a convenient illustration and proxy, it seems to us that the true counterfactual is in fact simply a hypothetical situation in which the services covered by Section 66(3) have not come under the control of the franchisee — i.e. they are independently run. There is no need to make further assumptions about their ownership or management in order to analyse whether the merger would lead to a substantial lessening of competition.
41. Our view is that Section 66(3) leads to an unambiguous specification of the counterfactual and of the scope of the merger inquiry. We have nevertheless considered, as a crosscheck, whether the implications of our analysis amounted to a reasonable policy framework for merger control as it applies to rail franchises.
42. The relevant policy implications of our interpretation are as follows:
  - (a) At the end of a franchise, the enterprise operating the services disappears and is replaced by the new enterprise formed from the merger of the Section 66(3) deemed enterprise with the new franchisee. Thus, competition remedies imposed in connection with a franchise award merger inquiry expire with the franchise.
  - (b) A re-award of a franchise to the incumbent operator triggers a fresh merger inquiry, enabling the Commission to impose competition remedies for the duration of the new franchise in the light of the prevailing market conditions.
  - (c) An amalgamation of franchises by the Department for Transport ahead of a franchise award is not subject to merger control, because the only relevant merger transaction is the one specified in Section 66(3) between the deemed enterprise and the new franchisee.
  - (d) In the case of a franchise award to an operator of an overlapping franchise which will expire within a relatively short period (as in the First / Thames Trains merger cleared by the OFT in 2004), the merger control inquiry must take account of the temporary nature of the overlap to determine whether there is a substantial lessening of competition, on the expectation that the authorities will

be able to consider the overlap again at the time of the second franchise award if that franchise it is retained by its incumbent.

43. These policy outcomes are reasonable and are in line with the precedents that we are aware of. This reinforces our view that our interpretation of Section 66(3) is correct.

### **The choice of counterfactual will affect the outcome of the inquiry**

44. A cursory review of the scope of First’s bus business suggests that there are a number of relevant markets that need to be considered in the inquiry, but that would be missed if First’s suggested counterfactual were to be adopted. These include:
- (a) The “handful” of point-to-point flows in Berkshire and in Wales referred to in First’s submission.
  - (b) Bus network markets in areas where First is the main bus operator and most train services are provide by Great Western or ex-Thames Trains services in the Avon, Berkshire, Herefordshire, Somerset, South Wales and Worcestershire areas.
45. There are also some relevant markets in which the lessening of competition associated with First’s acquisition of the Greater Western franchise could be significantly underestimated if First’s suggested counterfactual were to be adopted. These include:
- (a) Three-way overlap flows between Wessex Trains, Great Western and First bus services in the Bristol area, for example Bristol Temple Meads – Bath Spa.
  - (b) Bus network markets where First is the main bus operator and both Wessex and Great Western provide a significant number of train services, e.g. in Avon, Cornwall, Devon and Somerset.

### **Summary and conclusions**

46. Our conclusions can be summarised as follows:
- (a) First’s potential acquisition of the Greater Western franchise should be assessed within each relevant market against a counterfactual in which Greater Western services are run independently of all other operators in that market.
  - (b) It is appropriate for the Commission to consider the competition implications of the continuation of overlaps between First’s bus services and Great Western and ex-Thames Trains rail services, irrespective of the clearances of the predecessors of these overlaps by the Secretary of State and the OFT in 1996 and 2004.
  - (c) First’s claim that the choice of counterfactual only affects “a handful of overlaps in the First Berkshire and First Cymru areas” understates the importance of that choice. Adopting First’s proposed counterfactual would significantly impair the ability of the Commission to remedy the adverse effects on competition of First’s potential acquisition of the Greater Western franchise.