2 Conclusions

The reference

2.1. Under the reference (see Appendix 1.1) dated 30 July 1996 (made under sections 64 and 69(2) of the Fair Trading Act 1973-the Act) we are required to investigate and report whether a merger situation qualifying for investigation has been created as a result of enterprises carried on by or under the control of NEG having, within the four months preceding the date of this reference, ceased to be distinct from enterprises carried on by or under the control of MML. If we find that either the share of supply test or the assets test (referred to in section 64(1)*(a)* and *(b)* respectively) is satisfied, the reference requires us to exclude the other from our consideration.

2.2. As noted in paragraph 3.69, on 19 April 1996 NEG entered into a franchise agreement for a period of ten years with the Director of Passenger Rail Franchising (the Franchising Director) and a number of related agreements including the share purchase agreement for MML (that period would be reduced to seven years if certain conditions were not met). As further noted in paragraph 3.70, in accordance with the franchise agreement NEG took over responsibility for the operation of the MML services on 28 April 1996. Under section 66(3) of the Railways Act 1993 (the Railways Act), the acquisition of a passenger rail franchise is treated as the acquisition of control of an enterprise. Accordingly, for the purpose of section 65 of the Fair Trading Act, the enterprises of NEG have ceased to be distinct from the enterprise comprised by the passenger rail franchise carried on by MML.

2.3. As regards the share of supply test, we are required to be satisfied that, as a result of the enterprises of NEG and MML having ceased to be distinct, at least one-quarter of services of any description in the UK or in a substantial part of the UK is supplied by one and the same person (or the persons by whom the enterprises are carried on) or, if this is already the case, that the share of supply of the relevant services by that person or persons is increased.

2.4. Our terms of reference refer to `the supply of public transport services between London and, respectively, Derby, Sheffield, Chesterfield, Nottingham and Leicester' (which we refer to as `the five specified places'). Those services are by their nature confined to a particular geographical area of the UK, but our terms of reference do not specify a `substantial part of the UK' in which the share of supply test is thought by the Secretary of State to be satisfied. Only the five services on particular routes are mentioned by the Secretary of State and it is possible that it is intended to use the criterion of supply within the UK as a whole rather than supply within a substantial part of the UK.

2.5. As noted in Table 4.15*(a)*, we estimate that, prior to the merger, the coach services operated by NEL, a subsidiary of NEG, accounted for some 8 per cent of the value of public transport services between these five places and London and the rail services of MML for about 88 per cent. It is our view therefore that at least one-quarter of the supply of public transport services between London and, respectively, Derby, Sheffield, Chesterfield, Nottingham and Leicester is supplied by enterprises of NEG and MML and that as a result of the merger the condition referred to in section 64(3) prevails to a greater extent.

2.6. We have considered whether the share of supply test is met, with regard to the supply of services of any description, in a substantial part of the UK. For this purpose, the services we have had regard to are long-distance public passenger transport services, being passenger transport services involving journeys of more than 95 miles carried out wholly within the area described in paragraph 2.7. Although this description of services would include some NEL and MML services additional to those included in Table 4.15*(a)* with regard to some journeys to intermediate points along the particular routes, such journeys account for much lower revenue than those to and from London and we are aware of no other significant suppliers of such services; it is our view that this description would not cause the market share estimates mentioned in paragraph 2.5 to differ significantly. Therefore the conclusions reached in paragraph 2.5 remain valid when applying the share of supply test to our description of services.

2.7. The area within which we have applied the share of supply test is an area comprising Greater London in the south, the five specified places mentioned to the north and the area bounded to the east and west by the MML route and the M1 road respectively (see the map at Appendix 2.1).

2.8. The population of the five specified places alone is some 1.4 million, and over 2.5 million if some of the local authority areas between them are included; that of Greater London is almost 7 million. These populations represent 2.5, 4.7 and 11.9 per cent of the population of the UK respectively. The area described in paragraph 2.7 is over 5,000 square kilometres, over 2 per cent of the surface area of the UK. We have no doubt that such an area, given its size, character and economic importance, constitutes a `substantial part' of the UK so as to make it worthy of consideration for the purposes of the Act.

2.9. During our inquiry, NEG raised a number of concerns with regard to the application of the share of supply test. In particular:

(a) NEG argued that the MMC should not conclude that the share of supply test is met by the expedient of defining the services narrowly in terms of public transport services between London and the five specified places. To use the whole of the UK as the relevant area but to incorporate some form of geographical limit in the definition of services could result in mergers which were obviously *de minimis* being regarded as qualifying mergers, and to adopt that approach would render the threshold created by the use of the term `substantial' in section 64(3) redundant.

(b) With regard to our method for determining a substantial part of the UK, NEG argued that it could not see the basis for using the routes taken by the respective vehicles to determine the part of the UK served by the services in question, and that the geographical area was in its view defined arbitrarily. But if the routes were used for that purpose, NEG thought it would be inconsistent to include the whole of Greater London within the same geographic area because this would be mixing physical routes with catchment areas.

2.10. We sought the views of the Office of Fair Trading (OFT) on NEG's arguments in paragraph 2.9*(a)*. The OFT told us that it did not see much force in that argument: any way of describing goods or services (by reference to geographical criteria or otherwise) could potentially lead to consideration of insignificant merger situations, but the Act did not restrict the authorities' ability to describe goods or services in any way they saw fit. What prevented the authorities from adopting unreasonably narrow descriptions of goods or services was simply the general principle that they must act reasonably. The OFT did not think the merger in this case could be considered unworthy of consideration, whatever the position might be in some hypothetical examples, hence the OFT did not think the description of services adopted in this case could be criticized on this ground alone. The OFT accepted that the inclusion of reference to `substantial part' in the section 64(3) test did limit the ability of authorities to adopt a geographically limited description of services to the extent that it would be improper to adopt such a description of services simply in order to avoid the impact of the `substantial part' qualification. However, it did not think the descriptions of services adopted in this case gave rise to this objection: point-to-point services of this sort started at a particular point and ended at a particular point, and a practically infinite variety of routes may be taken in between. Hence, in the OFT's view, point-to-point flows were not in any sense an area or a part of the UK; they were flows. Thus it could not be said that the services of the description adopted were supplied in a part of the UK which was not substantial; the services could not be said to be supplied in any particular part of the UK at all.

2.11. With regard to NEG's first argument, stated in paragraph 2.9*(a)*, we would not necessarily accept NEG's concerns or the OFT's response, but we have not had to reach a conclusion on this point since, for the reasons given in paragraphs 2.6, 2.7 and 2.8, the share of supply test is met in a substantial part of the UK. With regard to NEG's second argument, summarized in paragraph 2.9*(b)*, we consider that we are required by the Act to ascertain whether there is any area which is a substantial part of the UK in which the 25 per cent market share condition is satisfied as a result of the merger. Accordingly, we do not accept that any area we select for the purpose of the share of supply test must be `relevant' in an economic sense. Whilst we do not accept that we are required to justify our choice of an area, our basis for using the routes taken by the respective vehicles is merely that they form clearly identifiable eastern and western boundaries to a substantial part of the UK in which we have determined that the services are supplied. Furthermore our approach contains no inconsistency in the manner suggested by NEG since the five specified places, and the *intermediate* area between them, would also include part at least of the catchment area.

2.12. We conclude that the share of supply test is satisfied and that a merger situation qualifying for investigation has been created. We have therefore to consider whether the creation of this merger situation operates or may be expected to operate against the public interest. Since the merger has only recently been completed and its effects may not yet be fully apparent, we have concentrated on whether it may be expected to operate against the public interest.

