2 Conclusions

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The reference

2.1. Under the reference (see Appendix 1.1) dated 31 October 1996 (made under sections 64 and 69(2) of the Fair Trading Act (the Act)) we are required to investigate and report on whether a merger situation qualifying for investigation has been created as a result of enterprises carried on by or under the control of British Bus having ceased to be distinct from enterprises carried on by or under the control of Cowie within the four months preceding the date of the reference. If we find that either the share of supply test[1] or the assets test[2] (referred to in paragraphs (a) and (b) respectively of section 64(1) of the Act) is satisfied, the reference requires us to exclude the other from consideration.

2.2. We are satisfied that, as a result of Cowie's acquisition of the share capital of British Bus on 1 August 1996 (described in paragraphs 3.62 to 3.67), enterprises carried on by British Bus ceased to be distinct from enterprises carried on by Cowie on that date, being less than four months before the reference was made to us.

2.3. As stated in the reference, it appeared to the Secretary of State that the value of the assets taken over exceeded £70 million. Appendix 3.5, showing the accounts of British Bus,

[1]Broadly, the share of supply test is satisfied where at least one quarter of the goods or services of any description which are supplied in the United Kingdom or in a substantial part of the United Kingdom either:

(a) are supplied by one and the same person or are supplied to one and the same person; or

(b) are supplied by the persons by whom the relevant enterprises (so far as they continue to be carried on) are carried on, or are supplied to those persons.

[2]The assets test is satisfied if the gross value of the world-wide assets taken over exceeds £70 million.

indicates that the gross assets of the company at 30 December 1995 were £195 million. Cowie has confirmed that at 1 August 1996 (the date on which the enterprises of British Bus and Cowie ceased to be distinct) the gross asset valuation of British Bus was £202 million. We therefore conclude that the assets test has been satisfied and that a merger situation qualifying for investigation has been created. We have therefore to consider whether the creation of that merger situation operates or may be expected to operate against the public interest.

The companies

British Bus

2.4. British Bus has its origins in the Drawlane Transport Group Ltd (Drawlane), an investment vehicle by which a group of businessmen had acquired a number of bus companies during the mid to late 1980s. In 1992 Drawlane set up British Bus Plc, which in December of that year acquired the majority of the assets and operating subsidiaries of Drawlane. British Bus Plc then disposed of a number of the Drawlane businesses which were unrelated to the core bus business and acquired further bus operating companies. The group was restructured and refinanced in a series of transactions between November 1993 and May 1994, partly in order to facilitate the pursuit of growth by acquisition, and in May 1994 British Bus became the group holding company.

2.5. At the same time, British Bus raised new equity and increased its borrowing facilities before embarking on a sustained programme of expansion by acquisition. Among the bus operations acquired by British Bus during 1994 and 1995 were Northumbria Motor Services Limited (Northumbria), which operates in Northumberland and Tyne and Wear; Yorkshire Woollen District Transport Company Limited (Yorkshire Bus), operating in west Yorkshire; LDT Limited (trading as The Shires), operating in Buckinghamshire, Bedfordshire and Hertfordshire; The Maidstone & District Motor Services Limited (M&D), operating in north Kent; and Kentish Bus and Coach Company Limited (Kentish Bus), which operates in north-west Kent and London. Two other bus operations of direct relevance to our inquiry had been acquired by the Drawlane group in 1988, namely London & Country Limited (London & Country), operating in Surrey and West Sussex, and Londonlinks, operating in south London. British Bus also owned bus operations which provided services in other parts of the country but where competition was less likely to be directly affected by the acquisition of British Bus by Cowie (see Appendix 3.4).

2.6. By the end of 1995 British Bus had a fleet of over 5,200 vehicles. It had turnover for that year of £261 million, profit before tax of £26 million and net liabilities of £65 million.

Cowie

2.7. Cowie was incorporated in 1938 and began trading in Sunderland as a retailer and repairer of second-hand motor cycles. It subsequently expanded into dealing in motor cars, initially second-hand and then also new cars. Cowie expanded further when it purchased Interleasing, a vehicle leasing operation, in 1964 and Hughes DAF Limited, a distributor of DAF coach chassis, in 1988. Since 1964, shares in the company have been quoted on the London Stock Exchange.

2.8. Cowie is now a major UK company, still based in Sunderland, with net assets of around £250 million and a market capitalization of about £981 million, based on the price of its shares on 31 January 1997. It currently operates in four business areas: vehicle leasing and financing; motor retailing; bus distribution; and bus service operations. In 1995 Cowie's vehicle leasing business had turnover of £225 million; its motor retailing business, turnover of £655 million; its bus and coach distribution business, turnover of £25 million; and its bus and coach operations, turnover of £96 million. Over the period 1993 to 1995 the bus and coach operations, which had achieved a turnover of only £14 million in 1993, produced greater growth both in proportionate and absolute terms than the other businesses and, following the acquisition of British Bus, this area of Cowie's business is likely, in the Board's view, to be the largest contributor to the group's profits.

2.9. Prior to the acquisition of British Bus on 1 August 1996, Cowie owned a number of bus operations. Grey Green Coaches Limited (Grey Green), based at Stamford Hill in London, was acquired in 1981. Leaside Bus Company Ltd (Leaside), also operating in north London, was acquired in September 1994 on the privatization of LTB's operating subsidiaries (see paragraphs 2.18 and 2.19). Cowie acquired SLT, the last bus subsidiary to be sold by LTB, in December 1994. Grey Green, Leaside and SLT operate routes only under contract to LTB. County Bus Holdings Ltd (County Bus), operating in Hertfordshire, Essex and London, was acquired from West Midlands Travel Limited in February 1996; it operates services under contract to LTB in north and east London, as well as some commercial and tendered bus services in Hertfordshire and Essex. Finally, North East Bus, operating commercial bus services primarily in Cleveland, south-west Durham and on the North Yorkshire coast, was purchased on 31 July 1996, immediately before Cowie's acquisition of British Bus.

The merger

2.10. The directors of British Bus had planned to float the company on the London Stock Exchange in the summer of 1995. However, that plan was abandoned when the Serious Fraud Office began an investigation into certain activities of two of the then directors of British Bus. Accordingly, British Bus's institutional and management shareholders decided instead to seek a trade sale of the company. After some initial discussions with other businesses, British Bus's financial advisers approached Cowie in the early part of 1996 and Cowie subsequently made an offer to purchase in June 1996. Cowie has told us that its aim is both to increase its activity in the bus operator's market throughout the UK and to make its bus operations division a third substantial limb of its group activities, so it was receptive to the approach. By that time, the only alternative which the shareholders of British Bus were still contemplating was a management buy-out of the company, but it was considered that this option would have left the company in a relatively weak position in the market, lacking the necessary funds for large-scale investment.

2.11. Under the terms of its offer, Cowie agreed to acquire the share capital of British Bus for a minimum consideration of £89 million and to assume responsibility for the payment of accrued dividends of £7 million. Up to a further £20 million of consideration was to be payable in the event that British Bus's operating profits for the year to 31 December 1996 exceeded £34 million. Cowie also agreed to pay off syndicated loans of £102 million which had been made to British Bus and to assume £84 million of credit agreement liabilities in relation to its bus fleet. The maximum aggregate consideration to be given for British Bus was therefore £302 million. The acquisition was conditional, among other matters, on the successful completion of a rights issue by Cowie to raise £186 million.

2.12. The purchase by Cowie of British Bus represents the largest single acquisition so far in the UK bus industry. Cowie told us that, since the acquisition, it had been made aware that another significant player in the industry had shown some initial interest in the possibility of purchasing British Bus, but tentative discussions which had taken place between this party and British Bus had not been pursued. Cowie accordingly considered itself to be the only realistic, well-resourced operator in the market which was in a position to acquire British Bus.

Regulation, deregulation and privatization in the bus industry

2.13. Prior to the mid-1980s, the bus industry was highly regulated and almost entirely in the public sector. The Transport Act 1985 (the 1985 Act) introduced major changes in relation to the supply of bus services outside London. It provided, among other matters, for the removal of limits on the number of bus services that could be supplied, the privatization of the National Bus Company (NBC), and the formation of local authority bus operations as arm's length public transport companies. In the unregulated market that now exists outside London as a result of the 1985 Act, anyone wishing to supply a bus service may do so after registering the service with the Traffic Commissioner for the region concerned, giving him 42 days' notice of their intention to introduce that service. Each of the six Traffic Commissioners (appointed by the Secretary of State for Transport) is responsible for supervising operators' quality of service and safety standards and for ensuring that they are properly equipped to carry out the services for which they are licensed. An operator who fails to run a service in accordance with its registration, or whose vehicles are not adequately maintained, can be penalized by the Traffic Commissioner. Commercial bus services are supplemented by socially necessary services subsidized by local authorities, such as school bus services or evening and Sunday services on otherwise mainly (although not exclusively) commercially run routes. Such routes are tendered on either a minimum cost or minimum subsidy basis (see paragraph 3.47).

