

2 Conclusions

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Introduction

2.1. On 26 March 2002, the Secretary of State for Trade and Industry referred to the CC, under the merger provisions of the Fair Trading Act 1973 (the Act), the proposed acquisition by Compass of Rail Gourmet Holding AG (RGH), Restorama AG (Restorama) and parts of Gourmet Nova AG (Gourmet Nova) for investigation and report. The final stage of this acquisition was completed on 5 April 2002.

2.2. The acquisition has a wider EC dimension. On 14 January 2002, the European Commission was formally notified of a proposed concentration within the meaning of the European Community Merger Regulation (ECMR), that Compass was proposing to acquire control of RGH, Restorama and parts of Gourmet Nova. The European Commission subsequently conducted an investigation and cleared the transaction on 26 February 2002 except in respect of the supply of on-train food services in the UK. Following a request by the UK Government, on 26 February 2002 the European Commission referred to the competent UK competition authorities that part of the proposed acquisition which related to the supply of on-train food services in the UK. We were asked to report by 17 June 2002 in order to meet the time limit set in the ECMR for the Secretary of State to publish the report.

2.3. Following the terms of reference (Appendix 1.1) we are required to investigate and report on whether the acquisition has resulted in the creation of a merger situation qualifying for investigation, with respect to the supply of on-train food services in the UK, and if so, whether the creation of that situation operates against the public interest.

2.4. Compass is a UK-based global food service business. Among its previous acquisitions were Travellers Fare (the privatized ex-British Rail company), which provided food on railway stations (1992), and Select Service Partner (SSP) (from SAS Airlines), which operated travel-related food service, mainly at airports and railway stations, throughout Europe (1993). In July 2000, Compass merged with Granada Group PLC, and demerged from it in February 2001 retaining Granada's food service interests. (See paragraphs 3.18 to 3.22.)

2.5. RGH, Restorama and Gourmet Nova were part of the Swissair group. Their business consisted of food services including the supply of on-train food services in the UK. Negotiations for the acquisitions, which began in May 2001, were delayed and complicated by the collapse of Swissair. We have established that the only involvement in the provision of on-train food services in the UK by any of the acquired companies which are subject to the reference consists of the contracts to provide such services held by the active UK subsidiaries of RGH, under the holding company Rail Gourmet UK Holdings Limited. These subsidiaries are Rail Gourmet UK Limited and Rail Gourmet Waterloo International Limited. Our investigation is therefore only concerned with the acquisition by Compass of these subsidiaries (RGUK). (See paragraphs 3.6 to 3.13.)

Jurisdiction

2.6. We are required by our terms of reference to establish whether arrangements between Compass and RGH, Restorama and Gourmet Nova, either in progress or in contemplation, if carried into effect, would result in the creation of a merger situation qualifying for investigation in accordance with section 64 of the Act. Compass informed us that it had completed the final stage of the acquisition of RGH, Restorama and parts of Gourmet Nova (the acquisition) on 5 April 2002 (see paragraph 5.15). As the acquisition of these companies has been completed, we are therefore satisfied that arrangements have been carried into effect which have resulted in Compass, RGH, Restorama and the relevant parts of Gourmet Nova ceasing to be distinct enterprises for the purposes of section 64 of the Act.

2.7. To establish whether or not there is a merger situation qualifying for investigation, we also have to consider whether the requirements of either paragraph (a) or (b) of section 64(1) of the Act are satisfied. The share of supply test is met if, inter alia, as a result of the merger the combined enterprise accounts for at least 25 per cent of the supply of on-train food services either in the UK or a substantial part of it. If this was already the case before the merger then the share of supply test will be met if the market share is enhanced by the merger. Our analysis of the share of supply test is set out below (see paragraphs 2.9 to 2.14). This showed that the acquisition has given the merged entity a share of supply of about 83 per cent of the value of contracts for the supply of on-train food services in the UK, an increment of about three percentage points on the share previously held by RGUK (see paragraph 4.89). We conclude that this satisfies the share of supply test, and that the acquisition has therefore resulted in the creation of a merger situation qualifying for investigation. Under our terms of reference there is no need for us to consider the assets test where we have found the share of supply test has been satisfied.

