

## 2 Conclusions

### **The reference**

2.1. Under the reference (Appendix 1.1) we are required to investigate and report whether a merger situation qualifying for investigation has been created in that enterprises carried on by or under the control of A1 Service have, within the six months preceding the date of the reference, ceased to be distinct from enterprises carried on by or under the control of Stagecoach. It appeared to the Secretary of State that the 'share of supply test' in section 64(3) of the Fair Trading Act 1973 (the Act) was satisfied in respect of bus services<sup>1</sup> in the area specified in the terms of reference, viz the region of Dumfries & Galloway and, in the region of Strathclyde, the districts of Cunninghame, Kilmarnock & Loudoun, Inverclyde, Renfrew, Eastwood, East Kilbride, Cumnock & Doon Valley and Kyle & Carrick. (We refer to this as the 'reference area'.)

### **Industry background**

2.2. For many years until the 1980s the bus industry was highly regulated and almost entirely in the public sector. The Government then introduced major changes, principally under the Transport Act 1985 (the 1985 Act) which removed quantitative restrictions on the supply of bus services outside London. The 1985 Act also provided for the privatization of the National Bus Company (NBC), which operated in England and Wales, and for the formation of local authority bus operations into arm's length public transport companies. The Transport (Scotland) Act 1989 provided for the privatization of the Scottish Bus Group (SBG). The SBG was the main supplier of bus services throughout Scotland except for local services in the four largest cities (Aberdeen, Dundee, Edinburgh and Glasgow) which were provided by municipal companies.

2.3. In the deregulated market anyone wishing to supply bus services requires a licence to operate public service vehicles (PSVs) but may then introduce services simply by giving 42 days' notice to the Traffic Commissioner for the region concerned. The Traffic Commissioners are responsible for supervising operators' quality of service and safety standards and for seeing that they are properly equipped to carry out the services for which they are licensed. An operator who fails to run services in accordance with its registrations, or whose vehicles are not adequately maintained, can be penalized by the Traffic Commissioner, whose ultimate sanction is to ban an operator from running services altogether. The Commissioners also have powers-which were strengthened by regulations introduced on 1 February 1995-to regulate services in cases of severe traffic congestion.

2.4. The NBC was divided into 72 companies which were then privatized between 1986 and 1988, many by sale to management buy-outs. No single buyer was allowed to acquire more than three NBC subsidiaries or to acquire companies operating in contiguous areas. Similarly in the

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<sup>1</sup>As defined in section 159(1) of the Transport Act 1968, as amended by paragraph 1 of Schedule 1 to the Transport Act 1985.

sale of the ten SBG companies in 1990 and 1991, no buyer was allowed to acquire more than two companies, or to acquire companies operating in contiguous areas. In the years since privatization many former NBC and SBG companies have been acquired by emerging large operators: see paragraph 2.6. (In some cases these subsequent acquisitions have been made by companies with operations in contiguous areas.)

2.5. The Government made clear from the time of the 1985 Act that it wanted local authorities to sell off their bus companies. So far it has not taken powers to require them to do so, but it has given incentives and over half of the municipal companies in Great Britain-including most of the larger ones-had been privatized at the time of our inquiry. Of the four Scottish municipal companies, three were sold off to their managers and employees between 1989 and 1993. As with former NBC and SBG companies, some of the former municipal operations which were the subject of management or employee buy-outs have since been taken over.

2.6. In the last few years a number of bus companies have grown rapidly, largely by acquisition. According to The TAS Partnership Ltd (TAS), a consultant specializing in the bus industry, in 1994 nine groups-Stagecoach, Badgerline Group plc (Badgerline), British Bus PLC (British Bus), West Midlands Travel Limited (West Midlands Travel, now part of National Express Group PLC (National Express)), The Go-Ahead Group PLC (Go-Ahead), Cowie Group PLC (Cowie), GRT Bus Group PLC (GRT), S B Holdings Limited (SBH) and MTL Trust Holdings Limited (MTL)-accounted for 56 per cent of UK bus market turnover. A merger between Badgerline and GRT to form FirstBus PLC (FirstBus) took place in June 1995. We refer to these companies as 'the emerging large operators'. Certain other companies, for example Transit Holdings Ltd and The Yorkshire Traction Company Ltd, have also each acquired bus operators in different parts of the country.

## **The companies**

### ***A1 Service***

2.7. A1 Service was founded in 1926 as a co-operative venture of local bus operators and was incorporated in 1931 as a company limited by guarantee, with no share capital. At the time of the merger with Stagecoach there were 21 shares in the business; these were held by ten members, each with between one and five shares. Three of the members were limited companies and the rest partnerships or individuals. Most of the members were also involved in other activities, eg private coach hire, outside the framework of the A1 Service business.

2.8. The company itself was of little substance. Its turnover, some £250,000 in the year to end-May 1994, consisted entirely of members' contributions to cover administrative costs, with no element of profit. It had net assets of £42,000. Company staff were responsible primarily for administrative matters, such as the negotiation of contracts. The members individually provided and maintained the bus fleet, managed the operations and retained the revenues from the services run by their own buses. The company had no depot, only a small bus stand and office building. In this report we use the term 'A1 Service' to refer to the company or (more often) the whole of the business acquired by Stagecoach, according to the context.

2.9. The Traffic Commissioner for Scotland told us that A1 Service had encountered maintenance problems at various times. At the last renewal of its operator's licence in December 1993 the company had been formally warned that any further problems could result in the licence being revoked.

2.10. At the time of the merger A1 Service's operator's licence allowed it to use up to 93

buses. In practice 81 were used in the business, of which around 30 were for schools contracts and the rest for local services run on a commercial basis. The members employed 134 staff on A1 Service work and the company employed 72, although most of the latter were on a casual basis. A1 Service's operations were mainly confined to the districts of Cunninghame and Kilmarnock & Loudoun, with a small presence in Kyle & Carrick.

2.11. No accounts were prepared for the A1 Service business as a whole. Estimates given to us indicated that its annual turnover was in the region of £3.5 million and that profit after interest was running at an annual rate of around £45,000 in the period immediately before the merger. Around 10 per cent of turnover was believed to have resulted from schools contracts and the rest from local services.

### ***Stagecoach***

2.12. Stagecoach started in 1976 as a small caravan and minibus rental business and expanded into long-distance coach services in the early 1980s. On deregulation of the bus industry in 1986 it decided to concentrate its future efforts in that market. It acquired three NBC companies-the maximum number permitted-on their privatization in 1987, and in 1989 took over four former NBC companies which had been the subject of management buy-outs. In 1991 it acquired two companies from the SBG, Fife Scottish and Northern Scottish. Stagecoach also expanded overseas via acquisitions in Malawi, Kenya and New Zealand.

2.13. In April 1993 Stagecoach made a placing and offer for sale of part of its ordinary share capital, raising some £20 million in additional capital, and obtained a Stock Exchange listing. Following the issue Mr Brian Souter, the Executive Chairman, and his sister Mrs Ann Gloag remained the principal shareholders with 49 per cent of the shares beneficially held between them (by end-September 1995 this figure had fallen to 39 per cent as a result of further share issues). In the offer document the directors expressed continued interest in the potential for profitable growth coming from the privatization of publicly-owned bus operators in the UK.

2.14. Between the flotation and the end of September 1995 Stagecoach made a further 16 acquisitions of UK bus operators, including two cases-Mainline Partnership Limited (Mainline) of Sheffield and SBH of Glasgow-in which it took stakes of 20 per cent. One of its 100 per cent acquisitions was of Western Scottish, the former SBG subsidiary in south-west Scotland which had been the subject of a management and employee buy-out in 1991, which Stagecoach acquired for £6 million in July 1994. Western Scottish provides bus services in the mainly rural area stretching from the south of Strathclyde region to the Solway Firth. Stagecoach subsequently acquired two smaller operators in south-west Scotland-The Arran Transport & Trading Company Ltd (Arran Transport) in October 1994 and A1 Service, the subject of the current inquiry, in January 1995-and merged their operations with those of Western Scottish. In March 1995 Western Scottish operated 340 buses, not including those used on former A1 Service routes.