2.14. The NBC, which operated in England and Wales, was divided into 72 companies which were privatized between 1986 and 1988, many by sale to management buy-outs. During the privatization, no single purchaser was in principle allowed to acquire more than three NBC subsidiaries or to acquire two companies operating in contiguous areas. The principle was largely followed; on only a few occasions were buyers allowed to acquire more than three NBC subsidiaries or to acquire contiguous operators. However, in the years since privatization many former NBC companies have been acquired by emerging large groups.

2.15. So far as local authority bus operations are concerned, the Government made it clear when the 1985 Act was passed that it wanted local authorities to sell off their bus companies. It has not yet taken powers to require them to do so but it has given them incentives. The majority of municipal companies in Great Britain, including most of the larger ones, have already been privatized.

2.16. The 1985 Act did not apply to the provision of bus services in London and such services are, by contrast with the remainder of the UK, accordingly still subject to regulation. Under the London Regional Transport Act 1984 (the 1984 Act), LT is responsible for providing or securing the provision of public passenger transport services for Greater London. In carrying out these duties LT, through its subsidiary LTB, must have regard to the transport needs for the time being of Greater London and the efficiency, economy and safety of operations. LTB is responsible for determining the route network and the frequencies of bus services in London in consultation with the bus operators and, where appropriate, the local authorities, and the general level and structure of fares. It also has responsibility for the physical infrastructure of the network, consisting of bus stops, bus stands and bus stations, and for passenger travel information.

2.17. In 1989 the operations of LBL (LT's bus operating arm) had been subdivided into 11 subsidiaries operating in different areas of London and were required to operate at arm's length from their parent. They competed with private sector operators (through the competitive tendering process-see paragraph 2.20) for the right to run services. A White Paper in 1991 signalled the Government's intention to introduce legislation to deregulate bus services in London, to be followed by privatization of the LBL subsidiaries.

2.18. In November 1993 the Secretary of State for Transport announced that legislation to provide for deregulation would not be introduced within the lifetime of the current Parliament, but that LT would nevertheless proceed with the sale of the LBL subsidiaries. The aim of privatization was to free those companies from the restrictions which public ownership had placed on them and in so doing to permit them to operate bus services outside Greater London.

2.19. The sale of LBL's subsidiaries began in January 1994 and was completed in January 1995; they were sold either to major groups or to their existing management and employees (see Appendix 3.1). As part of the privatization process, non-statutory competition guidance was issued by the Department of Transport (DOT) to prospective purchasers, stating that there was a strong presumption that a purchaser would not be allowed to acquire one or more LBL subsidiaries if the effect would be to increase its share of total bus mileage in London to more than 25 per cent, and would not be allowed to acquire companies operating in contiguous areas.

2.20. The 1984 Act requires LT to invite persons to submit tenders to carry on public passenger transport services. The principal objectives of competitive route tendering were to improve standards and to reduce costs by stimulating competition in the market through the introduction of private sector operators. LT began the process of route tendering in 1985, when a first package of small routes was tendered; around 5 per cent of the capital's services were then tendered in each subsequent year until 1995. The basis of tendering adopted was what is termed `gross cost'; under this system, the operator was paid a fixed amount to operate the route while LT retained all on-bus (that is, cash fares) and off-bus (for example, that deriving from travel passes-see paragraph 2.32) revenue. As a result of the introduction of gross cost tendering, over half of LTB's mileage was operated under competitively tendered gross cost contracts by 1995 and a number of new private sector operators had been introduced to the London market.

2.21. The remaining services, that is, those provided by the LBL subsidiary bus companies and which were not competitively tendered, were operated under so-called `block grant' arrangements during the period from 1985 to April 1993. Under the block grant arrangements, the companies retained on-bus revenue and received a subsidy from LTB representing the difference between their budgeted cost of operation and their budgeted on-bus revenue. LTB received and retained all the off-bus revenue. Between April 1993 and January 1994, however, as a precursor to privatization of the LT subsidiaries, the block grant arrangements were replaced by `negotiated net cost' contracts. Under such contracts, a balancing sum was paid either to or by the operator, representing the difference between the projected costs and projected revenues (on-bus and off-bus) of operating a service.

2.22. Government directives embodied in LTB's commercial policy require the London bus network to move to competitively tendered net cost contracts from April 1997 onwards. A rolling programme of conversion to net cost tendering was introduced by LTB in 1996, as a result of which all bus services in London will have been tendered on a net cost basis by the year 2001/02. Under net cost tendering, the operator is awarded the contract in return for a fee or a subsidy and the operator retains all fare income relating to the routes tendered. The aim of introducing tendered net cost contracts is to transfer all the revenue risk to operators; by so doing, it permits them to enjoy the revenue benefits accruing from service improvements which they fund or which result from their own management initiatives. (The evolving process of competitive tendering in London from 1985 to 2001 is shown diagrammatically in Appendix 3.3.)

2.23. LTB has around 56 pre-qualified potential bidders for contracts (see paragraph 3.18), of whom 32 were providing services in London as at 3 January 1997. A list of these operators and, where appropriate, the group to which they belong is shown in Appendix 3.2. It will be seen that there are seven large groups operating bus services in the capital accounting between them for 18 of the 32 operators; the remaining operators are either independent companies or else part of groups which do not have large market shares in London. LTB told us that only two new independent operators, Harris Bus Company Limited (Harris Bus) and Limebourne Ltd

(Limebourne), had entered the London market since privatization in 1994. They have recently won several small routes (see paragraph 2.74).

The relevant markets

2.24. The market for bus services affected by the acquisition of British Bus by Cowie is described in Chapter 4. As already noted (paragraph 2.9), Cowie has bus operations in a number of areas of the UK, but its existing operations and those of the recently acquired British Bus overlap or are contiguous only in some of these areas, namely in parts of London, Surrey, Kent, Essex, Hertfordshire, Yorkshire and north-east England. The principal overlap is in part of south London.

2.25. A horizontal merger such as has taken place between Cowie and British Bus may be seen as having potential consequences for competition in three different situations. First, there may be effects on actual or potential competition at the national level as a result of an increase in overall market share in the UK; secondly, competition may be affected where the merged companies formerly operated as separate companies in the same local market; and thirdly, there may be an effect on competition, actual or potential, where two companies which before the merger operated in contiguous markets have come together as one single company, now operating across the enlarged market.

The national bus market

2.26. By virtue of its acquisition of British Bus in August 1996 and, immediately before that, North East Bus, Cowie has become the third largest bus operator in the UK, measured in terms of turnover, with an estimated 14.9 per cent[1] of the national market. FirstBus remains the market leader nationally, with 19.8 per cent, while Stagecoach has 16.1 per cent (see Table 4.1). These three groups now have a combined share of 50.8 per cent of the UK market. Go-Ahead and National Express Group PLC (National Express), the fourth and fifth largest companies nationally, have considerably lower market shares, of 6.2 per cent and 5.2 per cent respectively.

2.27. Before the acquisitions referred to in paragraph 2.26, Cowie did not feature as a major bus operator at the national level and its own bus operations were small in relation to its vehicle leasing and motor retailing businesses. Its current position is attributable to rapid expansion since 1994, first through the purchase of Leaside and SLT as part of the privatization of the LBL subsidiaries in London, and then through the acquisition of North East Bus and British Bus in the middle of 1996.

The London bus market

2.28. At the local level, both Cowie and British Bus operate in two very different markets, namely the regulated market in London on the one hand and the unregulated market in other parts of the country on the other. We begin by considering the competitive situation in the regulated market in London following the merger and then go on to consider the effects of the merger in each of the areas outside London referred to in paragraph 2.24, taking into account where appropriate the issues of contiguity mentioned above.

Characteristics of travel in London

[1]Percentages are derived from turnover data taken from *Bus Industry Monitor 1996*, TAS Publications and Events Limited.

2.29. London (by which, in this report, we mean Greater London) is one of the largest urban bus markets in the world. It has a population of approximately 6.8 million, the vast majority of whom live within a five-minute walk of a bus stop. Some 3.6 million bus journeys are made each weekday, which account for around one-quarter of all road journeys in London. The current London bus network comprises over 700 routes, representing over 200 million scheduled miles a year.

2.30. Some 12 per cent of all bus usage within London consists of commuter journeys, many of which are to and from other forms of transport, while the remainder of journeys are for local shopping, school and leisure purposes. Bus usage as a means of travelling to work is some 40 per cent higher in London than in the UK taken as a whole. The average journey length is around 2 miles, the average route length 6 miles and the average journey speed between 10 and 11 miles an hour, although in south London, which has a less well-developed underground and road network than north London, speeds may well be lower.

