

**Notice of provisional decision to retain Undertakings given pursuant to section 88 of the Fair Trading Act 1973 following the acquisition by FirstBus plc of S B Holdings Limited**

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## Summary

1. In December 2005 FirstGroup plc (First) applied to the Office of Fair Trading (the OFT) for release of the undertakings it gave following its acquisition of SB Holdings Limited (SBH) in 1996. This acquisition was the subject of a reference to the Monopolies and Mergers Commission (MMC), which found that it may be expected to operate against the public interest. Although the MMC recommended a divestiture remedy, following the entry of Stagecoach into the Glasgow bus market, the Secretary of State for Trade and Industry decided instead to pursue behavioural undertakings, which were agreed in 2002. These undertakings require First not to raise bus fares in excess of the Retail Price Index (RPI) in either the First Glasgow or the First Edinburgh operating areas. They also require First in the First Edinburgh operating area to operate a mileage of at least 95 per cent of the mileage that First was operated in January 2002, not to increase commercial competition against tendered services where First was unsuccessful in bidding for the tender and to operate even spacing of new commercial services between those of competitors. Further fare and frequency obligations had also been placed on First but these expired in January 2005.
2. First submitted its application for release to the OFT in December 2005. The OFT submitted its report and recommendation to the Competition Commission (the CC) in December 2006. The OFT concluded that there had been a change of circumstance and recommended to the CC that it release First from the undertakings. Taking into account all the evidence it has seen, the CC has provisionally decided that the change of circumstance identified by the OFT is not sufficient to release First from the undertakings.
3. The CC noted First's arguments and the OFT's report, and has considered carefully the OFT's view that the change of circumstance was sufficient to justify First's release from the undertakings. The CC has noted First's argument that the MMC's adverse finding in 1997 focused on the loss of potential competition rather than actual competition, that this loss had been small and that the entry of Stagecoach into the Glasgow market following publication of the MMC's report demonstrated that the MMC had overestimated the extent of the loss of potential competition, which had been taken into account in the Secretary of State's decision to pursue behavioural remedies. The CC also noted First's view that there had been substantial actual new entry and expansion and that this provided a much more effective competitive constraint than the potential competition that had existed before the merger. However, the CC did not see evidence that allowed it to conclude that the competitive constraint lost as a result of the merger has been restored. In particular, the CC noted that although there has been entry and expansion by existing operators in the First Edinburgh and—more so—the First Glasgow operating areas, First's market shares in most of the unitary authority areas in these two operating areas remain high in relation to other operators such that it is unlikely that the competitive conditions absent the merger have been substantially restored. The CC also noted that the entry of Stagecoach into the Glasgow market resulted in very limited penetration and that the apparent failure of a large operator with an existing presence in Scotland, to expand into the market could be seen as demonstrating the difficulties of successful entry. In addition, the CC saw little evidence that First's behaviour shows it responding to competition, at least in the way that First has said it responds to competition.
4. The CC considered whether the undertakings may be having a distortive effect on the bus markets in the First Glasgow and the First Edinburgh operating areas. The CC considered it likely that capping fare increases at RPI over a period of time when bus industry costs have risen at a faster rate than RPI will have resulted in First's

fares on some routes no longer covering the costs of operating those routes. The CC also considered that it was possible that the mileage floor may be requiring First to run services that do not recover their costs of operation. Rather than suggest the release of the undertakings, the CC considered that these distortions could be dealt with by means of a variation to the undertakings.

5. The CC would be sympathetic to an application to vary the fare cap in such a way as to constrain fares by reference to an index more closely related to bus industry costs than RPI. The CC suggested that such an index may be based on a weighted average of the price of diesel-engined road vehicles (DERV) (ie a fuel escalator), the average earnings index, and RPI, where the weights are based on the distribution of First's costs. The CC would also be sympathetic to an application to vary the undertakings in respect of the mileage floor so that First was not required to operate services that it could demonstrate had persistently failed to recover their direct costs of operation and were unlikely to do so. First has not applied for any variation of the undertakings and has instead argued exclusively and consistently for their release.

## Introduction

6. On 24 January 1997 the MMC published its report into the acquisition by FirstBus plc (FirstBus) of 100 per cent of the issued share capital of SBH.<sup>1</sup> The MMC found that the acquisition operated or may have been expected to operate against the public interest. Specifically, the MMC found that in the deregulated bus market, actual and potential competition from large adjacent bus operators was the main safeguard against abuse of a dominant position and that, following the merger, this element would be significantly reduced for the foreseeable future. It noted that FirstBus was by far the largest operator in central and south-east Scotland where SBH supplied 40 per cent of the bus services and FirstBus's other subsidiaries 21 per cent. It concluded that the scale and dominance of FirstBus/SBH in central and south-east Scotland was likely to deter competition with SBH from the two other large adjacent operators, Stagecoach Holdings plc (Stagecoach) and Cowie Group PLC and that it would also deter entry by others. The MMC did not believe that the remaining constraints would put sufficient pressure on FirstBus to ensure that fares and subsidies were kept down and the frequency of services maintained. The MMC did not believe that there were likely to be benefits to the public interest arising from the merger such as to offset the detriment to competition. It therefore concluded that the merger was against the public interest.
7. In its report, the MMC recommended that behavioural remedies would be inadequate to remedy the adverse effects identified. Neither did the MMC believe that the divestiture of the enlarged Midland Bluebird would be sufficient to restore potential competition. The MMC therefore recommended that FirstBus should divest to a single buyer approved by the Secretary of State:
  - (a) the enlarged Midland Bluebird; and
  - (b) part of the SBH business including, as a minimum:
    - (i) one of the four central Glasgow depots and associated assets;
    - (ii) a network of routes spread reasonably over Glasgow representing 20 per cent of SBH's turnover; and

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<sup>1</sup>CC (1997), *FirstBus plc and SB Holdings Limited: A report on the merger situation*, cm 3531, is available at: [http://www.competition-commission.org.uk/rep\\_pub/reports/1997/395firstbus.htm#full](http://www.competition-commission.org.uk/rep_pub/reports/1997/395firstbus.htm#full).

- (iii) a bus fleet appropriate to service these routes.
8. The Director General of Fair Trading recommended the acceptance of the MMC's recommendations, with the slight revision that the routes sold should be those associated with the depot sold. On 24 January 1997, the then Minister for Corporate and Consumer Affairs announced that he accepted the Director General of Fair Trading's advice and requested him to seek undertakings to give effect to the MMC's recommended remedies. Following the general election and change of Government in May 1997, First formally approached the new Minister for Competition and Consumer Affairs requesting that he reconsider his predecessor's decision to accept the Director General of Fair Trading's advice to accept the MMC's recommendations. On the request of the new minister, the OFT undertook a review of the Scottish bus market and the MMC's recommendations. On 13 November 1997, the Director General of Fair Trading advised the new minister that, while he considered it no longer necessary for First to divest the Glasgow depot (and routes) he considered that the divestiture of Midland Bluebird remained necessary.
9. On 31 July 1998, the Secretary of State for Trade Industry Margaret Beckett announced that she had decided not to seek divestiture undertakings from First and that she would seek instead a package of behavioural undertakings.<sup>2</sup> In taking this decision, the news release states that, she took the view that that Stagecoach's entry into the Glasgow bus market shortly after the MMC's report materially altered the facts as perceived by the MMC. Although on a relatively small scale, the Secretary of State considered that Stagecoach's entry was a demonstration that competition in the relevant market was possible. The Secretary of State had remaining concerns that the scale and dominance of First following the merger may deter entry by others, but considered that these could be dealt with by behavioural undertakings.
10. Following a period of negotiation, in January 2002, the Secretary of State accepted undertakings from First (the undertakings).<sup>3</sup> These undertakings comprised the following main elements:
- (a) a fare cap, covering the routes within those local authority areas within the SBH (now known as First Glasgow) and enlarged Midland Bluebird and Lowland (now together known as First Edinburgh) operating areas where combined shares of supply exceeded 40 per cent, comprising a fare freeze for 24 months and increases of no more than the increase in RPI for the previous year; and
  - (b) anti-predation undertakings, covering only the enlarged Midland Bluebird and Lowland (now First Edinburgh) operating areas where combined shares of supply exceeded 40 per cent, including:
    - (i) fare and frequency obligations (which time-expired in January 2005), where a competing service had ceased to operate;
    - (ii) even spacing of new commercial services between those of competitors' services;

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<sup>2</sup>The press release relating to this decision can be found at: <http://www.gnn.gov.uk/Content/Detail.asp?ReleaseID=38882&NewsAreaID=2&NavigatedFromDepartment=True>.

<sup>3</sup>The OFT's advice to the Secretary of State in respect of her acceptance of these undertakings can be found at: [http://www.of.gov.uk/advice\\_and\\_resources/resource\\_base/Mergers\\_home/mergers\\_fta/mergers\\_fta\\_advice/firstgroup](http://www.of.gov.uk/advice_and_resources/resource_base/Mergers_home/mergers_fta/mergers_fta_advice/firstgroup). This advice also sets out developments between the MMC's report and the date of the advice.

<sup>4</sup>The fare and frequency obligations are designed to prevent predation to drive out a competitor and then raising prices and reducing frequency subsequently. The obligations in relation to even spacing and not increasing commercial competition against tendered routes are designed to prevent retaliation by First against competitors on other routes.

- (iii) commercial competition not to be increased against tendered services in areas where First has been unsuccessful in tendered bids; and
- (iv) minimum total registered commercial mileage (no less than 95 per cent of January 2002 levels), as an adjunct to the fare cap in the enlarged Midland Bluebird and Lowland operating area.

## **OFT recommendation**

11. On 16 December 2005, First submitted a request to the OFT for release from the undertakings. The OFT reviewed this request and, in accordance with section 88(4) Fair Trading Act 1973, as amended, submitted its advice to the CC on 13 December 2006.<sup>5</sup>
12. In the light of its review of First's application, the responses received to its consultation, and its own analysis, the OFT recommended that the CC release First from the undertakings, subject to the anti-predation undertakings being phased out over a limited period of time following the CC's final decision (the recommendation). The OFT noted that the First Edinburgh anti-predation undertakings in relation to fares and frequencies (see paragraph 10(b)) had never, as far as it was aware, been triggered and were therefore effectively time-expired.
13. In its report, the OFT identified a change of circumstance in the First Glasgow area consisting of actual entry from Stagecoach (which indicated a greater potential for Stagecoach to expand its presence in Glasgow than the MMC had understood in 1997) and entry and expansion by a number of small operators. It considered that this change of circumstance was sufficient to release First Glasgow from the fare cap in this area.
14. In reviewing First's application for release the OFT considered whether there had been a change of circumstance such that the degree of competition in the First Glasgow and/or First Edinburgh areas now meant that there was less need for the undertakings to remain in place. The OFT considered whether the appropriate benchmark against which to assess these indicators was the date of the MMC report (ie 1997, ie before the entry of Stagecoach) or the date of the undertakings (ie 2002, ie after the entry of Stagecoach). It decided that this entry might indicate that the potential for competition from Stagecoach might be greater now than the MMC had considered at the time of its report.
15. The OFT also identified a change of circumstance in the First Edinburgh area consisting of the growth of Lothian<sup>6</sup> in Midlothian and West Lothian (both within what was the Lowland operating area) and, more importantly, the relative success of smaller operators in the Scottish Borders (in the old Lowland operating area) and Sterling (in the old Midland operating area). It considered that this change of circumstance was sufficient to release First Edinburgh from the fare cap in this area.
16. The OFT acknowledged the concern expressed by some local authorities that release of the mileage floor could result in First deregistering a number of loss-making services, which may then fall to them to maintain. However, the OFT was of the view that the removal of the fare cap would remove the need for any mileage cap (as there would no longer be a need to prevent First from reacting to the price cap by cutting services). It also noted the view of some local authorities that First may be

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<sup>5</sup>The OFT's report submitted to the CC can be found at: [http://www.of.gov.uk/shared\\_of/mergers\\_ea02/361227/FirstBus.pdf](http://www.of.gov.uk/shared_of/mergers_ea02/361227/FirstBus.pdf).

<sup>6</sup>Lothian is the trading name of the bus operator Lothian Regional Transport.

inhibited from deregistering services even in the absence of a mileage floor because it would be uncertain that it would win any tender for those services. The OFT therefore considered that the changes of circumstance it had identified in respect of the First Glasgow area and the First Edinburgh area were sufficient also to justify release of the mileage floor.

17. In considering whether to recommend the release of the remaining anti-predation undertakings in the First Edinburgh area (ie those relating to even spacing of new commercial services and not increasing competition against tendered contracts lost) the OFT noted that there may be some wider benefit from these, and that smaller competitors may welcome them. However, the OFT stated that it must consider whether these undertakings were required to address any continuing adverse effects of the merger. It noted that there had been entry and expansion by smaller competitors in the First Edinburgh area and that the merger had not therefore deterred entry and expansion by smaller operators, but it recognized the presence of the anti-predation undertakings may have helped in this regard. The OFT also noted that the removal of the fare cap might provide First with an incentive to behave in ways against which smaller operators would require protection.
18. On balance, the OFT believed that the changes of circumstance it had identified warranted release from all the undertakings. In order to support and encourage increased entry expansion and survival of the small operators as they adjusted to First's being able to operate without the fare cap, the OFT recommended that the anti-predation undertakings in the First Edinburgh area be phased out over a period of 12 months.

