

# 2 Conclusions

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## The reference

2.1. This reference, the full text of which is set out in Appendix 1.1, was made to us on 22 May 1997 under sections 64 and 69(2) of the Fair Trading Act 1973 (the Fair Trading Act). Under it we are required to investigate and report whether a merger situation qualifying for investigation has been created as a result of enterprises carried on by or under the control of NEG having ceased, within the four months preceding the date of the reference, to be distinct from enterprises carried on by or under the control of Central Trains. If we find that either the share of supply test or the assets test (referred to in section 64(1)(a) and (b) respectively) is satisfied, the reference requires us to exclude the other from our consideration.

2.2. As described in paragraph 3.62, on 14 February 1997 NEG entered into a franchise agreement for a period of seven years and one month with the Director of Passenger Rail Franchising (the Franchising Director) and the West Midlands Passenger Transport Executive (WMPTE, which we refer to by its brand name of Centro). NEG also acquired the issued share capital of Central Trains. In accordance with the franchise agreement NEG took over responsibility for the operation of the Central Trains services on 2 March 1997. Under section 66(3) of the Railways Act 1993 (the Railways Act) the acquisition of a passenger rail franchise is treated as the acquisition of control of an enterprise. Accordingly, for the purpose of section 65 of the Fair Trading Act, the enterprises of NEG have ceased to be distinct from the enterprise consisting of the passenger rail franchise carried on by Central Trains. The date of the franchise agreement is less than four months before the reference was made to us.

2.3. The assets test is not satisfied because the value of assets taken over by NEG in this transaction was less than the £70 million threshold which now applies for the purpose of section 64(1)(b) of the Fair Trading Act (see paragraph 3.77).<sup>1</sup>

2.4. As regards the share of supply test in section 64(1)(a) we are required to be satisfied that, as a result of the enterprises of NEG and Central Trains ceasing to be distinct, at least one-quarter of services of any description supplied in the UK or a substantial part of the UK is supplied by one and the same person or, if this was already the case, that the supply of the relevant services by that person is increased. Our terms of reference refer to 'the supply of public transport passenger services involving journeys carried out wholly within the West Midlands'. (The reference defines 'the West Midlands' to mean the metropolitan districts (or boroughs) of Birmingham, Coventry, Dudley, Sandwell, Solihull, Walsall and Wolverhampton -that is, the former West Midlands metropolitan county-and we use the term in that sense throughout this report.)

2.5. As shown in Table 4.4, we estimate that total revenue from the supply of public transport passenger services involving journeys carried out wholly within the West Midlands in 1996 was some £193 million. NEG's share of this was 78 per cent, nearly all as a result of its ownership of WMT. The share of Central Trains (which was then in separate ownership from NEG) was 7.0 per cent, within which Centro-supported services accounted for 6.8 per cent (Centro's role is explained in paragraph 2.11).

2.6. NEG submitted that, since the revenue from Centro-supported services accrued to Centro and NEG exerted no material influence over those services, that revenue should not be counted as part of NEG's supply of public transport passenger services in the West Midlands. We note, however, that section 68 of the Fair Trading Act allows the MMC a wide discretion in the application of the share of supply test, including over whether different forms of supply should be considered together or separately and how to identify different forms of supply: the MMC may choose the approach considered most appropriate. Further, section 137(3)(b) provides that the supply of services includes both the rendering of services to order and the provision of services by making them available to potential users. This indicates that, in the application of the share of supply test in relation to the supply of services, a supplier's share can include services supplied where another person is able to determine the conditions under which those services are supplied. Given that NEG is the operator of the services and that, as we discuss later, that role might give it some opportunities for actions affecting the competitive situation in the market, we consider that it is appropriate for us to include the revenue from Centro services in calculating NEG's share of the supply of public transport passenger services in the West Midlands. We note that, in any event, Central Trains earns some revenue from the supply of services involving journeys carried out wholly within the West Midlands which are not supported by Centro (see paragraph 2.33(b)), and that NEG did not dispute that the share of supply test was satisfied.

2.7. It is clear to us from the figures quoted in paragraph 2.5 that NEG supplied well over one-quarter of public transport passenger services involving journeys carried out wholly within the West Midlands before the merger and that its share was increased as a result of the acquisition of Central Trains. The West Midlands has a population of 2.6 million (4.5 per cent of the UK total) and a land area of 899 square km (0.4 per cent of the UK total). It includes the city of Birmingham (the second largest in England), the city of Coventry and several large industrial towns such as Walsall, West Bromwich and Wolverhampton. We are in no doubt that it constitutes a substantial part of the UK for the purpose of section 64(3) of the Fair Trading Act (see paragraph 2.4). We therefore conclude that the share of supply test is satisfied and that a merger situation qualifying for investigation has been created. Accordingly we have to consider whether the creation of this merger situation operates or may be expected to operate against the public interest. Since the merger has

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<sup>1</sup>Central Trains does not own rolling stock or infrastructure (stations, track and so on): see paragraph 2.8.

been completed relatively recently and its effects may not yet be fully apparent, we have concentrated on whether it may be expected to operate against the public interest.

## **The regulatory and contractual framework for rail services**

2.8. The Railways Act brought about a major reorganization of the rail network in Great Britain, and by the General Election of 1 May 1997 nearly all the component parts of the new structure had been privatized. Twenty-five train operating companies (TOCs) operate passenger services under franchises awarded following a process of competitive bidding. They lease rolling stock from rolling stock companies (ROSCOs) and pay for rail access provided by Railtrack plc (Railtrack), from which they also lease railway stations.

2.9. All TOCs are subject to regulation by the Rail Regulator and the Franchising Director. The Rail Regulator is responsible for granting licences, for setting conditions for those licences and for enforcement of them. Different types of licence are required for the operation of the different categories of railway assets, namely a train operator's licence, station licence, light maintenance depot licence and network licence. TOCs typically need the first three in order to be able to operate. The Rail Regulator is also responsible for controlling access to the track-access agreements between Railtrack and TOCs require his approval and has functions in relation to domestic competition policy under the Fair Trading Act and the Competition Act 1980.

2.10. The Franchising Director's principal responsibilities include negotiating and awarding passenger rail franchises and monitoring the performance of the franchisees. His principal objectives, given to him by the Secretary of State for Transport in March 1994, are to secure that passenger services are provided under franchise agreements as soon as reasonably practicable and to secure an overall improvement in the quality of passenger services. In inviting tenders for franchises he sets out minimum service standards (the passenger service requirement, or PSR) and other requirements in relation to capacity and punctuality, for example which bidders must meet. The PSR specifies the routes and stations to be served, frequency, first and last trains and maximum journey times, although the degree of detail and hence the successful bidder's ability to change the service varies. Bidders have usually offered service enhancements, over and above the PSR, in their tenders: those offered by the successful bidders are incorporated in the franchise agreements and hence become commitments. The Franchising Director must also ensure that the franchise agreements contain such provisions as he considers necessary for ensuring that fares are reasonable (see paragraph 2.13). Once franchises are let he has a duty to secure compliance with the terms of the franchise agreements, to which end he has powers to make orders and, where appropriate, impose financial penalties on operators. He is also responsible for making subsidy payments to operators in accordance with the franchise agreements.<sup>1</sup>

2.11. In relation to franchises which include the operation of local services in the main conurbations (apart from London), the role of the Franchising Director is in effect shared with the relevant Passenger Transport Executive (PTE). PTEs, which were established under the Transport Act 1968, have a duty to secure the provision of such public passenger transport services in their area of responsibility as they consider appropriate for meeting requirements, in accordance with policies formulated by the corresponding Passenger Transport Authority (PTA) whose members are drawn from elected representatives of local authorities. Where passenger rail services are to be provided under a franchise agreement within a PTE's area of responsibility, the PTE may specify, as part of the PSR, the passenger rail services which it considers appropriate to meet its obligations. Where it does so, the PTE becomes a party to the franchise agreement and is responsible for providing any financial support required for such services (as determined by the franchise tendering

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<sup>1</sup>Subsidy levels typically decline year by year over the period of the franchise. In a small number of cases the franchise operator has agreed to make payments to the Franchising Director, rather than receiving subsidies.

process). Before entering into a franchise agreement, the PTE must obtain the PTA's approval. PTEs may specify fares for rail services in their area of responsibility. In most cases PTEs have retained complete control of fares and have chosen to take the 'revenue risk': in relation to services in those areas, the franchise operator is paid a predetermined fee and passes all the revenue to the PTE. However, Greater Manchester PTE and West Yorkshire PTE have transferred revenue risk to the relevant operators in their areas and Centro has agreed to share incremental revenue above a specified threshold with Central Trains: see paragraph 4.9.

2.12. Outside PTE areas TOCs set the fares subject to the terms of the franchise agreements. For each flow (that is, a journey between two points on the network), a lead operator is designated, normally the TOC which provides the largest number of services on the flow. The lead operator sets fares which are 'interavailable', in that all TOCs which run services on all or part of the flow must honour tickets issued by any other operator charging those fares. TOCs may in addition set their own dedicated fares<sup>1</sup> for the flow which are valid on their trains only. The lead operator may set dedicated fares only for first-class and advance-purchase tickets or for temporary and special fares (this is to prevent it from undermining interavailability). Income from interavailable fares is allocated between operators broadly in relation to the number of passengers travelling on each TOC's services but all income from dedicated fares is retained by the TOC which sets them.