2.31. LT's approach to integrated transport planning ensures that bus services in London for the most part complement rather than compete with rail and underground services. Thus, bus routes will typically not follow the same path as underground routes for their full length, although they may do so for certain stretches in central London. Again, bus routes run in areas or directions not served by other public transport; such routes typically cut across the main radial routes which run towards the centre of town in order, for example, to link housing estates with shopping centres or with schools. While the use of cars or taxis also provides an alternative to buses, they are far from complete substitutes for the bus in terms of price and convenience. A substantial minority of the population does not, moreover, have access to a car. We therefore think it is reasonable to exclude these other means of private and public transport from our consideration and to focus our analysis on bus services in the capital.

2.32. An important feature of travel in London is the availability to passengers of a variety of integrated travel passes, which allow travel for specified periods and within specified zones by different modes of public transport. Some passes are valid for rail, underground and bus, while others are valid for only one of these means of travel. Passengers pay in advance for these passes and LT assesses and apportions the resulting revenue-referred to as `off-bus revenue'-to the appropriate operators in accordance with a predetermined formula. Between 60 and 70 per cent of bus passengers do not pay an on-board fare, because they use some form of travel pass.

2.33. Although LTB controls almost all of the bus mileage within London through the tendering process, about 2 per cent is represented by commercial services. These take the form of either so-called section 3(2) agreements, which are commercial services run with the consent of LTB and operating along routes in London not served by LTB tendered services; or services run under a London local licence. Only section 3(2) agreements allow the operator to receive a share of London travel pass and other off-bus revenue (see paragraphs 3.39 to 3.42).

Principal operators in London

2.34. Table 4.3 shows that in terms of market share (measured by scheduled mileage on tendered routes), the principal operators in the London market are Cowie, Stagecoach, Go-Ahead, MTL Trust Holdings Limited (MTL), Metroline Holdings Limited (Metroline), CentreWest Limited (CentreWest) and London United Busways 1994 Limited (London United). Together, these companies account for 90 per cent of scheduled bus mileage in the capital. All retain core operating areas (defined by borough boundaries) deriving from the period before privatization. In practice this means that they still have all, or the majority, of their bus depots and routes within these core operating areas. As we have seen, however (paragraph 2.22), all routes in London are now to be subject to periodic competition through retendering.

2.35. As shown in Table 4.3, the market share of Cowie's subsidiaries in London as a whole in October 1996 was 18 per cent, while that of the British Bus subsidiaries was nearly 8 per cent. As a result of the merger, Cowie is now the largest operator in the capital. Go-Ahead and Stagecoach, both of which acquired former LBL subsidiaries at privatization, are also strong in the London market, with shares of 17.0 and 16.8 per cent respectively. It will be noted that the merger has increased Cowie's total share of scheduled mileage in London to almost 26 per cent, slightly in excess of the 25 per cent maximum (see paragraph 2.19) which was set as an informal guideline by the DOT for the purposes of privatization. The Office of Fair Trading (OFT) told us, however, that this indicative threshold was not intended to remain as a rigid rule in the post-privatization market.

2.36. As will be seen from Figure 4.3, Cowie's SLT is flanked to the west by London General Transport Services Limited (London General), and to the east by London Central Bus Company Limited (London Central) and South East London and Kent Bus Company Limited (Selkent). Both London Central and London General are owned by Go-Ahead; the former was acquired by Go-Ahead in 1994 at privatization, while London General, having first been acquired at privatization by its management and employees, was subsequently sold to Go-Ahead in June 1996. Selkent was acquired at privatization by Stagecoach.

2.37. The market shares of the principal operators in south London (at July 1996) are set out in Table 4.4. It will be seen that the merger has the effect of increasing Cowie's share of scheduled mileage in the boroughs of Croydon and Lambeth (the core operating area of SLT) from 34 per cent to around 43 per cent by virtue of the addition of routes operated by British Bus subsidiaries. Go-Ahead's share in Croydon and Lambeth is 38 per cent while Stagecoach has about 15 per cent. Other operators supply around 5 per cent of services in this area.

2.38. The acquisition of British Bus has also augmented Cowie's share of bus services in a wider area of south London, that is, an area which includes the boroughs adjacent to Croydon and Lambeth. Thus, the market shares of the principal operators in the four core operating areas of SLT, London Central, London General and Selkent taken together (comprising broadly the boroughs of Bexley, Bromley, Croydon, Greenwich, Lambeth, Lewisham, Merton, Southwark, Sutton and Wandsworth) are as follows: Cowie 32 per cent (SLT 17.4 per cent and British Bus 14.4 per cent), Go-Ahead 39 per cent and Stagecoach 16 per cent.

2.39. In north-east London, comprising broadly the boroughs of Enfield, Hackney, Haringey, Newham, Waltham Forest, Redbridge, Tower Hamlets, Barking & Dagenham and Havering, Cowie had a substantial presence before the merger but British Bus subsidiaries did not have significant market shares. Following the merger, Cowie's share of scheduled mileage has risen from a little over 30 per cent to nearly 35 per cent in this area (see Table 4.5). The major part of this share is accounted for by Cowie's Leaside subsidiary, with almost 22 per cent. Stagecoach has 35 per cent and Capital Citybus Ltd (Capital Citybus) 13 per cent of the mileage in the area.

Operational considerations

2.40. Bus operators running services in London need suitable facilities for the secure parking and maintenance of their vehicles. Requirements will vary, however, according to the scale of operations being undertaken. For example, a small operator with two or three buses running a single route may manage with no more than an overnight parking space, while maintenance of the vehicles can be contracted out. Operators running a number of routes or a large route which requires a fleet of buses (see paragraph 2.43), however, will need access to premises with more extensive facilities to secure, clean and maintain the vehicles, and for staff. Large operators typically have access both to one or more well-equipped bus depots and to `satellite' facilities situated closer than the main depot to the routes on which they are supplying services.

2.41. To avoid the costs of `dead mileage' and the risk that traffic congestion will prevent them from starting and subsequently running on time, operators need to be based close to the routes on which they are providing services. We were told that in London it was desirable to have depot facilities located at a distance of no more than four miles, and ideally as little as one mile or less, from a convenient start-point on the route, but that much depended on the traffic conditions in the area.

2.42. At privatization, the purchasers of LTB's subsidiaries bought, or in some cases leased, from LTB operational depots located in their core operating areas. Figure 4.4 shows the location of the Cowie and British Bus depots, and those of the other principal operators, in south London. Cowie owns most of its depots, but the British Bus depots at Battersea, Walworth and Cambridge Heath are leased from LTB. Cowie now has two depots in the borough of Croydon: its own SLT depot and the British Bus Londonlinks depot. British Bus is the only other operator with depots-at Croydon and Walworth-within SLT's core operating area, although Cowie told us that it intends to vacate the Walworth depot and not seek to buy or lease another when the current lease expires in November 1997, because of vandalism in the area.

2.43. The 700 or so routes which comprise the current London bus network vary both in length and in terms of the numbers of passengers which use them. LTB assigns to each route a peak vehicle requirement (PVR), which stipulates the number of buses which LTB regards as being necessary to operate that route during peak periods. In practice, operators will need to allocate some 10 to 15 per cent more buses to a route than the PVR figure, to allow for vehicles being out of commission for maintenance and repairs. Routes for which there is a high passenger demand will typically require higher-capacity vehicles, such as double-deckers, whereas lesser-used routes may be run successfully with single-deck vehicles such as midi- or minibuses.

The tendering process

2.44. Competition between bus operators in London takes place primarily at the point of tender for particular routes; it is competition `for the market' rather than competition `in the market' and generally occurs only once every five years. As described in paragraph 3.34, 5 per cent of scheduled route miles were put out to tender in each year between 1985 and 1995, so that around half the network had been tendered by 1995. As shown in Appendix 3.3, the tendering programme began to intensify in 1996, following the introduction of competitive tendering on a net cost basis. Some 10 per cent of scheduled miles in London are being tendered in the year 1996/97 and 22 per cent in each successive year from 1997/98 to 2000/01. There are 48 routes in Croydon and Lambeth in respect of which new contracts commence on dates between January 1997 and December 1998, representing a total of over 20 million scheduled miles. The tendering process for the first tranche of these routes has already begun and some small independent operators have been successful in winning some routes (see paragraph 2.74).

