

# **REVIEW OF A REQUEST BY FIRSTGROUP PLC FOR A VARIATION TO THE UNDERTAKINGS GIVEN FOLLOWING ITS ACQUISITION OF THE SCOTTISH PASSENGER RAIL FRANCHISE**

## **Provisional decision**

Published: 3 August 2010

The Competition Commission has excluded from this published version of the provisional decision information which the Group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [X]. Non-sensitive alternative wording is also indicated in square brackets.

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## 1. Summary

### ***Background***

- 1.1 In June 2004, the Competition Commission's (CC's) report (the 2004 report)<sup>1</sup> was published on the proposed acquisition by FirstGroup plc (FirstGroup) of the Scottish Passenger Rail (ScotRail) franchise.
- 1.2 Having found that the proposed acquisition would lead to a substantial lessening of competition (SLC) on certain routes, the CC accepted undertakings given by FirstGroup on 15 October 2004<sup>2</sup> (the Undertakings). The Undertakings place restrictions on FirstGroup for the duration of the ScotRail franchise. The franchise is set to end in October 2014. The Undertakings include a restriction on FirstGroup from altering the service level and fares on a number of local bus services (the Controlled Routes) which it operates in and around Edinburgh and Glasgow.
- 1.3 Following an internal business review in 2009 of its local bus networks in Edinburgh and Glasgow, FirstGroup identified a number of persistently loss-making routes which it concluded should be withdrawn or modified. Among these were certain Controlled Routes (the Relevant Controlled Routes) for which the Undertakings would need to be varied in order for FirstGroup to make its proposed service alterations.
- 1.4 On 22 December 2009, FirstGroup submitted an application to the Office of Fair Trading (OFT) for the Undertakings to be varied to allow it to withdraw seven Relevant Controlled Routes—X1, X23, X24, X26, X32, 58 and 165 (the Proposed

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<sup>1</sup>*FirstGroup plc and the Scottish Passenger Rail Franchise: a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited*, dated 25 June 2004.

<sup>2</sup>Subsequently varied on 2 February 2007.

Withdrawals); and modify nine Relevant Controlled Routes—X1, X3/36, X4/X5, 31, 43, 64, 109/119, 255 and 263 (the Proposed Modifications).<sup>3</sup>

- 1.5 FirstGroup requested a further variation to the Undertakings to permit it to seek consent from the OFT (and so obviate the need for advice to the CC) for any future requests for changes to the Controlled Routes, subject to the request meeting a certain set of predetermined criteria that would be set out in the Undertakings.
- 1.6 On 16 April 2010, the OFT submitted its advice to the CC in relation to FirstGroup's requests. The OFT advised the CC that there had been a change of circumstances in that the costs of operating the Relevant Controlled Routes had increased and/or passenger numbers had decreased such that the Relevant Controlled Routes had failed to cover variable costs on a persistent basis and there was no further remedial action that FirstGroup could reasonably take. The OFT therefore advised the CC that FirstGroup's request to withdraw and modify the Relevant Controlled Routes should be granted. The OFT did not reach a view on FirstGroup's further variation request in paragraph 1.5 as it said that this decision depended upon the CC's view in relation to the change of circumstances identified. The OFT's advice is published at the same time as this provisional decision.

### ***Our provisional decision***

- 1.7 We have provisionally decided that, taking into account the change of circumstances identified by the OFT in paragraph 1.6, it is appropriate to allow FirstGroup to make the Proposed Withdrawals and Proposed Modifications, with the exception of the Proposed Modification to service 263.<sup>4</sup> The Relevant Controlled Routes or parts of the Relevant Controlled Routes, with the exception of service 263, have since

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<sup>3</sup>The nature of the Proposed Modifications on each route is set out in Table 3.

<sup>4</sup>Our validation of the evidence revealed that certain figures provided by FirstGroup to the OFT for the Proposed Modifications contained a labelling error such that the financial figures on which we formed our view were different from those on which the OFT reached its view for these routes. This had a material effect on the figures for service 263.

2003/04 persistently failed to generate sufficient revenue to cover variable costs and this situation has deteriorated significantly due to falling passenger numbers and/or rising variable costs, despite reasonable attempts by FirstGroup to rectify the situation within the restrictions of the Undertakings. Absent FirstGroup's acquisition of the ScotRail franchise and the resultant Undertakings, it seems likely that, with the exception of service 263, FirstGroup would withdraw/modify the Relevant Controlled Routes.

- 1.8 We have also provisionally decided that it is not appropriate to change the process by which FirstGroup can request changes to the Controlled Routes. This matter was explicitly considered and rejected by the CC in the 2004 report. In our view, it is appropriate that decisions on matters relating to modifications and withdrawals continue to remain for the judgement of the CC based on the OFT's advice, as envisaged in the Enterprise Act 2002 (the Act).

### ***Next steps***

- 1.9 Any representations in relation to this provisional decision should be made by 31 August and sent to: T J Oyler, Remedies Manager, Competition Commission, Victoria House, Southampton Row, London, WC1B 4AD, or email: [tim.oyler@cc.gsi.gov.uk](mailto:tim.oyler@cc.gsi.gov.uk).
- 1.10 Following this consultation period, we will issue a final decision alongside draft revised undertakings. Subject to further representations, these draft revised undertakings will incorporate the proposed variations in paragraph 1.7. The draft revised undertakings will be consulted upon for 15 days, as contemplated in Schedule 10 of the Act, before being amended as appropriate and accepted.

## **2. Introduction**

2.1 This report sets out our provisional decision with regard to FirstGroup's request for a variation to the undertakings given by FirstGroup following the acquisition of the ScotRail franchise.

2.2 We set out:

(a) background to the review, including:

- (i) the 2004 report (paragraphs 3.1 and 3.2);
- (ii) the Undertakings given by FirstGroup in 2004 and varied in 2007 (paragraphs 3.3 to 3.5);
- (iii) the legal framework within which to consider the change of circumstances (paragraphs 3.6 and 3.7);
- (iv) FirstGroup's request for a variation to the Undertakings (paragraphs 3.8 to 3.14);
- (v) third parties' views on FirstGroup's request (paragraph 3.15); and
- (vi) the OFT's advice to the CC (paragraph 3.16);

(b) our assessment of the change of circumstances and the appropriateness of varying the undertakings (paragraphs 4.1 to 4.67); and

(c) our provisional decision and next steps (paragraphs 5.1 to 5.5).

## **3. Background**

### ***The 2004 report***

3.1 In its 2004 report, the CC identified that FirstGroup's acquisition of the ScotRail franchise would give rise to adverse effects in two types of markets:

(a) In particular markets for point-to-point public transport journeys. The CC identified 46 routes where the possibility of adverse effects resulting from loss of competition arose: on 21 of these routes there was no effective competition 'in hours'

(between 7 am and 7 pm on Mondays to Saturdays); and on 27 of these routes there was no effective competition 'out of hours' (between 7 pm and 7 am on Mondays to Saturdays and all day on Sundays).<sup>5</sup> Of the 46 routes on which problems were identified, the CC's concerns related to either:

- (i) overlap routes—where the revenue from the overlap flows between bus and rail services exceeded 10 per cent of route revenue and the CC was concerned that there could be potential for FirstGroup to encourage passengers to switch from bus to rail services by increasing fares and/or to a lesser extent by a reduction in frequency or rerouting of services, and/or reconfiguration of routes; or
- (ii) wider catchment routes—where the CC was concerned that routes might be reconfigured to serve as feeder services into rail stations so as to encourage passengers to switch to using rail.

(b) 'In wider public transport network markets in the Strathclyde Passenger Transport Executive (SPTEx) area, Edinburgh and the Lothians, and elsewhere in Scotland.'<sup>6</sup> The CC was concerned that FirstGroup would introduce its own multi-modal ticket scheme, influence the setting of fares on any multi-operator, multi-modal travelcards or favour its own bus operation in the provision of information.