The companies

National Express Group PLC

2.13. As described in more detail in Chapter 3, NEG was formed in 1988 by a management buy-out of the National Bus Company's (NBC's) scheduled long-distance coach service business. It became a publicly quoted company in 1992 and subsequently made acquisitions of airports, further express coaching activities, buses and train operating companies (TOCs); it also has a share of London and Continental Railways Limited (L&CR) which is to develop the rail link to the Channel Tunnel. This reference is chiefly concerned with NEG's express coaching services, which are operated in the UK mainly through its subsidiary NEL (some services in Scotland are operated by its subsidiary Scottish Citylink Coaches Limited (Scottish Citylink) and some airport services by Speedlink Airport Services Limited (Speedlink)).

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

2.15. For the year ended 31 December 1995, total turnover of NEG was £318 million (1994-£170 million) and operating profit £44 million (1994-£16 million). NEL made operating profits of £5.2 million on turnover of £97.6 million in 1995.

2.16. As noted above, our terms of reference refer to services between the five specified places in the East Midlands and South Yorkshire and London (`the reference services'). As shown in Table 2.1, five NEL services (which we refer to as the `relevant coach services') operate between these five specified places and central London, two of which only operate once a day. As is apparent from Table 3.15, the total revenue of the other three relevant coach services (services 440, 450 and 560) was £3.9 million in 1995, with operating profit of £[*] million. Operating profit as a percentage of turnover was significantly higher on the services to Leicester, Derby and Nottingham (about [*] per cent) than on services to Sheffield and Chesterfield (some [*] per cent, similar to that for NEL as a whole).

Midland Main Line Limited

2.17. MML operates InterCity passenger services mainly between South Yorkshire, East Midlands and London St Pancras calling at 20 stations, seven of which are operated by MML and leased from Railtrack Group PLC (Railtrack). MML was created in April 1995 following the break-up of the larger vertically integrated profit centre known as Midland Cross Country and was one of the second round of passenger TOCs to be privatized under the Railways Act. For the year ended 31 March 1996 total revenues were £116 million, including passenger ticket revenue of £63 million, revenue from rolling stock, train maintenance revenue of £24 million and financial support of £17 million. About 45 per cent of MML's costs are charges paid to Railtrack and to the train leasing company Porterbrook Leasing Company Limited (Porterbrook).

Background to the merger

2.18. In December 1995 NEG submitted an indicative bid to the Franchising Director for the MML franchise and in January 1996 was one of four companies short-listed for that franchise. On 27 March the Franchising Director told NEG that it was the preferred bidder for MML. As noted in paragraph 2.2, the MML franchise was awarded to NEG in April 1996; the franchise is for a ten-year term provided increased services and additional rolling stock are introduced (the franchise reverts to a seven-year term if these conditions are not met).

2.19. The ten-year franchise entails an initial subsidy from the Franchising Director to NEG of £[*] million in year 1, declining over the next two years, followed by payments to the Franchising Director in each of the next seven years. These payments increase in each of these seven years, to £[*] million in year 10. In total, the franchise requires a cumulative payment, net of initial receipts, of £[*] million to the Franchising Director over ten years. The franchise commits NEG, among other things, to operate a minimum service level; to provide (if it is to run for the full ten years) additional rolling stock for a new weekday half-hourly stopping service between London and Leicester; to refurbish existing rolling stock; to improve stations; and to undertake a feasibility study into development of an East Midlands Parkway station (see paragraph 3.85). The franchise also includes limited regulation of fares-discussed in paragraph 2.29. As explained further in paragraph 3.73, NEG's bid, compared with the other bids, required the lowest net present value of subsidy by a significant margin as well as offering service improvements.

2.20. As discussed in paragraphs 3.77 to 3.81, NEG's projections assume a [*] per cent increase in revenues, in nominal terms, over ten years. Fares are assumed to increase by [*] per cent a year in nominal terms; much of the projected increase in revenue is therefore planned to come from initiatives designed to increase the number of passengers, as well as from factors such as population growth, economic growth and the effects of motorway congestion. Operating costs, in contrast, are forecast to increase by some [*] per cent in nominal terms over ten years, less than inflation, on the

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*Figures omitted. See note on page iv.

assumption of certain cost savings. Such longer-term projections, particularly those requiring increases in passenger numbers, are subject to considerable uncertainty, but have to be taken into account in the franchising process.

2.21. As noted further in paragraphs 3.96 to 3.108, there were extensive consultations between NEG and the OFT in the period up to the reference to us. NEG was prepared to offer behavioural undertakings on fares and service levels; these were regarded by the Secretary of State as insufficient to allay the competition concerns identified. On 27 June the Secretary of State set a deadline for undertakings that NEG would withdraw from coach operations on point-to-point journeys between London and Derby, Leicester, Sheffield, Chesterfield and Nottingham. The undertakings (see paragraph 3.107) sought by the Secretary of State would also have required NEL to provide an alternative operator of the services with access to some of NEL's network benefits-for example, inclusion of its services in the NEL timetable, and access to NEL's sales agents and stops. Since those latter undertakings were unacceptable to NEG, the merger was referred to the MMC.

The relevant markets

2.22. We have examined the reference services operated by both coach and rail in the context of wider developments in the coach and rail industry.

Coach services

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

2.24. NEL has a major share of express coaching in Great Britain, estimated in our 1994 report on NEG's acquisition of Saltire (the Saltire report)[1] at 77 per cent (including the effect of the acquisition of Scottish Citylink, owned by Saltire), with the next top ten companies sharing 18 per cent and the remaining companies 5 per cent. NEL told us that there was likely to have been only a slight reduction in its national share of the coach market since that report. Competition remains on a number of individual routes into London (NEL estimating that there is competition on some 45 per cent of services, weighted by coach miles, into central London). Some instances were quoted to us of NEL acquiring entrants or entering into contracts with them to run services on NEL's behalf. Fares have broadly increased relative to the retail price index (RPI) since 1982, but in real terms remain below the levels before deregulation.

2.25. Coach fares are not subject to regulation. In the Saltire report, we noted that coach companies sought to set their fares at least 30 per cent lower than comparable tickets for competing rail services and at the same time broadly to match other coach operators' fares. Such lower fares are necessary to compete with rail travel's shorter journey times and, for most passengers, added convenience. We noted in that report NEG's argument that the main constraint on the ability to put up fares on the Scotland-London routes was the pricing policy of British Railways Board (BRB),

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[1]*National Express Group PLC and Saltire Holdings Ltd: a report on the merger situation*, HMSO, Cm 2468, February 1994.

*Figures omitted. See note on page iv.

and in concluding that the acquisition by NEG of Scottish Citylink-its main competitor on these routes-was not against the public interest, we also took the view that competition from rail services was the main constraint on NEL's ability to raise fares on these routes.

2.26. There are no regulatory barriers to entry for coach operators, and capital costs are relatively low. Nevertheless, there has been little entry, and no national competitor to NEL (or its predecessors) has emerged since deregulation. We referred in the Saltire report to a number of possible entry barriers, including:

(a) NEL's national network of ticket agencies;

(b) lack of access to coach terminals;

(c) the NEL established brand name and livery and its national network; and

(d) the possibility of retaliation by NEL, in particular by reducing fares to match those of competitors.