2.45. LTB told us (see paragraph 5.35) that the average number of bids that had been submitted per tendered route for London as a whole since privatization was 4.5. A downward trend was evident, with an average of 6.3 bids per tender between January and June 1995, reducing to 6 per tender between July and December 1995, 3.9 per tender between January and June 1996 and 2.6 per tender between July and December 1996. In south London, only three routes had been offered for tender in the SLT core operating area between privatization of that subsidiary in January 1995 and the acquisition of British Bus in August 1996, and all of them had been retained by SLT. The total number of bids received for these routes had been three, four and four respectively. The bidders for two of those contracts had included both Cowie and

British Bus, so the companies had been competing prior to the merger. LTB told us that it was particularly concerned about competition in south London in view of the reduction both in the number of bids for LTB tenders and in the number of major operators in the area: the merger of Cowie and British Bus and the acquisition of London General by Go-Ahead meant that while there had, until the middle of 1996, been five major potential bidders in the area, there were now only three: Cowie, Stagecoach and Go-Ahead. Moreover, the leading national operator, FirstBus, had a negligible presence in the London market[1] (see paragraph 4.34).

The other relevant markets

2.46. We consider now the competitive position in the markets outside London in which Cowie and British Bus operate. As already noted, the parties overlap or are contiguous in parts of Surrey, Essex, Kent, Hertfordshire, Yorkshire and the north-east of England. We consider each in turn.

Surrey and Kent

2.47. As will be seen from the map at Figure 4.9, which shows the depots and number of buses of the main operators in Surrey, west Kent and south Essex, British Bus operates services from depots across a swathe of Surrey and north and west Kent from Guildford in the west to Tonbridge in the east. For convenience, we consider the markets in Surrey and Kent together below.

2.48. British Bus is the leading operator in Surrey. Table 4.13 shows that it has a 50 per cent share of registered bus mileage in Surrey as a whole. Its London & Country subsidiary alone has 35 per cent of bus mileage in the county. In the three districts of Surrey which are contiguous with south London, British Bus's shares are higher. Thus, Cowie estimates that British Bus has shares of bus mileage in Reigate & Banstead of 64 per cent, in Epsom & Ewell 58 per cent, and in Tandridge 85 per cent.

2.49. The principal operating area of SLT is contiguous across its southern border with Tandridge and Reigate & Banstead, and is near to Epsom & Ewell and Sevenoaks (see Figure 4.9). The area of contiguity with SLT's boundary is, however, quite small. Cowie did not operate in Surrey or Kent prior to the merger, so there is no loss of actual competition in those counties. However, before privatization, when it was a subsidiary of LBL, SLT operated a route from Croydon into Tandridge, originally run by British Bus's London & Country. The route was a joint LTB and Surrey County Council tender. Subsequently, London & Country won back the route.

2.50. Some 68 to 70 per cent of total bus mileage in Surrey is accounted for by commercial services. Tendering applies in relation to 65 per cent of the total number of routes operating in the county, but such tenders are typically for school services or evening and Sunday services on otherwise commercial routes or for much shorter routes than the commercial ones. We were told by Surrey County Council that in the east Surrey area (comprising Tandridge, Reigate & Banstead and Epsom & Ewell districts), the average number of bids per tender for tendered routes had fallen and in 1995/96 was only 3.5.

2.51. Competitors to British Bus in east Surrey include East Surrey Buses, which has 13 per cent of bus mileage in Tandridge and 5 per cent in Reigate & Banstead; Epsom Coaches, which

[1] On the day before our report was due to be submitted, FirstBus announced that it had conditionally agreed to acquire CentreWest.

has 35 per cent in Epsom & Ewell and 10 per cent in Reigate & Banstead; and Tillingbourne, with 11 per cent in Reigate & Banstead. These are all comparatively small operators.

2.52. British Bus is also the leading operator in west Kent, where its share of bus mileage is 64 per cent, principally through its operating companies M&D and Kentish Bus.

2.53. In north-west Kent, the position before the merger was that the River Thames divided the operations of Cowie's County Bus operations in south Essex from those of British Bus's Kentish Bus in north-west Kent. On the south side of the river, Kentish Bus operated from two depots, while County Bus had a depot at Grays in Essex. However, the scope for competition here is limited by the River Thames, since the only crossing in this area, at Dartford, is at times congested and thus imposes additional costs in terms of dead mileage on operators with services on the other side of the river from their depot. At present there are only four infrequent bus services over the Dartford Crossing.

Hertfordshire

2.54. Cowie and British Bus both provide bus services in Hertfordshire, where British Bus is the leading operator. Cowie operates principally through County Bus, and British Bus through The Shires. The map at Figure 4.10 shows the ten districts in Hertfordshire, as well as the location of the depots of Cowie and British Bus and their competitors in those areas. British Bus's 39 per cent share of bus mileage in Hertfordshire as a whole is now increased to 50 per cent when Cowie's 11 per cent share is added to it.

2.55. As will be seen from Table 4.16, which shows the market shares of Cowie and British Bus in each of the ten districts, there is some overlap in services between the two operators in most of the ten districts, although the increment in each district which results from the merger is quite small. The parties' existing services overlap slightly in some areas.

2.56. Sovereign Bus and Coach Company Ltd (Sovereign) and University Bus provide competition within the county, while other bus companies operating around the area include MTL, Metroline, Stagecoach, FirstBus, CentreWest and Go-Ahead. Hertfordshire County Council does not consider that the merger raises significant concerns. We received no expressions of concern about the merger so far as this market area is concerned.

Yorkshire

2.57. British Bus's Yorkshire Bus operates in west Yorkshire and in Selby in north Yorkshire (see the map at Figure 4.11) and runs services into Sheffield and York. Until recently, North East Bus had a depot in Ripon, some 40 miles from Selby. Services from that depot ran into the centre of York and overlapped on a short stretch of the route into York with Yorkshire Bus services. However, Cowie stopped running its bus services from Ripon to York in September 1996 and intends to dispose of the Ripon depot. There is accordingly no overlap at present between North East Bus and Yorkshire Bus to the south. Blazefield Holdings Limited (Blazefield) operates in north Yorkshire between North East Bus and Yorkshire Bus.

North-east England

2.58. As already noted (see paragraph 2.9), Cowie acquired North East Bus from National Express on 31 July 1996, immediately before the merger with British Bus. North East Bus operates services principally in Durham and Cleveland, and into north Yorkshire (see the map at Figure 4.11, which shows the depots of North East Bus). To the north of North East Bus's operating area lies that of British Bus's Northumbria, operating principally in Northumberland. The parties run services which overlap very slightly within the centre of Newcastle.

2.59. Cowie told us that the proportion of bus services provided by the various operators in the region has not changed since the MMC's 1995 report on the supply of bus services in the north-east of England.[1] Table 4.18 shows that, in the north-east Tyneside region, Cowie's North East Bus subsidiary has a market share of 19 per cent and British Bus of 11 per cent. Cowie therefore now has almost 30 per cent of the market in this area. Other competitors in the area include Go-Ahead, with a market share of 28 per cent, and Stagecoach, with nearly 26 per cent.

Public interest issues

2.60. We turn now to consider the public interest issues raised by the merger at the national level, in London and in the other areas discussed. We consider the national level first.

The national level

2.61. As we have seen (paragraph 2.26), the merger has resulted in three large bus companies of roughly equal size accounting for over 50 per cent of the bus market at the national level. FirstBus, Stagecoach and Cowie are much larger than their nearest rivals, Go-Ahead and National Express, and each operates with a large fleet of buses in many parts of Great Britain.

2.62. Cowie put it to us that the acquisition of British Bus had enabled it to become an effective third competitor to the two existing market leaders and would bring to bus passengers nation-wide the benefits of its philosophy of providing a quality bus service to customers. Cowie accepted that its approach to further expansion manifested a willingness to acquire bus operations if opportunities arose. Its immediate task was to bring British Bus up to the standards of the rest of the group. Cowie said that it was prepared to compete with other bus companies of any size, in any market, if that would produce the best outcome for its bus business.

2.63. We have received no evidence from third parties to suggest that the acquisition would have detrimental effects at the national level. The DOT told us that it had no concerns in this respect; indeed, it considered that the assets of British Bus were better used in expanding a (then) lower-ranking group, Cowie, than being divided between the two largest players, FirstBus and Stagecoach. The merger might, it thought, also bring benefits in terms of the overall quality and image of bus services in Great Britain.