3.2 The CC found that 'the SLC that would be expected to result from the merger would be expected to have the further adverse effects of higher bus fares, poorer services on overlapping bus routes and reduction in choice of services available to passengers on overlap routes, with similar adverse effects on other services resulting from the effects on the broader network markets'.<sup>7</sup>

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<sup>5</sup>21 and 27 does not sum to 46 routes as there are some routes on which both in-hours and out-of-hours problems were identified.

<sup>6</sup>2004 report, paragraph 5.110.

<sup>7</sup>2004 report, paragraph 5.110.

## **The Undertakings**

3.3 The Undertakings were given by FirstGroup and accepted by the CC on 15 October 2004. The Undertakings place restrictions on FirstGroup's ability for the duration of the ScotRail franchise (due to expire in October 2014) to alter the service level and fares and to reconfigure routes which fell into either of the categories in paragraph 3.1 (the Controlled Routes). Table 1 below sets out a breakdown of the number of Controlled Routes, which FirstGroup operates in and around Edinburgh and Glasgow through its two operating companies, First Edinburgh and First Glasgow. Table 1 is based on the routes listed in Annex F of the Undertakings.

TABLE 1 **Controlled Routes as listed in the Undertakings**

	<i>In hours</i>	<i>Out of hours</i>
Overlap routes	11	20
Wider catchment routes	<u>10</u>	<u>7</u>
Total routes	21	27

Source: The Undertakings, Annex F.

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3.4 In addition to the Controlled Routes in Table 1, a number of routes were also listed as Possible Routes, which are kept under review by the Monitor (appointed as a result of the Undertakings) should there be a reduction in effective competition between buses.

3.5 The Undertakings were subsequently varied on 2 February 2007 to address specific changes of circumstance from the time the Undertakings were given, in particular in relation to: (i) changing the definition of 'Fare Limit' and 'Base Fare Groups', in which there were insufficient comparators; (ii) an alignment of the definitions of the 'Glasgow and Edinburgh Regions' between the Undertakings and the SBH

undertakings,<sup>8</sup> and (iii) clarification of the ‘effective competition test’. The Undertakings (as varied on 2 February 2007) are set out in full on our website.<sup>9</sup>

### ***Legal framework***

3.6 The Act provides the CC with the power to vary, supersede or release an undertaking given to it either on direct application or acting on the advice of the OFT that by reason of a change of circumstances it is necessary to make a change to undertakings.<sup>10</sup>

3.7 The procedure for reviews of CC undertakings (and orders) is set out in a Memorandum of Understanding<sup>11</sup> between the CC and the OFT agreed in February 2009. The agreed procedure provides that, first, the OFT will consider as required by the Act whether there has been a ‘change of circumstances’, and second, if there has been, what action should be taken. It will then submit its report and recommendation to the CC. The CC will then assess the OFT’s report and recommendation and make its own determination on what action to take in the light of the OFT’s advice.

### ***FirstGroup’s request for variation***

3.8 FirstGroup stated that ‘the circumstances in which [FirstGroup] has to operate each of the services proposed for withdrawal or modification has changed as a result of a significant reduction in passenger numbers and/or a significant increase in the cost of providing the service’.

3.9 FirstGroup added that:

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<sup>8</sup>Undertakings given following the MMC’s report on the merger between FirstBus plc and SB Holdings Ltd; CC report (1997) *FirstBus plc and SB Holdings Limited*.

<sup>9</sup>[www.competition-commission.org.uk/inquiries/completed/2004/first/notice\\_annex\\_2.htm](http://www.competition-commission.org.uk/inquiries/completed/2004/first/notice_annex_2.htm).

<sup>10</sup>The Act, sections 82(5) and 92. In practice, the CC does not deal with direct applications because of the procedure agreed in the Memorandum of Understanding between the CC and the OFT (see paragraph 3.7).

<sup>11</sup>[www.competition-commission.org.uk/about\\_us/our\\_organisation/workstreams/pdf/mou\\_between\\_of\\_t\\_and\\_cc.pdf](http://www.competition-commission.org.uk/about_us/our_organisation/workstreams/pdf/mou_between_of_t_and_cc.pdf).

in order to comply with the Undertakings, [FirstGroup] is forced to run certain Controlled Routes at a considerable loss. [FirstGroup] considers that this is not an outcome that was intended by the CC. Indeed, a number of the Routes (including all those proposed to be withdrawn) [redacted] are not covering their variable costs ... [Continuing] to operate routes that make a substantial loss puts a severe financial strain on First Glasgow and First Edinburgh and thereby threatens the continued operation of other (non-controlled) services, especially where their continued operation is marginal.

3.10 FirstGroup stated that even if ‘all [of FirstGroup’s] proposed changes to Controlled Routes are made, all bus passengers will continue to have a viable choice between bus and rail for their journey on the overlap flows identified by the CC’.

3.11 Details of the 16 Relevant Controlled Routes, which are subject to the Proposed Withdrawals and Proposed Modifications, are presented below in Tables 2 and 3 respectively.

TABLE 2 **Controlled Routes subject to the Proposed Withdrawals**

<i>Operator</i>	<i>Service number</i>	<i>Route</i>	<i>Controlled</i>	<i>Current frequency of service</i>
Edinburgh	X1	Blackridge—Edinburgh	In hours	4/5 peak journeys and 1 off-peak journey Monday–Friday
Edinburgh	X23	Deans—Edinburgh	In hours	1/2 peak journeys Monday–Friday
Edinburgh	X24	Deans—Edinburgh	In hours	1 peak journey Monday–Friday
Edinburgh	X26	Fauldhouse—Edinburgh	In hours	1 peak journey Monday–Friday
Edinburgh	X32	Deans—Edinburgh	In hours	1 peak journey Monday–Friday
Edinburgh	58	Stirling—Dunblane	In hours & out of hours	½ hourly peak and hourly off-peak
Glasgow	165 (ex 203)	Glasgow—Cambuslang	Out of hours	Monday–Saturday hourly evening service only between 1845 and 2400, plus early morning journeys before 0800. Sunday hourly service between 0845 & 2345.

Source: FirstGroup.

*Notes:*

- Services X1, X23, X24, X26 and X32 are commuter services operating only in the peak periods, directionally into Edinburgh in the morning and outward in the evening.
- Service 58 is an infrequent service principally linking Stirling with Dunblane, but with occasional journeys extending to Cowie and Kinbuck, although only the Stirling–Dunblane section of route is controlled under the Undertakings.
- Service 165 links Glasgow with Cambuslang, and operates all day Sundays, with a few evening and early morning journeys during the week.

TABLE 3 **Controlled Routes subject to the Proposed Modifications**

<i>Operator</i>	<i>Service number</i>	<i>Route</i>	<i>Controlled</i>	<i>Time period for modification</i>	<i>Proposed modification</i>
Glasgow	X1	Glasgow–Hamilton	In hours	Peak periods	Reduce frequency from 15 to 20 mins
Glasgow	X3/36	Glasgow–Abronhill	Out of hours	Evenings post-19.00 & Sundays	Curtail service 36 at Muirhead (to match Mon–Sat daytime operation)
Glasgow	X4/X5	Glasgow–Abronhill	Out of hours	Evenings post-19.00	Reduce frequency from 20 to 30 mins
Glasgow	31	Glasgow–Lindsayfield	In hours	All	Curtail service at East Kilbride
Glasgow	43	Glasgow–Craigend	Out of hours	Evenings post-19.00	Cease operations
Glasgow	64	Glasgow–Carmyle	In hours & out of hours	Evenings post-19.00 Mon–Sat and all day Sunday	Cease operations
Glasgow	109/119	Glasgow–Baljaffray	In hours & out of hours	Evenings post-19.00	Reduce frequency from 30 to 60 mins
Glasgow	255	Glasgow–Newarthill	Out of hours	Evenings post-19.00	Reduce frequency from 30 to 60 mins
Glasgow	263	Glasgow–Little Earnock	Out of hours	Sunday 10.00–18.00	Reduce frequency from 20 to 30 mins

Source: FirstGroup.