### **Procedure before the CC**

19. First submitted its application for release from the undertakings to the OFT in December 2005. The OFT conducted an assessment of that application, including a public consultation, and submitted its report to the CC in December 2006. The CC considered the OFT's report in January 2007. Following that consideration, the OFT, at the CC's request, sought further information from First in relation to its costs and how they have changed in relation to the RPI and bus industry cost indices. First responded to this request in early February 2007. The CC considered the information provided by First in February and March 2007.
20. In April 2007 the CC wrote to First setting out its provisional decision in relation to its application for release. The letter stated that the CC did not consider the change of circumstance sufficient to justify release of the undertakings. However, the letter also stated that the CC had noted that there might be a need to vary the undertakings to allow First to increase fares at a rate that more closely reflected bus industry costs [redacted].
21. Later in April 2007, CC staff met with First and its advisers to explain the reasons for the CC's position. This meeting was requested by First following receipt of the CC's initial provisional decision. The CC gave careful consideration to First's request. In the light of the exceptional circumstances of this case, the CC agreed to arrange an oral hearing, at which First could state its case. At the end of April 2007 and in early May 2007, in advance of that meeting, the CC received submissions from First. In these submissions, First challenged the CC's approach to its request for release, provided updated market share data, provided more information on the role of smaller operators, provided more information in relation to its reaction to the entry of Stagecoach and Lothian, and reiterated its argument that the Competition Act 1998 rendered the anti-predation undertakings unnecessary.

22. The CC held a formal hearing with First in May 2007. At the end of May, First provided a further submission to the CC covering points raised at the hearing. This included a statement of how First responded to competition and data that, in First's view, illustrated how it had responded to competition on a number of routes in the First Glasgow area and the First Edinburgh area.
23. At the end of July 2007, the CC reconsidered its provisional decision (as set out in the April 2007 letter) in the light of the additional information provided by First since that date. This notice sets out the results of that consideration.

### **Notice of provisional decision not to follow recommendation**

24. The CC has provisionally decided not to follow the OFT's recommendation to release First from the undertakings. The CC has provisionally decided that the undertakings should be retained, although it would be sympathetic to a variation of the undertakings in order to rebase or recalibrate the fare cap and the mileage floor.
25. In reaching its provisional decision that the undertakings should not be released the CC considered whether the change of circumstance identified by the OFT—and the additional information provided by First in relation to that change of circumstance—had enabled it to conclude that there had been sufficient change in the costs and benefits associated with the undertakings such that they should be released. In considering this the CC considered whether the change of circumstance suggested that the changes in the market had restored the competition that had been lost as a result of the merger. The CC also considered whether the change of circumstance suggested that the undertakings had resulted in significant incremental costs in terms of distortions in the market. Changes in the costs and, or in the alternative, in the benefits associated with the undertakings might be sufficient to make their retention inappropriate.
26. The CC's provisional decision is that the change in circumstance identified by the OFT is not sufficient for it to accept the OFT's recommendation to release the undertakings. The remainder of this provisional decision sets out the CC's reasons for its provisional decision, covering the legal framework, and the CC's consideration of the change of circumstance in relation to whether it has restored the level of competition lost as a result of the merger and in relation to the distortive effects of the undertakings in turn. It concludes by setting out the CC's overall assessment of whether the change of circumstance identified is sufficient to justify release.

### ***The legal framework***

27. The undertakings were given by First and accepted by the Secretary of State under section 88 of the Fair Trading Act 1973. Under the Enterprise Act 2002 (the Act) power to supersede, vary or release undertakings under section 88 passed from the Secretary of State to the CC, subject to the designation of the relevant undertakings by an order made by the Secretary of State. The relevant provisions are found in paragraph 16 of Schedule 24 to the Act. The undertakings, described as 'The undertakings given to the Secretary of State by Firstgroup plc following the report of the Commission entitled "FirstBus plc and S B Holdings Limited: A report on the merger situation"', were designated in the in The Enterprise Act 2002 (Enforcement Undertakings and Orders) Order 2006 (SI No.355/2006).

## ***The assessment of competition***

28. First has argued that in assessing competition the CC should consider not whether there existed in the relevant areas some absolute level of 'effective competition' but should rather consider whether the undertakings are remedying, mitigating or preventing the substantial lessening of competition caused by the original merger (to the extent that such a substantial lessening still persists). First said that, in its view, the degree of competition that had been lost as a result of the merger was small. It noted that the MMC's adverse finding had been based on the loss of potential, rather than actual competition. It considered that the entry of Stagecoach following publication of the MMC's report demonstrated that the MMC had overestimated the extent of the loss of potential competition, and that this was borne out by the Secretary of State's decision to seek behavioural undertakings rather than divestiture undertakings. In First's view, there had been substantial actual new entry and expansion since 1996 and this provided a much more effective competitive constraint than the potential competition that existed prior to the acquisition.
29. The OFT's recommendation that the CC release First from the undertakings relating to the First Glasgow area was based on its view that the entry and expansion of smaller operators and the greater potential for expansion by Stagecoach meant that the market was more contestable both than the MMC had thought in 1997 and than when undertakings were accepted in 2002.
30. The CC considers that, in assessing whether the change of circumstance identified by the OFT is sufficient to release the undertakings, it must consider whether the change of circumstance has restored that level of competition lost as a result of the merger. Ideally, this would be assessed by comparing the situation absent the merger (ie the counterfactual) with the situation in which the merger has taken place. However, as the situation absent the merger is not observable, it is not possible to do this literally. In standard merger analysis it is possible for the CC to reach a view on the counterfactual. In this case, the merger took place more than ten years ago. The CC has therefore concentrated its consideration of whether the change of circumstance identified by the OFT has restored the level of competition lost as a result of the merger on the implications of observable changes in relation to bus operations in the First Glasgow area and the First Edinburgh area. It has considered both changes from the date of the MMC's report (1997) and from the date of acceptance of the undertakings (2002). In considering whether those changes have been sufficient to restore the level of competition lost as a result of the merger, it has weighed the evidence in the round.
31. In its assessment of the change of circumstance in respect of competition in the First Glasgow and First Edinburgh areas, the OFT considered a number of indicators of the degree of competition: changes in turnover, changes in fleet size, changes in registered mileage, new entry and expansion, changes in the relative success of new entrants or services, direct competition from overlapping services, and tendered services. The OFT also considered the views of third parties. In deciding what, if any, action is appropriate on the basis of the change of circumstance identified by the OFT, the CC has also considered these indicators. The CC's view in relation to each is discussed below.
32. In considering any indicators that related to market share (eg turnover, fleet size, registered mileage) the CC considered both the change and absolute level of share held by First. This was important because taking account only of changes could be misleading. For example, whilst a change in share of 15 percentage points ([~~3~~]) may

look large<sup>7</sup> and may suggest an increase in competition, the current share of 75 per cent may also look large and may suggest that the current level of competition is insufficient to restore the lessening of competition that resulted from the merger.

33. During the CC's assessment of the OFT's advice to it, First made additional submissions directly to the CC. To the extent that these additional submissions involved new information or new argument as to the level of competition in the First Glasgow and First Edinburgh areas, which were not raised in the OFT's report, the CC's consideration of them is set out below, following its consideration of the indicators discussed in the OFT's report.
34. This section concludes with the CC's assessment of the change of circumstance in respect of competition.

### *Changes in turnover*

35. The OFT noted in its report that turnover figures in relation to the Scottish bus market as a whole (1996 as against 2003) indicated that First had lost share both to Stagecoach and Lothian. The CC noted first that these comparisons related only to particular points in time (1996 and 2003) and did not show movements across time, no data had been provided that allowed trends over time to be observed. It was not therefore possible to know whether the changes shown by these data were in any way exceptional, for example, having been affected by factors specific to the year in question, or whether they were representative. While taking these data into account, the CC was not therefore able to place as much weight on them as it would have done had comparable data been available for other years as well, especially where such data allowed trends over time to be observed. The 'snapshot' nature of this data is common with other data provided by First in support of its application, and so this difficulty recurs throughout the CC's analysis. The CC considers that while the data may provide a crude indicator suggesting an increased competitive constraint over time, they are not sufficient to demonstrate this conclusively.
36. Second, the CC noted that these comparisons used measures that related to Scotland as a whole and not to the First Glasgow or First Edinburgh areas. The CC therefore could not infer with any confidence from these comparisons that there had been an increase in competition either from 1997 until now or from 2002 until now. In addition, the CC also noted that the changes shown were not shown as being a response to competition.

### *Changes in fleet size*

37. The OFT has, in its report, noted changes in First's fleet size compared with the fleet size of its competitors. In 1996 First had held 51 per cent of the fleet used in the First Glasgow area with what First referred to as its 'actual and potential competitors' holding 49 per cent whereas in 2005 First had 39 per cent with 'actual and potential competitors' having 61 per cent. In 1996 First had a 64 per cent share of the total fleet in Glasgow while what First saw as its 'main competitors'<sup>8</sup> had a 36 per cent share. By 2003 this relative position had shifted, with First having a 47 per cent share

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<sup>7</sup>Using the latest figures provided by First (which have not been verified by the other operators). First's share in City of Glasgow fell by 15 percentage points but this change covers an 11-year period (1996 to 2007).

<sup>8</sup>'Main competitors' refers to those operators in actual competition with in the Glasgow area. First provided fleet sizes for what it considered to be its actual and potential competitors in the area. This showed First as having 64 per cent share of the Glasgow fleet and its competitors as having a 36 per cent share. However, First's figures included all operators present in the area. It is not clear whether this included fleets of tendered services or only those on commercial operations.

and its 'main competitors' a 53 per cent share, which remained the position in 2005/06.

38. To some extent this does suggest an increase in the capacity of First's main competitors to constrain First through entry or the threat of entry. However, the data provided only allowed for comparisons of particular points in time; no data had been provided that allowed trends over time to be observed. This presented the same difficulty as in relation to changes in turnover (discussed in paragraph 36); it may have been the case, for example, that in the years preceding 2005/06 First's competitors' fleet sizes were much smaller than First's so that the relativity suggested by the 2005/06 data is unusual. The CC was not therefore able to place as much weight on them as it would have done had comparable data been available for other years as well, especially where such data allowed trends over time to be observed. In relation to fleet sizes, the CC considered that while the data may provide a crude indicator suggesting an increased competitive constraint over time, they are not sufficient to demonstrate this conclusively.
39. As the OFT noted in its report that it was not possible to see how the fleet sizes in the First Edinburgh area had changed over time due to incompatibility of the data sets from 1996, 2003 and 2005. However, the OFT did note that some competitor's fleets had expanded, a number of smaller competitors had exited and others had entered the market. The same information was not provided for the First Edinburgh area and it was not possible for the OFT to say how First's share of all fleet in the area had changed over time.

#### *Changes in registered mileage*

40. The OFT noted in its report that First's estimates of registered mileage in the First Glasgow area showed a substantial loss of share for First in most areas as compared with the position in 1996. However, as the OFT pointed out, its share in two out of the six unitary authority areas had changed by only a small percentage [%]. The CC also noted that even in those areas where First's share had decreased significantly, its share remained high. In [%] per cent. In [%] per cent.
41. In addition, the CC noted that First remained by far the largest single operator in all of these unitary authorities in the First Glasgow area covered by the undertakings. Stagecoach's highest share in these unitary authorities in the First Glasgow area is [%] less than one-third of First's. Arriva's highest share in these unitary authorities in the Glasgow area is [%] per cent, less than one-quarter of First's. In City of Glasgow Stagecoach and Arriva each have low shares of mileage, [%]. In North Lanarkshire Stagecoach has a low share of mileage, with [%] per cent. Given that First remained by far the largest single operator across the First Glasgow area, and given that the mileage shares of Stagecoach and Arriva remained low, the CC doubted that the figures provided suggested an increase in competitive constraint in the First Glasgow area that would have restored or helped to restore that lost as a result of the merger.
42. In addition, the CC noted that these changes in market share had been calculated by comparing First's mileage in one four-week period in October 2005 with its mileage in one four-week period in April 1996. Thus, the data only compared two particular points in time, with the difficulties discussed in paragraph 36. Furthermore, the CC noted that the shares of registered mileage used in the OFT's report were estimates provided by First. The OFT had attempted to verify those estimates, by sending them to Stagecoach, Arriva and the Scottish Transport Commissioner. Only Stagecoach replied, and expressed doubt about the accuracy of the some of the estimates (Stagecoach's concerns have been noted below in relation to specific estimates). Given this, and given that the OFT was not able to check all the estimates provided

by First, the CC had continuing concerns about their reliability. Given these difficulties with the data, the CC is even less confident that it can infer from these figures the emergence of a competitive constraint over time in the First Glasgow area that would have restored or helped to restore that lost as a result of the merger.