2.64. Until two or three years ago, bus operations formed only a comparatively small part of Cowie's operations. Its emergence as one of the largest bus operators in the UK has been achieved by rapid acquisition of substantial bus companies, most recently that of British Bus. There has accordingly been little opportunity to assess Cowie's readiness to gain market share through competition with other bus operators rather than through acquisition. Head-to-head competition between bus companies can only take place in particular local markets rather than across the UK as a whole. However, we have a concern that the largest companies, particularly the top three, may take account of the others' national and local market shares in determining their strategies as regards entry and competition in particular local markets. The risk is that the companies will co-operate rather than compete with each other at this level. In this context, we note Cowie's statement that it intends to compete and that it will strengthen the competitive position of British Bus in the markets in which it operates. We also note that British Bus was

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[1] *The supply of bus services in the north-east of England*, HMSO, Cm 2933, August 1995.

already a very large bus company before the merger (with almost 10 per cent of total UK bus services). We consider on balance that the group's enhanced size and overall national market share are as likely to generate competition as to lessen it.

2.65. We considered one further aspect of the merger at the national level, as it may relate to competition in the national market. This arises from the fact that, as we have seen (paragraph 2.8), Cowie, in addition to its bus service operations, has related businesses in bus distribution and vehicle leasing and financing. There is the potential for Cowie to conduct business among these related activities in such a way as to affect adversely the competitive position of other bus operators. In particular, Cowie's bus distribution business is the sole UK importer for DAF bus and coach chassis. However, there are a number of other suppliers of bus and coach chassis in the UK; and moreover, we have received no evidence from other bus operators which suggests that Cowie is exploiting its position in the distribution of bus parts, or any expressions of concern that it might do so. So far as the leasing side is concerned, it is clear that Cowie has many competitors in supplying leases; and again, we received no evidence from other bus operators on this aspect of Cowie's operations. Taking all these considerations into account, we conclude that the vertical integration aspects of Cowie's enhanced operations may be expected not to operate against the public interest.

London

The nature of competition in London

2.66. LTB told us that a primary objective of the policy of competitive route tendering in London had been to improve standards and reduce costs by stimulating competition in the market through the introduction of private sector operators. It told us that this policy had been successful; costs per mile had been reduced by 40 per cent and the subsidy had fallen from £265 million in 1984/85 to £118 million in 1987/88 and to £13 million in 1996/97 (all at 1996/97 prices).

2.67. As we have seen (paragraph 2.18), the London bus market is likely to remain regulated for the foreseeable future. Such key elements as the route network, the level and structure of fares and the frequency of services in London all remain within the control of LTB. There is accordingly little opportunity for head-to-head competition on routes; nor is there very much scope for anti-competitive or exploitative behaviour in the provision of bus services in London. Competition takes place in advance of the provision of bus services, at the point at which operators bid for the right to run particular routes under contract to LTB. Such competition is *for*, rather than *in*, the market. Contracts are generally awarded for a five-year term (although with a `break' clause available to either party after three years). This means that competition for routes is in effect a periodic, one-off process and, provided the successful operator runs the service to specification, it cannot be challenged during the contract period.

2.68. LTB is under a statutory duty by virtue of the 1984 Act to have regard to the key issues of efficiency, economy and safety of operations in respect of the provision of services in London, and it is also obliged to invite tenders for such services. In addition, it has certain supplementary obligations to the Secretary of State for Transport, who issues directions regarding quality of service. LTB told us that it has no express statutory obligation to consider competition in the London market when awarding contracts, although informal guidance from the Secretary of State at the time of privatization had stated that one of the objectives of that process was to produce sustained and fair competition. LTB also told us that it was not obliged to award a contract to the operator putting in the lowest bid, unless the margin between the bids was substantial, because the question of quality-and hence overall value for money-also had to be taken into account. Nevertheless, it is clear to us that LTB has had primarily to balance the twin objectives of reducing the subsidy by seeking as low a bid as possible on the one hand and maintaining quality of service on the other. In practice, the need to reduce subsidy has so far constrained LTB's ability to take other considerations into account; these might include actively encouraging a more diverse range of operators to enter the London market. From the evidence available to us (see paragraphs 3.30 and 5.27), LTB has the discretion to tender and award either individual routes or groups of routes together, as it judges appropriate.

2.69. LTB told us that the major companies operating in London had a good idea of the current level of prices in the market and the prices at which they and the other operators were prepared to run particular routes. Although LTB had no evidence of collusion, the number of tenderers had reduced and only two new independent operators had succeeded in winning routes in the London market since privatization, leaving it with the impression that the major companies were content not to compete. LTB submitted that it was essential that there should be at least four or five bidders for each contract, in order to stimulate competition on price. LTB believed that the greater the number of tenderers, the greater the uncertainty for each bidder and the greater the likelihood, therefore, that each would put in a keen bid.

2.70. Cowie put it to us that any operator-particularly an incumbent operator-had to proceed on the assumption that there would be at least one other bidder who was likely to offer a competitive price. This was because of the secrecy of the bidding process, the fact that no tenderer knew whether or not he was the sole bidder or one among several, or the bid price of any possible competitor, and the fact that the uncertainty in the tendering market was not reduced with smaller numbers of bids. As to the number of bids per tender received by LTB, Cowie said that it did not know the actual position, since LTB did not make details available to bus operators. The reduction in the average number of bids since the beginning of 1995 might, it thought, be attributable to the fact that relatively few routes had been put out to tender during that time; with a greater number of tenders coming up, operators were likely to become more selective and identify more realistic opportunities. So far as south London in particular was concerned, there was the uncertainty created by the proposed Croydon Tramlink, which might temporarily have destabilized the market in south London; Cowie suggested that more tenderers could be expected when the effect of the Tramlink on bus operators' revenues became clearer.

2.71. In assessing whether the merger may be expected to operate against the public interest in respect of the standards and costs of bus services in the capital, we accordingly considered in particular the following matters:

- the nature and extent of any barriers to entry or exit and their likely effect on potential bidders;
- the implications for bid prices and quality of service of a decline in the number of bids per tender in London since the beginning of 1995;
- the significance of the high market shares held by large operators;
- the extent of competition for routes and evidence of possible advantages enjoyed by the large operators with networks of routes in particular parts of the capital; and
- the role and powers of the regulator in ensuring a competitive market in London.

Possible barriers to entry

2.72. We began by considering whether there were any significant barriers or deterrents to entry to the London market; that is to say, factors which might inhibit potential operators from bidding for routes. In this connection, we first considered the size of the contracts coming up for tender in London and in particular those becoming available in south London. As we have seen, routes vary considerably in terms of the number of buses required to operate them. LTB told us that many of the south London routes were substantial and that smaller operators were unlikely to be able to compete for them. That meant that any bids would have to come from the larger players. Cowie thought that a small operator would be able to enter the market on a considerable number of routes in London, in particular those with a PVR of fewer than 25 buses. It noted that there were many routes coming up for tender in the next two years with a PVR of under 15 buses. On the other hand, Cowie recognized that many routes with high PVRs demanded a large and well-resourced operator. Leaside, for example, operated the route number 253, one of the biggest in London, with a PVR of 48 buses and requiring 130 drivers. Accordingly, it was necessary for a number of operators in London to have the purchasing powers and economies of scale to run significant and demanding routes such as the number 253.

2.73. We analysed the size of all routes due to be tendered over the next five years in London as a whole, and compared them with the size of routes due to be tendered in 1997 and 1998 in the boroughs of Croydon and Lambeth, where LTB has particular concerns about the competitive position (see Table 4.12). We wanted to assess to what extent small operators and new entrants would be able to run the routes. We found that, in terms of PVR, a higher proportion (26 per cent) of the routes being tendered in Croydon and Lambeth requires 16 or more buses than for London as a whole (16 per cent); at the same time, a much smaller proportion of routes in the two boroughs than in the whole of London requires only between one and five buses (7 per cent compared with almost 27 per cent). On the other hand, a substantial proportion in both categories-67 per cent of routes in Croydon and Lambeth, and 58 per cent of all London routes-has a PVR of between 6 and 15 buses. As we have seen (paragraph 2.30), the less well-developed underground network in south London makes bus travel particularly important in this part of London and may help to account for the somewhat higher proportion of larger routes. Nevertheless, 43 per cent of the routes coming up for tender in Croydon and Lambeth over the next two years will require ten buses or fewer; these are the sorts of routes on which we should expect smaller operators to be prepared to bid for tenders.

2.74. Some smaller operators have recently won tenders in the Croydon and Lambeth area from British Bus's Kentish Bus. Harris Bus has won a route due to start in April 1997, for which the PVR is ten buses, and has won four more small routes from other operators. Limebourne has also won a route due to commence in April 1997; here the PVR is seven. All these routes are contracted on a net cost basis. Crystals Coaches (Crystals) has won a third route from Kentish Bus which it started to operate in November 1996. Another small operator, Armchair Travel, has won a route from London & Country. We think it is likely that the success of small operators will continue as more routes become available.