2.15. Until 1994 Stagecoach's operations consisted largely of inter-urban services and local services in rural areas and small and medium-sized towns. In 1994 it made a major move into urban areas with the acquisitions of Busways Travel Services Limited (Busways) in Newcastle, two of the ten London Bus companies and Cleveland Transit Limited, as well as its stakes in Mainline and SBH. A map showing Stagecoach's UK operations is at Appendix 3.1 and a full list of its acquisitions between 1987 and September 1995 is at Appendix 3.2.

2.16. The group is now the leading UK provider of local bus services with an estimated 13 per cent of the total, measured by turnover. Its turnover in the year to end-April 1995 was £338 million and Stagecoach told the MMC that by March 1995 its turnover had reached an

annual rate of £400 million, of which £360 million was in the UK. The group operates some 5,800 buses in the UK and a further 900 overseas. Operating profit before interest in 1994/95 was £39.8 million, representing 11.8 per cent of turnover (see Table 3.3). At April 1995 some 7 per cent of Stagecoach's issued share capital was held by employees under an Employee Share Ownership Plan (ESOP).

2.17. There have been several recent references to the MMC which have involved Stagecoach:

- (a) In November 1994 its acquisition of a 20 per cent stake in Mainline was referred under the merger provisions of the Act. The MMC's report<sup>1</sup> concluded that the two enterprises had ceased to be distinct, that the acquisition constituted a merger situation qualifying for investigation and that the creation of that situation was against the public interest because of its adverse effects on competition in the relevant area. Although the MMC recommended that the adverse effects could be remedied by a prohibition on Stagecoach raising its stake in Mainline above 20 per cent, the Secretary of State decided that Stagecoach should be required to divest the holding. Stagecoach has been granted leave to seek judicial review of both the MMC's report and the Secretary of State's decision.
- (b) In December 1994 Stagecoach's acquisition of a 20 per cent stake in SBH was similarly referred and the MMC reached a similar conclusion.<sup>2</sup> In this case, the MMC recommended that Stagecoach be required to divest the holding and the Secretary of State accepted the recommendation. Stagecoach has sought leave to seek judicial review of that report also.
- (c) In November 1994 the Director General of Fair Trading (DGFT) made a monopoly reference to the MMC concerning the supply of bus services in the north-east of England. The MMC concluded,<sup>3</sup> *inter alia*, that a scale monopoly situation existed in favour of Stagecoach and that some of the actions of its Busways subsidiary were against the public interest, in particular the actions which caused the final collapse of Darlington Transport Company Limited. The Secretary of State accepted the MMC's findings and, broadly in line with their recommendations, asked the DGFT to seek undertakings designed to prevent Stagecoach from engaging in predatory behaviour against competitors.
- (d) In September 1995 Stagecoach's acquisition of Chesterfield Transport (1989) Limited was referred under the merger provisions of the Act. The MMC's report is due to be submitted by 3 January 1996.

## The merger situation

2.18. In November 1994 Stagecoach's Chairman, Mr Souter, made an informal offer to buy out any individual member of A1 Service who wished to sell and to work alongside any who chose to remain. The members, however, decided to sell the business as a whole. After further discussions Stagecoach announced on 23 December 1994 that it had agreed terms for the acquisition. The former Chairman of A1 Service told us that he could not recall any other approaches being made to buy the business and that, having reached an amicable agreement with Mr Souter, the members did not seek a competing bidder.

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<sup>1</sup>*Stagecoach Holdings plc and Mainline Partnership Limited: a report on the merger situation between Stagecoach Holdings plc and Mainline Partnership Limited*, Cm 2782, HMSO, March 1995.

<sup>2</sup>*Stagecoach Holdings plc and S B Holdings Limited: a report on the merger situation*, Cm 2845, HMSO, April 1995.

<sup>3</sup>*The supply of bus services in the north-east of England*, Cm 2933, HMSO, August 1995.

2.19. Eleven agreements were entered into on 22 December 1994 to implement the transaction: one between Stagecoach and the combined membership of A1 Service and the other ten between Stagecoach and each of the members respectively. These agreements contained restrictive covenants in which each member undertook not to operate local bus services (as defined in the 1985 Act) in the districts of Cunninghame, Kilmarnock & Loudoun and Kyle & Carrick for three years from 29 January 1995, the date of completion of the merger. This meant that the members could operate no commercial or tendered local bus services, but were free to undertake other activities, eg school bus contracts.

2.20. The consideration for the sale comprised £3.36 million for the business (£160,000 for each of the 21 shares), £880,000 for 67 vehicles acquired from the individual member firms, and £31,000 for ticketing and other equipment. £1.7 million was paid in cash and the balance in Stagecoach shares. Of the total consideration of £4,271,000, £732,000 represented the value of the net assets acquired (mainly the buses) and the balance goodwill. Thus the goodwill element in the purchase price broadly equated to A1 Service's annual turnover of around £3.5 million. This is a high level of goodwill, in relation to turnover, compared with other acquisitions in 1994 (see paragraph 3.41).

2.21. The average age of the buses acquired by Stagecoach was 13.3 years, compared with the average for Stagecoach's fleet (at April 1995) of 9.1 years. Stagecoach quickly sold or scrapped some 20 of the acquired buses, replacing them with more serviceable mid-life vehicles from other parts of the group. By the end of August it had introduced 21 brand new buses and Stagecoach told us that the average age of the fleet had fallen to six years. It also reduced the number of vehicles required from 81 to 71 by withdrawing from two commercial services and one schools contract and by doubling up so that three buses covered six other schools contracts. Generally, however, Stagecoach told us that it operated much the same services and routes as A1 Service had before. Stagecoach changed the company's name to Stagecoach A1 Service Limited (Stagecoach A1 Service) and the services are operated in that name, but in practice the business is run as a division of Western Scottish. We use the term Western Scottish in this report, however, to refer to that company excluding A1 Service unless otherwise stated.

2.22. A1 Service's lack of depot facilities led Stagecoach to lease a site in Ardrossan which it converted into a depot, investing some £100,000 in the establishment of routine maintenance and cleaning facilities. The Western Scottish workshops at Kilmarnock provide for more demanding maintenance and repair work.

2.23. Stagecoach told us that the merger had led to a small number of redundancies but these had been outweighed by new jobs created. It had harmonized terms and conditions of employment with those of Western Scottish and incurred significant expenditure on staff training to improve maintenance standards.

2.24. Of the ten former members of A1 Service, four retained vehicles and told us that they still tendered for schools contracts or intended to do so, but for the time being all but one of their vehicles were engaged in private hire work.

## **Jurisdiction**

2.25. Under the Act a merger situation qualifying for investigation may arise where enterprises cease to be distinct and where either the combined enterprise accounts for at least 25 per cent of the goods or services of a particular description supplied in the UK or a substantial part of it ('the share of supply test') or the gross value of world-wide assets taken over by the acquirer exceeds £70 million ('the assets test').

2.26. We are satisfied that, as a result of the transaction described in paragraphs 2.18 to 2.20, enterprises carried on by A1 Service have ceased to be distinct from enterprises carried on by Stagecoach.

2.27. In applying the share of supply test we are not confined to consideration of the reference area. The MMC have previously been advised by Counsel, and have taken the view, that it is open to them and consistent with the intentions and purposes of the Act to determine the most appropriate area, having regard to what is sensible in the context of the business concerned.<sup>1</sup> We take the same view in this case.