3.12 FirstGroup stated that the Proposed Withdrawals and Proposed Modifications formed only a small part of the overall changes to the First Edinburgh and First Glasgow

network resulting from its operating review and therefore showed that its review did not focus only on the Relevant Controlled Routes. FirstGroup stated that:

following the 2009 operational review, some 81 per cent of all First Edinburgh mileage had been subject to some change during the year. The proposed changes to Controlled Routes requested by First would apply to services which form only 16 per cent of the total First Edinburgh service mileage. While for First Glasgow the service changes had affected some 90 per cent of all route mileage in the operational area, the proposed changes to Controlled Routes would apply to services that make up only 11 per cent of total First Glasgow service mileage.

3.13 Depending on the outcome of the CC's decision in relation to the Proposed Withdrawals and Proposed Modifications, FirstGroup also requested:

the OFT and the CC to consider the possibility of a further variation to the Undertakings which would have the effect of introducing a more efficient mechanism for making similar variations to the Undertakings based on the OFT's consent, rather than the full review process under section 92 of the Act.

3.14 FirstGroup put forward its case that given that:

an OFT consent mechanism is now a typical feature of [CC] behavioural undertakings, coupled with the fact that the mechanism is already contained in relation to the capacity restrictions in the [ScotRail] Undertakings, [FirstGroup] considers that the Undertakings would function more effectively and would better reflect evolved CC practice if they contained a mechanism whereby future variations similar to those

requested in this instance could be reviewed and decided upon by the OFT using the criteria identified by the CC during this process.

### ***Third parties' views on the request***

3.15 Ten third parties commented on FirstGroup's variation request. The majority of third parties were against the Proposed Withdrawals and Proposed Modifications.

However, the extent of concern varied:

(a) Of the Proposed Withdrawals, no concerns were expressed in relation to services X23, X24, X26 and X32. West Lothian Council said that it was 'fully supportive of FirstGroup's proposal to develop a fully sustainable network of services in this area [ie across the entire local bus network in the West Lothian area]'. Edinburgh Council also did not object to the proposed withdrawal of the five 'X' services. Concerns were, however, expressed in relation to services X1, 58 and 165. We note these concerns and FirstGroup's response in our assessment of the relevant routes in paragraphs 4.5 to 4.17.

(b) Of the Proposed Modifications, no concerns were expressed in relation to services X1, X4/X5, 255 and 263. Concerns were expressed in relation to services X3/36, 31, 43, 64 and 109/119. We note these concerns and FirstGroup's response in our assessment of the relevant routes in paragraphs 4.18 to 4.41.

### ***The OFT's advice to the CC***

3.16 In its advice, which is published at the same time as this provisional decision, the OFT concluded that:

there is some evidence that there has been a change in circumstances since the ScotRail Undertakings were accepted that may warrant the variation of the Undertakings sought by [FirstGroup] to withdraw the controlled routes ... and to modify the services. Principally this is that the costs of operating these services have increased and/or passenger

numbers on these services (or part services) have decreased such that the services fail to cover variable costs, that they have failed to do so on a persistent basis, and there is no further remedial action [FirstGroup] can reasonably take. This was the criteria which the CC appeared to endorse in the context of considering [FirstGroup's] request to vary the mileage floor in the SBH Undertakings. On that basis, therefore, the advice of the OFT is that this variation request should be granted.<sup>12</sup>

#### **4. Our assessment of whether the change of circumstances requires us to vary the Undertakings**

4.1 As described in paragraph 3.6, we are required to consider whether, as a result of any change of circumstances identified by the OFT in its advice, the Undertakings are no longer appropriate and either FirstGroup can be released from them or they should be varied or superseded.

4.2 As described in paragraph 3.16, the OFT identified in its advice a change of circumstances relating to increases in costs and reductions in passenger numbers leading to services persistently being unable to cover their variable costs. To assess whether we are satisfied that there has been a change of circumstances which requires us to vary the Undertakings, in this section we examine:

- (a) the extent and effect of the change in the passenger numbers and costs on the Relevant Controlled Routes;
- (b) the reasonableness of the cost allocations used by FirstGroup;
- (c) whether FirstGroup has 'under-managed' the Relevant Controlled Routes so as to facilitate their withdrawal/modification and divert passengers to its rail services; and
- (d) in the light of (a) to (c), the appropriateness of varying the Undertakings.

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<sup>12</sup>OFT's advice, paragraphs 52–53.

4.3 To satisfy ourselves whether the change of circumstances required us to vary the Undertakings, we considered it necessary to gather additional financial data from FirstGroup. This enabled us to validate FirstGroup's cost allocation and to benchmark the changes in costs of the Relevant Controlled Routes to see if they had been under-managed (ie (b) and (c) in paragraph 4.2). This data validation identified some differences in figures from those supplied to the OFT for the Proposed Modifications.<sup>13</sup>

### ***The extent and effect of the change of circumstances***

4.4 In this section, we assess the extent and effect of the increases in costs and reductions in passenger numbers. We assess annual revenue, cost, profit and passenger data for each of the Relevant Controlled Routes from 2003/04 to 2008/09,<sup>14</sup> first for those subject to the Proposed Withdrawals and second for those subject to the Proposed Modifications. We set out specific third party concerns on each Relevant Controlled Route and consider what alternative bus services are available.

### ***Proposed Withdrawals***

4.5 Annual revenue, passenger, cost and profit figures from 2003/04 to 2008/09 for the Relevant Controlled Routes subject to the Proposed Withdrawals are shown in Table 4 and graphically in Figures 1 to 4 below.<sup>15</sup> For the purpose of our assessment, we have defined 'costs' as variable costs (comprising direct costs and semi-direct costs) and 'profit' as contribution (which is revenue less variable costs). We explain our reasons for adopting these as definitions of 'costs' and 'profit' in paragraphs 4.44 to 4.47.

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<sup>13</sup>Specifically, the Proposed Modifications contained a labelling error such that the financial figures on which we formed our view were different from those on which the OFT reached its view for these routes. This had a material effect on the figures for service 263.

<sup>14</sup>All data is based on FirstGroup's financial year, which ends on 31 March.

<sup>15</sup>All figures quoted in this report are in nominal terms and changes in revenues, costs and profit are nominal changes.

TABLE 4 Revenues, passenger numbers, variable costs and contribution on the Proposed Withdrawal routes, 2003/04 to 2008/09

Service no	£					
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
<b>(a) Revenues</b>						
X1	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X23	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X24	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X26	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X32	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
58	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
165	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
<i>Numbers of passengers</i>						
<b>(b) Passenger numbers</b>						
X1	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X23	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X24	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X26	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X32	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
58	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
165	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
£						
<b>(c) Variable costs</b>						
X1	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X23	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X24	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X26	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X32	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
58	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
165	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
<b>(d) Contribution</b>						
X1	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X23	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X24	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X26	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
X32	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
58	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
165	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: CC analysis of FirstGroup data.

FIGURE 1

**Proposed Withdrawals: revenues per route, 2003/04 to 2008/09**

[REDACTED]

Source: CC analysis of FirstGroup data.

FIGURE 2

**Proposed Withdrawals: passengers per route, 2003/04 to 2008/09**

[REDACTED]

Source: CC analysis of FirstGroup data.

FIGURE 3

**Proposed Withdrawals: variable costs per route, 2003/04 to 2008/09**



Source: CC analysis of FirstGroup data.

FIGURE 4

**Proposed Withdrawals: contribution per route, 2003/04 to 2008/09**



Source: CC analysis of FirstGroup data.

4.6 The seven Relevant Controlled Routes subject to the Proposed Withdrawals are the five 'X' services (X1, X23, X24, X26 and X32), all of which are operated by First Edinburgh; service 58, also operated by First Edinburgh; and service 165, which is operated by First Glasgow. Of the Proposed Withdrawals, the five 'X' services are wider catchment routes and services 58 and 165 (previously service 203) are overlap routes.