2.75. We considered whether the move towards 100 per cent net cost tendering in London over the next five years would be likely to act as a deterrent to the entry of new, small operators. Net cost contracts transfer all the revenue risk to operators and a study[1] of markets outside London has suggested that net cost tenders generate fewer bids than those for gross cost contracts. Small operators are less likely to have at their disposal the financial resources to take on the greater risk associated with these contracts. Unlike large operators, who may be able to gain economic advantages from having a cluster of routes in close proximity to each other and a single depot from which to operate, small operators will be less able to spread the risk of loss

[1]See second footnote to paragraph 4.75.

from one route across several others. Nevertheless, as we have just seen (paragraph 2.74), smaller operators have been prepared to bid for routes on this basis and some have already been successful.

2.76. New entrants may also experience difficulty in obtaining suitable depot facilities in the capital. We considered whether incumbents, particularly the former LTB subsidiaries, enjoy a significant advantage in this respect. LTB put it to us that the problems associated with access to depots constituted a significant barrier to new and, in particular, small entrants; it was very difficult, LTB told us, to find available land suitable for depots in London. The Borough of Lambeth told us that there were few sites available in that borough which would be suitable for use as a new bus depot (see paragraph 4.80). Cowie on the other hand maintained that appropriate sites were relatively easy to find; only a flat parking area was required, as maintenance could readily be contracted out. It told us that a very informal spot survey which it had carried out on a single day down the A23 corridor suggested that at least 17 possible sites might be available. Moreover, the eight- or nine-month lead-time between the award of a contract and the commencement of operations afforded operators plenty of time to acquire the vehicles and infrastructure needed. Cowie cited CentreWest's acquisition of a new depot in Orpington in 1995 as an example of how it was possible to find suitable sites.

2.77. We invited evidence on this matter from a number of operators, including smaller operators, who had more recently secured routes in the London market. None of these had, however, found it necessary to seek new depot facilities in London in order to secure the routes. Nevertheless, we did not form the impression that these operators would be deterred from bidding for routes because of the potential difficulties of finding suitable premises; one of them, Crystals, told us that it intended to continue to tender for routes within or outside its operating area. We conclude that, although ready access to a depot gives operators who have such facilities a significant advantage when tendering for routes in London, there will be smaller operators determined to gain routes in the capital who will not be deterred by the challenges in this respect.

2.78. We also considered whether small operators might regard the fixed-term nature of contracts in London as constituting a deterrent to entry into the London market. Net cost contracts are for a five-year term but allow the operator to terminate the contract after three years. Within the three-year period, LTB will renegotiate its level of subsidy or service requirements only if circumstances which are beyond the control of the operator, such as an increase in traffic congestion, make it necessary to do so. Outside London, only six weeks' notice by the operator to the Traffic Commissioner is required to surrender a route. The relative difficulty of exiting the London market may accordingly represent something of a deterrent to entry by smaller operators.

Declining bid numbers

2.79. We next considered whether the merger might be expected adversely to affect competition for tenders in the London market. In view of LTB's concern at the decline in the number of bids that it has recently received, we considered first the recent past record of bidding.

2.80. The average number of bids per tender across London as a whole has been falling since January 1995 (see Figure 4.5). This may be indicative of reduced competition but there are alternative explanations as to why the number of bids per tender should have declined over the period. When tendering recommenced after the completion of privatization, it seems likely that some operators put in bids to `test the water', perhaps without much expectation of success. Others, who expected but failed to win routes, may have become discouraged as they recognized the level of bid prices they would need to match. LTB told us that it had initially been encouraged by the willingness of small operators to put in bids but examination had shown that the bid prices they were submitting were substantially higher than those of other bidders. LTB had accordingly taken steps to encourage these operators to sharpen their bids to match prevailing price levels, with some success. It told us that one small operator, Harris Bus, for example, had recently won several routes after a number of previously unsuccessful attempts, as a result of putting in much keener bids. Smaller operators may also have been deterred by the considerable administrative effort required to put in an acceptable bid; bidders are required to satisfy LTB as to the arrangements they have made in respect of vehicles, staffing, premises, financial resources and health and safety matters, and small operators are likely to find this process more onerous than the larger bus companies.

2.81. A new, more substantial tranche of tendering is now under way. Considerably more routes will be available for tender each year (see Figure 4.6, which shows the number of routes that were put out to tender in 1995 and 1996 and the number scheduled to come up for tender over the next five years, and Appendix 3.3). As the number of tenders increases, we think it likely that operators will become more discriminating and focus on selected routes which they consider they have a real prospect of winning. As a result, numbers of bids per tender are unlikely to increase and may indeed fall a little on a route-by-route basis, but we expect that the operators that do bid will be offering keener prices.

2.82. We also considered whether the reduction in the number of bids might be related to the bid prices, on a per mile basis, that were submitted by operators in the period we are examining. While, overall, the average subsidy per route paid to operators fell between September 1995 and December 1996, the average reduction in the price tendered per mile has diminished over the same period (see Figure 4.7); and hence, the rate of decrease in the subsidy has been slowing down. Although there is an apparent correlation between bid numbers and average rates of reduction in the tendered price per mile, we believe this relationship should be treated with caution. Other factors are likely to have had at least as great an impact on the rate at which tendered prices have been declining. Indeed, it seems likely that much of the readily available cost saving was achieved through the competitive tendering procedures from 1985 to 1994, that is, prior to privatization. LTB put it to us that the current economic situation was also relevant to the level of prices: the hardening of wage rates combined with a reduction in competition was causing it concern, and the massive reductions in tendered prices which had occurred over the past ten years were unlikely to continue. Accordingly, we believe that the slowing rate of reduction in tendered prices may be expected to continue for reasons not directly related to the degree of competition.

Market share

2.83. One of the major concerns about the merger expressed by LTB was the increased market share which it gave Cowie in London as a whole but more particularly in south London, and the threat to competition which this would pose. We considered the implications of Cowie's increased share of scheduled mileage in London as a whole and in south London in particular as a result of the merger. Cowie put it to us that competition in the London market was fierce. Tenders were being renewed on a continuous basis, the market was heavily contested and the merger would create no market dominance whatsoever. Adjacent to SLT were London General and London Central (both Go-Ahead subsidiaries) and Selkent (Stagecoach), strong companies which, together with smaller operators, could counterbalance and compete with Cowie in the area. But in any event, Cowie argued, market share in London did not confer an advantage on an operator in a situation where the bidding process placed all entrants on an equal footing. Market share did no more, it said, than show the track record of the company seeking or retaining tenders. Contracts were usually tendered for five years, giving certainty of operation and encouraging market entry, since budget plans could be predicted over a foreseeable period. Every route was contestable and indeed was actually contested every five years. Cowie estimated that since the completion of the acquisition on 1 August 1996, Cowie and British Bus between them had already lost tenders and routes amounting to approximately 1.2 per cent of the London market, primarily in the Londonlinks and Kentish Bus subsidiaries.

2.84. We do not accept that market share is unimportant in the regulated London market. However, a high market share, either in the London market as a whole or in particular parts of it, may have a different significance from that in unregulated markets, both in terms of the manner in which that share was originally obtained and also since competition only occurs once every five years and then on a tendered basis rather than head-to-head on a route. In London, high market share is also associated with a network of depots and incumbency on large numbers of linked routes. This is why the DOT issued its non-statutory guidance at privatization to the effect that no purchaser should be allowed to have more than 25 per cent of total bus mileage in the capital (see paragraph 2.19). As already noted, the greater part of scheduled mileage in London is accounted for by the seven largest groups; other operators have only 10 per cent of the total. We consider further to what extent high market share confers an advantage on operators in the discussion of competition between operators in the next section.

Competition for routes

2.85. We examined the nature and extent of competition for routes in London. First, we looked at what competition had taken place between Cowie and British Bus before the merger, that is between January 1995 and July 1996. There were 11 occasions during this period on which a Cowie subsidiary and a British Bus subsidiary submitted tenders for the same contract (see Appendix 4.1) and on three of these occasions the tender was for a route on which the Cowie or British Bus subsidiary was the incumbent. On the face of it, the merger would therefore appear to have brought about some limited reduction in competition. In addition, we found that there had been 14 occasions on which subsidiaries of Cowie had competed against each other for contracts over the two-year period beginning January 1995, and five occasions on which British Bus subsidiaries had done so.

2.86. We considered whether Cowie and British Bus subsidiaries were likely to compete with each other in future. Cowie told us that it had not yet decided whether to merge the bus operations of Cowie and British Bus under a single management or to retain them as separate businesses. It intended to spend the coming year assessing its different bus operations across the country before deciding what the structure would be. It was part of Cowie's philosophy to encourage competition within the group. Cowie submitted that strong and independent management with devolved responsibilities had been the key to the group's success; in terms of tendering for routes in London, that meant that the operating subsidiaries would have freedom to decide when and where they put in competing bids against each other. Cowie also submitted that, as efficiencies with respect to existing routes were fully exploited and the opportunities for companies to reduce their costs became fewer, operators would be even more willing than they were now to widen their initial sphere of operation and follow the lead of, for example, CentreWest in treating the whole of the LTB area as open to them. Expansion would be the inevitable recourse as efficiencies ran out. For Cowie's part, it was still in the process of bringing British Bus's operations up to its own operating standards. So for the moment Cowie was not looking for expansion but rather consolidation.