2.13. The Franchising Director's policy in regulating fares is to constrain only particular categories of fares. Generally these include Saver fares or unrestricted standard-class return fares; weekly standard-class season ticket fares; and, within the London, Edinburgh and Cardiff areas, most season tickets plus some standard-class single fares. The particular fares to be capped vary between franchises according to circumstances. For the three years from January 1996 capped fares are pegged to the retail price index (RPI), whilst for the following four years increases are limited to RPI 1 per cent. NEG told us that, by selecting key season ticket and leisure fares for direct regulation, the Franchising Director was influencing all other fares because of the need for TOCs to retain a sensible commercial relationship between the levels of regulated and other fares.

2.14. As noted in paragraph 2.9, the Rail Regulator must approve any agreement giving access to the rail network. In accordance with guidance given by the Secretary of State for Transport in 1994 he decided that, in order to facilitate franchising, entry by rival TOCs seeking to provide a service competing with a service provided under a franchise should be restricted for several years (this policy is known as moderation of competition). The Rail Regulator's policy is that no significant new entry should be allowed before 1 April 1999 on flows nominated by a TOC.<sup>2</sup> However, a TOC which already has access rights on a particular flow is generally permitted to agree additional access rights with Railtrack, even if this is in competition with other TOCs also present on that flow. As regards the second stage of the moderation of competition, the Rail Regulator told us during the inquiry that, from 1 April 1999, new entry would be allowed on flows where there was existing competition and the restrictions on the other flows would be loosened: his current intention was that operators would be able to nominate a new list of flows and entry would be allowed up to a ceiling of 20 per cent of aggregate revenue on those flows. Existing competition on nominated flows would count towards the ceiling.

2.15. A more detailed account of the working of the new structure of the railway industry and its regulation is at Appendix 3.6.

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<sup>1</sup>In practice dedicated fares are invariably lower than the corresponding interavailable fares because there would be no reason for passengers to pay more for a journey when the TOC is obliged to honour the interavailable fare.

<sup>2</sup>A flow may be nominated if it is material to the operator, which in the case of Central Trains is defined as accounting for more than 0.02 per cent of its total revenue. The smallness of this figure reflects the very large number of separate flows on Central Trains' network.

## **The companies**

### ***National Express Group PLC***

2.16. As described in more detail in paragraphs 3.2 to 3.9, NEG was formed in 1988 by a management buyout of the National Bus Company's (NBC's) scheduled long-distance coach service business. It became a publicly quoted company in 1992 and subsequently made acquisitions of airports, further coach activities, bus companies and TOCs; it also has a share of London & Continental Railways Limited (L&CR) which is to develop the rail link to the Channel Tunnel.

2.17. The issues arising in this reference fall into two groups: those which affect the West Midlands and those which affect other areas.

2.18. As regards the West Midlands the issues mainly concern the combination of ownership of Central Trains and WMT. WMT is the successor to the bus operation of Centro. It was privatized in 1991 by sale to a management and employee buyout and acquired by NEG in April 1995 for some £250 million. In 1996 WMT acquired a one-third interest in Altram (LRT) Limited (Altram), which has won the concession to build, finance and operate the Midland Metro Line 1 (Midland Metro), a light rail system running between Wolverhampton and Birmingham which is due to come into operation in August 1998.

2.19. The issues arising *outside* the West Midlands mainly concern the overlap<sup>1</sup> between services provided by Central Trains and by NEG's coach services, which within Great Britain are operated principally through its subsidiary NEL (although most services in Scotland are operated by Scottish Citylink Coaches Limited (Citylink) and some airport services by Speedlink Airport Services Limited (Speedlink), two other subsidiaries of NEG).

2.20. NEL provides a nation-wide network of scheduled coach services under the National Express name and livery. NEL is not itself a coach operator. It contracts with individual coach operators (many of them ex-NBC bus companies and now part of other bus groups) which, for a pre-arranged fee, provide coaches, drivers and-for certain services-stewards or hostesses. NEL runs the central marketing, ticket sales and reservations systems and establishes timetables, fares and fare structure, conditions of carriage and service quality standards.

2.21. Besides the overlap between Central Trains and NEL there is a small element of overlap between the services of Central Trains and two of the other four TOCs which NEG has acquired, namely Midland Main Line Limited (MML) and North London Railways Limited (NLR). MML operates inter-urban passenger services mainly between South Yorkshire, the East Midlands and London St Pancras. NLR operates passenger services on the Northampton, North London and West London lines. The remaining TOCs which NEG has acquired are Gatwick Express Limited (Gatwick Express) and ScotRail Railways Limited (ScotRail).

2.22. NEG's acquisition of MML was itself the subject of a merger reference to the MMC. In a report published in December 1996<sup>2</sup> the MMC concluded that the acquisition might be expected to operate against the public interest by leading, over time, to higher coach fares or higher fares on both coach and rail and/or a lower quality of coach services or a lower quality of both coach and rail services on certain routes from central London than would have otherwise been the case. The MMC recommended that these adverse effects be addressed by a set of behavioural undertakings relating to coach fares and levels of service on the routes concerned. The Secretary of State

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<sup>1</sup>In this report we use the term 'overlap' to refer to routes or parts of routes on which Central Trains and one or more of NEG's other subsidiaries operate services.

<sup>2</sup>*National Express Group PLC and Midland Main Line Limited: a report on the merger situation*, The Stationery Office, Cm 3495, December 1996. Referred to in this report as the MMC report.

accepted this recommendation and asked the DGFT to seek undertakings from NEG accordingly. NEG's acquisition of ScotRail has also been referred to the MMC and we are reporting on that reference at the same time as on the Central Trains case.

2.23. For the year ended 31 December 1996 NEG's total turnover was £483 million (1995-£318 million) and its operating profit was £62 million (1995-£44 million). WMT made an operating profit of £38 million on turnover of £178 million for 1996. The equivalent figures for NEL were £7 million and £106 million.

2.24. NEG told us that its management was highly decentralized in keeping with the local nature of its businesses. It operated its rail businesses on a wholly separate and independent basis from its coach business.

### ***Central Trains Limited***

2.25. Central Trains includes most of the activities of the former Regional Railways Central, one of the five integrated profit centres of British Railways Board's (BRB's) Regional Railways business sector. Its services comprise a 'hub and spoke' urban network centred on Birmingham and operated on behalf of Centro; inter-urban services centred on the Midlands; and urban/rural services covering a wide area of central England and into Wales. A map of its network is at Figure 4.3. It generally operates short trains of up to three vehicles over a network totalling some 2,400 km and calling at over 300 stations. Draft accounts for the year ended 31 March 1997 show Central Trains' revenues as £[\*] million on which it made an operating loss of £[\*] million before subsidy of £196 million. The subsidy was partly offset by revenues of £[\*] million which Central Trains collected on behalf of Centro.

### **Background to the merger**

2.26. Following the issue of an information memorandum by the Franchising Director in September 1996 NEG submitted an indicative bid for the Central Trains franchise. It was one of [\*] companies shortlisted and on 17 January 1997 it submitted its final bid. NEG was informed on 11 February 1997 that it had been chosen as the preferred bidder and, as noted in paragraph 2.2, it entered into the franchise agreement on 14 February 1997.

2.27. The agreement provides that NEG will receive from the Franchising Director and Centro financial support totalling, at constant (February 1997) prices, £188 million in 1997/98, declining to £133 million in 2003/04.<sup>1</sup> In real terms the figure for 2003/04 represents a fall of 33 per cent compared with the subsidy claimed by BRB in 1996/97 in respect of Central Trains' services. In addition to meeting the PSR, NEG is committed by the franchise agreement to provide no less than the current number of train miles annually for the life of the franchise and to provide a range of enhancements to services and stations, mostly in the West Midlands (see paragraph 3.70). It is also committed under its Passenger's Charter to meeting higher standards of punctuality and reliability. NEG's bid required the lowest subsidy [ \* ] compared with the under-bidder as well as offering comparable service enhancements (see paragraphs 3.64 to 3.66).

2.28. As described in paragraph 3.78, the Franchising Director had made clear to NEG during the tendering process that he would need to be satisfied that any competition issues which might arise as a result of NEG's other interests would not jeopardize or delay the award of the franchise

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<sup>1</sup>Centro will pay 29 per cent of the total financial support over the life of the franchise. It should be noted that this element of the support will be partly offset by the revenues collected by NEG and passed on to Centro.

\*Figures omitted. See note on page iv.

to NEG. His concern was that he might again become involved in a reference to the MMC, as in relation to the MML franchise, the outcome of which would be uncertain. [

*Details omitted. See note on page iv.*

] NEG told the Franchising Director that it would be prepared to give [ \* ] undertakings if necessary.