4.7 Table 4 shows that, for all the Relevant Controlled Routes subject to the Proposed Withdrawals, between 2003/04 and 2008/09:

- (a) Total passenger numbers fell by [15–30] per cent. Only route 58 showed an increase in passenger numbers.
- (b) Total revenues increased by less than only [0–10] per cent but were more than offset by a significant increase ([20–35] per cent) in variable costs.
- (c) Annual contribution losses increased by [75–100] per cent from a loss of £[ ] to a loss of £[ ]. No Relevant Controlled Routes subject to the Proposed Withdrawals made positive contributions to depot overhead costs during the period.

*The five 'X' services*

- 4.8 The five 'X' services are low-frequency commuter services, operating to and from Edinburgh during peak times only (into Edinburgh in the morning and out of Edinburgh in the evening). Passenger numbers across the five 'X' services declined by [35–50] per cent between 2003/04 and 2008/09. Over the same period, revenues for the five 'X' services declined by [10–25] per cent and variable costs increased by [5–20] per cent. The combination of these adverse movements resulted in contribution for these services becoming increasingly negative—total losses on the five 'X' routes increased by [55–70] per cent to a loss of £[~~3~~] in 2008/09.
- 4.9 FirstGroup stated that the reduction in passenger numbers on the five 'X' services 'may be partly attributable to the ongoing construction work on the new Edinburgh tram which has increased journey times to the west end of Edinburgh by around 10 minutes'. As construction on the new Edinburgh tram network began in June 2008, with the new trams originally scheduled to come into operation in July 2011 and FirstGroup's financial year ends on 31 March, the historic financial impact of the construction of the new tram network should only be limited to the 2008/09 figures. Excluding the 2008/09 figures on the five 'X' services, then between 2003/04 and 2007/08, performance has still significantly deteriorated over the period. Save for route X32, all other 'X' routes saw passenger numbers declining between 2003/04 and 2007/08, with all 'X' routes showing increased contribution losses over this period.
- 4.10 The CC found an SLC on the five 'X' routes in the 2004 report following concerns raised by third parties.<sup>16</sup> With the exception of service X1 (see paragraphs 4.11 and 4.12), third parties no longer seemed to hold significant concerns about the five 'X' routes (see paragraph 3.15). FirstGroup is actively discussing with West Lothian

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<sup>16</sup>See 2004 report, [Appendix G](#), paragraph 19.

Council ideas for redeployment of the resource savings from the withdrawal of the five 'X' routes to other services which could be strengthened. FirstGroup said that many of the flows in question on the five 'X' routes had alternative FirstGroup bus services (for example, services 16, 27 and 28, of which services 27 and 28 are Controlled Routes).

- *Service X1*

4.11 SESTran was concerned that the withdrawal of the X1 service would leave no adequate alternatives for passengers travelling beyond Bathgate to Armadale and few alternatives for those passengers travelling to Blackridge. SESTran noted that the Airdrie–Bathgate rail project would be completed in December 2010 and that this would be likely radically to alter demand for the X1 bus service. SESTran therefore proposed that only minor alterations should be allowed to the X1 service prior to December 2010.

4.12 The X1 service has experienced a significant reduction ([35–50] per cent) in passengers between 2003/04 and 2008/09 but a slight reduction in variable costs ([0–10] per cent), leading to a significant increase in contribution losses of [25–40] per cent. FirstGroup noted that services 8 and 9 would continue to provide two direct services per hour to Edinburgh from Armadale and, although there would be no direct service between Blackridge and Edinburgh, passengers could use FirstGroup, SD Travel or Passenger Travel services and change at Bathgate.

*Service 58*

4.13 FirstGroup stated that, for service 58, there was 'an expanding market between the University of Stirling and Stirling City Centre', which had led to an increase in passenger numbers of [15–30] per cent between 2003/04 and 2008/09. This contributed to total revenues increasing by [25–40] per cent. However, variable costs over this

period increased by more ([45–60] per cent). The net effect of this was that contribution losses on service 58 increased very significantly (by [400–500] per cent) to a loss of £[~~8~~].<sup>17</sup>

4.14 Service 58, which operates half-hourly in peak and hourly off-peak between Stirling and Dunblane via Bridge of Allan, was of most concern to third parties. Stirling Council was concerned that alternative services to service 58 were infrequent and did not enter the Stirling University campus, but only stopped at the Stirling University road end. Tactran (Tayside and Central Scotland Transport Partnership) and the University of Stirling were also concerned about the withdrawal because this service provided the only link between Dunblane and Stirling University.

4.15 The flows between Stirling University (situated north-east of Stirling) and Dunblane/Bridge of Allan, which were of concern to third parties, were not identified by the CC in the 2004 report as problem overlap flows.<sup>18</sup> In addition, FirstGroup noted that there were a range of alternative FirstGroup and competing services between Bridge of Allan/Dunblane and Stirling that stopped at the university road end, which was less than 500 metres from the existing service 58 stop in the university. These services included FirstGroup's service 54, which is a Controlled Route, operating three times per hour between Bridge of Allan and Stirling via Stirling University, as well as a range of tendered and commercial services operating between Dunblane and Stirling via Bridge of Allan with a total frequency of 20 services per day Monday to Friday.<sup>19</sup>

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<sup>17</sup>We note that the two absolute figures may not be entirely comparable given the service changes on service 58, which involved routing via the university campus.

<sup>18</sup>Problem overlap flows were Dunblane–Bridge of Allan, Bridge of Allan–Stirling and Dunblane–Stirling.

<sup>19</sup>Tendered and commercial services operating between Dunblane and Stirling via Bridge of Allan include Scottish Citylink services, Harlequin C48, Crieff Travel service 47 and Docherty's Midland Coaches service 20. These have a total frequency of 20 services per day Monday to Friday, 21 on Saturdays and 7 on Sundays. There are also commercial services operating direct between Dunblane and Stirling (including the hourly Scottish Citylink service M8).

### *Service 165*

- 4.16 Although passenger numbers on service 165 declined by [20–35] per cent between 2003/04 and 2008/09,<sup>20</sup> passenger yield (revenues per passenger) increased over this period, resulting in total revenues increasing slightly by [0–10] per cent. However, with variable costs increasing by [40–55] per cent over this period, the contribution loss on service 165 increased by [125–150] per cent to a loss of £[~~8~~].
- 4.17 Two third parties were concerned that the withdrawal of service 165 would leave areas ‘totally unserved during the evenings and all day on Sundays’. In response, FirstGroup said that there were alternative FirstGroup bus services (including services 263, 267, 16 and 18, all of which are Controlled Routes) operating more frequently than service 165 and covering the overlap flows that were of concern to the CC.

### *Proposed Modifications*

- 4.18 Annual revenue, passenger, cost (ie variable cost) and profit (ie contribution) figures from 2003/04 to 2008/09 for the Relevant Controlled Routes subject to the Proposed Modifications are shown in Table 5 and graphically in Figures 5 to 8. The data represents just the section of the service that is subject to the modification and not the entire service.<sup>21</sup>

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<sup>20</sup>FirstGroup stated that the ‘reduction in passenger numbers may be partially attributable to: depopulation ...; the lack of investment in the Rutherglen town centre on the route compared to other new shopping centres that have opened in Glasgow during this time including The Fort (late 2004) and Silverburn (late 2007)’.

<sup>21</sup>In contrast, the figures for the Relevant Controlled Routes subject to the Proposed Withdrawals in Table 4 are for the entire service.