2.87. We note Cowie's comments to the effect that in future different subsidiaries within the group might tender against each other for particular routes. There may indeed be circumstances in which it would serve the group's interests to allow its subsidiaries such autonomy. As we have seen (paragraph 2.85), both Cowie subsidiaries and British Bus subsidiaries have competed among themselves over the past two years, so clearly each company has considered it to be in its interests to do so on at least some occasions. However, we can equally envisage circumstances where it would be more advantageous for Cowie to co-ordinate its bids in the interests of making the best use of its resources and improving its profitability.

2.88. We were conscious of LTB's concern about the reduction in the number of large operators (and hence potential competitors) in south London, especially since the acquisition by Cowie of British Bus and of London General by Go-Ahead. Accordingly, we analysed the nature and extent of competition for bus routes in London, particularly based upon the 130 routes previously operated by large (incumbent) bus operators which had been put out to tender by LTB during the two calendar years 1995 and 1996. For much of our analysis we distinguished between routes in north London (of which 59 had been tendered) and south London (71 tendered routes). We also took into account the locations of competing large bus companies-that is, whether they or their particular subsidiaries were located in north London or in south London and whether these operations were adjacent or not adjacent (as defined-see paragraph 4.48) to the route being tendered. We also examined the competitive role and experience of small operators.

2.89. We found (Tables 4.7 and 4.10) that each of these tendered routes attracted an average of 4.2 bids, with slightly more (4.6) in north London and slightly fewer (3.9) in south London. Bids came from incumbent operators, other large operators in the same area of London or those with adjacent operations, small operators and, to a lesser but still important extent, from other large operators based in the other half of London or having non-adjacent operations. The large incumbent operators retained their tendered routes in 69 per cent of the cases (Table 4.8), the proportion being slightly higher in south London (72 per cent) than in north London (66 per cent). The retention rate for Cowie was 72 per cent but that for British Bus was only 29 per cent (Table 4.6). Given the nature of possible advantages to incumbent operators, we are not surprised that a significant proportion of routes should have been retained by the incumbent.

2.90. Of the 40 routes that were not retained by the incumbent large operators, 18 were won by small operators and 22 by other large operators, 13 of whom were located in the same half of London as the tendered route, 12 being classified as adjacent operators. Across London as a whole, the success to bid ratio was 11 per cent for small operators, 8 per cent for other large operators based in the same half of London (8 per cent also for large adjacent operators) and 11 per cent for large operators based in the other half of London (also 11 per cent for large non-adjacent operators). Our analysis of the bidding activities of the different groups and their subsidiaries (Table 4.9) showed that operators based in north London had bid for more tendered routes and had a higher success to bid ratio than operators based in south London. Large operators based in north London had some success in winning tendered routes in south London.

2.91. The numbers of observations on which our analysis has been based are relatively small due to the limited number of routes tendered by LTB since privatization, and may not necessarily be a good guide to future outcomes where more routes are tendered each year. We do, however, consider that they provide evidence that there are competitive forces at work in both the northern and southern segments of the London bus market. A sizeable proportion of routes have been lost after tendering by the previous incumbents. Their losses have been to other large operators in close proximity, large operators based further away and small operators. Furthermore, there is evidence that bus operators in north London do bid for, and sometimes win, routes in south London. It is open to LTB as the regulator to act to encourage more such competition if it feels it is necessary.

2.92. In the south London area the main operating subsidiaries of Cowie and British Bus were SLT and Londonlinks respectively. In the past two years, 1995 and 1996, eight of the routes they operated had been tendered by LTB. Of these, five were retained by the Cowie/British Bus subsidiary but three were lost to other operators-one a large adjacent operator, one a large non-adjacent operator and one a small operator (Table 4.11). Of course, the numbers here are very small but this pattern of out-turns is in keeping with the analysis of competition in the whole London bus market. The two most significant companies with areas of operation in close proximity to those of SLT and Londonlinks in south London are London General (part of Go-Ahead) and Selkent (a Stagecoach subsidiary). We found that between them they submitted eight bids for the eight SLT/Londonlinks routes that were being tendered, winning one. Of 29 other routes in south London where they might have been expected to bid (see paragraph 4.52) they only bid for three, not winning any of them. This may be considered to weaken the threat of potential competition in south London from other south London operators and will, no doubt, be kept under review by LTB.

2.93. During 1997 and 1998, 48 routes running primarily in Croydon and Lambeth are due to be tendered, representing around 44 per cent of the total 46 million route miles of such routes in those boroughs (see paragraph 4.73 and Figure 4.8). Of the 48 routes, 26 are currently being run by Cowie or British Bus subsidiaries and represent a significant proportion of Cowie's and British Bus's total mileage in the two boroughs-55 per cent in the case of Cowie's subsidiaries and 76 per cent in the case of British Bus's subsidiaries. Other operators are incumbent on the remaining 22 routes. It is clear that a significant proportion of Cowie's current operations in Croydon and Lambeth will be open to contest in the short to medium term.

The regulatory role of LTB

2.94. We consider, finally, the central role of LTB in ensuring a competitive market for bus services in London. As the regulator, LTB is clearly in a powerful position, although there are limitations upon its ability to secure a competitive market. In evidence to us, the DOT noted that, while decisions about the procurement of bus services in London were entirely a matter for LT, the financial targets set for LTB by the Secretary of State for Transport did ensure that LTB sought the best value for money on a route-by-route basis. Among the criteria used for evaluating tenders, price would be very important but not necessarily decisive. The DOT told us that it thought LT would take some account of the medium- to long-term implications for the general competitive situation in the London market, but that it was for them to weigh up these factors.

2.95. We consider that there may be greater opportunities in future for LTB to take longer-term considerations into account when awarding tenders. As LTB and potential bidders become more confident and knowledgeable about the market, it is likely that bid prices will tend to converge and accordingly that there will be more opportunity for LTB to have regard, to a greater extent than before, to matters such as the promotion of competition in the London market. In addition to its duty to secure bus services in London, LTB has powers in the last resort to provide such services itself. We would expect it to use its powers to give greater emphasis to long-term considerations such as competition in the capital, the tendering and allocation of blocks of routes and the encouragement and promotion of a more diverse range of operators in London. Moreover, given the concern which LTB has expressed about the problems which operators have in obtaining suitable depot space in London, it should be possible for LTB to adapt its current policy; in particular, LTB should seek to ensure that operators currently in possession of a depot which has surplus capacity make such capacity available to other operators seeking premises, subject of course to normal commercial terms being secured by the incumbent. Cowie indicated to us that British Bus had, in the past, volunteered to make depot space available to other operators when it had had spare capacity.

Findings on the London market

2.96. In reaching a conclusion on the effects of the merger on the London market, we consider that two points are of particular importance. First, the London market is different from other markets in the UK in terms of both size and structure. It has an important element of regulation and bus services form part of a wider subsidized public transport system. Routes are subject to competitive tender (indeed, by 2002/03 all routes will have been tendered) and this means that each route is contested on a regular, albeit infrequent, basis. Secondly, the London market has undergone a number of changes in recent years and has not yet stabilized. Competitive tendering was introduced on a gradual basis in 1985 and ten years later 55 per cent of the scheduled mileage of London as a whole had been put out to competitive tender. Tendered routes were let on a gross cost basis while non-tendered routes were first subject to block grant arrangements and then transferred on to a negotiated net cost basis. The total subsidy dropped massively over this period as the high-cost routes were among the first to be subjected to the competitive process. Further changes to the tendering regime were temporarily put in abeyance while the privatization of the LBL subsidiaries took place during 1994. Tendering began again in 1995 when an accelerated programme was introduced for the introduction of all tendering on a new, net cost basis as from 1996/97. More generally, the possibility has from time to time been discussed of deregulating the London market. All these proposed changes have made it more difficult to reach firm judgments about the lessons to be learnt from the past and their implications for the future.