2.29. Following the submission of binding tenders by the shortlisted bidders Centro raised concerns about aspects of the competitive environment in the West Midlands in the event of the franchise being awarded to NEG, which was already by far the largest provider of bus services in the area. NEG told us it considered that most of these were issues which either did not arise from the award of the franchise or were appropriately addressed in the franchise agreement. Nevertheless it had agreed to be bound by further assurances which were incorporated in the franchise agreement at Schedule 14. The text of the schedule is reproduced at Appendix 3.7.

2.30. Following the award of the franchise to NEG there were further exchanges between NEG and the Office of Fair Trading (OFT), including on the purpose and extent of Schedule 14. Centro submitted to the OFT that it could not be wholly confident of the enforceability of Schedule 14 and proposed that the assurances be given the force of statutory undertakings under the Fair Trading Act. The DGFT nonetheless advised the Secretary of State that the merger should not be referred to the MMC and that no undertakings in lieu of a reference were required. The Secretary of State, however, decided to refer the merger because of competition concerns in the supply of public transport services in the West Midlands.

## **The relevant markets**

### ***The West Midlands***

2.31. The great majority of journeys to work in the West Midlands are made by car (72 per cent in 1993/95, with 13 per cent made by bus or coach and only 2 per cent by rail: see Table 4.1). There are no precise figures for journeys other than travel to work but it is likely that the proportion made by car is even higher. Information on journeys in the morning peak (Table 4.2<sup>1</sup>) shows that rail's significance is mainly as a mode of travel into Birmingham city centre: rail's share of such journeys in 1995 was as high as 13 per cent, compared with 30 per cent for bus and 58 per cent for car. A comparison with 1986 data shows that car has been gaining mainly at the expense of bus, with little change in rail's share (though the absolute number of journeys has been falling).

2.32. The percentage of West Midlands households without a car is, nevertheless, significantly higher than in Great Britain as a whole, as is typical for urban areas (see Table 4.3).

### ***Rail services***

2.33. Rail services within the West Midlands fall into two groups:

- (a) Local services are operated by Central Trains but are provided to a specification laid down by Centro via the franchise agreement. Centro laid down the PSR for its services in considerable detail, specifying not only the routes and stations to be served, frequency, first

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<sup>1</sup>These data are not directly comparable with those in Table 4.1 because they take no account of car passengers or of other modes of transport such as bicycle and walking.

\*Details omitted. See note on page iv.

and last trains, maximum journey times, weekend services and load factors but also the rolling stock to be used, staffing levels and information to be provided on trains and at stations. The trains are required to be in Centro's livery. Centro told us that the franchise agreement effectively determined the timetable for its services. Centro also decides the structure and level of fares and receives the revenue from the services (subject only to an arrangement laid down in the franchise agreement under which Central Trains receives half of any increase in revenue over the level of two years earlier, adjusted for fare changes). Centro pays Central Trains for the running of the services and we refer to them in this report as Centro-supported or simply Centro services.

- (b) Other services are provided by trains with an origin and/or destination outside the West Midlands but which stop at two or more stations within the West Midlands. These include the non-Centro services of Central Trains as well as services run by five other TOCs: The Chiltern Railway Company Limited (Chiltern), NLR, North Western Trains Company Limited (North Western Trains), South Wales and West Railway Limited (SW&W) and West Coast Trains Limited.<sup>1</sup>

Of total passenger revenue from West Midlands rail services in 1996 (£15.8 million), 83 per cent derived from Centro services, 3 per cent from other services operated by Central Trains and the remaining 14 per cent from services provided by other TOCs (see Table 4.4).

2.34. Centro sets the interavailable fares for all flows within the West Midlands. TOCs can set lower dedicated fares valid on their own services but as far as Central Trains is concerned this excludes Centro services. (See paragraph 2.12 for a summary of fare-setting arrangements under the privatized railway structure.)

### *Bus services*

2.35. About 94 per cent of bus service km in the West Midlands are accounted for by services run on a commercial basis and the remaining 6 per cent by subsidized services run under contract to Centro (known as 'tendered services'). Since 1986 commercial bus services have not been subject to economic regulation, hence operators are free to vary their services and set their own fares. Schedule 14 of the franchise agreement has, however, given Centro some control over WMT's commercial services (see paragraph 2.63).

2.36. Bus operators in the West Midlands obtain revenue from four main sources:

- (a) revenue collected on the bus for single and return journeys, which accounts for around 40 per cent of the total;
- (b) payments made by Centro in proportion to the use made of services by those-notably children, pensioners and the disabled-entitled to concessionary fares (some 30 per cent of total revenue);
- (c) revenue from the sale of prepaid travel cards valid for one week or longer. WMT's various travel cards account for almost 20 per cent of total bus revenue. Two multi-operator schemes, Busmaster (bus only) and Centroc card (rail and bus), together account for a further 2 per cent. Individual operators other than WMT are not thought to have significant income from their own travel cards; and

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<sup>1</sup>West Coast Trains Limited is owned by the Virgin Rail Group Ltd, as is another TOC, CrossCountry Trains Limited. We use the term Virgin to refer to either or both of these TOCs, according to the context.

- (d) revenue from one-day travel cards. WMT's Daysaver card (sold on the bus) accounts for about 7 per cent of total bus revenue. There are one-day versions of the Centrocard but until September 1997 they could not be purchased on the bus (revenue from these cards is included at (c) above).

2.37. WMT's share of the total number of bus service km fell from 88.5 per cent at the time of deregulation (October 1986) to 77 per cent at August 1992 and to 68 per cent at April 1994 but has since risen to 79 per cent as a result partly of acquisitions, partly of withdrawals by other operators and partly of organic growth. Its share of total bus revenue earned in 1996 was some 85 per cent. Its share of tendered service km is, however, only around 45 per cent.

2.38. Three large bus groups each account for a small proportion of the West Midlands bus market:

- (a) FirstBus plc (FirstBus), which operates in Worcestershire but has some services in the Black Country and Birmingham and accounts for 3 per cent of total bus service km in the West Midlands;
- (b) Stagecoach Holdings plc (Stagecoach), which operates in Warwickshire and further east and runs some services in Coventry and into Birmingham (2 per cent); and
- (c) Cowie Group plc (Cowie), which operates in Staffordshire, Shropshire and Leicestershire and has some services running into the West Midlands (1 per cent).

The remaining 15 per cent of bus service km are provided by about 40 smaller operators, none of which individually has more than 3 per cent of the total (see Table 4.5).

2.39. Centro told us that there had been no active competition between the four major groups and that competition with WMT had been mainly small-scale from operators using inferior-quality vehicles. Most other operators used WMT's fare scale, which was also the basis of the maximum fares set by Centro for tendered services. Thus WMT announced fare increases in advance and other operators made arrangements to increase fares on both commercial and tendered services at the same time. NEG, however, said that there was considerable price competition from other operators (see paragraph 4.19).

2.40. WMT, besides having a one-third share in the Altram consortium which won the concession for the Midland Metro (see paragraph 2.18), is also the nominated operator of the service. Centro has set the minimum level and quality of service but other commercial aspects, including fares, will be determined by Altram. Centro has required the Midland Metro to accept its Centrocard.

## ***Outside the West Midlands***

### ***Rail services***

2.41. Central Trains operates inter-urban and urban/rural services in a wide area stretching from the Welsh coast to the Lincolnshire coast, from Liverpool in the North-West to Norwich and Stansted Airport in the South-East and to Cardiff in the South-West (see Figure 4.3). In operating these services Central Trains is subject to the following main regulatory and contractual constraints:

- (a) It is required by the franchise agreement to operate services in accordance with the PSR, drawn up by the Franchising Director, and the enhancements put forward by NEG in its tender. It operates one service under contract to each of Nottinghamshire and Leicestershire County Councils for which the councils specify in detail the services to be provided.

- (b) Some of its fares are regulated by the Franchising Director (see paragraph 2.13). For Central Trains the categories of fares capped are ordinary return fares and weekly standard-class season tickets. At present some 29 per cent of Central Trains' farebox revenue (excluding revenue from Centro services) is subject to control by the Franchising Director or by Nottinghamshire or Leicestershire County Council. Cheaper fares with validity restrictions (such as SuperSaver, APEX and cheap day return) are not subject to price caps.
- (c) Central Trains' performance in complying with the franchise agreement and in meeting the standards under its Passenger's Charter is monitored by the Franchising Director and an incentive system of rewards and penalties applies.

2.42. Because of its central location, Central Trains faces competition from several other TOCs which provide services on many of the same flows. As noted in paragraph 2.14, these TOCs face no regulatory constraints on stepping up the level of their services on those flows. They may also set dedicated fares for tickets valid only on their own trains with a view to stimulating additional patronage and/or winning a higher share of existing revenue. The Rail Regulator has removed protection from new entry enjoyed by Central Trains and MML on certain flows where they both run services.

2.43. The results of survey evidence on some of Central Trains' routes (not including the local West Midlands services) show that around one-third to one-half of passengers travel for leisure reasons, with significant proportions travelling to work or college, travelling on business or making shopping trips (see Appendix 4.5).