43. In relation to the First Edinburgh area, the OFT noted that First submitted that in five of the seven unitary authorities it had lost market share to other operators, in some cases almost [redacted] per cent. The most significant loss appeared to have occurred in [redacted], where First's share of mileage was [redacted] per cent in 1996 but had dropped to [redacted] per cent in 2005. The majority of this loss in share appeared to have resulted from gains by [redacted], whose share over the same period had increased by a significant amount from [redacted] to [redacted] per cent. [redacted] had also entered the market, but by 2005 had achieved only small share of [redacted] per cent. First's share in [redacted] also appeared to have fallen. In [redacted] First's share fell from [redacted] per cent in 1996 to [redacted] per cent in 2005, in the [redacted] from [redacted] per cent in 1999 to [redacted] per cent in 2005 and in [redacted] from [redacted] per cent to [redacted] per cent. In [redacted], First's share was almost at the same high level in 2005 [redacted] as in 1996 [redacted] and in [redacted] First's share was at the same high level ([redacted] per cent) in 2005 as in 1996.
44. The CC considered that the market share figures provided for the Edinburgh region presented a mixed picture. In four out of the seven unitary authorities First's share appeared to have fallen significantly, although in three of these four areas it was still very high. As the OFT noted in its report, the 95 per cent mileage floor to which First is subject must mean that First's loss of mileage share is largely the result of expansion by other operators. But in all the unitary authorities except one (ie [redacted]), First was still by far the biggest single operator in 2005. The CC was therefore not persuaded that the figures presented suggested an increased competitive constraint on First that would have restored or helped to restore that lost as a result of the merger. In addition, the CC noted that the data provided only allow comparison between two points in time, resulting in the difficulties discussed in paragraph 36.

#### *New entry and expansion*

45. First stressed in its submission that Stagecoach opened a depot in Glasgow soon after the MMC's report was published and that at the time of First's submission to the OFT operated five services in competition with First, concentrating on the most profitable routes. In its report to the CC, the OFT included new entry and expansion as an element of the change of circumstances it identified. However, it did not include entry and expansion by Stagecoach as an example of such new entry and expansion.
46. The CC noted that the decision of the Secretary of State in 1998 to seek behavioural rather than structural undertakings from First was taken on the basis that Stagecoach's entry into the Glasgow bus market had materially altered the facts as perceived by the MMC. Thus, given that the decision to put in place the existing remedies was taken after Stagecoach's entry, the CC considered that it would not be appropriate to take account of the entry of Stagecoach when considering whether the change of circumstance was sufficient to justify release of those remedies.
47. Notwithstanding this, has taken account of the history of Stagecoach's participation in the market. The CC the CC noted that Stagecoach's penetration of the First Glasgow area appeared to have been very limited. The mileage figures included in the OFT's report show that in April 1996 Stagecoach had not entered [redacted], had a share of only [redacted] per cent in four unitary authority areas (ie [redacted], [redacted], [redacted], and [redacted]) and only in one unitary authority area ([redacted]) had a achieved a significant share of mileage, where it had [redacted] per cent. The figures for October 2006 showed a much smaller

Stagecoach operation in the First Glasgow area. Although its shares in two unitary authority areas (ie [redacted] and [redacted]) had risen to [redacted] per cent and [redacted] per cent respectively, its shares elsewhere had fallen. The figures showed no mileage in four unitary authority areas (ie [redacted], [redacted], and [redacted]). In [redacted], where Stagecoach had appeared strongest in 1996, its share had fallen considerably to [redacted] per cent. Although Stagecoach's entry demonstrated that entry was possible in the First Glasgow area, the CC could not infer from these mileage share figures an increase in the competitive constraint posed by Stagecoach on First. Indeed, the CC noted that the apparent failure of Stagecoach—a large operator with an existing presence in Scotland—to expand in Glasgow could be seen as demonstrating the difficulty of successful entry sufficient to impose a significant constraint.<sup>9</sup>

48. Furthermore, since these figures provided only a comparison of particular points in time they presented the CC with the same difficulties as discussed in paragraph 36.
49. As the OFT noted in its report, First submitted that 16 smaller operators had entered or expanded their operations in the First Glasgow area and were still operating, while only four had exited. First particularly noted the examples of McKindless and Caledonia, which it said had entered or expanded significantly since the merger.
50. The CC noted the entry and expansion by other operators in the First Glasgow area. Generally, in assessing whether bus operators are actual competitors to one another, the CC considers the relative frequency of their services and the proportion of the route on which the other operator competes.<sup>10</sup> This was not possible in this case as timetables for the relevant services had not been provided. This analysis is discussed further in the context of direct competition on overlapping services below, see paragraph 63 et seq.
51. As noted above, mileage figures were not provided specifically for these operators so it has not been possible to observe the size of their operations in the Glasgow area over time. However, the mileage comparisons provided in the OFT's report did include 'other operators'. The CC noted that in five out of the six unitary authorities in the Glasgow area, the share of mileage enjoyed by other operators appeared to have risen between 1996 and 2005. In 2005 in [redacted] other operators accounted for [redacted] per cent of mileage, up substantially (by [redacted] percentage points) from 1996. In 2005 in [redacted] they accounted for [redacted] per cent of mileage, up substantially (by [redacted] percentage points) from 1996, in [redacted] per cent up [redacted] percentage points, in [redacted] per cent up substantially (by [redacted] percentage points) and in [redacted] [redacted] per cent up by [redacted] percentage points. Only in [redacted] was there no change, with other operators' share remaining at [redacted] per cent.
52. This did suggest a significant increase in the presence of smaller operators in the Glasgow area. However, it was not possible to use these mileage figures to illustrate the impact of the competitors First had specifically mentioned. It was also important

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<sup>9</sup>In its report into FirstGroup's acquisition of the Scotrail franchise, the CC noted that First appeared successfully to have fended off Stagecoach's entry. See CC (2004) *First Group 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 plc*, paragraphs 4.40, 5.55. The CC's view that the failure of Stagecoach, the UK's second largest bus operator, to enter the Glasgow area on a significant scale suggested the difficulty of network entry is set out in *First/Scotrail* paragraph 5.59.

<sup>10</sup>See for example *First/Scotrail* paragraph 5.12-5.13, available at: [http://www.competition-commission.org.uk/rep\\_pub/reports/2004/490firstgroup.htm](http://www.competition-commission.org.uk/rep_pub/reports/2004/490firstgroup.htm). The same approach was also used in the CC's analysis in CC (2005) *Arriva plc and Sovereign Bus and Coach Company Limited. A report on the acquisition by Arriva plc of the Sovereign Bus and Coach Company Limited* (available at: [http://www.competition-commission.org.uk/rep\\_pub/reports/2005/496arriva.htm](http://www.competition-commission.org.uk/rep_pub/reports/2005/496arriva.htm)), CC (2007) *Stagecoach and Scottish Citylink. A report on the completed joint venture between Stagecoach Bus Holdings Limited and Braddell PLC in relation to megabus.com, Motorvator and Scottish Citylink* (available at: [http://www.competition-commission.org.uk/rep\\_pub/reports/2006/516citylink.htm](http://www.competition-commission.org.uk/rep_pub/reports/2006/516citylink.htm)) and CC (2006) *FirstGroup plc and the Greater Western Passenger Rail franchise. A report on the acquisition by FirstGroup plc of the Greater Western Passenger Rail franchise* (available at: [http://www.competition-commission.org.uk/rep\\_pub/reports/2006/510western.htm](http://www.competition-commission.org.uk/rep_pub/reports/2006/510western.htm)).

to note that, as discussed previously in relation to the mileage shares of Stagecoach and Arriva (see paragraph 42), the mileage figures showed that First was still by far the biggest single operator in each of the unitary authority areas and across the Glasgow area as a whole.

53. The CC noted the possibility that these other operators having increased their presence in the First Glasgow area may suggest an increase in the level of potential competition faced by First in the area.<sup>11</sup> However, the CC noted that these small operators still had a very limited share of mileage in the various Glasgow unitary authorities. As previously noted (see paragraph 48) the CC considered that the failure of Stagecoach to expand beyond a very limited share of mileage in the First Glasgow area may also have the effect of making entry or expansion by other operators less likely. The CC was therefore not persuaded that the increase in the mileage share of other operators in the First Glasgow area suggested an increase in the level of potential competition faced by First that would have restored or helped to restore that lost as a result of the merger.
54. Furthermore, the availability of mileage figures allowing only comparisons between particular points in time raised the difficulties discussed in paragraph 36.
55. In the First Edinburgh area, the OFT noted in its report that First stated that it faced increased competition from Lothian. First have stated that in aggregate Lothian compete along the whole of the route. As an example of the increased competition in West Lothian First has cited services operated by Davidson and Horsburgh. In the Scottish Borders, First said that Munro's had introduced new services that competed on eight of its services in this area and that since 2002 Munro's had been competing with it along the whole length of three local commercial services, matching First's frequencies. In Stirling, Falkirk and Clackmannanshire, First noted that ten independent operators had introduced new services in competition with it.
56. As in relation to the First Glasgow area, the CC noted that there had been entry and expansion by other operators in the First Edinburgh area, although there appeared to be less in the First Edinburgh area than in the First Glasgow area. However, as in relation to the First Glasgow area, it was not possible in this case to consider relative service frequencies as timetables for the relevant services were not provided.
57. Mileage figures were not provided specifically for these new entrant operators so it was not possible to observe the size of their operations in the First Edinburgh area over time. However, the mileage comparisons provided in the OFT's report did include 'other operators'. 'Other operators' in West Lothian, the Scottish Borders and Stirling have increased their mileage share by between 10 and 30 percentage points ([X] percentage points, [X] percentage points, and [X] percentage points respectively). In Falkirk there was very little change in mileage shares. These figures may suggest a significant expansion by smaller operators in West Lothian, the Scottish Borders and Stirling. However, the data provided only permit comparisons of particular points in time, raising the difficulties discussed in paragraph 36.
58. The CC noted the possibility that these other operators having increased their presence in the First Edinburgh area might suggest an increase in the level of potential competition faced by First in the area.<sup>12</sup> However, the CC also noted that these small operators still had a very limited share of mileage in the various

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<sup>11</sup>The mileage comparisons are only provided as between 1996 and 2005, so it is not clear whether the same result would follow from a comparison of 2002 and 2006.

<sup>12</sup>The mileage comparisons are only provided as between 1996 and 2005, so it is not clear whether the same result would follow from a comparison of 2002 and 2006.

Edinburgh unitary authorities. The CC noted that the most significant expansion in the First Edinburgh area appeared to have come from Lothian. The OFT noted in its report that Lothian said that it did not intend to expand depot numbers or fleet size, although it did intend to increase service mileage. However, the CC considers that that Lothian's local authority ownership may limit its capacity to expand in geographical areas outside its home base and change its operations at short notice. The CC was not persuaded that the increase in the mileage share of other operators in the First Edinburgh area suggested an increase in the level of potential competition faced by First.

### *Success rate of new services*

59. In its report, the MMC had noted that the survival rate of new services introduced by small operators in the First Glasgow area in the three years prior to the merger was 53 per cent, with 58 instances of entry over the period and 31 still operating in 1996/97. Data provided by First in its submission to the OFT showed that in the period from 1996/97 to 2005/06 there were 77 new services<sup>13</sup> introduced in the First Glasgow area, of which 52 were still operating, suggesting a survival rate of 68 per cent over a longer period than that considered by the MMC.
60. In the First Edinburgh area, data on the survival rate of services run by smaller operators was not available, but data on new services in total shows that since 2003 there have been 39 instances of new entry, of which 28 are still operating, suggesting a survival rate of 72 per cent.
61. The CC considered that these data did suggest an increase in the survival rate for new services since the MMC's report. Since the extent to which the new services that had been introduced and that had survived compete with First is not clear, the data did not conclusively show an increase in actual competition faced by First or whether it would have restored or helped to restore the competitive constraint lost as a result of the merger. The CC considered that the increase in the survival rate of new entrants could suggest an increase in the potential for entry in competition with First. However, the CC noted that it was not clear in this context what was meant by 'service', in particular because operators varied in how they register services, with some, for example, registering a daytime service and an evening service on the same route as two different services, while others register both daytime and evening services together as a single service. In addition, the number of services may not take account of changes in the length or route of a service. Services in 2005/06 may therefore not be comparable to those in 1996/97 or 2002/03.