2.28. Stagecoach challenged the size of the reference area as being inconsistent with what it saw as the limited area affected by the merger. In Stagecoach's submission the direct and indirect competition issues arose in an area which was very small in both geographical coverage and size of population.

2.29. Enlarging on this contention Stagecoach argued that the merger had a commercial effect in only three of the districts in the reference area, namely Cunninghame, Kilmarnock & Loudoun and Kyle & Carrick. The operations of A1 Service were local and did not involve inter-urban services. It did not have the financial resources to stretch its operations beyond the three districts named and had not in fact operated local services outside that area. The MMC had stated in a recent report on a bus merger that their duty was to look at 'substance, not form' and to consider 'commercial realities and results'.<sup>2</sup> In Stagecoach's view the commercial reality of the present merger was that A1 Service had since the 1930s consistently operated a confined local service; due to its unique operational characteristics, it was not predisposed to competitive forays beyond its local area.

2.30. Stagecoach pointed out that the area covered by the three districts constituted only 1 per cent of the land area of the UK and included only 0.6 per cent of the population. Although the share of supply test might be met there, the area was not 'worth consideration for the purposes of the Act' and hence was not 'a substantial part of the United Kingdom' as required by the Act (see paragraph 2.25).

2.31. We have given careful consideration to these arguments. It is true that the area of overlap between A1 Service and Western Scottish is small, being almost entirely confined to the districts of Cunninghame and Kilmarnock & Loudoun (see map at Figure 4.1). But bus operators are not restricted to the areas where they operate at any given time. A1 Service used to run a service from north Ayrshire to Glasgow and recently, following the merger, was involved in a joint service from Ayr to Greenock on the Lower Clyde. Based on the evidence received we consider that an operator based in the area of overlap between A1 Service and Western Scottish could run services profitably at a range of 20 miles or more from its depot, depending on the particular circumstances.

2.32. Accordingly it appears to us that it is appropriate that the area which we investigate should be wider than that proposed by Stagecoach. This consideration points to the inclusion of the adjacent districts of Cumnock & Doon Valley, East Kilbride, Eastwood, Inverclyde and Renfrew as well as the three overlap districts referred to by Stagecoach.

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<sup>1</sup>*Stagecoach Holdings plc and Lancaster City Transport Limited: a report on the merger situation between Stagecoach Holdings plc and Lancaster City Transport Limited*, Cm 2423, HMSO, December 1993, paragraphs 6.38 to 6.40. This advice was applied in *SB Holdings Limited and Kelvin Central Buses Limited: a report on the merger situation*, Cm 2829, HMSO, April 1995, paragraph 2.21, and in *Service Corporation International and Plantsbrook Group Plc: a report on the merger situation*, Cm 2880, HMSO, May 1995, paragraphs 2.6 and 2.7.

<sup>2</sup>*Stagecoach Holdings plc and Lancaster City Transport Limited*, op cit, paragraph 6.21.

2.33. An argument could be made for including Dumfries & Galloway too in the area for investigation. Western Scottish is the leading operator both in north Ayrshire and in Dumfries & Galloway, and changes in competitive conditions in the former area might be thought likely to affect the latter. However, the distance between the centres of population of the two areas is substantial and they appear to have little in common in terms of bus operations. We see little likelihood in practice that competition in Dumfries & Galloway would be affected by events in north Ayrshire, and we therefore exclude Dumfries & Galloway from the area for assessing the merger.

2.34. We therefore consider that the share of supply test should be applied in the eight districts of Strathclyde region included in the reference area but not the region of Dumfries & Galloway. We refer to this reduced area as 'the designated area'.

2.35. In considering whether it is appropriate for us to regard the designated area as 'a substantial part of the UK' we have had regard to the judgment of the House of Lords in the judicial review of the case of *South Yorkshire Transport Ltd.*<sup>1</sup> Their Lordships held that the words in question must on their true construction connote a part 'of such size, character and importance as to make it worth consideration for the purposes of the Act'.

2.36. We have also noted that in the course of his speech in that case, Lord Mustill said:

It seems to me that where the task is to interpret an enabling provision, designed to confer on the Commission the power to investigate mergers believed to be against the public interest, the court should lean against an interpretation which would give the Commission jurisdiction over references of the present kind in only a small minority of cases. This is the more so in the particular context of local bus services, since the provision of adequate services is a matter of importance to the public, as witness the need felt by Parliament to make special provision for them in the Transport Act 1985.<sup>2</sup>

2.37. The designated area represents 1.4 per cent of the UK population and 1.8 per cent of the UK geographical area. It includes the towns of Ayr, East Kilbride, Greenock, Kilmarnock and Paisley and the southern suburbs of Glasgow. Bus usage is above the Great Britain average in all but one of the districts concerned. We therefore believe the designated area is a part of the UK which is 'of such size, character and importance as to make it worth consideration for the purposes of the Act' and hence 'a substantial part of the UK' for those purposes.

2.38. For the purpose of carrying out the share of supply test, section 68(3) of the Act provides that the MMC shall apply such criterion or combination of criteria as appear to them to be most suitable in all the circumstances. In all previous merger inquiries in the bus industry the MMC have used registered vehicle mileage as the criterion for measuring the size of the market and calculating market shares. However, in the recent monopoly inquiry into the supply of bus services in the north-east of England, the MMC commented that while there was no single ideal measure, turnover seemed to meet the requirements of an ideal measure more closely than registered mileage. Registered mileage was a capacity measure and did not take account of vehicle size or different route characteristics. Turnover by contrast was a measure of sold output: it reflected the number of passengers and weighted their journeys by the fare paid. The main drawback with turnover, and the reason why it had not been used in previous merger inquiries, was the time and difficulty associated with collecting data (see paragraphs 2.4 to 2.6 of that

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<sup>1</sup>*R v MMC ex parte South Yorkshire Transport Ltd*, [1993] 1 WLR, p23.

<sup>2</sup>Op cit, p31.

report).

2.39. In the previous bus merger inquiries the shares of the relevant companies on the basis of registered vehicle mileage were well above 25 per cent. It was therefore unnecessary to impose the extra costs and burdens on the industry associated with collecting turnover data when there was no likelihood of a different conclusion on jurisdiction being reached on that measure. In the present inquiry there was reason to think that the determination of a qualifying merger situation might not be so clear-cut and we therefore collected data on both measures.

2.40. Table 4.5 shows that in May 1995 Western Scottish supplied 20.2 per cent of bus services in the designated area, based on registered mileage, and A1 Service 4.0 per cent, giving a combined share for Stagecoach of 24.2 per cent on that measure.

2.41. Taking turnover as the measure, Table 4.5 shows that the share of Western Scottish was 26.0 per cent and that of A1 Service 6.5 per cent, giving a combined total of 32.5 per cent for Stagecoach. A greater degree of estimation is needed in calculating shares on the turnover measure than on mileage, because of the absence of any alternative source of information on those operators which did not reply to our survey. Paragraphs 4.43 and 4.44 describe the process of estimation which we have used in arriving at the figures given above. We are satisfied that on any reasonable estimate Stagecoach's share is above 25 per cent. It is, indeed, to be expected that large operators (such as Western Scottish) and others operating a concentrated network will tend to have a higher share of supply measured by turnover than by mileage.

2.42. For the reasons given in paragraph 2.38 we consider that turnover is the most suitable criterion in all the circumstances, within the meaning of section 68(3) of the Act, for applying the share of supply test in this inquiry and in view of the figures given in paragraph 2.41 we conclude that the test is satisfied.