### *Coach services*

2.44. Until 1980 long-distance scheduled coach services in Great Britain were regulated, with a single operator holding a monopoly of services on each route. Following deregulation by the Transport Act 1980 there was initially a sharp increase in competition in coach services, including the establishment of the British Coachways Consortium of independent coach operators providing an alternative network of coach services to that of NEL's predecessor. This resulted in significant reductions in fares, and increases in the volume of coach travel, in part at the expense of rail use. Following the collapse of the consortium in 1982 there has been no sustained entry by coach operators on a significant network basis.

2.45. NEL has a major share of scheduled coach services in Great Britain, estimated in our 1994 report on NEG's acquisition of Saltire Holdings Ltd (Saltire)<sup>1</sup> at 77 per cent (including the effect of the acquisition of Citylink, owned by Saltire), with the ten next largest operators sharing 18 per cent and the remaining operators 5 per cent. NEG did not provide us with an estimate of its current share but it told the MML inquiry that there was likely to have been only a slight reduction in its national share of the coach market since the Saltire report. NEL's services cover over 200 routes and serve over 1,100 destinations. Many of the passengers travel long distances, transferring between different NEL services, particularly in London. Over three-quarters of NEL passengers travel for leisure reasons. Coach fares are not subject to regulation. Fares have broadly increased relative to the RPI since 1982, but in real terms remain below the levels before deregulation.

2.46. There are no regulatory barriers to entry for coach operators and capital costs are relatively low. Nevertheless there has been little sustained entry into long-distance coaching and there is no national competitor to NEL. Several of the overlaps between NEL and Central Trains

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<sup>1</sup>*National Express Group PLC and Saltire Holdings Ltd: a report on the merger situation*, HMSO, Cm 2468, February 1994. Referred to in this report as the Saltire report.

are on relatively short flows (up to 80 km), however, and on journeys of that length there has been some growth of inter-urban bus services provided by Stagecoach and others. We examine the extent of competition to NEL from such services in relation to the individual overlaps (see paragraphs 2.92 to 2.96).

### *The overlap between Central Trains and NEL*

2.47. In total there are over 40 separate flows on which both Central Trains and NEL provide a service, but on most of these NEL's service is infrequent and/or its revenue is small. We have concentrated our attention on 12 flows<sup>1</sup> where the overlap is significant, that is where NEL has three or more services a day in summer (the number of services in winter tends to be lower) and on which its annual revenue is more than £20,000. These flows, which are listed in Table 4.11, fall into three categories:

- (a) six flows where Central Trains is the only TOC or (in two cases) where MML is the only other TOC besides Central Trains;
- (b) two flows where Central Trains is the lead rail operator but a non-NEG TOC (Virgin in both cases) also operates; and
- (c) four flows where Central Trains is not the lead rail operator.

Tables 4.11, 4.12 and 4.13 set out information on these flows covering the revenue and number of passengers on NEG services; the identity of competing TOCs and coach/bus operators; frequency and journey times of all services; and fares charged on NEG rail and coach services. It may be noted that on most of these flows the number of Central Trains passengers is significantly greater than the number of NEL passengers. With one exception the 12 flows are inter-urban and much longer than the flows within the West Midlands where WMT operates.

### *The overlap between Central Trains and other NEG-owned TOCs*

2.48. Central Trains' services overlap with MML's on three main routes: Nottingham- Derby, Nottingham-Leicester and Nottingham-Sheffield. The last two of these are also routes on which Central Trains overlaps with NEL and are covered in Tables 4.11 to 4.13. We consider the competitive situation on these routes below (see paragraphs 2.92 to 2.96). On the remaining flow, Nottingham-Derby, Central Trains operates 32 trains a day while MML operates only three one-way trains from Nottingham to Derby, all at night (NEG told us that these services were provided only because the trains needed to be returned to MML's depot in Derby). There is also a minor overlap on the flow between Long Eaton and Derby, where MML operates two services a day to Central Trains' 33. We consider these overlaps on the Nottingham-Derby route to be immaterial and they are not considered further.

2.49. There is one overlap extending beyond the West Midlands, Birmingham-Northampton, between Central Trains and NLR. On this flow, however, Central Trains provides only one service a day to NLR's 17 and we are satisfied that the loss of competition resulting from the merger is not significant.

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<sup>1</sup>On one of these the overlap is between Central Trains and a WMT bus service.

## ***Transport integration***

2.50. In June 1997 the Government announced a review of transport policy and on 21 August 1997 the Department of the Environment, Transport and the Regions (DETR) issued a consultation paper entitled *Developing an integrated transport policy* (see Appendix 4.3). This is to pave the way for a White Paper which is to be published in the spring of 1998. A central theme of the consultation paper was that improvements in public transport were necessary to encourage a shift from private to public transport. Better integration between different transport modes was seen as an essential element in this process. We have taken account of the consultation paper in considering the effects of the merger.

## **The effects of the merger**

2.51. As noted in paragraph 2.17, the key issues in this inquiry differ between the West Midlands and elsewhere. We therefore address these two areas separately and then consider the benefits of the merger before coming to an overall conclusion on the consequences of the merger for the public interest.

## ***Effects in the West Midlands***

2.52. The merger brings into common ownership the leading suppliers of bus and rail services in the West Midlands. The bus company, WMT, also has a one-third interest in the consortium which holds the contract to build and operate the Midland Metro. The key issues in this area, therefore, are whether the merger gives opportunities to NEG to exploit its involvement in all three transport modes to the disadvantage of the travelling public and, if so, whether NEG is likely to take those opportunities. In assessing the merger's effects we consider in turn:

- the extent to which rail and bus services in the West Midlands are substitutable, that is, offer competing alternatives for the travelling public;
- the significance of Centro's control over rail services and fares;
- the significance of WMT's involvement in the Midland Metro project; and
- particular concerns that have been expressed to us about the potential adverse effects of the merger.

## ***The extent of competition between rail and bus***

2.53. As recorded more fully in paragraphs 7.21 to 7.33, NEG argued that local rail and bus services in the West Midlands served complementary functions and did not compete with each other. There were important structural differences between the two modes:

- (a) The bus network was much more comprehensive than rail, with 500 routes and 12,000 bus stops compared with seven rail routes and 71 stations. The overwhelming majority of bus journeys could not readily be made by rail. Historically the rail network had not been designed to operate as a suburban network-in contrast to the position in London and Glasgow-hence stations in Birmingham's suburbs were wide apart and did not reflect the centres of population, shopping and employment.
- (b) Bus journey times were much longer than for equivalent rail journeys and were less reliable. Many rail passengers travelling into Birmingham came from surrounding towns such as

Solihull, Sutton Coldfield and Wolverhampton: such journeys took 15 to 20 minutes by rail but about an hour by bus.

- (c) Buses tended to be used for much shorter journeys than rail, the respective average journey lengths being 4.5 km and 10 km.
- (d) Rail was used predominantly for commuting whereas most bus journeys were off-peak.
- (e) Customer profiles differed substantially, 40 per cent of rail commuters into Birmingham being in the professional and intermediate non-manual socio-economic groups while the equivalent proportion for bus passengers was only 16 per cent.

NEG added that bus services were considerably cheaper than the (subsidized) fares set by Centro on local rail services. WMT's fare structure was broadly similar across the West Midlands, regardless of whether there were overlapping rail services, and the level of fares was not set with reference to local rail fares.

2.54. Much of this analysis is uncontentious. Other witnesses, including Centro, also told us that buses and trains served essentially different markets. NEG's arguments do not, however, demonstrate that there is no substitutability at all between bus and rail: for example, there is clearly some use of buses for commuting, and some overlap in the socio-economic profile of bus and rail passengers. Some passengers are likely to have a choice between slower but cheaper bus services and faster but more expensive rail services. The greater frequency of bus services may for some passengers partly offset the greater speed of rail. The question remains, therefore, whether there is an element of substitutability between bus and rail, albeit small in relation to the total market for public transport passenger services in the West Midlands, which might in principle give NEG opportunities to raise fares or reduce service levels (and hence costs).

2.55. As shown in paragraph 4.21, there are overlaps between WMT's bus routes and the Central Trains network. These concern, first, WMT's limited-stop services on the Walsall-Birmingham and Coventry-Birmingham routes (for which higher fares are charged than on the generality of WMT's services) and, secondly, parts of WMT's ordinary services on several other routes. NEG estimated that the journeys which overlapped with Central Trains services accounted for no more than 2 per cent of WMT's total revenue.

### *The significance of Centro's control of rail services and fares*

2.56. At this point it is necessary to consider the implications of Centro's control of the levels of service provided and the fares charged by Central Trains in the West Midlands. As described in paragraph 2.33(a), the levels of service to be provided on Centro-supported routes are laid down in detail in the franchise agreement. Central Trains is therefore committed to providing those levels of service. Any changes over the period of the franchise could be made only by agreement with Centro and the Franchising Director. Centro also decided that when the Central Trains franchise was awarded it would maintain full control over the structure and level of fares on the services which it supports. The revenue from passengers using the services is, moreover, for Centro's account (subject to the qualification referred to in paragraph 2.58). Finally, Centro determines the interavailable fares for all services on flows within the West Midlands, not just those on its own services.