During the current inquiry, we found no evidence that lack of access to coach stations inhibited entry on the routes between the five specified places and London. On the contrary, Victoria Coach Station (VCS), the main terminal in London for NEL services, told us that there was capacity for new services at most times, and that its charges would not put new entrants at a disadvantage. NEL acknowledged to us, however, that it reduced fares to match those of its competitors, and some other parties from whom we heard suggested that NEL had developed a reputation for effectively retaliating to entry by new operators who set up in competition with it. The fact that NEL does not run coaches itself, but contracts with over 40 coach and bus operators (including many of the larger operators) for periods of up to five years and uses over 400 other companies to provide duplicate services at peak periods, would also seem to contribute to the lack of entry in competition with NEL.

2.27. Recent developments in the particular market for coach services between London and the five specified places show a number of similarities with the general trends discussed above. First, there was a degree of entry on to the routes following the deregulation of the coach industry in the early 1980s, one of the coach operators in the area being a member of the British Coachways Consortium. That entry was followed by significant reductions in fares and increases in frequencies. Following the collapse of the British Coachways Consortium, there have been relatively isolated examples of competition on the services. Coach fares have increased gradually compared with the RPI since the 1980s. On the other hand, in response to competition from two companies on services between Sheffield and London in 1993 and 1994, NEL introduced significantly lower special fares on that route, with the result that its fares between London and Sheffield and Chesterfield are now lower than those for the shorter journeys between London and the intermediate places: as shown in Table 2.2, for example, the standard return fare from London to Sheffield (a distance of 166 miles) of £15.50 compares with £23.50 from London to Nottingham (a distance of 130 miles). As noted in paragraph 2.16, the profitability of the service to Sheffield and Chesterfield is also significantly lower than that of the other relevant coach services to and from central London. NEL told us that it had recently acquired one of the competing companies, and contracted for the other competitor to operate services on its behalf. There is currently, therefore, no competition on coach services between central London and any of the five specified places, although there is one operator of one service a day between Southall and certain towns in the East Midlands.

Rail services

2.28. The Railways Act has resulted in a significant reorganization of the rail network in the UK. TOCs which operate the passenger services in a specific franchise area lease stock from rolling stock companies (ROSCOs) and pay for rail access from Railtrack from which they also lease some railway stations. Those TOCs are initially subject to regulation from two sources: the Rail Regulator and the Franchising Director. The Rail Regulator is the overall industry regulator and is responsible for granting licences (and setting any associated licence conditions), controlling access to the track and enforcing domestic competition policy between the TOCs. The Franchising Director's principal function is to administer and supervise the franchising of passenger rail services, including setting and monitoring service requirements such as safety, punctuality, regulation of maximum prices and determining the approved bidder and the level of subsidy.

2.29. Regulation of maximum prices applies only to particular categories of fare. In the case of MML, the regulated ticket categories currently account for approximately [*] per cent of passenger revenue. In addition to a basket of season tickets, `Saver' fares (return fares subject to certain restrictions on time of use) are pegged to the increase in the RPI until 1999. From 1 January 1999 the annual percentage increases are limited to 1 per cent below the change in the RPI. There is no regulation of ordinary single or return fares (unrestricted fares, priced considerably above Saver fares), `SuperSaver' fares (return fares cheaper than Saver fares but subject to greater restriction on time and day of use), `SuperAdvance Return' fares (slightly cheaper than the SuperSaver fare) or `APEX' fares (the cheapest of the standard fare categories). (These latter two fares are subject to advance booking of both outward and return journeys, APEX fares needing to be booked further in advance; the availability of both these fares is subject to a quota varying according to the projected demand for a particular train but each limited on average to only 30 tickets per off-peak train out of over 350 total standard class seats.) NEG argued that these fares were indirectly linked to Saver fares.

2.30. As noted in paragraph 4.33, the Rail Regulator must approve any agreement giving access to the rail network. He has announced that entry by rival TOCs seeking to provide a service competing with a service provided under a franchise will be restricted in the initial period of franchising, in order to assist the franchising process in its early stages. In the first stage until 31 March 1999, MML is given protection from competition on all those individual passenger flows which separately provided at least 0.2 per cent of MML's passenger revenue at the end of 1994. In the second stage, from April 1999 to March 2002, MML will be subject to competition on up to 20 per cent of revenue derived from certain `contestable' flows which, as noted in paragraph 4.34, is likely to provide very little scope for additional competition. However, if services are already operated by more than one TOC or particular localities are served by adjacent routes, there is no constraint on price competition.

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*Figure omitted. See note on page iv.

The overlap between NEL and MML

2.31. As shown in Figure 4.1, MML services operate between London and, respectively, Leicester, Nottingham, Derby, Chesterfield and Sheffield, serving a number of intermediate stations. MML also has a limited number of services to and from Leeds, although Leeds is chiefly served by InterCity East Coast (ICEC). Services between London and Leicester are half-hourly (some 32 journeys a day in each direction); between London and the other four places hourly with between 15 and 18 journeys a day. According to the invitation to tender (ITT) for MML issued by the Franchising Director, in the year to 31 March 1995 89 per cent of MML's passenger revenue was accounted for by journeys to and from London; passengers travelling between London and Sheffield, Chesterfield, Derby, Nottingham and Leicester accounted for 54 per cent of MML total passenger revenue.

2.32. The following NEL services connect two or more places served by MML.

TABLE 2.1 **Relevant coach services to and from central London operated by NEL**

Service	*Route (and journeys a day)*
440	Manchester (1)/Buxton (1)/Heanor (1), **Derby** (5), Loughborough (3)/Burton (1), **Leicester** (7), Milton Keynes (6), **London** (7)
450	Retford (1)/Alfreton (1), Mansfield (6), **Nottingham** (6), Milton Keynes (5), **London** (6)
465	Huddersfield (1), Leeds (1), **Sheffield** (1), **Nottingham** (1), **Leicester** (1), Northampton (1), **London** (1) (overnight)
560	Barnsley (4)/Rotherham (1), **Sheffield** (5), **Chesterfield** (5), Milton Keynes (1), **London** (5)
564	Halifax (1), Huddersfield (1), **Sheffield** (1), **Chesterfield** (1), Milton Keynes (1), **London** (1)*

Source: NEL.

*Other services on Route 564 operate direct from Halifax to London, not via Sheffield. Frequencies on all services may differ from the figures given on certain days of the week.

All the relevant coach services, therefore, also serve other places, and are considerably less frequent than the reference services supplied by MML.

2.33. In addition to services between the five specified places and central London, NEL operates services from some of the five specified places to Heathrow Airport, which is within Greater London. Seven coaches a day (six of which start from or terminate at Newcastle) operate on Service 230 from Nottingham and Leicester to Heathrow and Gatwick Airports; six coaches a day on Service 240 from Bradford and Leeds operate via Sheffield and Chesterfield to Heathrow and Gatwick Airports. The only alternative public transport routes from the five specified places to these airports are via MML requiring use of the underground, taxi or bus between St Pancras and Heathrow, or of bus or other rail services to Gatwick. Journey times to or from Heathrow by coach are, however, broadly equivalent to journeys via MML, and fares higher (although profitability considerably lower) than on the coach services to central London; the services are part of much longer routes, and in turn compete with only a small proportion of MML traffic. Neither the OFT nor any parties to the inquiry expressed any concern about the effect of the merger on those coach services to Heathrow or Gatwick Airports. Other TOCs also provide rail services on some of the routes between the five specified places (for example, between Sheffield, Chesterfield and Derby); the main overlap between NEL and MML on services between the five specified places themselves is on services between Derby and Leicester, about which we also received no expression of concern. There is no significant overlap between MML and NEL south of Leicester, but MML overlaps with Thameslink services from Bedford: the merger does not therefore have any direct effect in this area, nor on NEL's cross-country routes to or from the specified places (for example, between Leicester and Bristol), which are not served by MML.