2.43. As noted in paragraph 2.17(b), Stagecoach has a 20 per cent holding in SBH and the MMC concluded in their inquiry into that situation that the two enterprises had ceased to be distinct. If SBH's share of supply were counted as part of the Stagecoach group, the latter's share of the total supply in the designated area would be considerably higher than appears from paragraph 2.41. In view of the MMC's recommendation that Stagecoach should be required to divest its holding in SBH and the Secretary of State's acceptance of the recommendation, we have not counted SBH's share as part of the Stagecoach group, nor have we had regard to Stagecoach's holding in SBH in evaluating the public interest in this inquiry.

2.44. Having found that one of the two tests for a merger situation qualifying for investigation (see paragraph 2.25) is satisfied, by virtue of our terms of reference we conclude, for the reasons given in paragraphs 2.26 and 2.42, that such a situation has been created. We have therefore now to investigate and report on whether the creation of that merger situation operates or may be expected to operate against the public interest.

## **The market**

2.45. Chapter 4 presents information on bus services in the designated area in the context of other forms of transport there. Table 4.2 shows that use of bus services for travel to work in the designated area at the time of the 1991 Census was over 50 per cent higher than the Great Britain average and over four times greater than use of trains. The picture was not materially different for the three districts where the services of A1 Service and Western Scottish overlapped. (Information on use of different transport modes for purposes other than travel to work is not readily available.) The availability of cars was below the Great Britain average both in the designated area as a whole and in these three districts individually.

2.46. Rail services in the area are subsidized by Strathclyde Passenger Transport Executive (SPTE) on behalf of Strathclyde Regional Council but in general fares are still significantly higher than for bus services. Rail usage in the designated area is relatively low and presents only a limited degree of competition to Western Scottish on certain routes.

2.47. The possibility of substituting cars for buses clearly exists for a proportion of travellers but at any particular time there are substantial numbers of people who do not have this choice. This is particularly so in an area with below-average availability of cars. We therefore treat bus services as a separate market from cars for the purpose of our analysis. Taxis may present a reasonably close alternative to buses in circumstances where three or four people can share but this is likely to represent a small proportion of potential demand for bus services.

2.48. We consider that our market analysis should focus primarily on the supply of bus services.

2.49. Table 4.5 shows individual operators' shares in the supply of bus services in the designated area. Measured by turnover, Western Scottish (including A1 Service) has 32.5 per cent of the total, Clydeside Buses Ltd (Clydeside Buses) 21.5 per cent and SBH 15 per cent. Thus the three largest operators have nearly 70 per cent of the total between them.

2.50. Most of the turnover of Clydeside Buses and SBH arises in the northern part of the designated area along the Lower Clyde and in the Glasgow conurbation respectively. In the three overlap districts further south Western Scottish has 41 per cent of the total based on mileage<sup>1</sup> and A1 Service 10 per cent (as noted in paragraph 2.41, the shares of these two operators are likely to be higher than these figures when measured by turnover). Dodds of Troon Limited which trades as AA Buses (AA Buses) has 12 per cent and Clyde Coast Coaches Limited (Clyde Coast) 7 per cent. Clydeside Buses has under 2 per cent in these districts and SBH has no presence at all (see Table 4.6).

2.51. Clydeside Buses is a former SBG company sold to its management and employees in 1991. The company experienced financial and operating difficulties in 1994 and was acquired by British Bus, one of the emerging large operators, in November of that year. It has a fleet of some 220 buses and operates principally in the districts of Inverclyde and Renfrew.

2.52. SBH is the former Glasgow municipal bus operation which was bought out by its management and employees from Strathclyde Regional Council in February 1993. It acquired Kelvin Central Buses Limited, another former SBG subsidiary, in October 1994 and now has some 1,300 buses, operating principally in Glasgow and the towns immediately to the north, east and south.

2.53. AA Buses has 45 buses and operates in the three districts of overlap between A1 Service and Western Scottish. Clyde Coast until recently operated 30 buses in two of the three overlap districts (Cunninghame and Kilmarnock & Loudoun) and also in Inverclyde. Like AA Buses it is a long-established family business: both were offshoots of the original A1 Service consortium.

2.54. SPTE provides subsidies for services which are considered socially necessary but which are not provided by operators on a commercial basis. It invites operators to tender for these services (which are therefore referred to as 'tendered services') by specifying the level of subsidy with which they would be prepared to run them: the operator keeps the passenger revenue and hence takes the revenue risk. SPTE sets a tariff scale which establishes the

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<sup>1</sup>Turnover figures are not available for individual districts.

maximum fares.

2.55. In the designated area as a whole tendered services represented 6.5 per cent of the total mileage registered by all operators in the year to March 1994. The proportion varies widely between districts, being generally higher in rural areas: see Table 4.8.

2.56. SPTE is also responsible for providing transport for children who are eligible for free travel to school. In this case the level of subsidy which operators bid for represents the whole of the revenue from fulfilling the contracts.

### ***Entry conditions***

2.57. Entry into bus and coach markets has often been regarded as easy. The main assets (ie vehicles) can be obtained cheaply second-hand or hired and can readily be moved between areas. Regulatory requirements are few. New operators can begin with relatively simple operations, such as private hire and schools contracts, before moving into the supply of bus services. It is, however, more difficult to expand and create a network of services, since this will entail competing against existing operators who can be expected to respond. While small operators have certain cost advantages, these may be reduced as they grow in size, and large operators enjoy certain economies of scale and size compared with those of medium size and below.

2.58. There are certain aspects of bus markets-access to bus stations, availability of depots and maintenance facilities, other operators' prepaid ticket schemes, arrangements for passenger information-which may in particular circumstances constitute barriers to entry or growth. We have not received evidence that they do so in the designated area. The only potential barrier which appears significant in this inquiry is the reputation of an incumbent operator for aggressive or predatory behaviour. We return to this issue in our consideration of the public interest (see paragraphs 2.94 to 2.96).

### **Public interest issues**

2.59. In addressing the issues which the merger raises for the public interest we consider first the effects on competition and then other factors, including the benefits which the merger may be expected to bring about.

### ***Loss of competition between A1 Service and Stagecoach***

2.60. As described in paragraph 2.10, A1 Service's operations before the merger fell into two categories: local services run commercially and schools contracts. Schools contracts fall outside the definition of 'bus services' (see paragraph 2.1) but we are entitled to take them into account in our consideration of the public interest, and we have done so.

2.61. As regards local services, Table 4.6 shows that in Cunninghame district, where the bulk of A1 Service's mileage was run, A1 Service supplied 18 per cent of services measured by registered mileage and Western Scottish 10 per cent, while in the other main overlap district, Kilmarnock & Loudoun, A1 Service supplied 11 per cent and Western Scottish 70 per cent. (These figures include tendered as well as commercial services but in practice A1 Service ran no tendered services.)

2.62. Stagecoach told us that the registered services of A1 Service overlapped with four of

Western Scottish's. Much of the overlap mileage occurred on one route, Ardrossan-Kilmarnock. On that route A1 Service's buses ran at ten-minute intervals while Western Scottish ran only four times a day to connect with the Arran ferry at Ardrossan. Two other Western Scottish services, both hourly, ran on part of the same route (see paragraphs 4.47 to 4.51 for further details).

2.63. Stagecoach argued that in practice the competition between the two operators was negligible. A1 Service ran a frequent and very local service in the relatively well-populated corridor between Ardrossan, Irvine and Kilmarnock, whereas Western Scottish for the most part ran less frequent (typically hourly) services over longer routes, a few of which happened to coincide in part with A1 Service's. Moreover Western Scottish's services were aimed primarily at the residents of Kilmarnock whereas A1 Service covered the residents of Ardrossan and Irvine. A1 Service generally took the initiative to raise fares on the Ardrossan-Kilmarnock route where it was the dominant operator, and Western Scottish had generally charged the same fares as A1 Service on that route.