2.57. The situation therefore is that neither NEG nor its Central Trains subsidiary is able to reduce the levels of service provided on Centro-supported services, or to raise fares on *any* West Midlands rail services, without the danger of breaching the terms of the franchise agreement. To the extent that the rail services are substitutable for WMT's bus services on the overlap routes,

therefore, the competitive constraint which the rail services present cannot be relaxed by NEG unilaterally.

2.58. It should be noted that NEG has an interest in incremental revenue earned by the Centro-supported rail services (see paragraph 2.33(a)). This could in theory lead to NEG taking action on its bus services, in raising fares or reducing services, so as to encourage customers to move to rail, thus enhancing NEG's rail revenues. The revenue-sharing arrangement, however, gives NEG only a small and uncertain incentive: in its projections NEG foresees receipts of £[ \* ] a year at most. NEG pointed out that if patronage of the Central Trains services were declining for other reasons, such as an increase in other TOCs' services, the incentive arrangement might not be triggered even if NEG were able to encourage passengers to switch from bus to rail. In any event it had no guarantee that passengers would make this switch in response to a reduction in service or increase in fares on overlapping bus routes, and such changes would give opportunities to other bus operators to take some of WMT's business. We also note that such moves could breach the agreement which NEG has made with Centro (see paragraphs 2.62 and 2.63).

2.59. In the light of these factors we do not believe that the existence of the revenue-sharing arrangement will lead NEG to pursue a strategy of charging higher bus fares or reducing services with the aim of boosting rail patronage, even on those few routes where there may be an element of substitutability between bus and rail.

### *The significance of WMT's involvement in the Midland Metro project*

2.60. We described earlier (see paragraph 2.40) the nature of WMT's involvement in the Midland Metro project and the relative roles of Centro and the consortium. The Metro is of direct relevance to our inquiry only to the extent that there is an overlap between it and Central Trains. This applies to the end-to-end journey between Wolverhampton and Birmingham and to the section between The Hawthorns and Birmingham Snow Hill. The end-to-end journey would take much longer by Metro than by rail. There may be more potential for substitutability between Metro and Central Trains services on the section from The Hawthorns to Snow Hill-which accounts for about a quarter of the line's total length-with Metro's disadvantage in speed being offset by its greater frequency and possibly lower fares (though NEG told us that Altram had taken no final decision on the level of Metro fares). Centro, however, told us that the Metro was not considered to be in competition with heavy rail services. When the investment appraisal for the Metro project had been carried out in 1990, the vast majority of journeys projected to transfer to the Metro from other public transport modes were from the bus network. Furthermore, the project's principal rationale was to attract passengers from the car.

2.61. In any event, the analysis of the effect of the merger in this respect is largely the same as that applying to bus services: NEG is unable unilaterally to relax the competitive constraint, such as it is, presented by Central Trains to the Midland Metro and has no significant incentive to try to steer passengers on to the trains. The one difference is that NEG may have less freedom of action in relation to the Metro because it has only a one-third share in the consortium, as opposed to its 100 per cent ownership of WMT. Because of its experience in the local transport market it is likely that WMT will have a strong influence on the commercial policy of the Metro, including fares, but these matters are reserved for the Altram board.

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\*Figure omitted. See note on page iv.

## *Concerns expressed by Centro and other parties*

2.62. Despite the extent of control over Central Trains' West Midlands services given to Centro by the main body of the franchise agreement, the West Midlands PTA (WMPTA) and Centro were concerned that the award of the franchise to NEG would further strengthen NEG's position in the West Midlands public transport market as a whole in ways which could be contrary to the public interest (see paragraphs 6.50 to 6.53). Centro therefore insisted on the inclusion in the franchise agreement of a schedule (Schedule 14) which provided what it regarded as the necessary protection against abuse. The PTA and Centro expressed concern to us, however, that there might be difficulties over the enforceability of Schedule 14: if NEG were operating the Central Trains services satisfactorily, it was doubtful that the Franchising Director would be prepared to use his powers under the Railways Act to enforce the schedule, which largely concerned NEG's bus services. The Franchising Director told us, indeed, that there was doubt as to whether enforcement of the schedule was within his powers. Centro did not accept that the schedule was not enforceable by the Franchising Director but agreed that it was a contract between Centro and NEG and could in principle be enforced accordingly, though it argued that this could be difficult (see paragraphs 6.54 to 6.56).

2.63. The principal provisions of Schedule 14-the full text of which is set out in Appendix 3.7-may be summarized as follows:

- (a) *Provision of services.* Clause 3.1.1 essentially commits NEG to provide bus services on the corridors which overlap with Central Trains' services at the same level as before the merger. Clause 3.1.2 commits NEG not to reduce the level or quality of any commercial bus service operated by WMT in the Passenger Transport Area (broadly, the West Midlands as a whole), subject to specified exceptions.
- (b) *Participation in multi-modal ticket schemes.* Clause 3.1.3 commits NEG, as operator of Central Trains, of WMT's bus services and of the Midland Metro, to continue participating in the Centrocard scheme (see paragraph 2.36).
- (c) *Maintenance of bus fares.* Clause 3.1.4 commits NEG to charge bus fares on WMT's services which overlap with Central Trains' at the same level as fares elsewhere in the Passenger Transport Area.
- (d) *Provision of information.* Clause 3.1.5 commits NEG to provide information to the public about services of other bus and rail operators serving PTE stations to the reasonable satisfaction of Centro.
- (e) *Maximizing standards of transport by bus and Metro.* Clause 3.1.6 requires NEG to use all reasonable endeavours to co-operate with the PTE to maximize standards of public transport by bus and Metro in the PTE area.
- (f) *Creation of new multi-mode or multi-operator tickets.* The last paragraph of Clause 3.1 states that 'for the avoidance of doubt the creation of any new multi-mode or multi-operator ticket for use on the franchise operator's services within the Passenger Transport Area requires the agreement of the PTE'.
- (g) *Confidentiality.* Clause 3.2 prevents NEG from making available commercially sensitive information about Central Trains to other parts of the group.
- (h) *Separate reports and accounting for NEG's bus businesses.* Clause 3.3 requires NEG to maintain separate accounting records for each bus business of NEG which is a legal entity operating services within the PTE area and to provide financial statements to the PTE,

including 'such further financial information as may be reasonably required by the PTE for the purpose of determining that the franchisee [NEG] is complying with its obligations under this schedule'.

2.64. A number of concerns were also expressed to us by other bus operators providing services in the West Midlands. These operators emphasized what they saw as WMT's dominant position in the West Midlands bus market. They argued that this had been maintained and increased by WMT's use of its own season ticket schemes, which undercut the multi-operator Busmaster scheme; its unwillingness to participate in zonal versions of Busmaster which would compete more effectively with WMT's own zonal cards; and by WMT's acquisition of certain competitors. As competition had reduced, WMT had achieved monopoly profit levels, well above the industry average, and Centro was experiencing higher prices for the provision of tendered services.

2.65. Against this background, these operators submitted that the merger would act against the public interest because it would strengthen NEG's overall position in the West Midlands, giving rise to a public perception that NEG offered one-stop transport without the need to use other operators' services. One result would be further rises in the cost of tendered services. One company was concerned that the merger might enable NEG to introduce multi-modal ticket schemes which would not be open to other operators and could undercut the existing multi-operator Centrocarril, to the disadvantage of smaller operators.

#### *NEG's comments*

2.66. NEG, whose views are recorded more fully in Chapter 7, argued that WMT's high market share in the provision of bus services in the West Midlands did not confer a position of dominance. WMT faced over 50 competitors, including subsidiaries of the three largest UK bus companies (FirstBus, Stagecoach and Cowie). Its market share had fallen significantly since deregulation in 1986, despite its attractive services, and there had been numerous successful entrants. Although its return on sales was high, this partly reflected artificially low depreciation charges. Its growth in profitability had been largely achieved through cost savings. Its average fares had risen only slightly in real terms since its privatization in 1991 and compared well with those in other urban areas.

2.67. NEG defended WMT's offering of season tickets as pro-competitive and said that it was curious, in the light of the representations made to us by other bus operators, that no proposal for zonal versions of the multi-operator Busmaster ticket had been made to the relevant bus operators' committee in the last three years. In any event the competitive advantage conferred by WMT's own season tickets should not be overstated. Responding to the suggestion that WMT had increased its dominance through acquisitions, NEG said that WMT had acquired the businesses of only three small competitors since 1986. These acquisitions had been considered by the OFT and none of them had been referred to the MMC.

2.68. NEG submitted that, in any event, these matters related to WMT's existing competitive position and were not a consequence of the merger. It argued that WMT would gain no advantages over its competitors as a consequence of the merger. It had given the Schedule 14 assurances to reassure Centro of its intentions-Centro having indicated that its support for NEG's franchise bid was conditional on NEG giving assurances in relation to the provision of bus services in the West Midlands-and they were not necessary to remedy any loss in competition. It had given them willingly because they reflected its policies for low fares, high frequencies, intermodal and interoperator ticketing and better information for passengers. NEG saw no problem in terms of its ability to ensure that the assurances were observed but they were in any case legally enforceable by Centro.