2.34. We have therefore concentrated in this inquiry on the effects of the merger on the services between central London and the five specified places.

2.35. Table 2.2 shows the extent to which coach fares are lower than rail fares. Lower fares compensate for longer journey times (Derby-London, for example, takes 1 hour 48 minutes by rail and 3 hours by coach-see Table 4.2). There are also differences in availability of discounted tickets (for example, NEL offers coach cards with discounted travel for passengers aged 50 and over, but equivalent MML railcards are for passengers aged 60 and over; MML return fares are only for return within one month, NEL's for return within three months). Most coach tickets are pre-booked; in contrast most rail fares require no advance booking (the only exceptions being MML's SuperAdvance Return and APEX fares).

TABLE 2.2 **Comparison of NEL and MML fares between the five specified places and central London**

£

Between central London and	*NEL* *Standard Return*	*Economy Return*	*Economy Advance Return*	*MML* *Standard Return*	*Saver*	*Super Saver*	*Super Advance*	*APEX*
Sheffield	15.5	15.5	15.5	78	43.5	35	33	24.5
Chesterfield	15.5	15.5	15.5	77	43.5	35	33	24.5
Derby	23.0	19.0	17.0	61	38	29	27	19.95
Nottingham	23.5	19.5	17.5	61	38	29	27	19.95
Leicester	19.0	15.75	14.0	49	32	24	22	16.95

Source: NEG.

[
Details omitted. See note on page iv.
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2.36. About 40 per cent of MML passenger journeys are for leisure as opposed to business or commuting. By contrast, it is estimated that around 90 per cent of NEL passengers are travelling for leisure purposes, some 60 per cent visiting family and friends, with a high proportion of students, and of older age and lower income groups: the greater journey time precludes significant use of coaches on these routes for business travel or commuting. Competition between MML and NEL is therefore confined primarily to the supply of public transport services for leisure travel between central London and, respectively, Derby, Leicester, Sheffield, Chesterfield and Nottingham. The estimated shares of the number of leisure journeys on these services are as follows.

TABLE 2.3 **Estimated shares of number of public transport journeys for leisure purposes**

per cent

Between central London and	*NEL*	*MML*	*NEL & MML*	*Other rail*	*Other coach*
Nottingham	25	73	98	2	0
Leicester 18	82	100	0	0	
Sheffield 36	54	90	10	0	
Derby	15	85	100	0	0
Chesterfield	27	73	100	0	0
Total of the five reference services	24	73	97	3	0

Source: MMC study.

NEL accounts for about 24 per cent of the number of public transport journeys for leisure purposes and MML some 73 per cent. The services offered by NEL on these routes therefore provide lower fares to a substantial proportion of passengers on the reference services to central London, of particular value to those on lower incomes.

2.37. We have noted the absence of other coach operators providing references services to central London. While there are also no other TOCs operating reference services, the main line rail services of ICEC and InterCity West Coast (ICWC) border the MML routes. ICEC's service from Doncaster to London competes for peripheral traffic with MML's Sheffield service (as reflected in the market share figures in Table 2.3), while Nottingham is only 25 miles away from Grantham which is also served by ICEC. We are aware of no air services at present between any of the five specified places or any nearby airports and any of the airports in the London area (although scheduled air services have previously been operated between East Midlands International Airport (EMIA) and Heathrow). There are plans to develop an airport at Sheffield from which services may be operated to London, but these are likely to be used mainly by business travellers.

2.38. NEG argued that public transport could not be regarded as the relevant market, since it believed competition was primarily with car transport and its strategy was to attract additional rail traffic from use of car. Only limited estimates are available of the shares of private as well as public transport between London and the five places specified in the terms of reference. Car travel has been estimated to have accounted in 1991 for 65 per cent of all travel between London and Nottingham; rail for 31 per cent; and coach for 3 per cent. We have seen no specific figures for leisure travel between London and Nottingham, but, based on figures for journeys between Nottingham and south-east England as a whole, use of car for leisure travel is not likely to be significantly different from the figures for use for travel as a whole. We consider below (paragraphs 2.59 to 2.66) how far car use can be regarded as providing effective competition to the reference rail and coach services.

The effects of the merger

2.39. The key issues in this inquiry are the extent to which passengers regard the rail and coach services as substitutes for each other, and how far rail and coach operators compete for them; whether there are sources of rail or coach competition other than that which may be lost as a result of the merger; and whether there is sufficient competition from private cars for those passengers who have cars available to ensure that there is no adverse effect from any loss of competition between rail and coach. In assessing the effects of the merger, we have therefore considered in turn the extent of competition between rail and coach services and whether this would be affected by the merger; the extent of competition from rail or coach services provided other than by NEG or MML; the scope for new entry into rail and coach services; and the extent of competition from other modes of transport. In evaluating the effects of the merger on the public interest, we have also taken into account the possible benefits of the merger. During the inquiry, various concerns were expressed to us by rail users as to the prospects for rail services to places (such as Bedford) currently not served by NEL. These were and are matters for the Franchising Director to address.

The extent of competition between rail and coach services

2.40. As noted in paragraphs 2.31 to 2.36, the relevant rail and coach services differ in their attributes (rail being quicker, more frequent and more expensive); purpose of travel (rail being for business, commuting and leisure; coach almost wholly for leisure); and mix of passengers (coach having a predominance of students and the elderly, and lower socio-economic groups). Many of the parties from whom we have heard argued that rail and coach served different markets: others were concerned that, nonetheless, the degree of overlap was significant.

2.41. We noted in paragraph 2.36 that the scope for competition between rail and coach services was largely confined to the leisure market, which accounts for the bulk of coach travel on these routes but for a little less than one-half of rail travel. We estimated that by volume NEL accounts for some 24 per cent of leisure journeys by public transport on the reference services and MML some 73 per cent.

2.42. As discussed further in paragraphs 4.53 to 4.74, evidence of competition between rail and coach can be derived from evidence of pricing behaviour of the two modes; from survey evidence of reasons for passengers' choice of means of travel and passenger responsiveness to changes in price; and from more quantified evidence of cross-price elasticities, that is the extent to which demand for each mode of transport depends on relative prices.

2.43. As mentioned in paragraph 2.25, it was noted in the Saltire report, and confirmed by NEL in the current inquiry, that coach fares have to be set some 30 per cent below competing rail fares to offset the inconvenience of coach journeys such as longer journey times, but there is more dispute about whether rail fares are affected by the level of coach fares. We have noted, however, the initial experience of coach deregulation in the early 1980s, which resulted in a significant increase in competition and reduction in coach fares on these and other coach services. One study[1] we have seen suggests a reduction in fares of about one-third on some services to the East Midlands at that time, and a doubling in the number of coach passengers, with some 50 per cent of the newly-generated coach demand being passengers transferring from rail. The main BRB response to that coach competition was in its fares policy, including the introduction of the Saver tickets; another study[2] (although not on the reference services) showed that the introduction of Saver tickets similarly attracted passengers primarily from coach rather than car. NEG argued that that was an

[1]*Deregulation of Express Coach Services in Britain*, R P Kilvington and A K Cross, Oxford Studies in Transport, 1986.