### *Direct competition—overlapping services*

62. The OFT included in its report data showing the extent of competition faced by First and also the share of First's total annual revenue accounted for by services on which it faced competition. The OFT noted that to evaluate changes in competition it would need the equivalent data for 1996/97, which was not provided by First or available elsewhere.
63. The OFT was able to conduct a limited comparison with 2003 data in relation to the First Glasgow area. This suggested that the number of services on which First faced no competition fell by 12 from 23 to 11, that on a further seven services the competition faced by First increased while remaining less than 50 per cent of the

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<sup>13</sup>It should be noted that these are new services rather new competitors.

length of the route, and that the number of services where First now experiences competition along more than 50 per cent of the length of the route has increased by four. The OFT noted that First's services in the First Glasgow area that faced competition across more than 50 per cent of their length were generating more revenue in 2005/06 than in 2003. First told the OFT that this was due to: fares having increased in line with RPI, increased revenues generally as a result of free concessionary travel, those services which now faced competition across more than 50 per cent of their length but did not in 2003 being higher revenue-generating routes, and those routes which faced competition across more than 50 per cent of their length in 2003 and still did in 2005/06 being those on which First had introduced improvements to grow passenger numbers.

64. The OFT noted in its report that even taking account of these factors it was not clear why revenues on routes where First faced competition along more than 50 per cent of the length of the route would have increased by more than revenue on other routes had increased. The CC noted that fare increases and the impact of free concessionary travel would have been expected to affect all routes regardless of the level of competition. The CC also noted that it was not clear why those services currently facing competition along more than 50 per cent of their route earned more revenue in 2006 than they had in 2003. The OFT noted that First appeared to have increased service levels in response to entry and that First had provided some evidence that its profits had decreased on a selection of routes following entry, despite an increase in total revenue.
65. The OFT undertook a similar comparison for the First Edinburgh area. The data that the OFT compiled for the First Edinburgh area showed a very small (1%) decrease in the share of revenue for which First faced no competition, although the number of its services that faced no competition had increased by 39. The data showed a small (2%) decrease in the share of revenue for which First faced competition along less than 50 per cent of its route, and an increase in the number of such routes by 11. The share of annual revenue accounted for by routes on which First faced competition along 51 to 99 per cent of their length increased significantly (by 15%) in 2006 compared with 2003. First argued that this was for the same reasons as it cited in relation to the First Glasgow area, and also because new entry since 2003 had tended to increase the annual revenue in those categories with the most extensive competition. First argued that entry had had the effect of increasing its revenue because entry encouraged First to take action to retain passengers and also because entry tends to be on higher revenue routes where scope for increasing revenue exists.
66. The CC was not convinced by these arguments. The CC was sceptical that First would have been performing so poorly on these high revenue earning routes that the effects on its revenue from improved performance outweighed the effect on its revenue of abstraction by the entrant. The CC also noted that if First responded to competition by lowering fares, this could increase passenger numbers but the effect on revenue would be offset by the lower fares each passenger would pay.
67. The CC noted that in the First Edinburgh area the data did not appear to show significant changes in the number of routes on which First faced competition across the various percentages of their length. The fact that revenue on routes on which First faced competition along 51 to 99 per cent of their length rose may suggest that First was not constrained by that competition, although the introduction of the

Scottish national concessionary travel scheme<sup>14</sup> makes it difficult to reach a conclusion on this point.

68. The CC further noted that in Table 7 of the OFT's report, changes in the level of competition are shown across a number of routes, making it difficult to observe the effects on individual routes, let alone flows.
69. In previous inquiries,<sup>15</sup> the CC has said that where a competing operator runs services that overlap with a particular flow and where its services operate with at least 50 per cent of the frequency, the operator is an effective competitor on that flow. Acknowledging that operators are constrained in what they can do on particular flows by what they do on the rest of the route, the CC has also said that where effective competition exists across overlaps that account for at least 10 per cent of route revenue, the operator will be considered to be constrained across the route as a whole.
70. The CC noted that, when the data provided by First were considered using this approach, it was not clear that First faced sufficient competition in the areas covered by the undertakings to warrant their release. There were several problems with the data provided by First. First, the data were not based on individual flows, which would have provided a better picture of the level of competition. Second, the geographical overlaps with First's routes were not provided by a single operator and in many cases refer to the combined effect of a number of smaller operators, which may not meet the definition set out in paragraph 69 above of an effective competitor in the way that one larger single competitor might. Third, there was no indication of the revenues generated on the sections of the route where there is an overlap.
71. Although First argued that competitors generally operated on the busiest section of the busiest routes, it could not provide evidence that this was the case. For these reasons, the data provided by First, though intended as proxies, may have overstated the level of competition it faced.
72. The CC considered that analysis of the extent to which First faced competition on its highest revenue earning routes, bearing in mind the relative frequencies of First's services and those of its competitors could have provided a useful indication of the extent of the competitive constraint faced by First, thereby providing an indication of whether—as First has suggested—the increase in actual competition that it faces in the First Glasgow and First Edinburgh areas has restored the level of competition lost as a result of the merger. However, this is not contained in the OFT's report to the CC.

### *Changes in tendered services*

73. As the OFT noted in its report, while competition in tendered services does not appear to have been a concern for the MMC in 1997, tendered services can provide a way for operators to enter into provision of commercial services.
74. The OFT noted in its report that, in the First Glasgow area, on the basis of the evidence available, it seemed plausible that First's share of the number of tendered services had declined since 1996. In the First Glasgow area, First operated ten out of 132 (7.5 per cent) tendered services in 2003 and at the time of the OFT's report

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<sup>14</sup>This scheme was introduced in April 2006, and enables free (subsidized) bus travel for many elderly and disabled people in Scotland.

<sup>15</sup>For example, *First/Scotrail*, *Arriva/Sovereign*, *First/Greater Western*, *Scottish Citylink*.

operated 12 out of 132 (9 per cent) tendered services. In its 1997 report the MMC noted that the ratio of bids to tenders in the First Glasgow area was 3.7. In 2005, First reported this ratio to be 3.5, which suggested little change.

75. In relation to the First Edinburgh area, First provided bid to tender ratios for each unitary authority. No area had a ratio of less than 3, two areas had ratios of 5 and one area had a ratio of 3. First also provided examples in Stirling, Falkirk and Clackmannanshire of smaller operators winning important tenders.
76. The OFT also noted that the MMC's view in 1997 was that there was an overall perception in Stirling and Clackmannanshire that there was insufficient competition between quality operators appears to contrast with current views. The OFT further noted that local authorities that commented on this in response to the OFT's consultation on First's application were of the view that smaller independent operators were a constraint on First when bidding for tendered services.
77. The CC considered that the lack of concern expressed by the MMC in 1997 in relation to tendered services suggested that any analysis of tendered services should focus on whether any changes suggested any greater constraint on First in relation to those services subject to undertakings (ie commercial services in the First Glasgow and First Edinburgh areas). Bid to tender ratios over time could provide an initial indication of the level of competitor activity that might be useful in assessing this. However, the CC noted that the bid ratio provided by First for the First Glasgow area showed little change from 1997 and that only current ratios were provided for the First Edinburgh area. Data that showed smaller independents winning a larger number of tenders than in 1996/97 or 2003 might have provided an initial indication of whether a greater number of operators had a larger base from which to enter into competition with First on commercial services. But, notwithstanding the OFT's view that it was plausible that First's share of tendered services had declined since 1996, no evidence was provided to show this. The data that were provided allowed a comparison between 2003 and 2005, which showed no significant change.

### *The views of third parties*

78. In relation to competition in the First Glasgow area, the OFT received responses from a number of competitors that had started operating services since 1997. One said that many bus operators had started new services since 1997, while another said that it had withdrawn three services since 1999 which had been unable to break into First's customer base sufficiently to survive. SPT said that smaller operators currently provided a constraint on First on most of the main corridors but that many operated older vehicles, which it noted was consistent with being unable to invest at current fare levels. SPT later said that there appeared to be no barriers to entry to new operators entering the 'West of Scotland' marketplace and that the number of competitive buses operating on local registered services had increased significantly since the undertakings were accepted (ie since 2002). It also said that passenger choice through this competitive position was evident and that there was a market driven range of all day and season ticket options, with market forces apparently determining price rather than reliance on the undertakings. However, SPT also reiterated its concern about the quality of some of the 'competitive interventions'.
79. The Scottish Executive said that there was no evidence of increased competition between larger operators but that small independent companies were fiercely competitive on the more commercial routes. The Scottish Consumer Council did not comment directly on the level of competition from other bus operators but it was against any release from the undertakings, considering that this would negatively affect consumers who rely on the bus.

80. The CC noted that the general view of third-party competitors was that the fare cap should be released or relaxed to allow all operators to increase fares in line with increasing costs. However, while not disregarding this evidence, the CC noted that it could be argued to be in the interests of First's competitors to take this position since a relaxation of the fare cap would allow First to raise fares thereby providing its competitors with greater scope to do so.
81. Overall, the CC considered that the third-party responses received by the OFT did not suggest any significant increase in the competitive constraint faced by First in the First Glasgow area either since 1996 or 2003 that would have restored or helped to restore that lost as a result of the merger. (The effect of the undertakings is considered separately below.)
82. In relation to the First Edinburgh area, the OFT noted that views on competition varied according to unitary authority area. In Stirling, First was considered to dominate commercial services, though with smaller operators' presence meaning that First did not have complete control of the most lucrative corridors. In Clackmannanshire, third-party responses suggested significant competition with Mackie's Coaches Monday to Saturday 08.00–18.00 and it was noted that Stagecoach had won a council contract in 2005 and was considered a likely entrant into commercial services. In Falkirk, First had lost a number of tenders. The local authority in Falkirk said that commercial services had been introduced in August 2005 and in January 2006, which operated between 09.00–18.00 Monday to Friday and which competed with some of First's high frequency services. In West Lothian, smaller operators were noted as having expanded their services and were thought to constrain First. In the Borders most mileage was provided under contract to the council, and the size and nature of the market were considered to mean First did not face competition on its commercial services other than in Hawick and Galashiels.
83. The OFT noted that three out of the six responses it received to its questionnaire from competitors had come from competitors who started services since 1997. Lothian said that it was not aware of any material change in the entry and exit of smaller operators, but believed that smaller operators can and do constrain larger operators.
84. The Scottish Executive commented that in the operating area previously served by Midland Bluebird there was continued competition from smaller operators but no apparent increased competition from larger operators. The Scottish Executive made no reference to the Lowland area. No consumer groups responded to the OFT's enquiries.
85. Overall, the CC considered that the third-party responses received by the OFT did not suggest any significant increase in the competitive constraint faced by First in the First Edinburgh area either since 1996 or 2003 that would have restored or helped to restore that lost as a result of the merger. There was some suggestion from third parties of increased competition for First in Clackmannanshire and West Lothian, but the CC was not persuaded of the significance of this, especially in the light of its assessment of other indicators of competition in those areas (see above). (The effect of the undertakings is considered separately below.)

#### *Evidence of competition provided to the CC by First*

86. While its application for release from the undertakings was before the CC, First provided further information directly to the CC. This concerned:
  - (a) updated mileage shares;

(b) First's response to competitive pressure,<sup>16</sup> and

(c) competition from private car.

87. Each of these new pieces of information provided by First is discussed in turn below.

#### *Updated market shares*

88. First provided the CC with market shares based on registered mileage<sup>17</sup> that had been updated to 2007, as compared with the 2005 shares it had provided in its submission to OFT. First also related the changes in shares to population density, both for the First Glasgow area and the First Edinburgh area.

89. The CC considered these updated market share data, taking into account both the changes in shares and the absolute level of share, as it had done in relation to those market share data provided in the OFT's report. The changes in share for the First Glasgow area and the First Edinburgh area are considered in turn below.

#### *Changes in market share: Glasgow*

90. First provided market shares based on registered mileage updated to 2007 as compared with 2005 in its submission to OFT and related the changes in shares to population density, for the First Glasgow area. Table 1 shows changes in First's share of registered mileage at the time of the merger, in 2005 (as provided in its submission to the OFT), and in 2007. Broadly, these data suggested a decline in First's share of registered mileage since 1996, although the extent of the decline varies between unitary authority areas. In one unitary authority area, these data suggested that First's share of registered mileage increased slightly from 1996 to 2005 and then declined to below the 1996 level in 2007. Table 2 shows the share of registered mileage held by other operators in the First Glasgow area in 1996 and 2007. Broadly, these data suggested that Stagecoach's shares of registered mileage had risen in three unitary authorities and fallen in three unitary authorities. They further suggested that Arriva's shares had remained the same in five unitary authority areas and declined in one unitary authority area. The data suggested that the share of 'other' operators had increased in all unitary authority areas. Since 1996 shares were not available for McKindless no comparison was possible. However, the data show McKindless as having in 2007 significant shares of registered mileage in three unitary authority areas.