## *Assessment*

2.69. In addressing these concerns it is important to bear in mind that we are examining the effects of NEG's acquisition of Central Trains, which does not add to WMT's share of supply in the West Midlands *bus* market. It is, nevertheless, necessary to examine whether the merger may strengthen NEG's overall position in the supply of public transport services in the West Midlands, including buses, and whether, as a result, WMT may be expected to act in ways which benefit its own operations while putting others' at a disadvantage and hence weaken competition. As we have seen, there is relatively little substitutability between the different transport modes in the area but there are interactions between them. In principle the following possibilities arise:

- (a) *Ticketing.* The introduction of multi-modal tickets usable (and sold) only on NEG's bus services, the Midland Metro and Central Trains, priced below the equivalent Centrocard tickets, would enable NEG to increase patronage on its own bus services at the expense of other operators which currently benefit from Centrocard.
- (b) *Information to passengers.* NEG could provide information on trains and at railway stations about its own bus services but not those of its competitors.
- (c) *Information to other NEG companies.* Central Trains may hold information-for example, statistical information about passenger flows and ticket sales, results of surveys, planned timetable changes-which would be of commercial value to other transport operators. Such information could be supplied exclusively or preferentially to fellow subsidiaries of NEG, notably WMT.
- (d) *Joint marketing.* NEG could engage in marketing activities designed to promote the services of WMT (including the Midland Metro when it comes on stream) and Central Trains (for example, advertising, special offers, supply of promotional material) in ways which were designed further to marginalize its competitors in the West Midlands bus and rail markets.

2.70. It will be seen, however, that most of these points are addressed in Schedule 14 to the franchise agreement. This is true of points (a) to (c), whilst the scope for NEG to engage in joint marketing operations (d) which would significantly harm other operators, although not directly addressed in Schedule 14, is restricted by several of its provisions, notably the statement that the creation of any new multi-mode ticket requires Centro's agreement.

2.71. With regard to the concerns expressed by the PTA and Centro that Schedule 14 might not be enforceable by the Franchising Director and that it could be difficult for Centro to enforce it (see paragraph 2.62), we have noted NEG's comments (see paragraph 2.68). We would expect Centro, at whose behest the assurances were given, to be vigilant in policing them and we are not convinced that the difficulties it foresaw in enforcing Schedule 14 are such that NEG can disregard the risk of legal action by Centro. More important, it appears to us that for NEG to fail to comply with Schedule 14 would damage its relations with the PTA and Centro, its reputation-not least with the Franchising Director-and its chances of retaining the Central Trains franchise when it falls due. We therefore believe that NEG can be expected to comply with the schedule. It is also relevant that any anti-competitive behaviour by NEG could be drawn to the attention of the DGFT, who would take appropriate action.

## ***Effects outside the West Midlands***

2.72. Away from the West Midlands the issues raised by the merger arise primarily from the combination of ownership of Central Trains and NEL, NEG's principal coach subsidiary. We therefore consider next:

- the general question of the extent of competition between rail and coach services;
- the extent of competition from other (non-NEG) rail and coach services;
- regulatory and contractual constraints on Central Trains; and
- the issues of competition between public and private transport and the overall sensitivity of the travel market.

Against that analytical background we then look at the competitive situation on individual overlap routes.

### ***Extent of competition between rail and coach***

2.73. In considering the general question of the extent of competition, both actual and potential, between rail and coach services we have examined the evidence which we have obtained specifically for this inquiry and evidence obtained for the parallel inquiry into NEG's acquisition of ScotRail (see paragraph 2.22). This question was also a key issue in the MMC's inquiry into NEG's acquisition of MML.<sup>1</sup> We have noted the way in which that inquiry approached the issue and we believe that some of the evidence considered, being of general relevance, is applicable to the present inquiry too.

2.74. Whether there is a possibility of competition between two types of service depends on whether they serve the same market and are therefore effective substitutes for each other. As noted in paragraph 2.45, the great majority of NEL's passengers travel for leisure purposes. The pattern for Central Trains' passengers is much more evenly spread between different journey purposes but leisure is a major element. The possibility of competition is therefore very largely confined to the leisure market, as in the MML inquiry.

2.75. The MML report presented evidence of competition between rail and coach under three headings: the pricing behaviour of the two modes; surveys of passengers' reasons for choice of mode and passenger responsiveness to changes in price; and evidence of cross-price elasticities of demand.

2.76. As regards relative pricing behaviour, evidence received in the present inquiry confirmed that coach fares have to be set significantly below rail fares for the same journey in order to offset the normally slower speeds and other disadvantages of coach travel.

2.77. Evidence from the time of coach deregulation in the early 1980s showed that, when coach fares were cut, about half the newly-generated demand was from passengers transferring from rail. BRB's main response was to introduce lower fares aimed at leisure travellers.

2.78. As described in paragraph 4.37, survey evidence of passengers' reasons for choosing coach rather than rail shows that price is a major reason: survey evidence from early 1996 which NEG supplied to us showed that about 60 per cent of NEL's passengers stated that the low price

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<sup>1</sup>Op cit (see paragraph 2.22).

was the main reason for choosing to travel by coach. About 50 per cent of coach passengers surveyed said that they had seriously considered train as an alternative method of transport. Surveys (carried out in 1994 and 1995) of Central Trains' passengers showed that about 7 to 11 per cent of respondents had considered bus or coach as an alternative; where separate results were available the percentage was somewhat higher for leisure passengers (12 to 16 per cent).

2.79. As regards cross-price elasticities, a report commissioned by the MMC for the MML inquiry suggested a cross-price elasticity of coach demand with respect to rail fares of 0.3 (that is, a 10 per cent increase in rail fares would lead to a 3 per cent increase in demand for coach travel); and an elasticity of rail demand to coach prices of 0.14 (that is, a 10 per cent increase in coach fares would lead to a 1.4 per cent increase in rail demand). This report was based on general data and we believe the findings are broadly applicable to the present case.

2.80. NEG submitted that coach and rail were only indirect and partial competitors. They would compete at most in relation to lower-cost rail fares targeted at leisure passengers. Coach services were a relatively weak competitor in this market sector as there were substantial differences between rail and coach services in terms of speed, punctuality, frequency and passenger security. We noted from NEG's board minutes, however, that the company expected the privatization of passenger rail services to have an impact on NEL's coach services.

2.81. No single piece of evidence can be seen as conclusive in determining the extent of competition between coach and rail services. We believe in the light of all the evidence summarized above that there is in general an element of competition between the two modes, particularly for leisure passengers. Competition between coach and rail is therefore a factor to be taken into account by management in making decisions about fares and levels of service for both coach and rail services.

2.82. To the extent that there are overlaps between routes served by Central Trains and NEL, that element of competition has been lost as a result of the merger. In considering the implications of this loss of competition we need to address other factors which limit NEG's freedom of action.

### *Competition from other rail and coach services*

2.83. Competition from other TOCs is in principle likely to be a greater constraint on Central Trains than competition from coach or bus operators. As noted in paragraph 2.42, several other TOCs provide services on many of the same flows as Central Trains and are therefore able to increase services on those flows in competition with Central Trains. There is also some scope for price competition. We consider below the significance of this competition in relation to individual routes where the services of Central Trains overlap with those of NEL and/or another NEG-owned TOC.

2.84. As to *potential* rail competition, NEG argued that Central Trains' geographical location meant that an unusually large number of TOCs might be interested in providing competing services on Central Trains' routes when moderation of competition was relaxed in 1999. The Rail Regulator told us that this relaxation was likely to have only a limited effect on Central Trains because of the extent to which it was already subject to competition, although the flows on which it already faced competition would be opened up to new entry from all comers.

2.85. Turning to coach and bus competition, other operators provide inter-urban services on some of the flows where Central Trains and NEL overlap. NEG submitted that these competing services, operating over relatively short routes, had certain advantages over its own services, which were provided as parts of longer routes: they were more punctual and reliable, passengers could buy tickets from the driver rather than having to book in advance, and passengers could be dropped

off and picked up nearer their homes, whereas NEL's services generally operated only between city centres. We agree that these factors are relevant in assessing the strength of competition to NEL from other bus operators where it exists.

### *Regulatory and contractual constraints on Central Trains*

2.86. Central Trains is required by the franchise agreement to operate a specified minimum level of services (although it is free to *increase* services if it can secure the necessary track access). NEG told us that its services on the main overlapping routes were generally operating at the level of the PSR and could not be reduced without the franchise agreement being breached. Franchise commitments also restrict Central Trains' ability to reduce service quality.

2.87. Central Trains has some ability to vary fares. Saver fares, which are among those capped under the franchise agreement, are likely to be important for leisure travellers but Central Trains has the ability to increase SuperSaver, APEX and cheap day return fares, which are not regulated.