[2]Reported on page D2-5 of *Passenger Demand Forecasting Handbook*, British Railways Board, June 1994.

exceptional period, but although coach competition has subsequently much diminished and coach fares have risen (though still remaining below the pre-deregulation levels), the new fare structures introduced by BRB in the early 1980s in response to coach competition remain in operation.

2.44. A more recent example of fares competition relates to the introduction by BRB of APEX fares in the early 1990s. The evidence quoted in the Saltire report refers to a 30 per cent loss of coach passengers on routes to Scotland as a consequence, and NEG's own 1992 Annual Report and Accounts referred to APEX fares as being targeted primarily at coach services, although NEG told us that this referred primarily to the London-Scotland routes. Two studies we have seen[1] (one on services to and from Scotland and one on MML services) suggest that APEX fares have attracted significantly more traffic from coach than from car, with very little generation of journeys that would not otherwise have taken place. This was also the conclusion of a third and more recent study into the effect of MML's `London Day Out' fares.[2] Even though it may not be the intention in setting such rail fares to attract traffic from coaches, that would seem to be the effect, and one we would expect to be taken into account in setting the level of these fares.

2.45. Other survey evidence of passengers' reasons for choosing coach rather than rail also appears to show that price is a major reason: two studies quoted to us by NEL showed that 60 per cent or more of coach passengers used coach primarily for price reasons.

2.46. We also examined available statistical evidence on the extent to which passengers' choice of mode of transport was affected by changes in relative prices. For this purpose we commissioned a report from the Institute for Transport Studies (ITS) at the University of Leeds, which summarized recent estimates of cross-price elasticities of demand and own price elasticities of demand, and put forward the opinion of ITS as to the appropriate elasticities of demand for leisure travel on these services. The report is summarized in paragraphs 4.58 to 4.61. As noted in Table 4.17, ITS suggested a cross-price elasticity of coach demand with respect to rail fares of 0.3-that is, a 10 per cent increase in rail fares would lead to a 3 per cent increase in demand for coach travel; and a more limited elasticity of rail demand to coach prices of 0.14: that is, a 10 per cent increase in coach fares would lead to a 1.4 per cent increase in rail demand (this elasticity was still significantly different from zero by standard statistical tests). In the opinion of ITS, rail cross-price elasticities with respect to coach appear low, whereas coach cross-price elasticities with respect to rail are significantly higher. ITS suggested that elasticities were substantially higher for certain market segments (particularly students and pensioners): ITS put forward cross-price elasticities of coach demand with respect to rail fare of 0.9 for students and 0.6 for pensioners and of rail demand with respect to coach fare of about 0.5 for students and about 0.3 for pensioners.

2.47. NEG itself acknowledged a degree of competition between coach and rail, but believed its extent was limited, and argued that any effect of the merger would be offset by the other factors we discuss below. Its evidence included one recent survey[3] asking passengers on the reference services to what extent their choice between rail or coach travel depended on relative fares, journey time and frequency; although this did show a degree of responsiveness, particularly of coach use to rail fares, the study claimed that, taken together with other evidence on use of cars or decisions not to travel at all, demand for rail was largely unaffected by changes in coach fares, although a change in rail fares would affect coach demand to some extent. It would in our view be inappropriate to rely only on the `stated preference' approach as adopted by this study, which asked respondents to state how their behaviour would be affected by a large and possibly confusing range of hypothetical circumstances: actual behaviour may be significantly different. We also noted that the study did not

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[1]*Project APEX*, a report prepared for InterCity, BRB, November 1991; and InterCity Market Research, Midland Main Line Apex, April/May 1993.

[2]London Day Out on Train Survey, July 1996.

[3]Midland Main Line Stated Preference Study, MVA Consultancy, October 1996.

itself ask respondents whether they would use car travel in response to increases in coach or rail fares or not travel at all, about which separate assumptions had to be made in order to derive cross-price elasticities. We therefore do not accept that this study refutes the other evidence referred to above, which has shown that rail demand is to some extent responsive to coach fares.

2.48. In our view, no one piece of evidence can be regarded as determinative of the extent of competition between coach and rail services, and we have considered the full range of evidence presented to us. Although we accept that rail services would seem to provide stronger competition to coach than coach services to rail, we believe that in the light of all the evidence summarized above coach services can also be regarded as providing an element of competition to rail services. Competition between coach and rail is therefore in our view a factor to be taken into account by management in making decisions on fares and quality of service for both the coach and rail reference services, a factor that has been lost by bringing these competing modes of transport under single ownership.

2.49. In our view, therefore, the merger has resulted in a loss of competition between coach and rail for leisure passengers on services between the five specified places and central London.

Extent of competition from other rail or coach services

2.50. We have noted that there have been previous instances of competition on coach services between Sheffield and London, including recent competition from two companies subsequently acquired by or operating on behalf of NEL; there was also competition on coach services between Nottingham and Derby and London in the early 1980s which proved short-lived. Competition between coach operators while it lasted had a strong impact on coach fares, and fares remain low on the Sheffield services although the competitors on that route subsequently withdrew. We are aware of no significant competition at present on coach services between the five specified places and central London; although we are aware of limited services operated by another company between some of the specified places and Southall, we regard them as insignificant in the context of services to and from central London.

2.51. There are no other rail operators operating directly between the five specified places and London, and such competition would now be precluded by the Rail Regulator. NEG pointed to the potential for fare competition from adjacent ICEC and ICWC routes; but, as shown in Chapter 4, fares via ICEC are currently generally higher than those available on MML. While there is a limited degree of choice and competition, in particular for passengers who may drive to ICEC stations to use quicker ICEC services, we do not believe this represents such strong actual or potential competition to MML as significantly to constrain MML's decisions with regard to fares or levels of service.

Scope for new entry into coach or rail services

2.52. The extent of formal barriers to entry varies significantly for coach and rail services, and we therefore deal with each in turn.

Entry to coach services

2.53. A number of parties expressed the view that barriers to entry into coach services were a key issue in evaluating the effects of the merger. NEG and others argued that, in the absence of formal barriers to entry (for example, to register or require approval to operate a service), it could not seek to abuse its position on the coach services affected by the merger, any increase in coach fares or reduction in coach services being likely to lead to new entry.

2.54. NEG admits, however, that it was only following the recent entry on the services between London and Sheffield that it significantly reduced fares, as it has on other services which compete with other operators. We have noted the lower profitability of these services, even though occupancy rates are significantly higher. Actual competition rather than the threat of potential entry has been the main reason for the fare reductions, even though NEL has chosen to maintain these lower fares on these particular services after the new entrant withdrew. This particular example illustrates the benefits to passengers of actual competition on services, and suggests that potential competition represents a far weaker discipline on the fares charged.

2.55. We acknowledge that there are no formal barriers to entry into long-distance coach services; we have also taken into account the entry that has occurred, both previously on the reference services and currently on other services into London. There is, however, no `network' competition to NEL, only competition on certain corridors into London; and no current competition by coach operators on any of the relevant coach services despite the significant variation in fares and profits of those services.

2.56. As noted in Chapter 4, we put a questionnaire to a number of coach (and bus) operators in the East Midlands and South Yorkshire, which produced a great variety of responses as to the extent of any informal barriers to entry. Almost all of the respondents said that they would not consider operating in competition with NEL. However, about half of the respondents said that there were no barriers to entry, and of the various possible barriers to entry we put to them, there was no single individual barrier which a majority of respondents regarded as significant or very significant. A number of factors were mentioned by three or more respondents as of medium importance to very important, including there being only room for one operator on the routes; inadequate ticketing capability; inadequate brand recognition; fear of retaliation by price reductions; lack of access to the national coach network; no access to stations/stops; and fear of retaliation by withdrawal of contracts. Other factors mentioned by the respondents were the prospect of insufficient returns, lack of interest in the business, unwillingness to devote management resources to it or cost of vehicles or marketing.