2.64. Cunninghame District Council told us that the merger did not appear to have affected the level of competition in its area. Although Western Scottish operated widely throughout south-west Scotland, there was little overlap between its services and those which had been provided by A1 Service. Generally these services complemented rather than competed with one another. The Traffic Commissioner confirmed this and commented that there had been no significant registration changes as a result of the merger. Kilmarnock & Loudoun District Council, however, expressed concern that Stagecoach's acquisition policy was diminishing competition in its area. Stagecoach was now the only significant provider of commercial bus services in the district.

2.65. We agree that actual competition on commercial services between A1 Service and Western Scottish before the merger was limited. Nevertheless their presence on adjacent and partly overlapping routes is likely to have constrained the behaviour of each of them to some degree, as witness Stagecoach's comment about fares on the Ardrossan-Kilmarnock route (paragraph 2.63). Given Western Scottish's dominance in Kilmarnock & Loudoun, we share some of that district council's concern about the increment to Western Scottish's market share which has resulted from the merger.

2.66. As regards schools contracts, Stagecoach told us that a number of the contracts currently held by A1 Service had been won from Western Scottish at the last round of bidding three years earlier. Clearly therefore there had been active competition between the two operators in this part of the market and this could have been expected to continue in the absence of the merger. Information from SPTE, however, showed that there was no shortage of bidders for schools contracts in A1 Service's area of operations, although A1 Service had clearly had considerable success in its bids: at January 1995 it held some 50 such contracts (see paragraph 4.60).

2.67. Besides the effect on actual competition, dealt with in paragraphs 2.61 to 2.66, we need also to consider the loss of potential competition between A1 Service and Stagecoach.

2.68. As recorded in paragraph 2.29, Stagecoach submitted that historically A1 Service had not been an adventurous operator. Moreover, Stagecoach continued, the ten different firms which operated under the A1 Service umbrella had followed different policies on investment: some invested in fleet renewal but others did not. Generally its fleet was very old. There had been internal conflicts among the owners, maintenance and reliability problems and, as a result, a warning from the Traffic Commissioner which raised question marks over the company's ability to service its registered routes (see paragraph 2.9). In Stagecoach's view, A1 Service's ownership and management pattern was unsuited to the deregulated market and the company was in decline. In these circumstances, Stagecoach argued, the merger would have no effect on

potential competition.

2.69. Stagecoach added that the payments received by the former member firms of A1 Service would, indeed, strengthen potential competition by enabling them to invest and therefore compete more effectively. While Stagecoach had, for this reason, obtained restrictive covenants from the members preventing them from competing on registered services in the three overlap districts (see paragraph 2.19), the restrictions lasted for only three years (from January 1995) and did not cover schools contracts.

2.70. While there is some force in these arguments, we believe they give an exaggerated picture of the conservatism and decline of A1 Service. Stagecoach paid £4.3 million for the operation, with a high premium for goodwill compared with other acquisitions in 1994 (see paragraph 2.20). Although Stagecoach advanced an explanation for the size of the goodwill premium (see paragraph 6.33), we are clear that the price was relatively high, particularly taking account of the further expenditure which it immediately incurred on buses and a depot (see paragraphs 2.21 and 2.22). As noted in paragraph 2.31, A1 Service used to run a service to Glasgow. Stagecoach said that this was essentially a service run by one of the member firms, albeit in the name of A1 Service. That seems to us to indicate a greater prospect of innovation than if all new services had to involve the whole membership. Nevertheless we agree that A1 Service under its previous ownership was unlikely to present a significant competitive threat to Western Scottish as regards registered services once the latter had been acquired by a powerful operator such as Stagecoach.

2.71. On the other hand, had it not been for the merger, it is likely that Stagecoach would have initiated more vigorous competition with A1 Service with a view to expanding Western Scottish's turnover by that means rather than by acquisition. The benefits of that potential competition have been lost.

2.72. Turning to schools contracts, we have commented above that A1 Service could have been expected to continue providing effective competition to Western Scottish in future bidding rounds. SPTE told us that A1 Service was well regarded in its performance of these contracts. Several of the former members told us that they were unlikely to compete for future contracts, although four said that they had already bid for some or intended to do so in future. SPTE argued that the former A1 Service members would be at a disadvantage in bidding for schools contracts because they would be unable to combine meeting the schools' requirements with operating local services. Stagecoach said that this comment did not accord with industry experience since deregulation and the former members did not make the point in their evidence to us.

2.73. The nature of schools business is such as to be attractive to small operators. This suggests that, as in the past, there is likely to be adequate competition for the business. Moreover, schools contracts represented a relatively small proportion of A1 Service's revenue (see paragraph 2.11). For these reasons we do not attach a great deal of weight to this aspect of the merger's effects.

2.74. There remains the possibility that another operator might have acquired A1 Service. Other large operators told us that they were not aware that A1 Service had been for sale. Most said that, had they known, it was unlikely that they would have been interested, but Go-Ahead said that it would have looked into the possibility and FirstBus said that it was difficult to know if it would have made an offer without having sight of more detailed information about A1 Service. Of the two large operators with a presence in the designated area, British Bus (which owns Clydeside Buses) said that it was unlikely to have seriously considered making an offer, largely because of other projects which were taking its time and resources. SBH said that it would probably have spoken to A1 Service but that given the latter's size, and the lack of contiguity and synergy between it and SBH, the acquisition would not have been very logical. SBH would also

have been concerned about taking over an apparently disparate organization whose fleet would have required upgrading.

2.75. Among the other operators in the overlap area, AA Buses told us that it had never thought A1 Service would be taken over: it thought the operation might just disband. Asked whether AA Buses itself would have been interested in acquiring A1 Service, the company said that that would have depended on the price and whether AA Buses could raise the necessary capital. Clyde Coast said that it might have been interested in bidding for A1 Service if it could have raised the money and might be interested-subject to the same proviso-if A1 Service came back on to the market. Shuttle Buses Ltd (Shuttle Buses) said that in the latter case it would be interested in parts of A1 Service if it were sold piecemeal, but it was not in a position to take on the whole business.

2.76. It is a matter for speculation whether another operator would have been seriously interested in acquiring A1 Service. Given the unusual nature of that business, the age of its fleet and its problems with the Traffic Commissioner, it would not have appeared a particularly attractive prospect to acquire, as SBH commented. Moreover it operated in what other operators were likely to see as 'Stagecoach territory' and hence to offer limited prospects for growth without the risk of triggering a 'bus war'. On the other hand, there are several acquisitive bus companies besides Stagecoach and at the present time, with a rapid process of consolidation going on in the industry, we take the view that almost any sizeable bus company is saleable at the right price. It seems to us likely that Stagecoach's willingness to pay a relatively high price for A1 Service arose partly from a wish to ensure that the business was not bought by someone else.

2.77. Our view is that the merger did bring about a loss of both actual and potential competition between A1 Service and Western Scottish. The extent of this was modest as regards actual competition but more significant as regards potential competition.

### ***Competition from other operators***

2.78. The effects of the merger need to be seen in the context of the general competitive situation in the designated area. Moreover the merger itself may have indirect as well as direct effects on that situation.

2.79. Table 4.5 shows that, besides Western Scottish, the only operators with a share of supply in the designated area above 10 per cent are Clydeside Buses and SBH. Most of their operations are in the north of the designated area, however. In the three districts where the operations of A1 Service and Western Scottish overlap only one other company, AA Buses, has over 10 per cent of total supply and three others-Clyde Coast, Ashton Coach Hire Ltd (Ashton Coach Hire) and Shuttle Buses-have between 2 and 7 per cent (see Table 4.6).