2.8. Having established jurisdiction, we are required by our terms of reference to consider whether the merger situation operates against the public interest. Two constraints are relevant in this respect. First, by our terms of reference we are required to confine our consideration to the public interest effects of the acquisition with respect to the supply of on-train food services in the UK. Second, in carrying out our inquiry, we have been mindful of the limitations imposed upon the Secretary of State by Article 9(8) of the ECMR. Where a case has been referred under the ECMR to the competent authorities of a member state with a view to the application of that state's national competition laws, Article 9(8) states that the member state may take only the measures strictly necessary to safeguard or restore effective competition in the market concerned. Consequently, although we are required by our terms of reference and by statute to consider the public interest, the Secretary of State can only adopt a remedy which addresses the competition effects of the merger. We consider the competition issues in paragraphs 2.22 to 2.39.

Share of supply test

2.9. On-train food services have two components. They consist of buying food and drink and delivering it to trains (logistics), and on-board catering service to the passengers. The services offered to passengers consist of meals, or snacks and drinks from trolleys and buffet cars. The service provided varies according to the route and is determined by the TOC that holds the franchise for that route. Two main types of service are offered. On longer routes there is generally a full service of MBT, while on shorter routes there is usually only a trolley service. Trolley services in general require simpler logistics operations. (See paragraphs 4.12 to 4.20.)

2.10. On-train food services are provided by the TOCs or through contracts let by TOCs. The contracts are generally related to the length of the TOCs' franchise periods. There is a general distinction between contracts for MBT and for trolley services. All the TOCs that provide MBT operate the on-board catering service themselves, seeing this as essential for branding and customer relations; where there is any contracting out, this is only for the logistics. For trolley services, however, the TOCs generally contract out the on-board catering service together with the logistics. (Contract staff travel with the trolley and serve passengers.) The exception is Eurostar, which contracts out both on-board catering service and logistics under separate contracts. (See paragraphs 4.21 and 4.22.)

2.11. Passengers have a choice of buying food and drink before they board the train, so there is scope for on-train food services to be substituted by food bought on stations. The supply of food and drink on stations may, therefore, have an effect on supply of on-train food services, but we consider that it should be treated separately for the purposes of the share of supply test.

2.12. The supply of on-train food services in the UK is therefore essentially equivalent to the contracts to supply food logistics. Excluding Eurostar, the on-board catering service element is very small (almost exclusively limited to trolley service contracts). It is dependent on the relevant logistics contracts and is not tendered separately from those logistics contracts. This supply can be seen as part of the wider supply of transport-related food logistics (or even logistics more generally). However, it has special features arising from its dependency on conditions set by the TOCs. This leads us to conclude that the share of supply test should be based on the contracts to supply food logistics, together with related on-board catering services, to the TOCs operating in the UK.

2.13. We considered an analysis based on the value of all the contracts let by UK TOCs, including Eurostar. On this basis, RGUK has 53 per cent of the current contracts, of which around [38] per cent is for logistics only, and [15] per cent for on-board catering service together with logistics. Compass has 38 per cent, consisting of the Eurostar on-board catering service contract and a small contract with Scotrail. (See paragraphs 4.87 and 4.88.)

2.14. Compass suggested to us (and we find convincing) that the Eurostar on-board catering contract was essentially different, being part of the European rather than the UK market, and involving different contractual conditions and relationships. Also, Compass pointed out that it only had a 49 per cent shareholding in Momentum, the company supplying the Eurostar on-board catering contract. In removing Momentum from the calculation, the change in share of supply resulting from the acquisition becomes minimal, although it still results in the share of supply of the relevant services increasing from 80 to 83 per cent (see paragraph 4.89). In considering competition issues, account still has to be taken of the fact that RGUK supplies logistics for Eurostar in the UK, and the possibility that the acquisition could have an effect on competition for both of the Eurostar contracts. Nevertheless, we conclude that the Eurostar on-board catering service contract should not be considered part of the UK supply. We therefore conclude that the merged entity's share of the relevant supply of services has increased from 80 to 83 per cent as a result of the acquisition.