TABLE 1 **Changes in First's share 1996, 2005 and 2007 in the First Glasgow area**

| <i>Unitary Authority area</i> | <i>SBH + MB&amp;L</i> | <i>First</i> | <i>First</i> | <i>Change in mileage share (%)</i> | <i>Population density 2001</i> |
|-------------------------------|-----------------------|--------------|--------------|------------------------------------|--------------------------------|
|-------------------------------|-----------------------|--------------|--------------|------------------------------------|--------------------------------|

<sup>16</sup>In its April 2007 provisional decision letter to First, the CC noted that the Secretary of State had already taken into account potential competition from Stagecoach when agreeing to the undertakings. First has said that it did not know exactly what the Secretary of State took into account when agreeing the undertakings as this had not been disclosed. First questioned whether the CC had information available to it that First did not have in relation to the Secretary of State's decision. In First's view, while Stagecoach's entry was clearly the prompt for the behavioural undertakings, it was not clear to First exactly what degree of competitive constraint the Secretary of State considered Stagecoach to exert at the time. First also noted that the Secretary of State could not have taken into account Stagecoach's activities since the agreement of the undertakings. First argued that the entry of Stagecoach indicated greater actual and potential competition, argued that the small operators provided actual competition to First where they overlapped with First's flows and potential competition where they did not, re-stated its argument that Lothian was an important actual and potential competitor, and restated its argument that the anti-predation undertakings were obsolete given the Competition Act 1998. However, the CC's view was that these points were contained in the OFT's report, that it has considered them in considering the OFT's report and that its views are set out in paragraphs 29 to 86.

<sup>17</sup>As noted in paragraph 43, the CC had concerns over use of registered mileage as a measure as these have been provided on the basis on estimates. Also whilst the OFT tried to verify the estimates it received, the latest estimates provided by First have not been verified. Stagecoach had contested some of First's earlier estimates.

|                     | 1996<br>(%) | 2005<br>(%) | 2007<br>(%) | 1996–2005 | 1996–2007 | (persons per<br>hectare) |
|---------------------|-------------|-------------|-------------|-----------|-----------|--------------------------|
| City of Glasgow     | 89+1        | [           | ]           | ✂         | ]         | 32.9                     |
| North Lanarkshire*  | 61+4        |             |             |           |           | 6.8                      |
| South Lanarkshire   | 65+0        |             |             |           |           | 1.7                      |
| East Dunbartonshire | 87+8        |             |             |           |           | 6.2                      |
| West Dunbartonshire | 80+2        |             |             |           |           | 5.9                      |
| East Renfrewshire†  | 48+0        |             |             |           |           | 5.1                      |

Source: First.

\*Stagecoach believes its 2005 share was overestimated by First: [✂].

†Stagecoach believes its 2005 share was overestimated by First: [✂].

Note: Percentages may not add up to 100 due to rounding.

TABLE 2 Shares held by other operators in 1996 and 2007 in the First Glasgow area

| Unitary Authority area | Stagecoach |      | McKindless |      | Arriva |      | Others |      |    |   |
|------------------------|------------|------|------------|------|--------|------|--------|------|----|---|
|                        | 1996       | 2007 | 1996*      | 2007 | 1996   | 2007 | 1996   | 2007 |    |   |
| City of Glasgow        | 1          | [    | N/A        | ]    | 3      | ]    | 7      | ]    |    |   |
| North Lanarkshire†     | 2          |      | N/A        |      | 0      |      | 33     |      |    |   |
| South Lanarkshire      | 2          |      | ✂          |      | 0      |      | ✂      |      | 33 | ✂ |
| East Dunbartonshire    | 1          |      | N/A        |      | 0      |      | 5      |      |    |   |
| West Dunbartonshire    | 0          |      | N/A        |      | 0      |      | 18     |      |    |   |
| East Renfrewshire†     | 14         |      | N/A        |      | 6      |      | 32     |      |    |   |

Source: First.

\*First does not have details of McKindless' mileage share in 1996 because it was a very small operator with only 18 buses and a handful of routes.

Note: Percentages may not add up to 100 due to rounding.

91. First argued that actual mileages operated in each area showed that relatively small falls in the share of mileage in the more populous areas (which have correspondingly higher levels of bus demand) would be much more significant than changes in mileage shares in the less populous unitary authority areas.
92. Table 3 shows the relationship between total registered mileage and the population density in the unitary areas of the First Glasgow area. The CC considered that this cast doubt on First's view that more populous areas had higher levels of bus demand. It was not clear to the CC that the relationship between changes in shares and population density (Table 1) was significant in the assessment of competitive constraint. East and West Dunbartonshire, which experienced the largest falls in First's share (over [✂] percentage points), had broadly the same population density (about six persons per hectare); First's share in three areas had declined by broadly similar and substantial percentages (between [✂] and [✂] percentage points) while the population density of these areas varied significantly (two had between five and seven persons per hectare and one had 33 persons per hectare); and South Lanarkshire, where First's experienced its smallest fall in share (of [✂] percentage points), had the smallest population density (about two persons per hectare). The latter could be explained if First were the only operator in these low density areas, and if no other operator were likely to enter, which would make it is less likely that First would have lost share in these areas than in the more populated areas. But this would not be the case for the other areas.

TABLE 3 Total registered miles and population density in the First Glasgow area

|                     | <i>Population density (2001)<br/>(persons per hectare)</i> | <i>Total registered<br/>miles</i> | <i>Rank of<br/>registered miles</i> |
|---------------------|--|-----------------------------------|-------------------------------------|
| City of Glasgow     | 32.9   | 3,060,966                         | 1                                   |
| North Lanarkshire   | 6.8  | 887,799                           | 2                                   |
| East Dunbartonshire | 6.2  | 170,301                           | 5                                   |
| West Dunbartonshire | 5.9  | 291,775                           | 4                                   |
| East Renfrewshire   | 5.1  | 68,103                            | 6                                   |
| South Lanarkshire   | 1.7  | 598,339                           | 3                                   |

Source: First.

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93. First's share of registered mileage fell in all but one area between 2005 and 2007. But the CC noted, as in its consideration of the market share evidence in the OFT's report, that although First's registered mileage had fallen since 1996 its share remains high (at or over 60 per cent) in four of the six unitary authorities. The updated market shares provided by First did not alter this assessment.
94. The CC considered specifically whether these changes in market share mean that competitive constraint lost as a result of the merger had been restored. In considering this, the CC considered market shares in one area (eg Glasgow) by comparing the current share of the largest operator in that area with the largest share held by First or SBH (eg SBH in Glasgow) and considered what threat these operators posed for the largest operator in the other area (eg First in Edinburgh). However, the CC noted that on the basis of these market shares no operator in the First Glasgow area had a share comparable with that of the old SBH, the nearest was in East Renfrewshire where the share of Stagecoach (22 per cent) is broadly half of the share of SBH in 1996 (which was 48 per cent).

*Changes in market share: Edinburgh*

95. First provided market shares based on registered mileage updated to 2007 (as compared with 2005 in its submission to OFT) and related the changes in shares to

population density, for the First Edinburgh area. Table 4 shows changes in First's share of registered mileage at the time of the merger, in 2005 (as provided in its submission to the OFT) and in 2007. Broadly, these data showed that First's share of registered mileage has fallen in five unitary authority areas. In one unitary authority area First's share had remained more or less the same, and in another unitary authority area First's share appeared to remain more or less the same from 1996 until 2005, then declining in 2007. Table 5 compares First's share of registered mileage with its competitors in the First Edinburgh area in 1996, in 2005, and in 2007. Broadly, these data showed that Stagecoach's share had risen in three unitary authority areas, and had remained the same in four areas. Lothian's share had risen in relation to three unitary authority areas and remained the same in four areas. The share of other operators had fallen in four unitary authority areas, had risen in three unitary authority areas and remained more or less the same in one unitary authority area.

TABLE 4 Changes in First's share 1996, 2005 and 2007 in the First Edinburgh area

| Unitary Authority area | SBH + MB&L 1996 (%) | First 2005 (%) | First 2007 (%) | Change in mileage share (%) |           | Population density 2001 (persons per hectare) |
|------------------------|---------------------|----------------|----------------|-----------------------------|-----------|---|
|                        |                     |                |                | 1996–2005                   | 1996–2007 |   |
| City of Edinburgh      | 0+25                |                |                |                             |           | 17.0  |
| Midlothian*            | 0+64                |                |                |                             |           | 2.3   |
| East Lothian           | 0+45                |                |                |                             |           | 1.3   |
| West Lothian           | 0+91                |                |                | ✂                           |           | 3.7   |
| Scottish Borders       | 0+88                |                |                |                             |           | 0.2   |
| Stirling               | 1+91                |                |                |                             |           | 0.4   |
| Falkirk†               | 4+86                |                |                |                             |           | 4.9   |
| Clackmannanshire‡      | 0+71                |                |                |                             |           | 3.0   |

Source: FG.

\*Stagecoach believes its 2005 share was overestimated by FG: [✂].

†Stagecoach believes its 2005 share was underestimated by FG: [✂].

‡Stagecoach believes its 2005 share was overestimated by FG: [✂].

Note: Percentages may not add up to 100 due to rounding.

TABLE 5 Shares held by other operators in 1996 and 2007 in the First Edinburgh area

| Unitary Authority area | Stagecoach |      | Lothian |      | Others |      |
|------------------------|------------|------|---------|------|--------|------|
|                        | 1996       | 2007 | 1996*   | 2007 | 1996   | 2007 |
| City of Edinburgh      | 2          |      | 67      |      | 6      |      |
| Midlothian*            | 0          |      | 25      |      | 11     |      |
| East Lothian           | 0          |      | 15      |      | 41     |      |
| West Lothian           | 0          | ✂    | 0       | ✂    | 9      | ✂    |
| Scottish Borders       | 0          |      | 0       |      | 12     |      |
| Stirling               | 1          |      | 0       |      | 6      |      |
| Falkirk†               | 0          |      | 0       |      | 9      |      |
| Clackmannanshire‡      | 4          |      | 0       |      | 25     |      |

Source: First.

\*Stagecoach believes its 2005 share was overestimated by First: [✂].

†Stagecoach believes its 2005 share was underestimated by First: [✂].

‡Stagecoach believes its 2005 share was overestimated by First: [✂].

Note: Percentages may not add up to 100 due to rounding.

96. As for the First Glasgow area, First stated that actual mileages operated in each area showed that relatively small falls in the share of mileage in the more populous areas would be much more significant than changes in mileage shares in the less populous unitary authority areas.

97. Table 6 shows the relationship between total registered mileage and the population density in the unitary authority areas of the First Edinburgh operating area. The CC considered that this cast doubt on First's view that more populous areas had higher levels of bus demand. It was not clear to the CC that the relationship between changes in shares and population density is significant in the assessment of competitive constraint. The largest falls in First's shares (over [redacted] percentage points) were in areas with the lowest or near lowest population density (Scottish Borders, Stirling and Midlothian). In the City of Edinburgh,<sup>18</sup> which had a high population density, First experienced a significant [redacted] percentage point reduction in its share, as did in West Lothian, which had a much lower population density than the City of Edinburgh. Small reductions in First's share, ie of less than [redacted] percentage points, have occurred in Falkirk and Clackmannanshire, two areas with relatively high population densities. The one area (East Lothian) where First has increased its share (by a substantial amount, ie [redacted] percentage points) has a relatively low population density.<sup>19</sup>

TABLE 6 Total registered miles and population density in the First Edinburgh area

|                   | Population density (2001)<br>(persons per hectare) | Total registered<br>miles | Rank of<br>registered miles |
|-------------------|--|---------------------------|-----------------------------|
| City of Edinburgh | 17.0   | 2,741,441                 | 1                           |
| Falkirk           | 4.9  | 372,494                   | 3                           |
| West Lothian      | 3.7  | 421,537                   | 2                           |
| Clackmannanshire  | 3.0  | 114,186                   | 8                           |
| Midlothian        | 2.3  | 203,188                   | 6                           |
| East Lothian      | 1.3  | 216,868                   | 5                           |
| Stirling          | 0.4  | 280,402                   | 4                           |
| Scottish Borders  | 0.2  | 125,270                   | 7                           |

Source: First.

98. First's share fell in two areas between 2005 and 2007. However, the CC noted, as it did in its consideration of the OFT's report, that while First's registered mileage fell since 1996, its share remained high (at or over [redacted] per cent) in six of the eight unitary authorities.

99. When comparing the potential competition that was offered by First to SBH before the merger to the potential competition that the merged entity now faces shows a mixed picture. In five areas,<sup>20</sup> no operator had a share comparable with that of First before the merger, the nearest being in Clackmannanshire where the share of Stagecoach ([redacted] per cent) was broadly one-quarter of the share of First in 1996 ([redacted] per cent)<sup>21</sup>. In three areas,<sup>22</sup> the share of Lothian in 2007 was much higher than that of First in 1996 in the City of Edinburgh; is a little lower in Midlothian ([redacted] per cent compared with [redacted] per cent) and a lot lower in East Lothian ([redacted] per cent compared with [redacted] per cent).

100. First suggested that its shares in some parts of the First Edinburgh area were misleading [redacted].

<sup>18</sup>The City of Edinburgh is not part of the area covered by the undertakings. However, data on changes in mileage and population density in relation to the City of Edinburgh are still useful in checking First's suggestion that relatively small falls in the mileage in high population density areas would be more significant than in low population density areas.