2.57. The possibility of new entry should NEL abuse its position on these services (or, indeed, at current fare or service levels) cannot be wholly discounted. In our view, however, NEL has significant competitive strengths which are likely to discourage entry unless there should be a major deterioration in its performance. These strengths derive in particular from its network both of services, with almost 30 per cent of total passengers changing coaches during their journey, and of sales agents, and from its operating contracts with many of the main companies in the industry which have little interest in operating on their own account on these routes in competition with NEL. Its overall margins appear reasonable (although we have noted the relatively high margins on certain of the reference services) and quality of service high, and even if a new entrant is able to offer lower fares, NEL is known to respond by reducing fares to match those of competitors. Thus it is difficult for new entrants to establish a competitive advantage. It would not therefore, in our view, be reasonable to regard the prospects of entry as sufficient to prevent any gradual increase in coach prices or reduction in service standards on the reference services. We acknowledge that it may not be in NEL's interests to introduce drastic price increases or drastic reductions in service standards, as these could adversely affect other parts of its network.

Entry to rail services

2.58. We have noted in paragraph 2.30 that in contrast to the lack of formal barriers to entry for coach operators, there are formal restrictions on entry to operation of rail services: there is in effect no scope for operation of new competitive services before 1999, and only very limited provision for further competition from 1999 to 2002. There is considerable uncertainty, both as to the effects of allowing limited additional competition in 1999 and as to the policy to be adopted after 2002. In our view, therefore, the prospect of new entry by rail operators on the reference services is so uncertain and so small until far into the future that it can be disregarded for the purposes of this reference.

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

2.59. We refer in Chapter 7 to NEG's arguments that rail competes primarily with car and that, given the discretionary nature of demand for leisure travel, the sensitivity of such demand to fares would itself restrict the scope to increase fares or reduce services as a result of the merger.

2.60. On the figures we have seen, there is little doubt that cars account for the majority of trips between London and the five specified places. NEG in its tender for MML stressed its objective of increasing passenger numbers by attracting traffic from cars, in part by providing improved facilities for transfer between car and rail (the East Midlands Parkway Station, improved car park security etc). Many leisure passengers would not, however, have cars available for their journeys: at issue is whether competition for those who could make their journey by car is sufficient to safeguard those who do not have such an alternative.

2.61. We have referred in paragraph 2.44 to studies that suggest that diversion from coach to rail has exceeded that from car even though coach market share is substantially smaller. As we discuss in paragraphs 4.75 to 4.81, choice between car and rail travel appears to be primarily affected by factors other than rail fares. In one survey we have seen, less than one-quarter of respondents said that cost was the main factor in using car rather than rail.[1] In another a 20 per cent reduction in MML rail fares was estimated to be likely to result in less than 1 per cent of car users switching to rail-though equivalent to a gain of almost 20 per cent in rail traffic.[2] We also note in Chapter 4 the estimate by ITS of a cross-price elasticity of rail demand to car fuel costs of 0.25 (that is, a 10 per cent increase in car fuel costs would increase rail demand by 2.5 per cent). While we accept that car travel provides a degree of competition to rail, we do not on the evidence before us regard the alternative of car travel as providing a sufficiently strong competitive constraint to prevent any increase in rail fares or reduction in service standards.

2.62. We have also considered evidence on the overall price sensitivity of rail fares (which includes the effect of both diversion between different modes of travel and passengers' choice as to whether or not to travel at all). The various estimates we have seen suggest that business travel is price inelastic (that is, that an increase in fares is likely to lead to an increase in revenue). We have seen some estimates that leisure travel is price elastic, the MML ITT quoting an own-price elasticity of -1.5. Such a figure would imply that a 10 per cent increase in rail fares would lead to a 15 per cent reduction in passengers and a loss of revenue from leisure travel, but the effect on profit would depend on the extent that costs vary with passenger numbers. NEG itself stated that demand was not so responsive that it would be profitable to reduce prices generally; conversely, in our view, demand may not be sufficiently responsive to prevent NEG from raising prices.

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[1] MML Demand, Revenue, Product Analysis, Halcrow Fox, 1996.

[2] M1/A1(M) Corridor Cross Mode Elasticity Study, prepared for Department of Transport by Steer Davies Gleave, May 1994.

2.63. Existing estimates of the price sensitivity of rail fares are uncertain, and may themselves reflect the scope for substitution between coach and rail. ITS suggested to us that the estimated elasticity of -1.5 was based on evidence of between 10 and 20 years ago, when fares and elasticities may have been higher, and also only on flows from London, whose elasticities are higher than on flows to London. On the basis of a number of more recent studies, ITS put forward a leisure fare own-price elasticity of -0.9 for these routes: that is, a 10 per cent increase in fares would reduce passengers by 9 per cent implying that price increases could produce a slight increase in revenue and profitability. Price sensitivity also varies by type of passenger, operators being able by price discrimination to increase fares to categories of passenger with relatively inelastic demand. [

Details omitted. See note on page iv.

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2.64. There is in our view therefore no compelling evidence of high cross-price elasticity between rail and car, or of high own-price elasticity of demand for rail travel for leisure purposes (which also includes the effect of passengers preferring not to travel at all if prices increase). Hence, neither the prospect of passengers switching to cars, nor of their deciding not to travel at all, can be regarded as providing a strong constraint on the level of rail fares or service. It is in our view likely, on the basis of the evidence we have seen and in the absence of competition between coach and rail following the merger, that the introduction of gradual fare increases over time relative to inflation would increase net revenue, after allowing for the lower variable costs associated with fewer passenger numbers (for example, in the short run, the cost of selling tickets and, over time, changes to capacity).

2.65. We are not aware of any evidence of cross-price elasticity between coach and car. ITS put forward an own-price elasticity for coach travel of -1.1 (which will again include the effect of passengers choosing to travel by car or rail or not at all). Such an elasticity implies that a 10 per cent increase in coach fares would reduce demand by 11 per cent and reduce revenue, but profits would be likely to increase given the scope to adjust the costs of coach services in line with demand. The prospect of passengers switching to other means of travel, or not travelling at all, cannot therefore be regarded as providing a strong constraint on increasing coach fares or reducing quality of service following the merger.

2.66. We do not ascribe to NEG any current deliberate intention to raise fares or reduce quality of service. Neither competition with car nor the overall elasticity of demand to the level of rail or coach fares is, however, in our view sufficient to prevent NEG from pursuing such a policy in future and the merger has removed a constraint on NEG from doing so.