TABLE 5 Revenues, passenger numbers, variable costs and contribution on the modified parts of the Proposed Modification routes, 2003/04 to 2008/09

Service number	£					
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
<b>(a) Revenues</b>						
64	[X]	[X]	[X]	[X]	[X]	[X]
109/119	[X]	[X]	[X]	[X]	[X]	[X]
255	[X]	[X]	[X]	[X]	[X]	[X]
263	[X]	[X]	[X]	[X]	[X]	[X]
X4/X5	[X]	[X]	[X]	[X]	[X]	[X]
31	[X]	[X]	[X]	[X]	[X]	[X]
X1	[X]	[X]	[X]	[X]	[X]	[X]
43	[X]	[X]	[X]	[X]	[X]	[X]
36/X3	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]
<i>Numbers of passengers</i>						
<b>(b) Passenger numbers</b>						
64	[X]	[X]	[X]	[X]	[X]	[X]
109/119	[X]	[X]	[X]	[X]	[X]	[X]
255	[X]	[X]	[X]	[X]	[X]	[X]
263	[X]	[X]	[X]	[X]	[X]	[X]
X4/X5	[X]	[X]	[X]	[X]	[X]	[X]
31	[X]	[X]	[X]	[X]	[X]	[X]
X1	[X]	[X]	[X]	[X]	[X]	[X]
43	[X]	[X]	[X]	[X]	[X]	[X]
36/X3	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]
£						
<b>(c) Variable costs</b>						
64	[X]	[X]	[X]	[X]	[X]	[X]
109/119	[X]	[X]	[X]	[X]	[X]	[X]
255	[X]	[X]	[X]	[X]	[X]	[X]
263	[X]	[X]	[X]	[X]	[X]	[X]
X4/X5	[X]	[X]	[X]	[X]	[X]	[X]
31	[X]	[X]	[X]	[X]	[X]	[X]
X1	[X]	[X]	[X]	[X]	[X]	[X]
43	[X]	[X]	[X]	[X]	[X]	[X]
36/X3	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]
<b>(d) Contribution</b>						
64	[X]	[X]	[X]	[X]	[X]	[X]
109/119	[X]	[X]	[X]	[X]	[X]	[X]
255	[X]	[X]	[X]	[X]	[X]	[X]
263	[X]	[X]	[X]	[X]	[X]	[X]
X4/X5	[X]	[X]	[X]	[X]	[X]	[X]
31	[X]	[X]	[X]	[X]	[X]	[X]
X1	[X]	[X]	[X]	[X]	[X]	[X]
43	[X]	[X]	[X]	[X]	[X]	[X]
36/X3	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]

Source: CC analysis of FirstGroup data.

FIGURE 5

**Proposed Modifications: modified parts' revenues, 2003/04 to 2008/09**

[X]

Source: FirstGroup, CC analysis.

FIGURE 6

**Proposed Modifications: modified parts' passengers, 2003/04 to 2008/09**



Source: FirstGroup, CC analysis.

FIGURE 7

**Proposed Modifications: modified parts' variable costs, 2003/04 to 2008/09**



Source: FirstGroup, CC analysis.

FIGURE 8

**Proposed Modifications: modified parts' contribution, 2003/04 to 2008/09**



Source: FirstGroup, CC analysis.

4.19 Table 5 and Figures 5 to 8 show that for the Relevant Controlled Routes subject to the Proposed Modifications between 2003/04 and 2008/09:

(a) Revenue performance varied widely, eg revenues for service 43 grew by [40–55] per cent whereas service 31 revenues declined by [25–40] per cent.

(b) However, nearly all the routes with Proposed Modifications suffered a decline in passenger numbers, save for service 43, which was the only service which saw passenger numbers increase.

(c) Variable costs increased for all routes except for service 31.

(d) All routes, with the exception of service 263, made contribution losses in 2003/04, which deteriorated further in the period to 2008/09: the combined contribution losses on these routes of £[~~£~~] in 2003/04 increased by [125–150] per cent to losses of £[~~£~~] in 2008/09.

4.20 Of the routes subject to Proposed Modifications, three are wider catchment routes (services 31, 36 and X4/X5) and the rest are overlap routes. We consider these in turn.

### *Wider catchment routes*

4.21 The three wider catchment routes were of concern to the CC in the 2004 report because they reflected journeys from significant centres of population outside the main conurbation. All three routes have experienced significant reductions in passenger numbers and (with the exception of service 31) increases in variable costs, which in combination have led to significantly increasing contribution losses.

- *Service 31*

4.22 Passenger numbers on service 31 reduced by [45–60] per cent between 2003/04 and 2008/09, contributing to revenues falling by [25–40] per cent. Although variable costs over this period reduced by only [0–15] per cent, variable cost per passenger increased by [75–90] per cent. The net effect of the falling revenues and falling variable costs was that contribution losses increased by [60–75] per cent between 2003/04 and 2008/09 to £[~~8~~].

4.23 The Proposed Modification relates to curtailing the in-hours service at East Kilbride. This route, which has an in-hours frequency of two per hour, was of concern to the CC in the 2004 report because it could be reconfigured as a feeder route to the rail stations in East Kilbride.<sup>22</sup> The Proposed Modification would not create a feeder service to and from the rail station for the areas of Greenhills and Westwood Hill.

4.24 Two third parties were concerned that the Proposed Modification to service 31 would leave areas unserved for all seven days of the week. In response, FirstGroup said that there were alternative frequent FirstGroup services (services 16/18 and 20, of which there were seven direct services per hour) for the two affected overlap flows

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<sup>22</sup>See 2004 report, [Appendix G](#), paragraph 32.

that were of concern to the CC.<sup>23</sup> The remaining part of the route and services 16/18 and 20 would continue to be controlled by the Undertakings.

- *Service 36/X3*

4.25 Passenger numbers on service 36/X3 fell by [20–35] per cent between 2003/04 and 2008/09, contributing to revenues falling by just [0–10] per cent. Variable costs increased by [30–45] per cent, leading to contribution losses increasing by [70–85] per cent between 2003/04 and 2008/09 to £[~~3~~].

4.26 The Proposed Modification relates to curtailing the out-of-hours service at Muirhead. Service 36/X3, which has an out-of-hours frequency of two per hour, was of concern to the CC in the 2004 report because it served Cumbernauld. However, the Proposed Modification does not create a feeder service to and from the Cumbernauld rail station. One third party was concerned that the Proposed Modification would leave many areas totally unserved during the evenings and on Sundays. In response, FirstGroup said that post-modification there would be alternative bus services which would provide a minimum half-hourly service in the evenings.<sup>24</sup> The remaining part of the route and several of the alternative services would continue to be controlled by the Undertakings out of hours.

- *Service X4/X5*

4.27 On service X4/X5, passenger numbers fell by [5–20] per cent between 2003/04 and 2008/09. Although revenues increased by [5–20] per cent, variable costs increased by [35–50] per cent, leading to contribution losses increasing very significantly (by [200–250] per cent) between 2003/04 and 2008/09 to £[~~3~~].

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<sup>23</sup>Greenhills–Glasgow and Westwoodhill–Glasgow.

<sup>24</sup>Provided by the X3, X4, X5, FX3, 38, 38A and 38C services. Services X4 and X5 are controlled out of hours.

4.28 The Proposed Modification relates to reducing the frequency out of hours from 20 minutes to 30 minutes. Like service 36/X3, this route was of concern to the CC in the 2004 report because it served Cumbernauld, but the Proposed Modification does not appear to allow FirstGroup to create a feeder service to Cumbernauld rail station. There were no third party concerns. The route would continue to be controlled by the Undertakings.

#### *Overlap routes*

4.29 With the exception of service 43, all the other routes with problem overlap flows (services X1, 64, 109/119, 255 and 263) experienced falls in passenger numbers. Variable costs increased on all six of these routes, and contribution losses increased on all routes, although service 263 was only marginally loss-making and appears to be approaching break-even at a contribution level in 2008/09.

- *Service X1*

4.30 On service X1, passenger numbers fell by [25–40] per cent between 2003/04 and 2008/09. Revenues also fell by [15–30] per cent and, coupled with variable costs increasing by [15–30] per cent, contribution losses increasing very significantly (by [500–600] per cent) between 2003/04 and 2008/09 to £[~~500~~].