2.80. SPTE, whose functions are described in paragraph 3.14, told us that it was concerned about the merger because of its impact particularly on competition for subsidized local services and schools services. In its view Stagecoach appeared to be moving to a position where it would control the supply of local bus services and limit the extent of real competition for contracted services. It provided information about a substantial number of changes, mostly involving reductions in services or withdrawal by other operators, since Stagecoach had acquired Western Scottish in July 1994. These, it said, would serve to put the acquisition of A1 Service into context and illustrate the cause of its concern about future competition. In total, SPTE referred to eight providers of local bus services in Ayrshire and Argyll & Bute which had wholly or virtually withdrawn from those markets in the past year. Of the two significant new players to arrive in that period, one withdrew immediately and the other (Ashton Coach Hire) faced co-ordinated competition from a consortium which had included a Stagecoach company.

2.81. Stagecoach responded in detail to SPTE's comments. Regarding SPTE's expression of concern about subsidized local services it pointed out that A1 Service did not operate any such services. It described the claim that eight operators had withdrawn from the market as 'quite misleading'. Some of the operators referred to were, it pointed out, outside the designated area. Of the others, two had been banned by the Traffic Commissioner and one (Arran Transport) had been acquired by Stagecoach in a transaction cleared by the Office of Fair Trading (OFT). Another (Clydeside Buses) had merely closed its depot in the designated area (at Largs) but continued to run all but one of the services which had been based there. Stagecoach said that SPTE could not be regarded as an objective witness (see paragraph 6.35).

2.82. SPTE's evidence and Stagecoach's comments thereon are set out more fully in Appendix 5.1.

2.83. Among the other significant operators in the area of overlap between A1 Service and Western Scottish, AA Buses told us that it was not aware of any aggressive action by Stagecoach and had no concerns over its acquisition of A1 Service. AA Buses has, however, been involved in two developments in recent months which give some indication of its relationship with Stagecoach:

- (a) In March 1995 it began operating a service on a route from Ayr to Dalmellington, in Kyle & Carrick district, from which Western Scottish had been banned for one year by the Traffic Commissioner (see paragraph 4.32). AA Buses said that its entry into this route was not the result of any agreement with Stagecoach, nor was there any understanding as to what would happen when the ban on Western Scottish ended. It had, however, sought Stagecoach's reaction to its intention to register on the route because, it said, Stagecoach was not someone to fall out with (see paragraph 5.48). Stagecoach had raised no objections.
- (b) AA Buses was one of four operators-the others being Stagecoach A1 Service, Clyde Coast and Clydeside Buses-which started a joint service in July 1995 between Ayr and Greenock in competition with a service called 585 Coastline operated by Ashton Coach Hire (see paragraphs 4.52 and 5.49). The joint service adopted a similar name and number (Coastlink 535) and livery to those of Ashton Coach Hire's service. Ashton Coach Hire brought an action against three of the operators of the joint service and was granted an interim interdict (the equivalent of an injunction) preventing them from 'passing off' their service as being associated with Ashton Coach Hire's. The joint operators stopped using the name Coastlink 535 and repainted their buses, and the action was not pursued to a court hearing. Stagecoach A1 Service withdrew from this service in August 1995. Stagecoach told us that it withdrew because of adverse comments in the local press and by certain politicians which singled out Stagecoach for criticism. (The strength of the reaction to what was seen as a concerted attack on a small operator running a valued service was the main point to emerge from our consultation with members of the public (see paragraphs 5.81 and 6.14).)

2.84. The second of these operators, Clyde Coast, also told us that it had no concerns over the merger. This operator, however, reached agreement in the course of our inquiry to sell four minibuses and seven registrations of commercial services to Western Scottish. These registrations represented all its local bus operations except for its involvement in the joint Ayr-Greenock service, in which it took over the share of Stagecoach A1 Service as well as retaining its own (see paragraph 4.34). All the buses which it uses for this service are rented from Western Scottish. Thus apart from that service Clyde Coast has now withdrawn from the local service market (although not from schools business).

2.85. The third operator, Shuttle Buses, explained to us the circumstances of its withdrawal from providing bus services in the Kilmarnock area in the autumn of 1994 and their being replaced by Western Scottish (see paragraphs 5.58 and 5.59). There were now no areas where Shuttle Buses regarded itself as competing directly with Stagecoach and it had no plans to alter its operations: there were few areas where commercial services could be introduced without competing with Stagecoach, AA Buses or Clyde Coast, from whom Shuttle Buses would expect a robust response. Shuttle Buses said that it was not concerned by the acquisition of A1 Service because there was still sufficient competition from other operators. It would be concerned if Stagecoach increased its market share further either by acquisition or by competition. As regards schools contracts, Shuttle Buses commented that the number of competitors was already fairly small and shrinking.

2.86. We infer from the matters addressed in paragraphs 2.80 to 2.85 that the relationship between Stagecoach and the other remaining operators in the overlap area involves little competition and is mainly one of co-operation or the avoidance of conflict. Moreover, taking account of SPTE's evidence, we observe that a number of the small operators in the designated area have cut back or withdrawn from local service activity since Stagecoach's acquisition of Western Scottish in July 1994. The only entrant of any significance has been Ashton Coach Hire. Some witnesses suggested to us that there might be a financial relationship between Stagecoach and certain other operators but we found no evidence of that beyond the dealings which we have summarized above.

2.87. Stagecoach told us that Western Scottish was unprofitable when acquired. Stagecoach needed to add turnover to the business without increasing overheads so that it could spread the cost base more efficiently. In relation to both Arran Transport and A1 Service it faced the choice of either competing to put those operators out of business or acquiring them.

2.88. We are clear that Stagecoach's strategy is to increase its share of bus services in Ayrshire by a variety of means and that the remaining competition to Western Scottish is weak. While this strategy may be commercially sensible for Stagecoach, the consequence is likely to be that competition from other operators in the area will be further diminished.

2.89. It is not possible to say with certainty to what extent other developments tending to weaken competition are the result of the merger which we are investigating. The principal direct effect of the merger was to make Western Scottish the leading operator in Cunninghame district, the only one of the four districts in Ayrshire where it was not already dominant. The joint competitive attack on Ashton Coach Hire's Ayr-Greenock service (see paragraph 2.83) and the acquisition of much of Clyde Coast's bus operations (paragraph 2.84) can be seen as a consolidation of Western Scottish's position in Cunninghame (albeit that Stagecoach has now withdrawn, for public relations reasons, from the joint Ayr-Greenock service). Since the acquisition of A1 Service has increased Stagecoach's dominance in Ayrshire, we believe the merger has had the effect of further weakening the prospects for effective competition against Stagecoach from existing operators in that area.

### ***Possible market entry***

2.90. Stagecoach argued that entry into the bus industry remained easy: in particular the 'quality threshold' was low. Thus the prospect of entry was a permanent constraint on the ability of any operator which established a strong position in a local market to exploit that position by charging high fares.

2.91. We set out in paragraphs 2.57 and 2.58 a number of factors which might in some circumstances constitute barriers to entry. There are two in particular that we need to address

here: economies of scale, and reputation of the incumbent operator.

### *Economies of scale*

2.92. As regards the former, Stagecoach presented figures to us showing that, on average, its operating costs were 20 per cent below those of the rest of the industry. Much of this difference was, it said, due to economies of scale, notably in purchasing. Stagecoach was able to buy new buses at low prices, for example, and then achieve substantial savings in maintenance costs. Stagecoach was also a very efficient operator, with low overheads and efficient utilization of labour. Asked to compare Western Scottish's costs with those of small operators in the same area, Stagecoach said that the costs of small companies varied according to the quality of their operations: the costs of small well-run companies would probably not be markedly less than those of Western Scottish (which were above average for the Stagecoach group). More generally, however, Stagecoach emphasized its view that there were significant economies of scale and size in the bus industry. It estimated that on average small operators' costs were 25 to 30 per cent higher than Stagecoach's (see paragraph 6.10).