### *Competition between public and private transport and the overall sensitivity of the travel market*

2.88. NEG submitted that car travel was the most important source of competition to TOCs and that discounted rail fares were aimed primarily at attracting this business rather than the relatively small number of coach passengers. It did not, however, seek to argue that competition from the car was in itself sufficient to prevent increases in rail fares if there were no other constraints on such fares.

2.89. We note the overall importance of car travel and also that car travel is likely to be more attractive for journeys with a destination other than London (because congestion tends to be less and parking easier in towns and cities other than London). There is a significant contrast in this respect between the present inquiry and the MML inquiry, where journeys to London were prominent among those considered. Nevertheless a high proportion of coach and rail leisure passengers do not have a car available for their journey (see, for example, Table 4.10). We acknowledge that, for those who have access to a car, the car is an alternative to public transport and that the ability of some passengers to switch to car travel is one factor that public transport operators have to take into account. Another such factor is that some passengers may prefer not to travel at all if faced with higher-priced public transport. However, the existence of these other factors affecting transport operators does not alter the fact that there is an element of competition between rail and coach. The removal of this element of competition would in our view give a common owner of rail and coach services the incentive to exploit its position to some extent, for example by raising prices, and this remains the case even though there would also be some loss of patronage due to higher prices. We have taken a similar view in our parallel inquiry into NEG's acquisition of ScotRail.

## *Assessment*

2.90. In the light of the analysis set out in paragraphs 2.73 to 2.89 we take the view, first, that NEG would have the opportunity to raise coach fares on routes where NEL's services overlap with Central Trains' if competition from other rail and bus/coach operators was weak. It would also have the incentive to do so if the increase in profits which could be expected from such actions was material. Such fare increases would benefit NEG by bringing a higher yield per passenger from those continuing to use the coach and by raising Central Trains' revenue to the extent that passengers switched to rail, and these benefits would not be wholly offset by the loss of patronage which could be expected to occur. Increases in coach fares could be accompanied by increases in rail fares too, although that effect would be mitigated, partly by the regulatory control of certain rail fares and partly because of NEG's need to boost passenger numbers on Central Trains if it is to make a financial success of the franchise. We do not believe that it would be an attractive commercial strategy in general for NEG to reduce levels and/or quality of service on either coach or rail in order to cut costs. As regards coach, it would be difficult for NEG to reduce service standards on overlapping flows without affecting other services as well, including those where it faces competition from other bus/coach operators. As regards rail, a high proportion of costs consists of rolling stock leasing and track access charges and is therefore largely fixed. There is little scope for Central Trains to cut services without breaching the PSR, and the franchise agreement contains other safeguards affecting service quality.

2.91. Secondly, following the franchising of rail passenger services we would expect to see a more commercial approach by the management given that, on the one hand, subsidy levels have been determined for at least seven years in real terms and, on the other hand, the amount of subsidy typically declines, putting the franchisee under pressure to boost revenues. If the train services and competing coach services were not in common ownership, we would expect that the rail franchisee would see the winning of passengers from the coach network as a significant part of its strategy and that the coach company would respond vigorously to defend its market, with a resulting downward pressure on fares and stimulus to innovation and improved quality of service. Consequently, if competition between Central Trains and NEL affected a substantial proportion of Central Trains' business and other competitive pressures were weak, we would expect common ownership of the two companies to diminish the incentives on NEG and that some of the benefits which could otherwise be expected would be lost.

### *The overlapping flows*

2.92. Against this background we now consider the principal overlaps between, on the one hand, the services of Central Trains and, on the other hand, the relevant services of NEL and other NEG-operated rail services (see paragraphs 2.47 and 2.48). The 12 flows concerned are listed in Table 4.11 and further information about them is shown in Tables 4.12 and 4.13.

2.93. On four of these flows competing TOCs are present and carry the bulk of the rail traffic, and Central Trains does not set the interavailable fares. In these circumstances NEG has little scope to exploit its common ownership of rail and coach.

2.94. There are eight flows on which Central Trains has at least half of the rail traffic and NEL<sup>1</sup> earns significant revenue from its coach services. The key facts about each of these flows, including the extent of competition from other suppliers of rail and bus services, are as follows:

- *Birmingham-Derby*: Central Trains runs 21 services per weekday. Its revenue in the latest year was £[ \* ]. NEL operates five services per weekday, from which revenue in 1996 was £[

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<sup>1</sup>One case involves an overlap with a WMT bus service rather than an NEL coach service.

\* ]. Another TOC, Virgin, operates on this flow, providing 15 services per weekday. Virgin's service is a little quicker than Central Trains'. In 1996/97 it took half the revenue from rail services on the flow and it told us that it planned to enhance its service significantly from May 2000. There is no bus or coach competition to NEL.

- *Birmingham-Liverpool*: Central Trains provides 14 services per weekday from which its revenue in the latest year was £[ \* ]. NEL runs six services per weekday and its 1996 revenue was £[ \* ]. Virgin operates three through services per weekday and takes nearly a quarter of the rail revenue. Virgin plans to enhance its service to five trains per weekday from May 1998 with significant further enhancements from 2000, subject to securing track access. There is no bus/coach competition to NEL.

- *Sheffield-Nottingham*: Central Trains runs 15 services per weekday and MML three, whilst NEL provides 12 coach services. In the latest year Central Trains' revenue from the flow was some £[ \* ], MML's £[ \* ] and NEL's £[ \* ]. No other TOCs operate at present. However, NEG has no protection from rail competition under the moderation of competition policy. Regional Railways North East Limited (RRNE) told us that its franchise agreement required it to complete by March 1998 a feasibility study into the provision of new through trains between Nottingham and York via Sheffield. RRNE would be required to introduce this service if it was practicable and if no net loss to the company was forecast (or external funding of any forecast loss was offered). Work had not yet started on the feasibility study but initial indications were that an hourly or two-hourly service might be justified. Subject to satisfactory completion of the feasibility study and negotiation of additional track access, services could be introduced in May 1999. Stagecoach runs inter-urban bus services at comparable frequencies to NEL but slower. NEL has cut its day return fares in response to this competition.

- *Leicester-Nottingham*: MML is the lead TOC, providing 15 services per weekday to Central Trains' 17 but taking nearly two-thirds of total rail revenue from the flow (£[ \* ] to Central Trains' £[ \* ]). NEL provides 17 services per weekday with a 1996 revenue of only £[ \* ]. Because of the overlap between Central Trains and MML (the only TOCs which operate), the Rail Regulator has removed protection from competition. [

*Details omitted. See note on page iv.*

] Stagecoach and Trent Buses jointly provide an hourly inter-urban bus service (12 services per weekday in total). The service is slower than NEL's but NEL has cut its cheap day return fares in response to this competition.

- *Birmingham-Water Orton*: The overlap here is between Central Trains and WMT. Water Orton is just outside the West Midlands boundary and the rail service on the flow takes only 10 to 11 minutes. Central Trains provides 13 services per weekday but its revenue in 1996/97 was only £21,000. WMT's service is frequent (39 per weekday) and its 1996 revenue was £[ \* ]. WMT's service is scheduled to take three times as long as Central Trains'.

- *Birmingham-Leicester*: Central Trains is the only TOC operating on this flow. It provides 20 services per weekday and its revenue in the latest year was £[ \* ]. NEL runs six services per weekday; its 1996 revenue from these was £[ \* ]. New rail entry appears unlikely at least until 2002. Midland Fox (owned by Cowie) operates seven inter-urban bus services per weekday. They are slower than NEL's services but NEL has cut its day return fares in response to this competition.

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\* Figures omitted. See note on page iv.

- *Birmingham-Nottingham*: Central Trains provides 17 services per weekday, from which its revenue in the latest year was £[ \* ]. NEL operates six services per weekday but three of them are relatively slow. Its revenue from this flow in 1996 was £[ \* ]. No other TOCs operate on this flow (although Virgin operates on the Birmingham-Derby flow, part of the same route: see above) and entry appears unlikely at least until 2002. There is no bus/coach competition.

- *Birmingham-Cambridge*: Central Trains runs 14 services per weekday and took £[ \* ] in revenue in the latest year. The number of passengers ([ \* ]) was much smaller than on the other flows listed in this paragraph. NEL operates only three services per weekday, carrying [ \* ] passengers a year and earning revenue in 1996 of £[ \* ]. No other TOCs operate over the whole of this flow and entry appears unlikely. There is no bus/coach competition.

2.95. NEG argued that the NEL services on the overlapping flows were minor parts of much longer routes. This gave rise to three implications. First, the capacity available for passengers travelling only on the overlap flows was much less than appeared from the total capacity provided on the route as a whole. Secondly, there was no scope for reducing the level or quality of service on the overlapping flows without affecting the rest of the route. Thirdly, coach fares could not be increased on the overlap flows in isolation. We agree with the first two of these points. We are not convinced by the third, since there is no overriding reason why NEL should not charge a different rate, in relation to mileage travelled, for a particular section of a long route compared with the other sections. Indeed we note that NEL has introduced discounted day return fares on certain sections of route in response to competition from bus operators, thus disturbing the usual relationships between fares on different flows on the same route.