4.31 The Proposed Modification is to reduce frequency from 15 to 20 minutes in peak periods. In the 2004 report, the CC was concerned about one overlap between Hamilton and Glasgow because competitors' services took a much longer route and there was potential for interchange at Hamilton.<sup>25</sup> There were no third party concerns about the Proposed Modification. Post-modification, in addition to the reduced

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<sup>25</sup>See 2004 report, [Appendix G](#), Table 4.

frequency X1, there would remain several alternative services, including services 263, 266 and 267. The route would continue to be controlled by the Undertakings.<sup>26</sup>

- *Service 43*

4.32 On service 43, passenger numbers increased by [15–30] per cent between 2003/04 and 2008/09. Revenues increased by [45–60] per cent but variable costs increased by [35–50] per cent such that the net effect was for contribution losses to increase by [25–40] per cent between 2003/04 and 2008/09 to £[~~£~~].

4.33 The Proposed Modification of this service is to cease operation post-1900 hours. In the 2004 report the CC had concerns about four overlaps on this service during out-of-hours times. One third party was concerned that the Proposed Modification would leave many areas totally unserved during the evenings. FirstGroup said that services 16/18, 40, 41 and 263 provided at least a half-hourly service and service 46 an hourly service. The route would continue to be controlled by the Undertakings for any out-of-hours times unaffected by the Proposed Modification. Alternative services 16/18, 40 and 263 are also controlled out of hours by the Undertakings.

- *Service 64*

4.34 On service 64, passenger numbers fell by [5–20] per cent between 2003/04 and 2008/09 but revenues increased by [0–15] per cent. However, variable costs increased by [50–65] per cent such that the net effect was for contribution losses to increase very significantly (by [200–300] per cent) between 2003/04 and 2008/09 to £[~~£~~].

4.35 The Proposed Modification of this service, which in the 2004 report had two overlaps out of hours of concern to the CC, is to cease operation post-1900 hours and all day

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<sup>26</sup>Alternative services 263 and 267 are controlled out of hours.

on Sundays. One third party was concerned that the Proposed Modification would leave many areas totally unserved during the evenings and on Sundays. FirstGroup noted that there would continue to be six direct FirstGroup services per hour on the affected overlap flows.<sup>27</sup> The route would continue to be controlled by the Undertakings for the out-of-hours times unaffected by the Proposed Modification.

- *Service 109/119*

4.36 Passenger numbers declined on this route by [5–20] per cent between 2003/04 and 2008/09. Although revenues increased by just [0–10] per cent, variable costs increased by [10–25] per cent, leading to a significant increase in contribution losses of [40–55] per cent between 2003/04 and 2008/09 to £[✂].

4.37 The Proposed Modification is to reduce frequency from 30 to 60 minutes post-1900 hours. One third party was concerned that the Proposed Modification would ultimately lead to a withdrawal of the out-of-hours service. In response, FirstGroup noted that service 10, with a frequency of once per hour, overlapped with approximately 95 per cent of service 109. The service in hours would remain unaffected and the route would continue to be controlled by the Undertakings.

- *Service 255*

4.38 Passenger numbers on service 255 fell by [5–20] per cent between 2003/04 and 2008/09. Although revenues increased by [0–15] per cent, variable costs increased by [30–45] per cent, leading to a very significant increase in contribution losses of [150–200] per cent between 2003/04 and 2008/09 to £[✂].

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<sup>27</sup>Services 61, 250 and 255 between Carmyle and Glasgow; and services 16/18 and 263 between Bridgeton and Glasgow. We noted that the alternative services between Carmyle and Glasgow ran by Carmyle but not directly into Carmyle. Services 16/18, 61, 255 and 263 are controlled out of hours by the Undertakings.

4.39 The Proposed Modification is to reduce frequency on this service, which in the 2004 report had nine problem overlaps out of hours, from 30 to 60 minutes on evenings post-1900 hours. There were no third party concerns regarding the Proposed Modification. The route would continue to be controlled out of hours by the Undertakings.

- *Service 263*

4.40 Passenger numbers on service 263 fell by only [0–10] per cent between 2003/04 and 2008/09. Revenues increased by [25–40] per cent but variable costs increased by [30–45] per cent. The net effect of these changes was for route 263 to turn from making a positive contribution of £[£] in 2003/04 to making a contribution loss in 2008/09 of just £[£] (a fall in contribution of [100–125] per cent). Although this loss reached £[£] in 2006/07, the service showed significant improvement in financial performance between 2006/07 and 2008/09.

4.41 The Proposed Modification to this service, which had ten problem overlaps in the 2004 report, is to reduce frequency from 20 to 30 minutes on a Sunday only. There were no third party concerns regarding the Proposed Modification. The route would continue to be controlled out of hours by the Undertakings.

### ***Reasonableness of cost allocations***

4.42 Although the financial data presented in Tables 4 and 5 showed that, with the exception of service 263, the Relevant Controlled Routes have persistently failed to cover their variable costs since the time the Undertakings were put in place, FirstGroup submitted that it 'did not have the available software to ascertain this position at the time of the CC's investigation and hence it was not able to make arguments to the CC on this issue'. There is no assessment of the profitability of

individual routes in the 2004 report—the CC assessed the incentives for diverting passengers from bus to rail, not the existing financial situation.

4.43 To ensure that FirstGroup had presented an accurate and consistent picture of the Relevant Controlled Routes' financial performance since 2003/04, we assessed the reasonableness of FirstGroup's cost allocations by:

(a) defining the relevant costs, in particular which cost items to include or exclude;

and

(b) assessing whether FirstGroup's measurement of these cost items for the Relevant Controlled Routes had been done on a 'fair and reasonable' basis.

#### *Adopting appropriate definitions of costs and profit*

4.44 FirstGroup showed that all the Relevant Controlled Routes were making losses after the deduction of both direct and semi-direct costs:<sup>28</sup>

(a) Direct costs are those costs which vary directly in line with the level of service provided (typically defined in terms of bus hours operated and/or bus miles travelled). Direct costs comprised<sup>29</sup> drivers' payroll and expenses, the cost of fuel net of Bus Service Operator's Grant (BSOG, a government rebate on fuel duty) and the cost of hire of tyres.<sup>30</sup>

(b) Semi-direct costs are those costs which have both an element which increase in line with the level of service and a fixed element, which remain unchanged in relation to the level of service. Semi-direct costs comprised engineering costs,<sup>31</sup>

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<sup>28</sup>Overhead costs are fixed in relation to changes in the service level provided and comprise the cost of the buildings, administrative support, central group recharges, etc. Since the Relevant Controlled Routes are making losses after the deduction of direct and semi-direct costs, it has not been necessary to analyse overhead costs in any detail.

<sup>29</sup>Labels and definitions of all cost items are based on information from FirstGroup.

<sup>30</sup>FirstGroup, like many other bus operators, leases tyres from third-party tyre companies, which also provide tyre maintenance and replacement services, and are charged on a 'pence per a set number of miles' pricing formula. For new vehicles, the tyres are typically sold and leased back to the tyre company under the same leasing/maintenance arrangements. Therefore, we consider it appropriate to consider tyres as a direct cost item.

<sup>31</sup>Engineering payroll (including supervisory/skilled and semi-skilled staff); cost of materials in the course of vehicle maintenance; accident damage and vandalism repair; cleaning materials and plant repairs, etc.

traffic costs,<sup>32</sup> passenger carrying vehicle (PCV) insurance, PCV depreciation and lease costs and the cost of marketing and publicity.