2.97. We have considered carefully LTB's concern about the future integrity of the tendering process in London which it believes will be undermined by the merger between Cowie and British Bus. In LTB's view, the merger exacerbates existing threats to competition in the capital. As we have seen, it has reduced the number of significant players in the London market overall, while in south London, the area of particular concern to LTB, it has followed closely upon the purchase of London General by Go-Ahead, further reducing the number of separate large players south of the river. LTB believes that there is a reluctance on the part of the large operators to compete against each other in the capital and it has pointed to the declining bid rate for tenders since the beginning of 1995. Other factors have contributed to LTB's concern, in particular the existence of certain barriers to entry to the London market including problems of obtaining access to suitable depot facilities and the possibility that net cost tenders will deter smaller operators. We believe LTB's concerns have some validity.

2.98. Nevertheless, we do not think that these concerns represent the whole picture. As we have seen (paragraphs 2.89 to 2.91), there is evidence that both large and small operators compete for routes in London and that a number have changed hands. The volume of routes coming up for tender in each of the next five years is considerably greater than hitherto and may afford different sizes of operator the opportunity to bid to supply bus services. Cowie is only one of a number of large groups operating in the capital which have high market shares in particular areas; in particular, in south London Go-Ahead has an equally high market share as Cowie, and Stagecoach is also well represented.

2.99. We accept that there are inhibiting factors so far as new entrants to the London market are concerned (and here we have in mind those operators who are on LTB's list of 56 pre-qualified tenderers but who have not yet submitted bids, as well as completely new entrants). Thus, the high PVR requirements of many routes will rule out smaller operators for those contracts, but there remain substantial numbers of routes across the capital as a whole with PVRs of ten or less for those companies willing to bid to operate single routes if need be. In Croydon and Lambeth, nearly 43 per cent of all routes have PVRs in this category. The introduction of tendering on a net cost basis may be too risky for some smaller operators but a number have already tried for and won routes on this basis; moreover, these operators may be expected to seek to expand their business, not least in order to spread their risk over several routes. The need to acquire suitable depot facilities together with the administrative and financial challenges for smaller operators associated with tendering for London routes will again deter some from attempting to enter. But the more entrepreneurial operators will take advantage of the opportunity to lease rather than purchase vehicles and of the availability even in London of suitable premises to park and maintain their vehicles. Finally, for the reasons set out in paragraph 2.95, we believe that LTB will be in a stronger position than in the past to take account of the longer-term competitive position in London when assessing competing bids and making route allocations. Taking these factors and all the other evidence into consideration, we do not expect the London market to be significantly less competitive as a result of the merger.

The unregulated markets

Surrey, west Kent and north Essex

2.100. As we have already noted (see paragraph 2.49), although British Bus has high market shares in a number of areas of Surrey and north and west Kent, there is no loss of actual competition in these areas as a result of the merger. However, there is loss of potential competition from SLT. Cowie told us that prior to the acquisition it had no intention of operating commercial services from SLT into the Home Counties, as it saw no demand for such services (see paragraphs 6.30 and 6.31).

2.101. The DOT, which told us that it shared LTB's concerns about the merger, pointed to the domination which British Bus already enjoyed by virtue of the linked British Bus companies operating in south London, Surrey and west Kent (see paragraph 5.6) and said that this domination became unacceptable now that the company was part of a more substantial financial group, namely Cowie, with operations relatively close by in London. There were no other major companies with significant market shares, at least in east Surrey. A number of competitors to British Bus in Surrey expressed some anxiety about the merger (see, for example, paragraphs 5.70 and 5.87). However, these operators were primarily concerned at the strength of British Bus in Surrey, where Cowie does not operate and where, therefore, the merger would have no direct effect.

2.102. We considered the reasons why operators in London had taken little advantage of the opportunity afforded by privatization, when the rules constraining their sphere of operations were relaxed, to extend those operations over the Greater London boundary into Surrey and Kent. We were told by Kent County Council (see paragraph 5.123) that most of the commercially viable routes had already been taken and were being run very competitively; and that the tendered routes were so small and sparsely scattered throughout the rural parts of the county that it was generally not worthwhile for an operator in London to set up new bases in those areas. LTB told us that the failure to expand was partly due to inertia and partly to the strong position of British Bus in Kent and Surrey. We consider that there are few incentives for large

London operators to compete for tendered routes in the counties to the south of London. As to the commercial routes, there are a number of operators in London who could and would compete for those routes if they thought them commercially attractive and were prepared to enter into head-to-head competition with each other.

2.103. We do not share the concerns of the DOT and LTB in respect of the contiguity of Cowie's SLT to the British Bus operations in Surrey. There is no loss of actual competition in Surrey as a result of the merger. Before being acquired by Cowie, SLT ran only one route into Surrey and Cowie has never operated in the county. We were told that Cowie had no plans to compete in either Surrey or Kent, for the reasons given in paragraph 2.102. As regards the concerns about contiguity, the area of contiguity between SLT's core operating area and the British Bus operations in Surrey is in any event quite small; moreover, there are other large operators such as Stagecoach, Go-Ahead and London United, apart from those whose core operating areas are further afield, who would be in a position to compete if they found routes sufficiently attractive. CentreWest has already moved into the Orpington area from its core area in west London and we see no reason why other companies with operations in London should not move into other geographical areas. Accordingly, we do not consider that the merger will adversely affect competition in this area to any significant degree.

2.104. There was one other area of potential concern south of the river, namely the area in south Essex and north Kent where Cowie's County Bus operations and British Bus's Kentish Bus operations are separated by the River Thames at Dartford. We consider that potential competition by an operator based on one side of the river with an operator on the other is greatly reduced by the fact that the river crossing at Dartford imposes additional costs in terms of dead mileage on operators seeking to run services on the other side of the river from their depot. Accordingly, we do not consider that the merger will affect competition adversely in this area.

Hertfordshire

2.105. As we have seen (paragraph 2.55), the merger has resulted in minor increments in Cowie's market share of bus mileage in seven of the ten operating districts in Hertfordshire. However, there are other operators in all districts of the county and a number of large bus groups operating in the areas around it. Hertfordshire County Council told us that it was not concerned at the loss of actual or potential competition in the area. Accordingly, we do not consider that the merger will affect competition adversely in this area either.

North-east England

2.106. We have seen (paragraph 2.59) that the loss of actual competition in the area is small as a result of the merger: the overlap between Cowie's North East Bus and British Bus's Northumbria on routes in Newcastle is minor and we do not view it with concern.

2.107. We note that the number of major operators in the area has fallen from four to three as a result of the merger. All three groups (Cowie, Go-Ahead and Stagecoach) are, however, strongly represented in the region. In our report on bus services in the north-east of England,[1] we commented on the weakness of competition between the major companies. But in view of Cowie's stated intention to be a competitive force in the industry, we do not have any reason to expect that this merger would make the situation any worse. Accordingly, we do not consider that the merger will adversely affect competition in the region.

[1]See footnote to paragraph 2.59.

Yorkshire

2.108. Since the merger took place, Cowie has ceased operating its bus service from Ripon to York; this service is also served by an inter-urban route of Yorkshire Bus. Cowie told us that it intends to sell the Ripon depot and not to recommence services to York. There is accordingly no loss of actual competition in the area. FirstBus, Blazefield and other competitors are strong in the region. Accordingly, in this area too, we consider that the merger will not adversely affect competition.

Potential benefits of the merger

2.109. Cowie suggested that a benefit of the merger was that British Bus had been acquired by a purchaser able to preserve it as an integrated and operational bus group, when no other potential purchaser had been capable of doing so. Whether or not British Bus could have survived as an independent company without being acquired either by Cowie or another purchaser, we do not believe that in operational terms British Bus was a failing company or that its disposal was a `distress sale'.

2.110. Cowie told us that it had already committed £35 million of capital expenditure to upgrading British Bus's fleet, more than double the £17 million which British Bus had planned to invest before the acquisition. Cowie predicted that total investment might be in the region of £45 to £50 million by the end of 1997. We accept Cowie's argument that it is already seeking to increase revenues on bus travel in London by making marketing efforts in respect of particular routes and by making such travel more attractive than other forms of transport: by increasing passenger numbers, it increases its profitability. We consider that Cowie is likely to raise the standards of service offered by British Bus in the same way that it has improved those of SLT. To that extent, we believe that passengers may benefit.

Conclusion on the public interest

2.111. For the purpose of ascertaining the effects of the merger on the public interest, we divided our analysis into three parts and looked firstly at the national level, then the London regulated market and finally the relevant geographical areas of the unregulated market outside London. We had no difficulty in concluding that there were no adverse effects at the national level or in the non-London areas. However, matters in the London area are more finely balanced. Whilst there are some consequences of the merger which we could foresee adversely affecting the public interest (see paragraphs 2.97 to 2.99), we are not satisfied on the evidence that such adverse effects are probable as opposed to merely possible, not least because of the safeguards available to LTB in regulating the London market.

2.112. Accordingly, we find that the merger between Cowie and British Bus may be expected not to operate against the public interest.