The effect on the public interest

2.67. We have noted in paragraph 2.36 that the relevant coach services provide lower fares to a substantial proportion of leisure passengers on the reference services, of particular benefit to those on lower incomes. We have also concluded in paragraph 2.48 that there is competition, albeit of varying degrees, between coach and rail services. Rail has a stronger competitive impact on coach than coach on rail: but even this latter degree of competition is a factor relevant to the setting of rail fares, whose loss gives rise to concern because of the absence of other sources of strong price competition to rail. In our view, therefore, the merger has reduced competition between coach and rail on the services between the five specified places and central London. Were there rigorous competition from other coach operators, such as that recently experienced on services from Sheffield and Chesterfield which resulted in significant price reduction, we would not be concerned, but this was exceptional: we do not believe that there is currently sufficient competition from other coach or rail services, or sufficient prospect of entry from other operators of coach or rail services, to prevent increases in coach or rail fares and/or reductions in quality of coach or rail services as a result of the merger; nor that competition from private car or the overall elasticity of demand for coach or rail travel is sufficient to prevent such adverse effects. Because of the absence of such constraints we would expect NEG under normal commercial and financial pressures to take advantage of this position over time. We believe the merger may be expected particularly to affect coach fares and quality of service, but increases in coach fares and reduction in quality of coach services are in turn likely to affect rail fares and quality of service.

2.68. We have considered whether NEG would, by increasing coach fares or reducing coach frequencies, deliberately attempt to divert passengers from coach services, whose costs could be reduced in line with reduction in demand, to rail services, whose costs are predominantly fixed due to the requirement to operate a minimum level of service. NEG pointed to the limited benefit from doing so, given the small scale of coach travel on the reference services, and the risk that any such action on these services could jeopardize connections with other parts of its coach network. In our view, there is little risk of NEG seeking to divert passengers from coach to rail in such a way: any sudden reduction in the scale of coach services could adversely affect other parts of NEL's network, or increase the prospect that other operators could enter the market. Our concern is primarily that there will be a gradual upward drift in coach or both coach and rail fares, and/or reduction in quality of service as a result of the merger.

2.69. NEG also pointed to the regulation of the MML Saver fare, arguing that other rail fares are indirectly related to the Saver, and to the requirement to retain minimum service levels as reducing the possible impact on rail services. Saver fares currently account for some [*] per cent of MML revenues; the unregulated SuperSaver fare [*Details omitted. See note on page iv.*] accounts for [*] per cent, and the APEX fare for [*] per cent of revenue (indeed given restriction on use of some discounted fares, it seems likely that some standard fares, which account for [*] per cent of revenues, may also be used for leisure purposes in peak periods). SuperSaver fares are primarily used on different days of the week to Saver fares, and we are not persuaded that the relationship between the two can be regarded as fixed or that regulation of Saver tickets constrains the prices of SuperSaver or other leisure tickets. Reduction in competition would, therefore, in our view have effects on unregulated rail fares. Similarly, although the franchise agreement requires the maintenance broadly of the current level of services and stipulates minimum capacity on certain services, it does allow some scope to reduce capacity, and to alter certain conditions of travel-such as the flexibility of certain types of tickets-for the worse.

2.70. We considered whether loss of competition would lessen the likelihood of any possible reductions in fares or improvements in services which the companies might consider introducing in

*Figures omitted. See note on page iv.

*Figure omitted. See note on page iv.

future if they remained in competition. In a competitive environment, we would expect the cost savings consequent upon rail privatization ultimately to be reflected in lower fares to passengers; the intention in restricting certain fares to slightly below the increase in the RPI after 1999 is also to allow passengers to share in such savings. It is, however, difficult to quantify the effects of the merger in this respect: recent reductions in coach fares between London and Sheffield have been in response to competition from other coach operators rather than from rail, and, as shown in Table 4.12, fares on the other reference coach services tend recently to have increased somewhat above the RPI.

2.71. A number of parties have suggested that any adverse effects of the merger would be more than offset by the benefits. Among the benefits put forward were the financial benefits from acceptance of the NEG bid for MML as against (lower) alternative bids to operate the routes, although in practice these benefits might not be lost if NEG was required to divest MML but retained financial liability as it feared (see paragraphs 7.72 to 7.78) or if other remedies were imposed. Other benefits cited to us included the greater service improvements put forward by NEG compared with other bidders and the scope for greater integration between `feeder' coach and rail services. We acknowledge the high regard in which NEG is held by some of the parties giving evidence to us. A number of local authorities, for example, commended its performance in managing EMIA. Moreover, as a proven long-distance public transport operator, NEG is a desirable company to be competing for tenders to operate rail services such as those of MML. Certain of these benefits, particularly of any integration between coach and rail, could, however, be obtained without the merger. We are not persuaded that the benefits of the merger offset the adverse effects we have identified.

2.72. We have therefore concluded that there has been an element of competition between NEL's coach services and MML's rail services for the leisure passenger. This competition has been lost as a result of the merger. Because of the absence of other strong constraints on fares or quality of services, we would expect NEG under normal commercial and financial pressures to take advantage of this position. We therefore conclude that, in respect of services between central London and the five specified places, the merger may be expected to lead over time to the adverse effects of higher coach fares or higher fares on both coach and rail, and/or a lower quality of coach services or a lower quality of both coach and rail services, than would have been the case had the merger not occurred. These adverse effects are not in our view outweighed by the benefits of the merger. Accordingly we conclude that the merger may be expected to operate against the public interest. We are therefore required to consider what action may be taken for the purpose of remedying or preventing such adverse effects.

Remedies

2.73. We considered first a divestment of NEL's interest in the coach services between central London and the five specified places. Since NEL does not itself own the coaches operating the services or other facilities, such a remedy would require NEL to withdraw its current contracts for operation of these services, and to undertake not to enter into alternative contracts for operation of the services or to operate the services itself. Following such a `divestment', the services would be relatively unattractive to alternative operators, since it would be difficult for them to publicize the availability and times of their services without inclusion in the NEL timetable and to secure adequate sales outlets. Such a divestment could in consequence reduce the use of the reference coach services by passengers who currently connect with other NEL services at VCS, to the detriment both of the alternative operators and of coach passengers in general. The services between the five specified places and central London are also part of longer routes: there is a risk that neither NEG nor any alternative operator might choose to provide services to the other places served by the relevant services following any such divestment. The consequences of divestment are therefore highly uncertain. Only four of the 20 bus and coach operators responding to our questionnaire said that they would be `quite likely' to operate the services if NEL withdrew. Two of these said that they were more likely to do so if NEL was required to make the benefits of its network available but even then would not necessarily operate the current level or pattern of service. There is, therefore, a serious risk that following divestment service levels would be reduced, or services to some destinations would be withdrawn. Such a situation is not, in our view, in the interests of coach users or of coach operators.

2.74. It was partly for these reasons that the OFT, in its negotiations with NEL prior to the reference being made to us, sought divestment combined with undertakings to require NEL to provide the benefits of its network to other operators of the services. NEL objected to the practical difficulties of incorporating other operators in its timetables, since such operators might wish frequently to change their services. This would not seem to us an insuperable objection: three such operators are currently included in NEL's timetable, and given the restricted availability of the timetable, it might be feasible to send out amendments if required. NEL also objected to its appearing to sanction the services by operators of unknown and unreliable quality. These objections could hardly be sustained against some of the larger bus and coach operators, although any provision for a `quality threshold' would be difficult to devise. There is, however, clearly some uncertainty whether such practical difficulties could satisfactorily be resolved.

2.75. More fundamentally, we have considerable doubts about the ultimate competitive result that would be achieved by requiring NEG to make available facilities for its competitors in the manner contemplated. We believe such an arrangement is artificial, and would create a relationship of mutual dependency and identity of interest within which effective competition between coach and rail services could hardly be expected to flourish. In addition, we are concerned that the interests of coach users would not be well served. We believe there is a serious risk that, following divestment of the services by NEL, alternative operators might not provide these services in their entirety or to the current standards even if the facilities of NEL's network were made available to them.