- 4.45 In our view, a commercial bus operator will typically consider the financial sustainability of a route based on its ability to cover its direct and semi-direct costs in the medium term: whilst a bus operator might accept losses after direct costs in the short term for a new route, it would be reasonable to expect a bus operator to continue operating a more mature route only if it could cover both its direct and semi-direct costs, as well as make some contribution to the fixed costs of the business.
- 4.46 For a route to be financially sustainable, it is our view that the cost of putting a vehicle on to a route should be included, eg the costs of maintaining the roadworthiness of the vehicle (ie its repairs and maintenance costs) and its replacement costs (ie in the form of depreciation and/or leasing costs), as well as the costs in relation to road tax, motor insurance and vehicle licensing. We also treated traffic and marketing costs as semi-direct costs, which are 'avoidable' if no services were operated and would increase in relation to increases in the level of service, albeit less directly than driver or fuel costs, for example.
- 4.47 In the context of this review, because FirstGroup has continued to operate the Relevant Controlled Routes since the Undertakings were put in place in 2004, we did not consider it critical for our assessment to define the 'short term' and 'medium term'. Instead, we treated all the Relevant Controlled Routes as mature routes which should be reasonably expected to make a contribution to fixed costs (ie revenues fully cover both direct and semi-direct costs and a proportion of overhead costs). Our definition of 'variable costs' therefore includes both direct and semi-direct costs and

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<sup>32</sup>Cost of traffic supervision and depot administration, drivers' uniforms, ticketing and associated equipment, etc.

the appropriate measure of a route's profit is contribution (ie the route's total revenues less the route's direct and semi-direct costs).

### *Validation of FirstGroup's route profitability on the Relevant Controlled Routes*

- 4.48 Whilst the allocation of direct costs to a particular route is relatively straightforward since these costs vary directly in line with the hours and miles operated on a particular service and can therefore be accurately measured, the allocation of semi-direct costs to a particular route can be relatively more problematic.
- 4.49 To ensure that FirstGroup had presented a reasonably accurate statement of the Relevant Controlled Routes' cost performance, we assessed whether the route-costing assumptions for the Relevant Controlled Routes were 'fair and reasonable' by determining whether their cost allocation assumptions were consistent with those routes outside the scope of the Undertakings (Non-Controlled Routes).
- 4.50 We assessed the consistency of the route-costing methodology for the Relevant Controlled Routes within First Glasgow and First Edinburgh, relative to its other routes. We were satisfied that for all the routes operated by First Glasgow and for the Livingston and Bannockburn depots of First Edinburgh (out of which the Relevant Controlled Routes are operated), the cost allocation methodology was consistently applied between the Relevant Controlled Routes, other Controlled Routes and the Non-Controlled Routes. There was no evidence to suggest that costs had been wrongly allocated to the Relevant Controlled Routes.

### ***FirstGroup's management of the Relevant Controlled Routes***

- 4.51 In this section, we assess whether FirstGroup has 'under-managed' the Relevant Controlled Routes such that its costs, when benchmarked against other routes, are relatively higher.

4.52 This section is split into three:

- (a) First, we assess the changes in costs of the Relevant Controlled Routes relative to a selection of other routes operated by FirstGroup in and around Edinburgh and Glasgow.
- (b) Second, we consider the changes in costs relative to other operators in Scotland.
- (c) Third, we consider the attempts made by FirstGroup to rectify the declining performance of the Relevant Controlled Routes, given the restrictions placed on FirstGroup under the Undertakings.

*The relative cost efficiency of the Relevant Controlled Routes to other FirstGroup services*

4.53 Since all the Relevant Controlled Routes were showing losses at the contribution level (ie after the deduction of variable costs, as defined in paragraph 4.49), we considered it appropriate to focus on the cost items contained within variable costs as the relevant cost benchmarks (ie excluding overheads). We looked separately at the cost data for First Edinburgh and First Glasgow.

*First Edinburgh*

4.54 In First Edinburgh, we compared how the Bannockburn and Livingston depots' cost performance compared with the other depots operated by First Edinburgh.<sup>33</sup> We found that there was no evidence to suggest that the Bannockburn and Livingston depots were incurring higher driver costs, net fuel costs or other costs relative to the other depots operated by First Edinburgh in 2006/07 and 2008/09.

4.55 We also examined the individual routes operated out of the Bannockburn and Livingston depots:

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<sup>33</sup>Our assessment was based on data for 2006/07 and 2008/09.

(a) In the Bannockburn depot, which operates just one Relevant Controlled Route, route 58, we examined direct and semi-direct costs as a percentage of revenues. We found that, although the direct and semi-direct costs for route 58 were in the upper quartile of costs for routes operated out of the Bannockburn depot, there was no conclusive evidence to suggest that route 58's cost performance relative to other routes (including Non-Controlled Routes) was an outlier result among the other routes within the Bannockburn depot. None of the other routes that exhibited higher direct costs relative to the average of all routes operated out of the Bannockburn depot were Controlled Routes.

(b) In the Livingston depot, which operates the five 'X' routes, we examined direct costs and semi-direct costs per mile. We found that the direct costs per mile on the five 'X' routes were consistent with other routes. We also found that, although the five 'X' routes generally exhibited higher semi-direct costs per mile than the other routes, the semi-direct costs per mile for the five 'X' routes were not inconsistent with those 'X' routes that are not Controlled Routes. Furthermore, given the restrictions placed by the Undertakings on FirstGroup's ability to control costs by changing service frequency on the low-frequency 'X' routes, we found that there was no evidence to conclude that the five 'X' routes were operated relatively inefficiently when compared with the other 'X' routes which are not Controlled Routes.

#### *First Glasgow*

4.56 In First Glasgow, which operates all nine of the Controlled Routes subject to the Proposed Modifications and one of the routes subject to the Proposed Withdrawals,<sup>34</sup> we found that the Relevant Controlled Routes operated by First Glasgow demonstrated a wide range of figures for variable cost per mile. There was no

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<sup>34</sup>Our analysis was based on the First Glasgow profit and loss statements for 2003/04 and 2008/09.

evidence to suggest that the Relevant Controlled Routes operated at relatively higher levels of variable cost per mile than other routes operated by First Glasgow.

### *FirstGroup's cost trends relative to other operators*

4.57 The Confederation of Passenger Transport UK (CPT) cost index is a publicly available index of industry costs for each major geographic region in the UK, based on a biannual survey of bus and coach operators' costs (last 12 months to June and December).<sup>35</sup> The CPT cost index for Scotland was based on between eight and eleven respondents over the period from 1 January 2004 to 31 December 2009. FirstGroup, as a major bus operator in Scotland, accounts for a large part of the CPT Scotland cost index.

4.58 Based on First Glasgow's management accounts, Table 6 provides a summary of the historic cost trends of First Glasgow for driver payroll, fuel and variable costs (ie excluding overhead costs) against the relevant CPT Scotland cost index.<sup>36</sup>

TABLE 6 **First Glasgow cost trends relative to the CPT Scotland cost index**

	12 months to Dec 05		12 months to Dec 06		12 months to Dec 07		12 months to Dec 08	
	First Glasgow	CPT Scotland	First Glasgow	CPT Scotland	First Glasgow	CPT Scotland	First Glasgow	CPT Scotland
Driver costs	[redacted]	6.2	[redacted]	2.1	[redacted]	5.8	[redacted]	5.3
Fuel costs	[redacted]	19.8	[redacted]	31.7	[redacted]	4.6	[redacted]	16.8
Total costs (excl O/H)	[redacted]	6.4	[redacted]	7.5	[redacted]	5.9	[redacted]	6.6

Source: CC analysis of CPT and FirstGroup data.

4.59 In Table 6, we selected driver and fuel costs given that they both represent direct costs which account for a significant proportion of total costs for bus operators. In the case of First Glasgow, in 2008/09, driver payroll costs accounted for around [redacted] per

<sup>35</sup> [www.cpt-uk.org](http://www.cpt-uk.org).