Market definition: the TOCs' power

2.15. Having considered the share of supply test, we then looked at the economic market, starting with an assessment of market power. It appeared to us that it was this, not the share of supply, which was critical in determining whether the acquisition had any effect on competition. As the supply of on-train food services to TOCs operates through a series of contracts, which are let at different times by the TOCs, it would not matter for the purposes of competition if one company held all the contracts at any point in time, as long as this or other factors did not restrain or prevent the possible entry of a competitor, each time one of those contracts was tendered, or else act to restrain or prevent the regular tendering of the contracts. Whether the acquisition could have this effect will depend on the extent to which it increases the market power of the merged entity, both in relation to potential competitors and in relation to the TOCs. (See paragraphs 4.48 to 4.52, 4.63 and 4.90.)

2.16. It is the TOCs that decide whether or not food services are provided on trains, and if so, what they should be and at what price. There is no requirement that franchise agreements for operating rail routes must require TOCs to provide a food service or to control its quality or price. The requirement to provide an on-train food service is only included in individual agreements between the SRA and the TOC if the TOC offers to provide such a service in its bid for the franchise. The agreements do not specify what food service the TOC is required to provide. (See paragraphs 4.11 and 6.103.) The only way in which the provision of food services might influence whether a TOC will be successful in securing or renewing a franchise would be through general measures of customer satisfaction with the service. The primary purchase decision made by passengers is travel, not food and drink. Their satisfaction primarily depends on train reliability, comfort and safety.

2.17. Nevertheless, TOCs consider that (except on short-distance or commuter routes) the provision of food and drink is an essential part of the service expected by passengers. The main reason for offering it is not to make profits from it as a stand-alone activity. We have been told that in most cases the food service is provided at a net loss to the TOC, accounted for as part of operating costs rather than as a profit centre. The TOCs provide it because they believe that it is one important element in attracting and keeping passengers, who have the alternative choice of travelling by road or air. Large passenger volumes are essential to the TOCs' profitability. (See paragraphs 4.37 to 4.42.)

2.18. The TOCs also see the provision of food service as an important part of their direct personal contact with passengers and are strongly concerned to present it as part of their brand image. This is particularly true of the higher-value, first class and meals services which are now often presented as part of a hospitality package similar to that provided by airlines to business passengers. This is why the TOCs always use their own staff to provide MBT on-train services and will not consider franchising other brands. Eurostar presents its on-board catering service, provided by Momentum, as a Eurostar service. Even those trolley-only services, which are manned by contract staff, are almost always presented as part of the TOC's service to passengers. (See paragraph 4.38.)

2.19. The TOCs' contracts for on-train food services vary in detail but there are two main patterns. For MBT services, the supplier recovers product costs and takes an agreed mark-up on them, recovers direct operating costs, and receives a negotiated contribution to its overheads. For trolley services, the supplier recovers contract costs and makes an agreed margin on products sold. In both cases, the TOCs generally require the services to be provided on an open-book basis, to stipulate the product specification, to source and price, and provide and control the use of the service centres at railway stations, where the food and drink is assembled and loaded on to the trains. (See paragraphs 3.77 to 3.82, 4.15 and 4.43.)

2.20. Within this context, RGUK has inherited the logistics supply system and many of the staff from ERC, the successor to the original nationalized monopoly supplier. It understands the business thoroughly, and is used to dealing with all the TOCs. This gives it an apparently strong market position in relation to any competitor as contracts are tendered. However, if the contract were not awarded to RGUK, the staff and basic facilities would be transferred to the successful bidder, so this apparent advantage does not rest on any very strong foundations.