<sup>19</sup>First told us that its high share in this area was due to it winning tenders, which were strongly competed for by other operators—including Lothian.

<sup>20</sup>West Lothian, Scottish Borders, Stirling, Falkirk and Clackmannanshire.

<sup>21</sup>Note the possible queries with First's estimates of Stagecoach's share.

<sup>22</sup>City of Edinburgh, Midlothian and East Lothian.

101. Table 7 shows the number of routes and parts of routes that cover different categories of costs—direct costs, semi-direct costs and overheads. [REDACTED].
102. Accepting First’s data [REDACTED],<sup>23</sup> the CC did not consider that the updated market shares provided by First changed its position from that reached on the basis of the OFT’s report, discussed above. The CC considered that on the basis of these updated figures First’s registered mileage fell since 1996 but that its share remained high (at or over [REDACTED]) in six of the eight unitary authorities in the First Edinburgh area. [REDACTED] However, First told us that part of the increase in its share in East Lothian was due to its winning tenders. As the CC has been unable to split out commercial and tender mileage, it considered that these data were inconclusive.

TABLE 6 Number of routes [REDACTED]

|   |            | Parts of routes |            | Routes     |            |
|---|------------|-----------------|------------|------------|------------|
|   |            | Yes             | No         | Yes        | No         |
| [ | [REDACTED] | [REDACTED]      | [REDACTED] | [REDACTED] | [REDACTED] |
|   | [REDACTED] | [REDACTED]      | [REDACTED] | [REDACTED] | [REDACTED] |

Source: CC calculations on data provided by First.

*First’s response to competition*

103. First provided the CC with a number of documents that it considered provided evidence of how competition has affected First’s bus activities.
104. First provided a note setting out how it responds to competition.<sup>24</sup> [REDACTED]
105. The CC took the view that, [REDACTED], there were generally three ways in which other bus operators would start services in competition with First:
- (a) competing directly with First on major routes during peak hours (eg 07.00 to 19.00);
  - (b) winning tender services in off-peak hours (eg evenings and weekends) and using the vehicles operated on those services to develop commercial services on the same routes or other routes; and
  - (c) extending routes from areas in which they operate that are adjacent to First’s core network.
106. First stated that where it experiences such entry [REDACTED].
- [REDACTED]<sup>25</sup>
107. First stated that, [REDACTED]. First also said that, [REDACTED]. First stated that it may also [REDACTED].
108. First stated that, [REDACTED].

<sup>23</sup> [REDACTED]

<sup>24</sup>The first half of this note discussed competition from private car. This is considered in paragraph 119 et seq below.

<sup>25</sup>[REDACTED]

109. In conjunction with its note, First provided appendices showing changes that had occurred on particular routes, which it claimed showed the competitive pressures it faced. The CC considered these documents and looked for evidence of First having implemented the sequence of steps it said that it implemented in response to competition. [REDACTED]
110. Appendices 2–4 to First’s note provided examples of elements of what it claimed were responses to competition, including [REDACTED]. However, none of these appendices showed First following the sequence of steps it set out in its note [REDACTED].
111. In relation to one element of First’s approach to responding to competition, namely [REDACTED]. However, the evidence does not isolate whether the changes First mentioned were in response to competition. The CC noted that the practice of [REDACTED] was, at least to some extent,<sup>26</sup> something that First would be expected to engage in anyway in order to maximize profits. In addition, the CC noted that evidence had only been provided in respect of one service, [REDACTED], and not for any other routes, making it difficult to draw any wider conclusions.
112. In relation to another element of First’s stated approach to responding to competition, namely [REDACTED], the 3 examples provided by First [REDACTED] were not supported by any data analysis:
- (a) There was no evidence given to support the claim that First’s response [REDACTED] was due to a competitor running services. Such a response, could, for example, be a natural reaction to those parts of the service being unprofitable. To verify this claim First could have provided an analysis of competitor timetables. We would also wish to understand why this was the only example provided and whether such responses had occurred on other routes.
  - (b) In response to [REDACTED], First [REDACTED]. The CC has seen no evidence of how [REDACTED] changed or why it apparently only changed on a Sunday.
  - (c) [REDACTED] Whilst this might be a valid competitive response, the lack of information about the other operator’s services [REDACTED] meant that the CC could not identify whether this was a reaction to those services rather than being heavily influenced by overall increases in passenger demand.
113. In relation a further element of First’s stated response to competition, [REDACTED], First submitted an Excel file showing [REDACTED] in response to competition. [REDACTED] However, the CC noted that this practice, [REDACTED], was a profit maximizing technique absent any competition. Indeed, First itself said in its note that this practice, [REDACTED] allowed it ‘to maximise the revenue potential of each bus’. Furthermore, First only provided this data in relation to one service, [REDACTED]. It was therefore not clear whether [REDACTED] was introduced on this service as a response to competition as opposed to being used more widely, on routes where there was no competition.<sup>27</sup>
114. In relation to another element of First’s stated response to competition, [REDACTED], First presented no evidence demonstrating that this practice had occurred in response to competition on any of the services we are considering. First in its note mentioned [REDACTED]. However, it is important to note that the CC’s interest is in [REDACTED] as reactions to

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<sup>26</sup>It could be argued that an operator would face a stronger incentive to [REDACTED] if it faced competition since the probability that passengers left waiting by its buses would take a bus run by a competing operator (rather than simply waiting for its bus) would be higher the in face of competition than without. However, even in the absence of a competitor, an operator that [REDACTED] would run the risk of losing passengers.

<sup>27</sup>As noted at footnote 26 in relation to [REDACTED], [REDACTED] may be used as a competitive response but may also be a profit-maximizing absent competition.

competition, not as a method of launching new services.<sup>28</sup> First has provided no evidence of how this practice has been used as a competitive response on the routes in question.

115. In relation to a further element of First's stated response to competition, [redacted], First provided evidence that it said showed this practice as a response to competition. In particular it noted that [redacted] due to competition. The evidence submitted could show First reacting to competition, albeit on a limited number of routes [redacted].<sup>29</sup> However, it did not explain either whether [redacted] or whether First had followed the sequence of steps in its stated response to competition by [redacted].
116. Appendix 5 to First's note [redacted]. However, as in relation to those routes listed [redacted] in appendices 2–4 of First's note, no evidence was provided to suggest that First had followed the sequence of steps in its stated response to competition, [redacted]. The CC could not therefore conclude that the withdrawal of these services was a response to competition.
117. Appendix 6 to First's note did not set out First's behaviour in response to competition but rather explained the effect of competition on First. The appendix showed [redacted]. However, no evidence was provided to show that where First had [redacted] it had done so consistent with its stated response to competition ie that it had only done so after first having tried to implement the first two steps in its sequence of competitive responses. Furthermore, First did not provide evidence to suggest that its behaviour was in response to an increase in competition rather than changes in overall levels of demand.

#### *Increasing car ownership*

118. First drew the CC's attention to the gradually increasing level of car ownership in Scotland, which it argued had significantly decreased demand for bus travel. First stated that the number of households in Scotland without a car had fallen from almost 40 per cent in 1999 (and First believes presumably from a level higher than this prior to 1999, at the time of the merger) to just over 30 per cent towards the end of 2006. First said that this indicated that it faced highly effective competition, even if not exclusively from large scale neighbouring bus network operators (ie of the type that the MMC identified in its 1997 report as having been lost as a result of the merger).
119. When an application is received for release or variation of undertakings, it is for the OFT to assess whether there has been a change of circumstance, and it is for the OFT to make a recommendation to the CC of what action should be taken in relation to the undertakings by reason of that change of circumstance. The OFT submits its advice, including its assessment of the change of circumstance and its recommendation, to the CC. The CC then considers, generally on the basis of the OFT's report, whether and what action should be taken in the light of the change of circumstance identified by the OFT.
120. First did not submit evidence or argument to the OFT in support of increasing car ownership as an element of the change of circumstance that it claimed supported release of the undertakings. Increasing car ownership did not form part of the change of circumstance identified by the OFT in its advice to the CC. It is therefore not open

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<sup>28</sup>We have not seen any evidence to support the proposition that First launched these new services in areas where there is more competition than in other areas.

<sup>29</sup>[redacted]

to the CC to consider whether increasing car ownership suggests that the undertakings should be released.

121. However, it is worth noting that the CC has considered the extent of the competitive constraint from private car on bus in recent merger inquiries. In *First/Scotrail*, for example, comparing the own price elasticities of car and bus, the CC found that the extent of competition from car on bus was 'insufficient to constrain fare increases or any reductions in service levels'.<sup>30</sup> In the same report the CC also found that over time trends in fares on public transport had differed significantly from trends in the inflation-adjusted cost of using private car. Indeed, the CC noted in this report that 'over the last 20 years ... bus fares have increased in real terms by some 40 per cent, whereas the inflation-adjusted cost of using private car has been broadly unchanged'.<sup>31</sup> The CC also noted in this report that the constraint from private car was limited by the proportion of bus users who did not have access to private car.

### *CC view on change in competition*

122. The CC notes that there does appear to be some evidence that could suggest an increase in the competitive constraint faced by First, since 1996 and since 2003. In particular, such evidence includes changes in the share of the bus fleets used in the First Glasgow area, changes in share of registered mileage and in share of registered services (at least in some unitary authorities), entry and expansion (albeit it that this is less in the First Edinburgh area than in the First Glasgow area), and the survival rate of new entrants. There is also some indication that First has a lower market share in the First Glasgow area and (albeit it less so) in the First Edinburgh area. However, notwithstanding all this, the CC notes that First's market shares in most unitary authority areas in both the First Glasgow area and the First Edinburgh area remain generally high in relation to other operators such that it is unlikely that the competitive conditions absent the merger have been substantially restored. The CC also notes that there appears to be little evidence that First's behaviour shows it responding to competition, at least in the way that First has said that it responds to competition.
123. In addition, it is the CC's view that considerable caution must be exercised when assessing most of the data provided. Much of this data is problematic, and as a result, its significance in indicating increased competition is unclear. Some of the market share data provided by First has been queried by Stagecoach. Some of the data sets provided (eg in relation to mileage shares, shares of registered services, fleet sizes) only allow comparisons between particular points in time rather than the observation of trends over time, and several of the data sets in respect of market share (eg in relation to registered mileage) provide comparisons only between two isolated four-week periods.
124. In the light of the persistence of high market shares for First across most of the unitary authority areas in the First Glasgow area and the First Edinburgh area, the apparent lack of competitive response and in the light of the uncertainty surrounding much of the data provided, the CC does not consider that there is sufficient evidence to demonstrate an increase in the constraint faced by First in either the First Glasgow area or the First Edinburgh area that would restore the competition lost as a result of the merger.

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<sup>30</sup>See *First/Scotrail* Appendix D, paragraph 5.

<sup>31</sup>*Ibid.* See also *Scottish Citylink* paragraph 4.33.

### ***The effects of the undertakings***

125. The CC accepts that in certain circumstances behavioural remedies, and price controls in particular, can have adverse effects on markets. If these undertakings had resulted in significant unforeseen adverse effects, this could suggest a change of circumstance sufficient to justify their release. Similarly, if the benefits of the undertakings had diminished this might mean that the balance of costs and benefits associated with the undertakings had shifted sufficiently to justify release.
126. With this in mind, the CC has considered whether the undertakings are resulting in adverse effects, either stemming from the fare cap, the mileage floor or anti-predation undertakings.

### ***The effect of the fare cap***

127. In its report, the OFT noted that both First and third parties had expressed concern that the prohibition on fare increases in excess of RPI was having an adverse effect on entry and the viability of competitors because bus operating costs have increased at a significantly faster rate than inflation. Many third parties told the OFT that First's cheap fares could be seen as 'predatory'. Some third parties were also concerned about the possibility of a negative effect from the fare cap on quality of service.
128. In the First Edinburgh area some local authorities expressed concern that the fare cap was undermining the commercial viability of services to the point that they may be withdrawn, in which case the local authority would be asked to increase the level of subsidy.<sup>32</sup>
129. The OFT's view was that [redacted]. The OFT further noted that even though it had granted First consent for a fare increase in excess of RPI in 2005, the presence of the fare cap may create a period of uncertainty which discourages entry; although consent may be granted operators cannot know in advance whether it will be and therefore cannot rely on this in their business planning. The OFT also noted in its report that First's coverage in the First Glasgow area made it a price-setter. This increased the importance of the constraint on its fares for other operators in that area which, in the case of operators with smaller reserves, may result in contraction or exit if they were unable to recover the full costs of their services. Although the OFT consented to an above-RPI increase in 2005 [redacted].
130. Noting that the fare cap undertakings may be having a distortive effect on the market, in January 2007 the CC requested further information in order to consider this further. In particular the CC requested information about the way in which First's costs had moved as compared with RPI over time, in order to establish whether there was likely to be distortive effect. It also requested information about the way in which First's costs had moved in relation to two indices that it considered should more closely reflect movements in bus industry costs than the RPI, namely the Contract Price Adjustment (CPA) index and the Confederation for Passenger Transport (CPT) index.
131. First provided costs<sup>33</sup> and RPI figures for the period 1997/98 to 2005/06, with projections for 2006/07. The CC noted that data for First Edinburgh (which covers the Midland Bluebird and Lowland area) were complicated by a restructuring in 2002/03 and 2003/04, [redacted]. Examination of First's submission showed that its mileage in the First Edinburgh operating area fell by around [redacted] miles between 2000/01 and

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<sup>32</sup>Currently, the mileage floor in the Edinburgh area effectively prevents First from doing this.