<sup>36</sup> Given that FirstGroup adopts a March financial year and the CPT Scotland cost index used by FirstGroup is based on calendar year, there were some timing issues in relation to how FirstGroup presented the two datasets in its submission. Rather than attempt to recalendarize First Glasgow's financial data to December year-ends, we have compared First Glasgow's March year-end figures with the previous year's CPT's figures, eg we would compare First Glasgow's figures ended 31 March 2005 with the CPT's 31 December 2004 figures. We have not included data for First Edinburgh as we did not have annual data for each year between 2005 and 2008.

cent of total costs (including overheads) and net fuel costs accounted for around [X] per cent. Based on Table 6, First Glasgow's driver payroll cost performance does not appear inconsistent with the CPT Scotland driver cost index. However, the changes in First Glasgow's fuel costs relative to the CPT Scotland fuel cost index appear highly volatile. As CPT highlighted in its summary of results for its cost index, 'the impact of fuel hedging continues to have a major influence on the figures'.<sup>37</sup>

4.60 Our analysis of FirstGroup's data supports the OFT's view that 'the cost increases First has experienced do not appear to be out of line with increases in bus industry costs. That is, First is no less efficient than other bus operators'.<sup>38</sup>

#### *Attempts made by FirstGroup to rectify declining performance on Relevant Controlled Routes*

4.61 FirstGroup provided information on the action it had taken to improve the declining performance on the Relevant Controlled Routes. Given the restrictions created by the Undertakings in relation to frequency, service levels and fares, FirstGroup provided a number of examples of initiatives designed to increase passenger numbers on the Relevant Controlled Routes. These initiatives included:

- (a) the introduction of start time adherence (STA) monitoring across First Glasgow's entire network, designed to improve punctuality by controlling bus distribution, thereby providing a more attractive service and encouraging greater patronage;
- (b) the introduction of a 'two journey ticket' promotion on First Glasgow services in 2007 to increase passenger usage; and
- (c) improvements to specific services, for example:
  - (i) services 43 and 11 were coordinated on a common section to provide a joint 10-minute service rather than two separate 20-minute services;
  - (ii) low-floor buses on services 109/119, 255 and X4/X5;

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<sup>37</sup>CPT Cost Index (31 December 2009) [www.cpt-uk.org/\\_uploads/attachment/1056.pdf](http://www.cpt-uk.org/_uploads/attachment/1056.pdf).

<sup>38</sup>OFT's advice, paragraph 39.

- (iii) additional buses added to improve reliability on services 255 and 263; and
- (iv) Cumbernauld FirstWeek and Lanarkshire FirstWeek tickets introduced on services 36/X3, 165, 255, 263, X1 and X4/X5.

4.62 We found that these initiatives were reasonable attempts in the circumstances to improve patronage, albeit with limited success in reversing the falling trend in passenger numbers and worsening financial performance.

### ***Our assessment of the appropriateness of varying the Undertakings***

#### ***FirstGroup's Proposed Withdrawals and Proposed Modifications***

4.63 In paragraphs 4.5 to 4.62, we found that:

- (a) Since 2003/04, the Relevant Controlled Routes, with the exception of service 263, have persistently failed to cover their variable costs and this financial position has significantly deteriorated. We would reasonably expect mature routes operated by a commercial bus operator such as FirstGroup to cover their variable costs. On almost all flows there are alternative direct bus services and the Proposed Withdrawals and Proposed Modifications do not seem to be driven by the adverse effects the CC was concerned about in the 2004 report (paragraphs 4.5 to 4.41).
- (b) FirstGroup's methodology of allocating costs across the Relevant Controlled Routes is fair and reasonable; and consistent with that adopted for routes operated by First Edinburgh and First Glasgow which are outside the scope of the Undertakings (paragraphs 4.42 to 4.50).
- (c) There is no evidence to suggest that the Relevant Controlled Routes exhibited significantly higher costs relative to the other routes operated by First Edinburgh or First Glasgow (or against other bus operators in Scotland), which showed that the Relevant Controlled Routes have not been undermanaged in order to facilitate their withdrawal/modification (paragraphs 4.51 to 4.60).

(d) Taken against the restrictions placed on FirstGroup by the Undertakings in relation to changing service levels on the Relevant Controlled Routes, FirstGroup has made reasonable attempts to improve the financial performance of the Relevant Controlled Routes through initiatives to stimulate growth in patronage, albeit with limited success (paragraphs 4.61 and 4.62).

4.64 In our view, it seems likely that, absent FirstGroup's acquisition of the ScotRail franchise and the resultant Undertakings, First Group would withdraw/modify the Relevant Controlled Routes, with the exception of service 263, on the basis that since 2003/04 they have been persistently loss-making and this situation has deteriorated despite reasonable attempts to rectify the situation. It is our view that the change of circumstances identified by the OFT means that it is appropriate for us to vary the Undertakings to permit FirstGroup to make the Proposed Withdrawals and Proposed Modifications set out in Tables 2 and 3, with the exception of the Proposed Modification to service 263 on which the contribution losses incurred are neither persistent nor significantly increasing.

#### *FirstGroup's request for further change provisions in the Undertakings*

4.65 As set out in paragraphs 3.13 and 3.14, FirstGroup also requested a further variation to the Undertakings to permit it to seek consent from the OFT (and so obviate the need for advice to the CC) for any future requests for changes to the Controlled Routes, subject to the request meeting a certain set of predetermined criteria that would be set out in the Undertakings.

4.66 In our view, the Act expressly provides a mechanism for the review of undertakings when there has been a change of circumstances. The 2004 report explicitly considered that additional provisions for changes of circumstances were not necessary and set out what it considered might constitute a change of circumstances:

In general, therefore, we do not consider it necessary or appropriate to allow any further mechanism for change. While it will be for the OFT to consider in light of the facts and circumstances at the time whether there has been a change of circumstances such that the undertakings are no longer appropriate, we would anticipate that factors beyond the control of FirstGroup which have an ongoing effect on their ability to comply with the undertakings, such as legal, regulatory or fiscal changes, or changes in local authority transport policy which have a major effect on the revenue of the company, are examples which could be regarded as a change of circumstances for these purposes.<sup>39</sup>

4.67 In our view, there is no reason to alter this finding in the 2004 report. Our assessment has shown that the combination of changes in passenger numbers, costs and revenues is not straightforward and any individual route may have unique circumstances which need to be taken into account. In our view, such complex factors are not capable of being effectively captured in a simple set of rules that could be incorporated into revised undertakings.

## **5. Provisional decision and next steps**

### ***Our provisional decision***

5.1 On the basis of paragraphs 4.63 and 4.64, we have provisionally decided that, as a result of the change of circumstances identified by the OFT, it is appropriate to vary the Undertakings to permit FirstGroup to make the Proposed Withdrawals and Proposed Modifications set out in Tables 2 and 3, with the exception of the Proposed Modification to service 263.

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<sup>39</sup>[2004 report](#), paragraph 6.25.

5.2 Table 8 shows the number of Controlled Routes that would remain following the proposed variation to the Undertakings in comparison with the number of existing Controlled Routes (shown in brackets).

TABLE 8 **Controlled Routes after Proposed Withdrawals and Proposed Modifications**

	<i>In hours</i>	<i>Out of hours</i>
Overlap routes	10 (11)	18 (20)
Wider catchment routes	<u>5 (10)</u>	<u>7 (7)</u>
Total routes	15 (21)	25 (27)

Source: CC analysis.

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*Note:* Existing numbers of Controlled Routes listed in brackets. The changes account for the Proposed Withdrawals (seven routes), one of which is controlled both in hours and out of hours.

5.3 For the reasons set out in paragraphs 4.65 to 4.67, we are, however, not minded to vary the Undertakings so as to modify the process by which FirstGroup can request changes to the Controlled Routes. We consider it appropriate that matters relating to modifications and withdrawals continue to remain the judgement of the CC based on the OFT's advice, as envisaged in the Act.

### **Next steps**

5.4 Any representations in relation to this provisional decision should be made by 31 August and sent to: T J Oyler, Remedies Manager, Competition Commission, Victoria House, Southampton Row, London WC1B 4AD, or email: [tim.oyler@cc.gsi.gov.uk](mailto:tim.oyler@cc.gsi.gov.uk).

5.5 Following this consultation period, we will issue a final decision alongside draft revised undertakings. Subject to further representations, these draft revised undertakings will incorporate the proposed variations in paragraph 5.1. The draft revised undertakings will be consulted upon for 15 days, as contemplated in Schedule 10 of the Enterprise Act 2002, before being amended as appropriate and accepted.