2.93. Stagecoach's views on this subject conflict with the analysis in the MMC's recent report on *The supply of bus services in the north-east of England* where it was noted that small firms tended to have the advantage over large ones in labour costs and in the cost of management control. We have not been able, in the framework of this inquiry, to explore this subject in depth, nor do we believe it was necessary to do so. We take the view that, while degrees of efficiency may vary widely, economies of scale and size are not such as to present a barrier to small firms entering the market because the costs and risks involved in setting up a small-scale operation are low. On this, we agree with Stagecoach (see paragraph 6.11). The difficulties in building up the size of such a business and improving its quality are, however, likely to be more significant. Expansion has usually to be at the expense of another operator and, given the substantial running costs of bus operations, a competitive incursion may be difficult to sustain. This is particularly the case when the incumbent is more efficient than the average, as is generally the case with Stagecoach subsidiaries.

### *Reputation*

2.94. As regards the reputation of an incumbent operator, Stagecoach submitted a résumé of academic papers which argued that the deliberate cultivation of an aggressive reputation in order to deter competitive entry was not a rational strategy (see paragraph 6.17).

2.95. We are not convinced by this argument. First, there are other commentators who take a different view from those cited by Stagecoach (see paragraph 4.77). Secondly, and more important, it is necessary to look at the circumstances of particular industries. There is empirical evidence in previous MMC and OFT reports to show that predation or other forms of aggression have been part of the strategy of large operators in the UK bus industry, including Stagecoach. In the present inquiry we have seen an example of a concerted attack by four companies against a small operator, Ashton Coach Hire (see paragraph 2.83). In the MMC's recent inquiry into the supply of bus services in the north-east of England we concluded that two large operators, Go-Ahead and Stagecoach, had been engaging in predatory action against smaller competitors. In the case of Stagecoach's actions in Darlington the report concluded that these would deter future competitive entry into local bus markets where a Stagecoach company was established.

2.96. Regardless of the intention behind this kind of conduct, we believe the effect will in general be to deter small operators from entering markets where large operators with an aggressive reputation are prominent. For the reasons set out above and in paragraphs 4.78 to

4.81, we consider that Stagecoach is such an operator.

### *Possible entry by other large operators*

2.97. We considered whether other large operators would be likely to enter the Ayrshire market in competition with Stagecoach. It is relatively rare for the large operators to set up a new operation in an area remote from their existing territories. A more likely entry stratagem would be to acquire an incumbent with a view to expanding from an existing base. The only remaining incumbent of any size apart from Western Scottish is AA Buses. It is doubtful that other large operators with no presence in south-west Scotland would see AA Buses, which has 45 buses, as providing an adequate base for expansion against Western Scottish (which has over 400, including those used on A1 Service routes), or that the Ayrshire market is sufficiently attractive to justify such an initiative. We believe other operators are in any case likely to see the area as 'Stagecoach territory'.

2.98. We asked the two large operators with a presence in contiguous areas whether they might expand into Ayrshire. British Bus, which owns Clydeside Buses, said that whilst it was constantly exploring the possibilities of expansion in Scotland, its attention was more focused on the larger conurbations and any future decisions regarding Ayrshire would depend on what other operations it was able to acquire in Scotland. Clydeside Buses itself told us that in assessing specific expansion possibilities it took all matters into consideration, including possible retaliatory moves by operators which might be at its expense. At present it did not plan to extend further into Ayrshire but this decision might be revised in future. SBH said that it saw Ayrshire as poor bus territory and a little too far removed from its existing area of operation, though it could not rule out the possibility of expanding there if the incumbent was charging high fares and offering a poor service.

2.99. In previous reports on bus merger inquiries the MMC have placed weight on potential competition from large operators in neighbouring areas. This factor has to be examined in relation to the circumstances of the individual case. Clydeside Buses has a history of financial weakness and was acquired by British Bus less than a year ago. It has recently closed its small depot in Cunninghame. SBH is essentially an urban operator and does not see Ayrshire as an attractive area for expansion. In the present case, therefore, our view is that, while British Bus and SBH are significant competitive forces in the north of the designated area, their presence there and the possibility of their expanding into Ayrshire in future are unlikely to be much of a constraint on Stagecoach's behaviour in Ayrshire.

2.100. It is relevant also to recall that in their inquiry into bus services in the north-east of England the MMC found little evidence of active competition between large operators.

### *Conclusion on possible market entry*

2.101. For the reasons set out in paragraphs 2.90 to 2.100, we take the view that new entry is unlikely to be a source of effective competition to Western Scottish in the designated area.

## ***Other effects of the merger***

2.102. Stagecoach submitted that the merger would bring several benefits for the public interest. A1 Service had a very old fleet of buses and had been called to account by the Traffic Commissioner for its poor standard of maintenance. It was a very traditional operator which undertook little innovation to generate extra traffic and instead looked to cover inflation, increasing costs and falling passenger numbers by raising fares for the remaining passengers. Stagecoach said that it would apply its radically different philosophy of new vehicles, better quality service, improved marketing and innovative services to generate extra passengers, thus yielding extra revenue to allow fares to be held constant or reduced and to pay for investment in new equipment, vehicles and premises. Stagecoach also said, and we accept, that it had improved the terms and conditions of employees and given the drivers training in the reporting of defects.

2.103. There is no doubt that the quality of vehicles in use on A1 Service's routes has markedly improved since the merger (see paragraph 2.21). The Traffic Commissioner told us that Stagecoach was tackling the maintenance problems from which A1 Service had suffered. The various steps it was taking would lead to a better service to passengers and improved road safety. For these reasons the Traffic Commissioner welcomed the merger.

2.104. SPTE told us, however, that the number of complaints from schools about the performance of A1 Service's schools contracts which were found to be justified had risen by 50 per cent in the period following the merger. Stagecoach questioned SPTE's figures. It mentioned that it was losing money heavily on those contracts. It could not operate in the same very informal way as A1 Service and when the contracts fell due for renewal in 1996 its bids would be higher than those previously submitted. The comments we received from the schools suggested that there had been difficulties following the merger but that Stagecoach had taken steps to address these. We do not underestimate the importance of schools transport being provided to a high standard but the complaints about Stagecoach's performance are not such as to indicate a serious continuing problem.

2.105. As regards new services, Stagecoach mentioned two specific plans. First, it planned to introduce a network of express services linking the towns in A1 Service's territory with Glasgow, Kilmarnock and Ayr. Similar services operated by other Stagecoach companies elsewhere had been very effective in generating new traffic. Secondly, it intended to introduce minibuses and small buses on high-frequency routes penetrating more deeply into housing estates.

2.106. As regards fares, Stagecoach told us that, while the industry as a whole had on average increased fares by 2 per cent a year above the rate of inflation, that was not Stagecoach's policy. Such real fare increases led to falling passenger numbers and this was not a sustainable strategy for the long term. Stagecoach's policy was to freeze fares in cash terms wherever possible. It estimated that its group fare increases in recent years had on average been below inflation. Western Scottish had previously seen fare increases as the first recourse whenever it needed an increase in revenue but Stagecoach had held fares unchanged since acquiring the company in July 1994. It intended to follow its normal group policy in relation to the merged Western Scottish/A1 Service. The former owners of A1 Service, by contrast, had planned to increase fares in January 1995.

2.107. We accept that Stagecoach is likely to be more innovative than the old A1 Service in the services offered, to increase efficiency and to hold fares in the short run (we address the longer-term prospect below). Most importantly it has already improved vehicle standards, to the benefit of public safety. We also believe the prospects for terms and conditions of employment are better under Stagecoach than under the previous ownership.

2.108. If another operator had acquired A1 Service some of the benefits outlined above might similarly have resulted, but that is inevitably speculative. It is relevant to recall that Stagecoach has a reputation for investing heavily in new vehicles, has levels of operating costs well below the industry average and has a good record for service innovation elsewhere. Its general record in restraining fare increases is also better than the industry average.