2.96. Taking account of these arguments, as well as the analysis in paragraphs 2.73 to 2.91 and the key facts concerning the individual flows which are set out in paragraph 2.94, we have considered the likelihood of NEG increasing coach and, to a lesser extent, rail fares as envisaged in paragraph 2.90. Our views on this aspect are as follows:

- (a) In relation to those flows on which there is actual competition from other TOCs—that is Birmingham-Derby and Birmingham-Liverpool—we are satisfied that this competition is enough to deter NEG from attempting to exploit its position. We hold the same view in relation to two other routes—Sheffield-Nottingham and Leicester- Nottingham—where there is a clear prospect of competition from other TOCs and/or there is existing competition from inter-urban bus services.
- (b) In relation to Birmingham-Water Orton, which is an urban route, competition between rail and bus is weak for the reasons set out in paragraph 2.53. Central Trains' revenue on this flow is only £21,000. We consider that the loss of competition which has resulted from the merger is not material.
- (c) In relation to Birmingham-Leicester, NEG faces no rail competition. The question to be addressed, therefore, is whether the competition presented by Midland Fox's inter-urban bus service is sufficient to constrain NEL's fares. Midland Fox's service is significantly slower (110 minutes, compared with 60 to 90 minutes for NEL) and may be less comfortable than NEL's but has the advantages described in paragraph 2.85. Moreover since Midland Fox is already operating on the route, it would be a straightforward matter for it to increase the number of services, or introduce faster, limited-stop services, if an opportunity were presented by increases in NEL's fares. Finally NEL has actually reduced its day return fare on this flow in response to the competition from Midland Fox. We therefore believe that this competition does act as a sufficient constraint on NEL's fares on this flow and that the

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\* Figures omitted. See note on page iv.

merger has not created an opportunity for Central Trains to raise fares because the competitive constraint represented by NEL's coach service is not weakened. We are satisfied that, in this way, actual and potential bus competition will deter NEG from attempting to exploit its position.

- (d) In relation to the two remaining flows, Birmingham-Nottingham and Birmingham-Cambridge, there is no existing competition and we found no evidence of other companies intending to provide either rail or bus/coach services. However, we see little possibility that NEG could exploit its position by reducing the level or quality of service, partly because the NEL services are parts of much longer routes<sup>1</sup> and partly because of the regulatory constraints on the rail side. Whilst in principle there is a greater possibility of NEG being able profitably to raise fares, on the two flows together the annual revenue of NEL is only £234,000, which may be compared with NEL's total turnover in 1996 of £106 million. Central Trains' turnover on the two flows is £774,000 (compared with total turnover, excluding Centro services, of some £74 million). NEG told us that it operated its rail and coach businesses quite separately from each other (see paragraph 2.24). It appears unlikely, bearing in mind also the impact of rail fare regulation for certain types of ticket, notably Savers, that the potential gain from an attempt at joint exploitation of the situation would be sufficient to lead to a departure from this approach. Moreover in the case of Birmingham-Nottingham-a route which is of comparable length to those where inter-urban bus services are already provided-we see a possibility of entry by bus operators if NEL's fares were to rise significantly. We cannot rule out the possibility that NEG might pursue a policy of raising fares for leisure passengers on coach and, to a lesser extent, rail on these two flows but the commercial incentives are small and on the evidence we do not expect that it will do so.

2.97. It remains for us to consider the importance of the loss of the dynamic benefits of competition which might have been expected to develop between rail and coach operators in separate ownership (see paragraph 2.91). In this respect we note that the overlapping flows between Central Trains and NEL represent a small proportion of total revenues for each of them. In most cases the overlaps arise on relatively short sections of much longer routes. Moreover, as we have seen, there is significant competition from other transport operators on the majority of these flows. In these circumstances we do not consider that the loss of potential competition is material in relation to the routes on which Central Trains and NEL overlap.

### ***The benefits of the merger***

2.98. NEG submitted that the merger would bring benefits to the public interest in two ways. First, its successful franchise bid would save the taxpayer some £45 million a year compared with BRB's claim for 1996/97 while also supplying a significantly higher quality of service: NEG was committed by the franchise agreement to a range of improvements in services. Secondly, NEG's involvement in other modes of transport, notably bus and Midland Metro services in the West Midlands, put it in a unique position to achieve integrated transport systems. It described a number of initiatives in the areas of joint ticketing, provision of information and the sale of tickets which it was developing with Centro and with other bus operators (see paragraph 4.26). These initiatives were designed to improve public transport services and hence attract more passengers who would otherwise use private cars. Some of Central Trains' commitments under the franchise agreement are also concerned with transport integration (see paragraph 3.70).

2.99. As regards the benefits to the taxpayer of NEG's franchise bid, the relevant comparison is with a bid which might have been expected to be accepted in the absence of NEG's rather than with

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<sup>1</sup>One of the three NEL Birmingham-Cambridge services is free-standing and is not part of a longer route.

the previous situation. In this respect we note that NEG's bid was [ \* ] than that of the under-bidder while offering comparable service enhancements (see paragraphs 3.64 to 3.66).

2.100. As regards transport integration, several third parties-including Centro and five local authorities, both within and outside the West Midlands-considered that the merger offered valuable opportunities as a result of NEG's involvement in different transport modes. Some referred to NEG's good record in pursuing such opportunities. Integration between modes does not depend on common ownership but in principle it should be easier for operators in common ownership to reach agreement on matters such as intermodal ticketing and we agree that NEG is well placed to take the lead in developing and implementing integrated systems in the West Midlands. We would have been concerned if NEG were enabled by the merger to pursue that goal in ways which excluded other bus operators, so weakening competition. We have noted that the existence of Schedule 14 and the role of Centro provide the necessary safeguards against that possibility (see paragraph 2.71). The opportunities outside the West Midlands are less because NEG's coach and rail services tend to compete with, rather than complement, each other in those areas. It is likely that developments in Government policy following the White Paper will be designed to foster co-operation between independent operators. To that extent the integration benefits of the merger may be diminished. But it remains the case that NEG is pursuing policies which are broadly consistent with the thrust of Government policy as it has emerged to date.

### **The effect on the public interest**

2.101. We have noted that WMT, NEG's principal bus subsidiary, has a very strong position in the West Midlands market for bus services and that it will also be the operator of the new Midland Metro light rail project (see paragraph 2.52). The extent of competition in the West Midlands between bus and the rail services of Central Trains is, however, quite limited and the same will be true of competition between the Metro and rail services when the Metro starts operating (paragraphs 2.54 and 2.60). Moreover NEG is under an obligation to deliver the level of rail services which Centro has specified in detail in the franchise agreement, and cannot vary fares on any West Midlands rail services at all, these matters being determined by Centro (paragraph 2.57). We do not believe that the arrangement whereby NEG shares any incremental revenue for Central Trains above a defined threshold will lead NEG to pursue a strategy of charging higher bus fares with the aim of boosting rail patronage on the few routes where there may be an element of substitutability between bus and rail (paragraph 2.59).

2.102. We noted that the PTA and Centro had thought it necessary to obtain binding assurances from NEG concerning bus and multi-modal services, which were incorporated in the franchise agreement as Schedule 14, that would prevent abuses which they feared might otherwise result from the merger (see paragraphs 2.62 and 2.63). We also noted that other bus operators had expressed concerns that the merger could reinforce WMT's position in the West Midlands bus market (paragraphs 2.64 and 2.65).

2.103. The merger substantially increases NEG's ownership of passenger transport services in the West Midlands and in the absence of countervailing factors this would have increased its influence in the market. However, having regard to:

- (a) the low substitutability between bus, Midland Metro and rail services; and
- (b) the regulatory and contractual controls exercised over Central Trains by Centro, the Franchising Director and the Rail Regulator; and in particular

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\*Details omitted. See note on page iv.

- (c) the assurances which NEG has given in Schedule 14 to the franchise agreement, which bear on NEG's involvement in all three of the principal transport modes (bus, rail and Metro), and with which we expect NEG to comply,

we do not expect NEG to exercise additional market power in the West Midlands passenger transport market as a result of the merger (see paragraphs 2.69 to 2.71).

2.104. In relation to the position outside the West Midlands, because of competition from other TOCs and bus operators, we do not believe that the merger has given NEG opportunities to exploit its market position by raising fares on the great majority of flows where there is a significant overlap between Central Trains and other NEG companies. There are two possible exceptions, together accounting for about £1 million of annual revenue for NEG, where NEG might be able to increase coach and, to a lesser extent, rail fares as a result of the merger, but on the evidence we do not expect that it will do so (see paragraph 2.96). The merger has caused a loss of the dynamic benefits which might have been expected to result from competition between Central Trains and NEL but given the limited extent of that competition, and the existence of other commercial and competitive pressures on NEG, we do not consider that loss to be material (see paragraph 2.97).

2.105. We believe that some benefits will result from the merger in the form of initiatives to promote transport integration in the West Midlands (see paragraph 2.100).

2.106. For the reasons set out in paragraphs 2.103 to 2.105 we conclude that the merger does not, and may not be expected to, operate against the public interest.