2.21. We conclude that the TOCs effectively have control over the market, as they set all the conditions under which the on-train food service is provided. RGUK also has some competitive advantages as the experienced incumbent for most of the contracts, but this is dependent on the TOCs' continued satisfaction with its service rather than any intrinsic market power.

Competitive constraints

2.22. We considered whether barriers to entry already existed, independently of the acquisition, that could prevent a firm from making a bid for one of the on-board food service contracts offered by the TOCs. These appeared to be different for the trolley and MBT contracts. (See paragraphs 4.79 to 4.85 and 4.91 to 4.95.)

2.23. There appear to be few barriers to entry for the supply of trolley services. A number of smaller operators have secured these contracts. The logistics are simpler, usually just supplying and loading a trolley at the departure station, and a relatively small capital outlay is required to bid and operate a trolley contract. (See paragraphs 4.105 to 4.107.)

2.24. There also appears to be significant competition for the contract to supply the on-board catering service for Eurostar. This is seen as part of the market to provide on-train food

service on international services for which a number of European consortia regularly compete. (See paragraphs 4.55, 4.56, 4.87 and 6.28.)

2.25. By contrast, we found little interest in entering the market for the MBT logistics contracts (for UK main lines and Eurostar). This may in part reflect the nature of the bidding market. Many large contracts have not yet come up for tender more than once since the setting up of ERC, British Rail's privatized On Board Services (OBS). ERC held all the initial contracts with the TOCs, which RGH effectively inherited through its acquisition of ERC in 1997. Given the length of food logistics contracts, which are related to franchises, it could be expected that this market would take time to open up. Significantly, a competitor (Sodexo UK) did secure one of the larger contracts when it was retendered in 2000. However, in some other cases the sitting contractor, RGUK, has had its contract renewed, thus far, after renegotiation but without a full tender. The question is whether, as many of the rail franchises come to be renewed or bid in the next few years, there are significant barriers to other suppliers putting in credible bids for the on-train food services. (See paragraphs 4.98 to 4.104.)

2.26. Low profitability could discourage entry, particularly if it is seen to be maintained by the way the on-train food service contracts are structured. The contractors' profits are related to the volume of passengers and the proportion of them buying food. The risk for the supplier depends on whether projections of passenger numbers are achieved. The recent losses made by RGUK are at least partly due to the fall in passenger numbers following the Hatfield crash in October 2000. The crash at Potters Bar in May 2002 has now created additional uncertainty. [*Details omitted. See note on page iv.*]. Profitability also depends on the ability to avoid penalties for poor performance. It has been represented to us that the returns to be gained from these contracts are too low for it to be worth bidding for them unless a considerable share of the market is secured. We do not believe that this is necessarily the case, as economies of scale are not apparent. What is clear is that, at present, the tight control of the TOCs over specifications, together with transparent open-book contracts, does not provide opportunities for increasing profit margins. This argument is borne out by the fall in RGUK's contribution margin, on its three largest contracts, from around [] per cent in 1998 to between [] and [] per cent by 2001. (See paragraphs 3.83 to 3.89.)

2.27. Another relevant factor which might discourage entry is the potential for the TOCs to take the logistics supply in-house. This remains an alternative for the TOCs, although only Anglia Railways Train Services Ltd (Anglia) has already done so. We were given evidence that at least one of the TOCs had used the threat of an in-house alternative to negotiate down the terms of its contract with RGUK on renewal. (See paragraphs 4.36, 4.99 and 4.100.)

2.28. The low public image of rail food might also be expected to deter other food service providers from seeking to enter the market. The fact that the food service is identified with the TOC's brand should discount this. However, companies may be deterred more generally by the image of the rail industry (in terms of its inherited reputation for bureaucracy and poor customer service) and perceptions of difficulties in dealing with the rail industry. The basic way in which the rail industry has provided food services is not seen to have changed significantly over the years, and the TOCs do not yet appear to be offering much scope for innovation by catering service contractors. There are some signs that this is changing with the introduction of different catering possibilities on new trains, but this is a long-term process. (See paragraphs 4.47 and 6.36.)