<sup>33</sup>It is assumed that the cost data provided by First covers only the relevant unitary authorities in the operating areas.

2003/04 (representing approximately [redacted] per cent total mileage, which was [redacted] in 2001/02). [redacted]

132. Figure 1 shows changes in First's costs compared with RPI, by applying the RPI increases to the 1997/98 cost figures for First Glasgow and First Edinburgh. Figure 1 also includes a series for First Edinburgh's costs increased by RPI from 2003/04 onwards (ie following the restructuring).

FIGURE 1

### Changes in costs and RPI over time

[redacted]

Source: CC analysis and First.

133. Figure 1 showed that [redacted].
134. [redacted]
135. Figure 1 showed that [redacted]. This suggests that the RPI index per se may not fully reflect movements in bus industry costs.
136. In response to a request from the CC, First provided data in relation to three indices, each of which could provide a better proxy for changes in bus industry costs than RPI—the CPT index for the whole of the UK, CPT index for Scotland and CPA uplift.<sup>34</sup>
137. Figures 2 and 3 show the impact these fare caps would have had in First Glasgow and First Edinburgh had they been applied from 2002/03.<sup>35</sup>

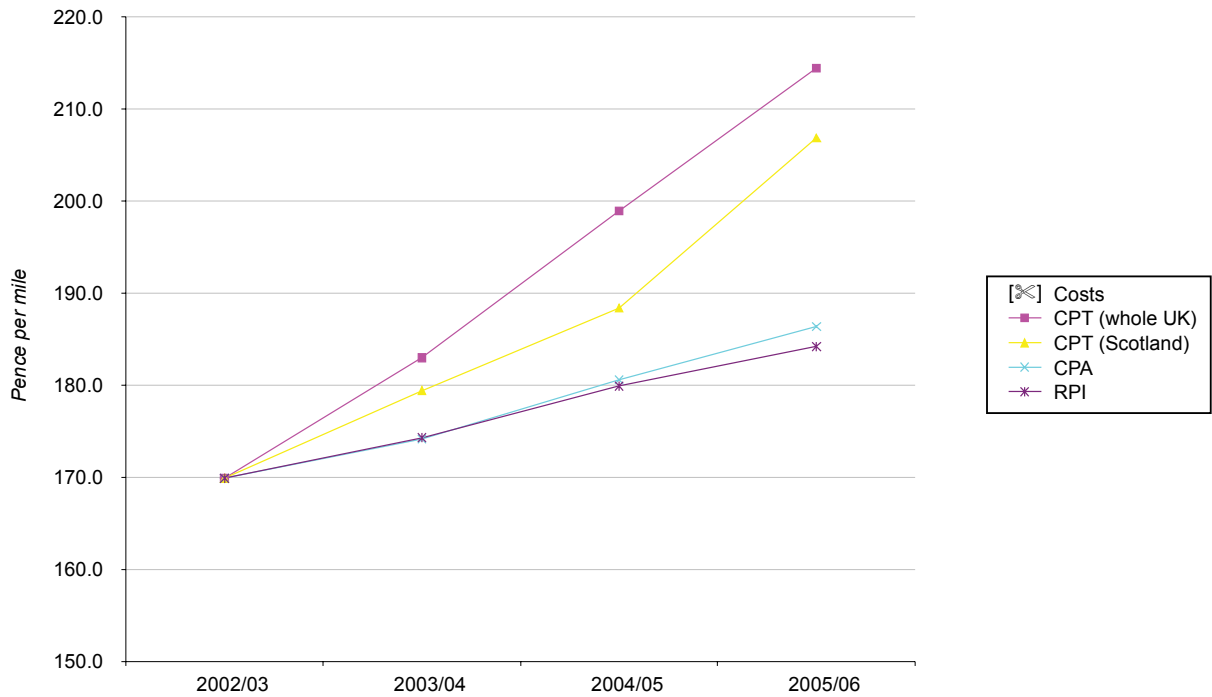
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<sup>34</sup>The CPA uplift is applied by Transport for London to bus contracts—including those operated by First—for the period 2004–2006.

<sup>35</sup> It was noted that First Edinburgh was restructured in 2002/03 and 2003/04.

FIGURE 2

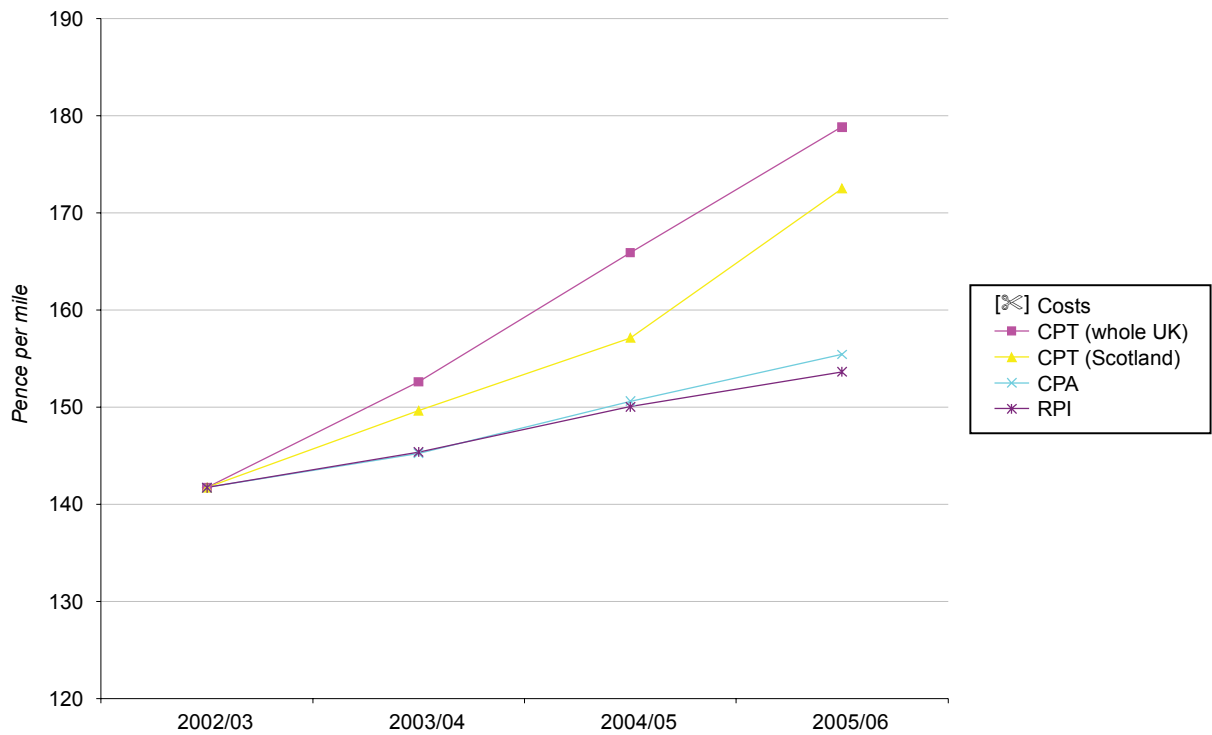
**Impact of indices in First Glasgow**



Source: CC analysis and First.

FIGURE 3

**Impact of indices in First Edinburgh**



Source: CC analysis and First.

138. In addition to these effects on competition, First has argued that the fare cap has restricted the ability of First and other operators to invest in new services, buses, and premises.
139. The CC considers that there is evidence to suggest that bus industry costs have risen at a faster rate than RPI in the period since the fare cap was introduced. Noting that First abided by the fare cap since September 1997 in the Glasgow operating area and since 1998 for the Midland Bluebird and Lowland operating area, and assuming that fares in 1997 were at the competitive level, the CC considers that there is now reason to expect that the fare cap has resulted in First setting fares below the competitive level, at a level that would preclude efficient entry. The CC notes that there has been entry into the First Edinburgh area and—more extensively—the First Glasgow area but that this has only been limited. The CC considers that this is consistent with a fare cap constraining First to set fares below the competitive level.

### *The effects of the mileage floor*

140. The mileage floor requires First to operate at least 95 per cent of its commercial mileage in the First Edinburgh area in January 2002 (ie the date of acceptance of the Undertakings). There are no similar restrictions on First in the First Glasgow area. The OFT suggested that the purpose of the mileage floor was to prevent First from evading the fare cap by reducing the number of services or the frequency of services. However, the OFT noted that the mileage cap may, regardless of the fare cap, have a distortive effect on the market if it compelled First to continue running services that would be unprofitable even at higher fares than permitted by the cap. The OFT noted that one local authority commented that it had not increased the number of tendered services since 1999, and considered that this may be as a result of the mileage floor.
141. First has argued that the mileage floor has the effect of [REDACTED].
142. The CC acknowledges that there has been a greater number of entrants in the First Glasgow area than in the First Edinburgh area. However, [REDACTED] one reason for the higher level of entry in the First Glasgow area than the First Edinburgh area may be that the demand for bus services had not grown or had even decreased in the First Edinburgh area in contrast to demand for bus services in the First Glasgow area. It is not therefore clear to the CC that the difference in the number of entrants as between the two areas is related to the mileage floor.
143. The CC notes that it is clear that the mileage floor does appear to be a constraint on First's behaviour. As the OFT has noted, [REDACTED].
144. The CC has asked First whether the negative effects of the undertakings in terms of its operation [REDACTED] were as much a result of the fare cap—[REDACTED]—as the mileage floor. Specifically, the CC asked whether, if the fare cap were rebased or recalibrated [REDACTED]. First responded by stating [REDACTED].
145. The CC considers that the mileage floor represents an effective constraint on First. However, the CC notes that it is possible, given the rise in bus industry costs over the period for which the undertakings have been in place, that the mileage floor is distorting the market [REDACTED]. The CC considers that any such problem is likely to be exacerbated by the fare cap, [REDACTED]. However, the CC considers that it is plausible that in some areas it may not be possible, regardless of the fare cap, for First successfully

to implement fare rises [X]. The CC therefore considers that the mileage floor may in itself have a distortive effect on the bus market in the First Edinburgh area.

### *The effects of the anti-predation undertakings*

146. The anti-predation undertakings consisted of three elements: fare and frequency obligations (where a competing service ceased within three years of the undertakings to operate as a result of First setting lower prices or increasing frequency of that service); even spacing of services (First must ensure that any new commercial services are evenly spaced between those of a new competitor); competition against tendered services (First must not introduce or increase any existing commercial service in competition with a tendered service for which its bid was unsuccessful). These undertakings apply only in the First Edinburgh area, there are no such restrictions in the First Glasgow area.
147. The undertaking in relation to fares and frequencies has time-expired. Indeed, First has stated that its view is that the anti-predation undertakings have had no substantial effect other than as an additional regulatory burden on First.
148. First argues that the anti-predation undertaking is now obsolete as a result of the Competition Act 1998. It notes that bus operators in Scotland are very aware of the prohibition contained in Chapter II of the Competition Act 1998, especially following Lothian's complaint to the OFT about alleged predatory behaviour by First in Edinburgh.
149. The CC noted that the value of the anti-predation undertakings in protecting inefficient operators would be limited if it were the case that the fare cap resulted in First being unable fully to recover its costs. The CC considers that there is evidence to suggest that this is the case (see paragraph 128 et seq).
150. The CC noted the relatively small number of cases in relation to predation in the bus industry under the Competition Act 1998. Neither was it possible to say whether First was any more or less likely to engage in predation than other operators. However, the CC noted that the OFT is not required to investigate every complaint it received. The decision to conduct an investigation is a discretionary matter: the OFT needs to be satisfied that an investigation would be consistent with its administrative priorities. Further, if the OFT were to open an investigation it is unlikely to be able to reach a final decision within 18 months. The CC therefore took the view that it was possible that First would be able to engage in predatory conduct and that some cases would not be caught under the Competition Act 1998. In contrast, it would be relatively easy to take action under the two remaining anti-predation undertakings, assess whether there had been a breach and address the issue directly with First.
151. The OFT further noted that third parties have indicated some value in the anti-predation undertakings and concern at their possible release.
152. The CC recognizes that, as First has pointed out, predatory behaviour may be the subject of a private action under the Competition Act 1998. However, so far as the CC is aware the number of private actions brought under that Act to date is small. The CC cannot tell whether, with time, private actions will provide bus operators with equivalent protection to that found under the anti-predation provisions of the undertakings. However, there is at present no reason to believe that they do.
153. The CC is concerned that there may be scope for First to engage in predatory behaviour that would not adequately be addressed under the Competition 1998. The CC does not consider that the threat of private actions under the Competition Act

1998 would be likely significantly to constrain First's behaviour. The CC has seen no evidence to suggest that the anti-predation undertakings are resulting in a significant additional regulatory cost for First or the market as a whole. Noting this, and the OFT's view that these undertakings bring an additional benefit supplementary to the Competition Act 1998, the CC considers that the effect of the anti-predation undertakings is positive.