2.76. Similar objections apply to an alternative form of `divestment' analogous to franchising that was put to us, namely that the services should still be operated in the NEL livery as part of the NEL network and included in NEL's timetables with tickets sold by NEL's sales agents; but that the basis of the contract between NEL and the coach operators should be changed to allow the operators full freedom in setting the level of fares and determining the level of frequency and to receive all revenues from the services and bear the full risk of operating them. Such an approach would therefore allow the new operators and their users the full benefits of the NEL network. NEG did not argue strongly against such an approach, but as with the undertakings initially sought from NEL, the closeness of the working relations that would be required between the operator and NEL would itself much inhibit the extent to which effective competition could be expected to arise. The operator would be dependent on the network arrangements made for it by NEL, including the timetable and ticket agents, much of its business would come from passengers connecting with other NEL services, and indeed its own success would depend on the overall health and success of NEL. In such circumstances, it would seem implausible that a supposedly independent coach operator would seek to compete aggressively with rail for a higher share of the reference services with a company on which it was so highly dependent.

2.77. For the reasons given in the preceding paragraphs, we do not favour any form of divestment of the relevant coach services. Moreover, there are other means available to address the adverse effects identified in this case, namely to require appropriate behavioural undertakings.

2.78. As regards possible divestment of MML, we have noted the difference in scale of the two operations, MML's turnover of over £100 million being far greater than the revenue of the relevant coach services of less than £5 million. NEG's tender for MML was significantly better than that of other bidders in terms both of financial benefits to the Exchequer and of quality of service to users. Other means are available to address the adverse effects identified. To require divestment of MML would in our view be inappropriate and disproportionate to those adverse effects.

2.79. As discussed in paragraph 2.21, NEG initially proposed behavioural undertakings. Its proposals included undertakings on fares, frequency and quality of coach services, and on increases in MML's APEX fares. In addition, as noted in Chapter 7, it told us that it would be prepared to accept some additional undertakings both as to coach and rail services (to include, for example, undertakings relating to MML's SuperAdvance Return fares, availability of lower cost coach and rail tickets, and capacity).

2.80. We considered whether behavioural undertakings should be applied to both coach and rail services, or to the coach services alone. To the extent that we are concerned about higher rail fares or lower quality of rail services resulting from the merger, we believe that undertakings on coach fares and services alone will provide sufficient safeguard against such adverse effects. A much higher proportion of rail costs is fixed than of coach costs, and assuming coach fares are kept in check and coach services do not deteriorate, it would make no commercial sense for NEG to pursue a policy of diverting passengers from rail to coach through higher MML fares or poorer MML service. Appropriate undertakings with regard to coach fares and services will thus remove any incentive for NEG to increase rail fares or to allow rail services to deteriorate as a result of the merger. Such undertakings would therefore suffice to address all the adverse effects identified. We therefore believe it appropriate to confine the scope of the required undertakings to NEL's coach services between the five specified places and central London.

2.81. Dealing first with fares, as noted in paragraph 3.100 NEG proposed to the OFT not to increase coach fares more than the increase in the RPI or movements in NEL fares generally. We considered whether it would be appropriate to require fares to be reduced relative to the RPI but, as we noted in paragraph 2.70, it is not possible with any precision to estimate whether or to what extent fares would decline relative to the RPI in the absence of the merger, or to what extent the merger would itself reduce the likelihood of such a decrease in fares relative to the RPI. In our view so far as fares are concerned, a sufficient remedy, that would safeguard the interests of both coach and rail passengers, would be to require NEG to undertake to limit increases in fares on the coach services between the five specified places and central London to the increase in the RPI for the duration of the MML franchise. NEG suggested that such an undertaking should not apply for such a lengthy period to the special fares between Sheffield/Chesterfield and London, which it could only maintain at the current relatively high level of seat occupancy. We do not think it appropriate to make an exception for these services: although the special fares were introduced in response to coach competition between London and Sheffield, they are not out of line with similar fares on other services from London where competition continues, and NEG told us that it had persisted with these fares since the competitor withdrew partly to maintain the current level of passenger numbers. As a result of the merger there is a risk that it may wish to increase these fares in order to attract passengers to rail, and we therefore believe that the current level of fares should be maintained relative to the RPI for the full period of the franchise to continue to provide an element of competition between coach and rail. It is, of course, open to NEG to request modification of the undertakings should circumstances significantly change.

2.82. It is also in our view necessary for NEG to undertake to make no changes to the terms and conditions applicable to coach tickets on the services between the five specified places and central London (for example, to restrict the availability of the cheaper tickets, or impose more restrictive advance booking conditions) that would require certain passengers to pay higher fares; not to introduce any quota system for coach tickets on the services; and to maintain the current availability of different categories of tickets for the coach services.

2.83. We also believe it necessary to require NEG to provide adequate capacity on the coach services between the five specified places and central London sufficient to meet current demand and any increase in demand in order to provide a degree of constraint over MML's fares. We therefore believe NEG should be required to undertake to provide no less than the current frequencies on these services unless there is a significant reduction in passenger numbers, and to provide adequate duplicate services to meet demand. NEG proposed for this purpose a formula whereby occupancy rates on each of the services should not exceed particular percentages over a given period of time. We give further details in paragraph 7.44 of NEG's proposals for two indices-one relating to seat occupancy (and hence also availability) and the other to the number of coaches that are fully booked-with a commitment that those indices would not fall outside a given margin of the historic figure for the index in any period. We recommend that NEG be required to agree appropriate formulae with the Director General of Fair Trading (DGFT) for the purpose of ensuring adequate seat availability and journey availability on the coach services between the five specified places and central London.

2.84. NEG had also proposed to the OFT to continue to provide quality standards (in terms of age and quality of coaches, amenities and other matters referred to in its existing crew and operator manual and quality assurance check list) on the services at least to the standards of other parts of the NEL network: this it should also, in our view, undertake to do.

2.85. NEG should also be required to agree arrangements for these behavioural undertakings to be monitored by, or on behalf of, the OFT. Such monitoring would be straightforward, since the undertakings contemplated relate primarily to published timetables and fare guides, the contracts with coach operators and manuals adopted throughout NEL's network, and NEL's own information on occupancy rates as applied to all its services. NEG had offered to the OFT to pay an independent body to undertake on the OFT's behalf the monitoring of performance against the behavioural undertakings: if the DGFT considers such a procedure appropriate, we recommend that it should be implemented.

2.86. To summarize, therefore, we recommend that, in order to prevent the adverse effects specified in paragraph 2.72, NEG should be required to undertake for the period of the MML franchise and in respect of coach services between central London and, respectively, Leicester, Nottingham, Derby, Chesterfield and Sheffield:

(a) not to increase coach fares above the increase in the RPI (paragraph 2.81);

(b) to make no restrictive changes to the terms and conditions applicable to coach tickets; not to introduce any quota system for coach tickets; and to maintain the current availability of different categories of tickets (paragraph 2.82);

(c) to provide adequate capacity on the coach services to meet current demand and any increase in demand; in particular to provide no less than the current frequencies on the services unless there is a significant reduction in passenger numbers and to provide sufficient duplicate services to meet demand; and for this purpose to agree with the DGFT appropriate formulae for seat occupancy and journey availability (paragraph 2.83);

(d) to provide a quality of service at least equal to the standards on other parts of the NEL network (paragraph 2.84); and

(e) to agree with the DGFT arrangements for the monitoring of performance against the foregoing undertakings (paragraph 2.85).