2.29. A further issue appears to be that because of the heavy branding by the TOCs, any food supplier that wanted to develop its own brand for on-train food service would not be able to do so. The TOCs will not allow this sort of brand competition on the trains. This could be a factor discouraging general food service companies from bidding in future. We had evidence that major food service providers do not see the provision of on-train food services as one of their target markets. (See paragraphs 4.37, 4.38, 4.108, 6.116, 6.117 and 6.128.)

2.30. These factors may also in part explain why other general logistics providers have not yet sought to enter the market. Some of them act as suppliers for the logistics provided by RGUK and could be expected to be in a position to contract to provide the full service for the TOCs. However, they appear to see rail catering as unattractive. (See paragraph 6.132.)

2.31. We conclude that there are factors which could discourage food service providers or other suppliers of food logistics from bidding to supply MBT services. These are related to the tight control exercised by the TOCs over the conditions under which on-train food services are supplied, and current uncertainty about profitability. A relevant factor is that the market has not yet fully developed from its origins in a nationalized monopoly supplier. This may partly explain why there does not appear to be a general interest in entering what is seen as an unattractive area, among players in the wider food service and logistics markets. (See paragraphs 4.101 to 4.104.)

Competition issues—is entry discouraged by the acquisition?

2.32. Before looking at the question whether further barriers are created by the acquisition, we addressed the point that the acquisition removes a potential competitor from the market. Compass (through SSP) was a bidder for the First Great Western Ltd (FGW) contract won by Sodexo UK, and might have been expected to bid against RGUK and others for future contracts. However, [

Details omitted. See note on page iv.

]. It is not, however, necessary to accept this point to draw the conclusion that the removal of Compass from the list of bidders would not in any case significantly reduce competition. In a bidding market of this kind it may only be necessary for one genuine and serious competitor to remain for competition to be maintained. The possibility that the TOC could bring the service in-house also acts further to maintain competitive pressure. (See paragraphs 4.93 and 4.99.)

2.33. The acquisition could discourage entry if it increased the merged entity's market power, in relation to competitors and the TOCs, compared with the power previously exercised by RGUK. This could happen if the acquisition created conditions that discouraged competitors from bidding, or if it gave the merged entity a new and unique advantage in bidding or such as would increase its market power in relation to the TOCs.

2.34. We have found little evidence to suggest that competitors have any reason to be more (or less) discouraged from bidding following the acquisition. The conditions imposed by the TOCs when contracts are tendered will be no different, and the potential for any supplier to make profits through its purchasing power will remain the same. Competitors will still face a market where one company has the dominant share and is seen as the sitting tenant which has inherited the business from British Rail. This dominant market share held by RGUK will now be owned by Compass, providing security through its strong financial position. However, while recognizing RGUK's position as the incumbent, the only way in which Compass would be able to increase its chances of winning future contracts as a result of taking over RGUK and building on that position would be through the legitimate means of improving management and efficiency. Nor does the acquisition increase the merged entity's market power in negotiating with the TOCs. The TOCs retain the option, which one has exercised and others say they have seriously considered, of bringing the logistics in-house if they cannot negotiate contracts acceptable to them. The TOCs also require open-book arrangements under their contracts, and this transparency is likely to continue. (See paragraphs 4.98 to 4.104.)

2.35. There is, however, a specific factor which, it has been suggested, might give the merged entity a new and unique advantage. This is the large share of concessions for station

food held by Compass. It has been suggested that this might enable Compass to do two things. First, it could increase prices and reduce quality by removing real choice between buying food on stations and on trains. Second, it could combine the logistics of supplying food to trains and stations in a way that its competitors could not match, and which would cut off the possibility of a competitor replacing it by depriving it of service centres. (See paragraphs 4.113 to 4.117.)