### ***Assessment and conclusion***

2.109. In this section we bring together the elements in our analysis and reach a conclusion.

2.110. We have commented (paragraph 2.77) that the merger brought about a loss of actual competition in relation to commercial services and schools contracts but that this effect was modest. The effect on potential competition was more significant.

2.111. We noted (paragraphs 2.88 and 2.89) that Stagecoach's strategy is to increase further its already high share of bus services in Ayrshire and that this is likely to lead to competition from existing operators, already weak, being further diminished. We see the merger as part of that strategy.

2.112. We have also taken the view that there is unlikely to be effective competition from new entry (paragraph 2.101).

2.113. The merger has already brought about certain benefits, notably in the form of better buses, and is likely to lead to innovative services being introduced, increased efficiency and fares being held in the short term. Some of the benefits resulting from the merger might have been achieved if another operator had acquired A1 Service (paragraphs 2.107 and 2.108).

2.114. We have to consider the likely effects of the weakening in competition which we have identified. There is evidence to show that demand for bus services in the UK is relatively insensitive to changes in price (see paragraph 4.67). A company aiming to maximize shareholder value can therefore be expected to put up prices unless it is constrained from doing so by external factors. Similarly a dominant operator can be expected to reduce service frequencies, since in the absence of alternative services such action would reduce costs more than revenues by increasing the average loading of its buses.

2.115. Stagecoach argued that this view of the price elasticity of demand in the bus industry was out of date. It had experience of considerable short-term responsiveness of consumer demand to deep fare discounts in recent cases where it had experimented with such a policy. It also emphasized that its record on fares was quite different from the industry average (see paragraphs 6.20 and 6.21).

2.116. We do not believe that Stagecoach's argument about high price elasticities of demand is of general application. While there may well be circumstances where deeply discounted fares form an element in a rational commercial strategy, Stagecoach itself told us that its experiment in Fife showed that it was not sensible to apply such discounts to a whole network, precisely because elasticity of demand was generally low. Deep discounting is likely to be confined to a minority of services and times of day where demand is more responsive to changes in fares.

2.117. As regards Stagecoach's general fares policy, the company submitted evidence showing that it had generally held down fares in areas where it had a dominant position (see paragraphs 6.22 to 6.27). We naturally applaud this policy but the sample is necessarily too small, and spans too short a time period, to enable general conclusions to be drawn. Our concern is that the period when the company has been able to achieve rapid growth through acquisitions

and improving the performance of the acquired businesses will come to an end before long. At that point, faced with continued expectations of growth on the part of investors, we believe Stagecoach will come under pressure to put up prices and scale back services in areas where competition is weak. We also note that Stagecoach paid a high price (see paragraph 2.70) for A1 Service and will want to earn a commensurate return on that investment.

2.118. In summary we have four concerns in this inquiry:

- (a) the merger has weakened existing and potential competition;
- (b) Stagecoach's aggressive reputation will tend to discourage competition;
- (c) price elasticity of demand in the bus industry is low so that it is rational for a dominant firm to raise prices; and
- (d) we envisage that there will be pressure on Stagecoach to continue increasing profits and that in the future it will achieve this partly by raising fares or reducing service levels in areas where it faces little competition.

2.119. We believe that in the deregulated bus market actual and potential competition are the main safeguards against abuse of a dominant position. The merger, directly and indirectly, reduces competition in the supply of bus services in the designated area and the remaining competitive pressures on Stagecoach are weak. In our judgment the loss of competition is not fully offset by the benefits of the merger.

2.120. In answer to the question posed in paragraph 2.44, we therefore conclude, on balance, that the creation of the merger situation operates and may be expected to operate against the public interest, with the particular adverse effects that in the longer term fares in the designated area may be expected to be higher, and levels of service lower, than would otherwise be the case; and that competition from existing operators in the designated area, and the prospect of new competitive entry, have been reduced.

2.121. We are therefore required under the Act to consider what action, if any, should be taken for the purpose of remedying or preventing the particular adverse effects which we have identified.

## **Recommendations**

2.122. The merger we are investigating was legally completed in January 1995 and has been consummated. A1 Service is and has for several months been run as a division of Stagecoach's subsidiary Western Scottish, which was already the dominant bus operator in its area of operation. There is no question of A1 Service's business returning to its former ownership.

2.123. We have considered recommending divestment. One would hope for an enhancement of competition, actual and potential, if A1 Service were acquired by another large bus company, or by one of the smaller bus companies operating in or near the designated area. But on the strength of the evidence we have received we are doubtful about the willingness of others to acquire A1 Service in current circumstances, and even more doubtful about the prospect of an acquirer entering with serious competitive intent into what will be seen as Stagecoach territory. Furthermore, divestment would put at risk benefits which the merger has brought (see paragraph 2.113). On balance we have concluded that behavioural remedies are preferable to divestment in this case. One member of the Group, Professor Pickering, disagrees with this conclusion: his views are set out in a note of reservation which follows this chapter. The rest of the Group have

taken these views fully into account in reaching their own conclusion not to recommend divestment as a remedy.

2.124. In framing the recommendations which follow we aim to remedy the adverse effects which we have identified in paragraph 2.120 by:

- (a) restricting the merged company's ability to exploit the strength of its position by raising fares and cutting services; and
- (b) fostering competition in the supply of bus services in the designated area.

2.125. Accordingly we recommend that Stagecoach should give the following undertakings:

- (a) not to increase fares in the designated area more than once a year and not to increase them by more than the rise in the retail price index;
- (b) not to deregister any existing commercial services in the designated area, or materially reduce the frequency of any such services, unless the DGFT agrees that a reduction in services would be justified by external circumstances such as a decline in patronage;
- (c) that if Stagecoach reduces fares to below those of a competitor on any route or part of a route in the designated area, it will not subsequently raise fares in real terms (ie by more than the increase in the retail price index), should the competitor withdraw, for a period of at least three years after the competitor's withdrawal;
- (d) that if Stagecoach increases its frequencies on any route or part of a route in the designated area operated by a competitor, or on which a competitor has announced its intention of operating services, should the competitor withdraw Stagecoach will not subsequently reduce commercial frequencies for a period of at least three years after the competitor's withdrawal;
- (e) that if a competitor enters a route, or a substantially similar route, operated by Stagecoach in the designated area, Stagecoach will not timetable, register or operate an additional or rescheduled journey before the competitor's service within a shorter interval than the competitor has itself timetabled, registered or operated before an existing Stagecoach service;
- (f) that if Stagecoach registers a commercial service in competition with another operator's tendered service in the designated area and the other operator subsequently withdraws, Stagecoach will not subsequently withdraw its commercial service for a period of at least three years from the other operator's withdrawal;
- (g) to provide information to the DGFT, in the form set out in Appendix 2.1, on the financial performance of its operations in the designated area; and to disclose in its annual report and accounts that it has made such information available to the DGFT, and that the information is available to members of the public in an indexed form on request to the DGFT;
- (h) not to acquire the whole or part of the undertaking or assets of the business of any other operator in the designated area unless the DGFT has given prior approval to the acquisition as unlikely to give rise to the adverse effects which we have identified in paragraph 2.120; and

(i) to release the former members of A1 Service from the restrictive covenants preventing them from competing against Stagecoach (see paragraph 2.19).

2.126. We have deliberately refrained from specifying a period for the duration of these undertakings, cognizant of the fact that it is open to Stagecoach to apply to the DGFT for an undertaking to be lifted at any time on the grounds that circumstances have changed.

2.127. Should these undertakings not be forthcoming within a time-scale and in a form satisfactory to the DGFT, Stagecoach should be required to divest itself of A1 Service to a purchaser approved by the DGFT.