### *CC view on the effects of the undertakings*

154. Overall, the CC considers that it is likely that the fare cap and mileage floor undertakings in their current form are producing distortive effects in the bus market in the First Glasgow area and the First Edinburgh area. The CC considers that it is likely that capping fares at RPI over a period of time when bus industry costs have risen at a faster rate than RPI will have resulted in First's fares on some routes no longer covering the costs of operating those routes. The CC considers that the effect of the mileage floor is less clear. Although it does appear that the mileage floor is requiring First to run services that do not recover their costs of operation, it is not clear to what extent this could be rectified by raising fares. However, the CC accepts that there may be services, especially those in areas of low population density, where First would not be able to raise sufficient revenue to cover costs by raising fares.
155. The CC does not consider that the anti-predation undertakings are generating distortive effects. Indeed, it further considers that these undertakings represent useful additional protection beyond the provisions of the Competition Act 1998.

### ***The CC's assessment of the case for release***

156. The CC has considered whether the change of circumstance identified by the OFT—and the additional information provided by First in relation to that change of circumstance—changed the costs and benefits associated with the undertakings such that they should be released. Taking into account all the evidence it has seen, the CC has provisionally decided that the change of circumstance has not changed the balance of costs and benefits associated with the undertakings should they should be retained.
157. In particular, the CC has not seen evidence that demonstrates an increase in the competitive constraint faced by First either since the time of the MMC's report (published in 1997) or the point at which the Secretary of State for Trade and Industry decided to pursue behavioural undertakings rather than a divestiture (1998) (or for that matter since the time undertakings were accepted (2002)) sufficient to restore the competitive constraint lost as a result of the merger. Thus, the CC considers that the undertakings continue to generate benefits by protecting consumers from fare increases and reductions in service quality (by reductions in mileage). The CC considers that the fare cap in its current form is likely to be resulting in distortive effects in the First Glasgow area and in the First Edinburgh area, [X]. The CC also considers it likely that the mileage floor in its current form is resulting in additional distortive effects in the First Edinburgh area [X]. However, the CC does not consider that these distortive effects justify the release of the undertakings given that the competitive constraint lost as a result of the merger does not appear to have been restored. Rather, the CC considers that they may be dealt with by means of a variation to the existing undertakings, discussed in more detail in the next section.
158. The CC noted that the evidence on competition both in the First Glasgow area and in the First Edinburgh area varied by unitary authority, there being a stronger case in

some unitary authorities that competitive constraints on First had increased than in others. The CC did consider therefore whether it would be practicable to release the undertakings in some unitary authority areas, while retaining them in others. When the CC asked the OFT for its view on this, the OFT said that this would increase the complexity associated with gathering information and monitoring the undertakings. The OFT also said that such an approach would necessitate the appointment of a third-party monitor, who could deal with this additional complexity. The OFT also noted that First applies a uniform pricing policy across an area, and that placing restrictions on it in some unitary authority areas and not in others would be inconsistent with this. The CC shares this view.

159. In addition, the CC noted that when in its 1997 report the MMC found a potential competition problem it did not single out certain local areas within the SBH operating area as being affected and others as not. This meant that adopting a more geographically specific approach would be inconsistent with the original findings. It would also require a more complete separate evaluation of actual and potential competition in each unitary authority. Further, the CC noted that the existence of network effects in the bus industry meant that considering each unitary authority in isolation could result in potentially misleading findings as to the extent of actual and potential competition. Given the concerns about the practicability of release by unitary authority and also these concerns about whether it would be correct in principle to do so, the CC did not consider further releasing the undertakings in respect of individual unitary authorities.

#### *Possible variation of the undertakings*

160. As noted in paragraph 126, the CC acknowledges that behavioural remedies can in certain circumstances have adverse effects on markets. The CC notes that bus industry costs do appear to have risen at a faster rate than RPI over the period of the fare cap, [§]. Assuming that First is an efficient operator, the CC considers that this could have a negative effect on entry and expansion. The CC also considers that the increases in bus industry costs may also mean that the undertakings have required or will require First to operate services which have been persistently unprofitable and are likely to remain so.
161. In considering whether, as a result of the change of circumstance, the costs and benefits associated with the undertakings have shifted sufficiently to justify release, the CC has weighed the changes in the competitive environment against the distortive effects of the undertakings and has provisionally decided that the change of circumstance does not justify releasing the undertakings. As noted above, the CC does consider that the fare cap and the mileage floor in their current forms may be having a distortive effect on the bus market in the First Glasgow area and the First Edinburgh area. However, it considers that this distortive effect can be dealt with by means of a variation to the existing undertakings.
162. The CC notes that First has not proposed any variation to the existing undertakings; it has argued exclusively and consistently for their release. However, the CC has given some thought to the broad nature of a variation that might address the distortive effects of the fare cap and the mileage floor in their current forms.
163. In relation to the fare cap, the CC would be sympathetic to varying the cap such that fare increases were constrained by reference to an index more closely related to bus industry costs than the RPI. Having considered various alternative indices (see paragraph 133 et seq and Appendix A), the CC currently favours the use of an index comprising a weighted average of the average earnings index, the average retail price of DERV (ie a fuel escalator) and the RPI, where the weights reflected the

distribution of First Edinburgh and First Glasgow's costs. Such an index has the advantage of being constructed from indices that are readily available, therefore avoiding the need to collect data specifically for this purpose. It would also be based on indices not influenced by input from First, an important advantage over the CPA and the CPT, and especially the CPT for Scotland. This would not only reduce any ability that First may have to manipulate the index but would also prevent any effect whereby First's incentive to control costs was weakened by those costs passing through automatically into its permitted fare increases. The CC may also consider a one-off adjustment to the level of fares. Any such adjustment would be aimed at ensuring that current fare levels were sufficient to allow an efficient operator to recover its costs.

164. Although third-party views have not been sought on a possible variation of the undertakings, the CC notes that SPT has said that while it, in principle, supports the release of the undertakings, if it was thought that they should remain, a more realistic constraint might be to relate the cap to a transport-related cost index rather than RPI.
165. The CC has not specifically considered what variation to the mileage floor may be appropriate. However, it would be sympathetic to any request to vary the mileage floor in such a way as to ensure that First was not required to continue to run services that it could demonstrate had persistently failed to recover their direct costs of operation and were unlikely to do so.

### **Next steps**

166. The CC is issuing this notice to provide an opportunity for representations to be made in relation to its provisional decision to retain the undertakings. This notice also provides an opportunity for representations to be made in relation to the CC's willingness to consider an application by First to vary the undertakings.
167. Comments are therefore invited and should be received by the CC no later than 17.00 on 6 December 2007 and should be addressed to:

Cathryn Ross  
Director of Remedies and Business Analysis  
Competition Commission  
Victoria House  
Southampton Row  
London  
WC1B 4AD

Or emailed to: [cathryn.ross@cc.gsi.gov.uk](mailto:cathryn.ross@cc.gsi.gov.uk)

168. Before issuing its final decision in relation to the undertakings, the CC will have regard to any representations made in accordance with this notice and may modify its decision as a result of such representations.

*(signed)* PETER FREEMAN  
Chairman  
15 November 2007

## Alternative cost indices

### Introduction

1. Having noted that bus industry costs appear to have risen at a faster rate than RPI, both since 1996/97 and since 2003, the CC has considered the relative merits of various other indices as a possible basis for a fare cap. It is important to note that First has not submitted an application to vary the undertakings so that the fare cap operates on the basis of a different index than RPI. The CC has set out its considerations here in support of its view that such a variation would be feasible, and would therefore provide an alternative means (other than release) by which to address the distortive effects of the undertakings.

### Consideration of different indices

2. In considering whether it was likely that the fare cap had resulted in a situation in which First was unable fully to recover its costs, the CC compared the RPI over time, against First's actual costs and also against various off-the-shelf indices of bus industry costs, ie the CPT index for the whole of the UK, the CPT index for Scotland, and the CPA index. The CPT indices are compiled by the Confederation for Passenger Transport. The CPA index is the Contract Price Adjustment index applied by Transport for London to bus contracts, including those operated by First, in the period 2004 to 2006. First provided this index for the period 2003/04 to 2005/06 so that the CC could conduct analysis over time. The CC has also considered the possibility of using an alternative index, calculated more closely to resemble the distribution of First's costs. Each of these is discussed in turn below.

### *CPA index*

3. First considered that the CPA index was an uplift on contract price including profit and not on cost. The CPA index was also a contractual compromise between Transport for London and the operator. It was based on a composition of fuel (5 per cent, being revised to 7 per cent), labour costs (55 per cent, revised to 62 per cent), RPI (25 per cent, revised to 16 per cent) and profit (15 per cent).
4. Whilst this was not a cost index, it was nevertheless a way of controlling prices. It was not clear to the CC why this index could only be relevant to London and not to Scotland. However, the CC noted that if the problem with a fare control based on the RPI is that it does not move in line with industry costs, the evidence on applying the CPA and RPI in Figures 2 and 3 suggested that moving to the CAP index would not address this problem, because there was little difference between the two indices in the three years shown. Although this may change following the recent revisions, the CC reached the view that the CPA would not be likely to address the distorting effects of the current fare control.

### *CPT index*

5. The CPT index is based on responses from bus operators which CPT aggregates in accordance with guidance from the OFT. There are only eight respondents in Scotland, and the data is weighted by each respondent's cost base. As First has a

relatively strong position in Scotland, the CC considered that it is likely that its cost base significantly influences the index, [✂] the CC was sufficiently concerned by the potential for First to influence the CPT index to reach the view that it would not be a suitable basis for the fare control.

6. The CPT index for the whole of the UK reflects costs across the UK and does not therefore directly reflect conditions in Scotland. It has moved at a higher rate than all the other cost indices discussed here (see Figures 2 and 3 in the text of the notice), and would therefore not provide a more suitable basis for the fare control than those other indices.

### **An alternative index**

7. Given its views that neither the CPA index nor the CPT index would be an appropriate base for the fare control, the CC was keen to explore the feasibility of an alternative index. The CC considered that it would be important to ensure that any alternative index on which the fare control was based would not in itself require a great deal of additional calculation. It noted that it may be possible to compile an index that would reflect movements in bus industry costs by calculating a weighted average of:
  - average earnings index;
  - an index of average retail price of DERV (ie a fuel escalator); and
  - RPI.

8. This would have the advantage of being an index that reflected First's main cost drivers. However, the RSG was keen to ensure that any alternative index would not undermine First's incentives to achieve cost reductions by simply allowing increases in First's costs to be passed on to passengers. Since none of the components of this index would be driven by First's costs, it would maintain the incentive on First to keep its costs under control. It would have the further advantage of being based on data from readily-available sources.

9. Whilst being similar to the CPA, this alternative index may have different weightings and could be applied to each of First Edinburgh and First Glasgow in a manner that reflects the relevant weightings of these costs within each operating area. Based on First Edinburgh's and First Glasgow's submitted costs for the past ten years this would be as set out in Table 1 below.

TABLE 1 Possible weighting of indices

|                              | First<br>Edinburgh | First<br>Glasgow |
|------------------------------|--------------------|------------------|
| Average earnings index       | ✂                  |                  |
| Average retail price of DERV |                    |                  |
| RPI                          |                    |                  |

Source:

10. If such an index were to be adopted as the basis for the fare control, the weightings could be specified in the (new set of) undertakings, which could allow for changes in the weightings to be agreed with the OFT as appropriate. This would provide a

mechanism for ensuring the continued relevance of the index in the face of changes in costs over time.

## **Conclusion**

11. The CC identified four possible indices that could be used in varied undertakings to provide the basis for the fare cap. These are: the CPA index, the CPT index for the UK, the CPT index for Scotland, and an alternative index based on a weighted average of changes in three indices relevant to bus industry costs.
12. The CC considered that if fare increases in line with RPI have not kept pace with bus industry costs, the fact that there is little difference between the CPA and the RPI in years available suggests that controlling fares on the basis of the CPA may do little to address the distortive effects of the undertakings.
13. The CC considered that First's own data is such a large component of the CPT index for Scotland as to render it open to manipulation and to make it an inappropriate basis for a control on First's fares. The CC also considered that CPT index for the UK as a whole could form a reasonable basis for the fare control. However, it noted that the difference between the CPT index for the UK and that for Scotland may suggest that movements in cost in Scotland are significantly different to movements in cost elsewhere in the UK.