2.36. Compass's share of station concessions has fallen from 100 per cent (acquired in 1992 from British Rail's privatized Travellers Fare) to 62 per cent, and there is a continuing downward trend as more concessions are set up, especially at the larger stations. The concessions are generally short term. Nevertheless, SSP, a subsidiary of Compass, still operates most of the main brands to be seen on station concourses and could be in a position to adjust the prices and quality of those outlets in ways which would influence the choice of passengers to buy food and drink on or off the train. However, there are clearly limits to this, set by on-station competitors (and Railtrack and the TOCs which let the station concessions, and are encouraging development). Compass has no ability to change the price and quality of the products served on the trains because this is controlled by the TOCs. It has an interest in maintaining the high quality of its station offerings and it encourages internal competition between the brands it operates. This is being reinforced through increased competition and the development of the major city stations as food shopping centres for surrounding city centre areas. The scope (or incentive) for Compass to increase prices and reduce quality through its combined interest in the provision of food and drink on stations and on trains is therefore very limited. (See paragraphs 5.91 and 5.92.)

2.37. Compass did at one stage envisage using the storage area for its on-station concessions to supply trains. Concern was also expressed by one of the TOCs that Compass might do this in future contracts and thus deprive future competitors of the use of service centres. However, there are three factors that suggest this would not happen in practice. First, those service centre facilities for supplying food to trains which we have seen are located in positions where they can serve platforms, and are too cramped to do anything else effectively. The centres for supplying shops on the stations are also very cramped. They are separately located and could not normally be used to supply the platforms. We understand that these physical constraints apply generally, at least at the major city stations. Second, we were told that the product ranges supplied to trains and on stations are very different. Third (and most significantly), the shore bases for supplying the trains are under the control of the TOCs, which would not relinquish them, or allow arrangements to be made which prevented a potential competitor (or the TOCs themselves) making use of them in future. (See paragraphs 3.74 and 5.120 to 5.122.)

2.38. There would not seem to be any reason why holding the Eurostar logistics contract through RGUK would give Compass an advantage in future in bidding for the Eurostar on-board catering service contract. The two contracts are for separate services and there do not seem to be synergies to be exploited. (See paragraph 4.87.)

2.39. We therefore conclude that the acquisition in itself will not discourage other firms from bidding for on-train food service contracts, nor will the merged entity's substantial presence in both on-train and on-station food services give rise to opportunities to exercise an increased degree of market power and behave in a manner detrimental to the existing degree of competition.

Public interest issues

2.40. Since we find that the acquisition does not increase any barriers to market entry, and thus has no significant effect on future competition for the contracts to provide food services on trains, it does not in itself affect the public interest. Indeed, it has been represented to us that Compass has an opportunity to improve the service in the contracts that it has taken over through improved management, efficiency and innovation, in partnership with the TOCs.

2.41. However, we do have concerns about the extent of the control that the TOCs exercise over their contracts for on-board food service provision. We accept that the apparent lack of wider interest in bidding for these contracts may be due in part to the fact that the market is still developing from its origins as a public sector monopoly. However, we do believe that more might be done, in the interest of the consumers of railway food, to encourage the TOCs to innovate, and to bring more players into the provision of food on trains, with a view to increasing quality and variety, and improving the creativity with which this aspect of their business is managed. We note that the SRA said that it could consider requiring operators to retender their contracts for on-board catering more frequently to try to encourage growth in the number of players in the market (see paragraph 6.110). We note that the Department for Transport agrees that this area is within the competence of the SRA. We suggest that the SRA should consider constructive ways to ensure that there is more frequent competition to provide more innovative on-train food services.

Conclusions on the public interest

2.42. Having regard to the considerations we set out above, we conclude that the acquisition by Compass of RGH, Restorama and parts of Gourmet Nova does not operate against the public interest.