

Part II

Background and evidence

3 The companies and the merger situation

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Introduction

3.1. This chapter provides information about the history, current operations and financial performance of the companies involved in the merger situation. It goes on to describe the merger itself and relevant aspects of the franchise agreement concerning Central Trains, and finishes with the competition issues which were addressed at the time the franchise was awarded.

National Express Group PLC

History and origins

3.2. The origins of NEG lie in the creation in 1968 of the state-owned NBC which effected the integration of a large number of both state- and privately-owned bus and coach operators which had previously operated independently of one another. This was the result of a Government initiative to create a more integrated national public passenger transport system. In 1974 the National Express brand was introduced to cover scheduled long-distance coach services operated by the constituent members of the NBC.

3.3. The Transport Act 1980 removed the need for road service licences for coach services on which no passenger travelled less than 48 km measured in a straight line, thus beginning deregulation of bus and coach services. In the face of the ensuing new competition, the frequency and general competitiveness of National Express services were significantly enhanced. A premium brand, Rapide, was introduced on selected routes, involving higher-specification coaches with more on-board facilities, and more direct routes.

3.4. Following deregulation of local bus services outside London under the Transport Act 1985, the Government decided to privatize the NBC on a piecemeal basis. A large number of management buyouts followed including that of the long-distance coach activity of the NBC, operated by NEL, in 1988.

3.5. NEL's core business, the provision of scheduled long-distance coach services, continued to be operated by contract coaches and crews. The new management began to diversify through acquisitions, notably of the local bus operator Crosville Wales, the coach operator Amberline and the coach operation that later became Express Travel.

3.6. The financing costs of these acquisitions, the poor trading performance of all except Express Travel and the impact of the recession on the core businesses resulted in a deterioration of the group's financial position from early 1990. On 23 July 1991 a new management team, backed by a number of development and venture capital investors, effected a management buy-in. A new group holding company, National Express Group Limited (later to become PLC), was formed and effected a share exchange to acquire the existing holding company which subsequently transferred its group shareholdings to the new company and became dormant.

3.7. The new management team, led by Mr Ray McEnhill until his retirement in August 1996, began to refocus the group on its core activities, selling Crosville Wales and Amberline and divesting interests in a number of joint ventures. The new corporate strategy was to:

- (a) refocus the business of the group;
- (b) improve the efficiency, quality and level of service within the group's existing operations;
- (c) develop new products within the existing operations; and
- (d) develop organically and by the acquisition of new businesses related to passenger transport and handling services.

3.8. In October 1991 the group acquired Speedlink, an operator of coach services primarily between Heathrow and Gatwick.

3.9. In December 1992 NEG arranged an offer and placing of some 27.8 million ordinary shares of 5p each at £1.65 per share and the shares were admitted to the Official List of the London Stock Exchange. The offer and placing comprised the issue of 15.5 million new ordinary shares to raise some £23.9 million after expenses and the sale of 12.3 million ordinary shares by existing shareholders. NEG used £9 million of the proceeds to redeem its 10 per cent cumulative preference share capital and the remainder to expand the group, modernize the coach network and introduce new facilities to meet additional requirements highlighted by market research.

Activities and development since flotation

3.10. Since flotation NEG has continued its expansion and development by acquiring, *inter alia*:

- (a) Citylink¹ for £5.6 million in May 1993;
- (b) Eurolines (Nederland) BV for £2.2 million in July 1993-this was NEG's first continental European acquisition;
- (c) East Midlands International Airport (EMIA) from the then four local authority shareholders for £28.3 million in August 1993;
- (d) Bournemouth International Airport for £7.4 million in April 1995;
- (e) WMT, the largest provider of bus services in the West Midlands and previously the municipal bus operation of Centro, for £248.3 million in April 1995;
- (f) a one-third interest in Altram, together with a contract from Altram for WMT to operate Line 1 of the Midland Metro light rail line, in October 1996. Altram has a 23-year concession to design, finance, build, maintain and operate the Midland Metro, services on which are expected to begin in August 1998;
- (g) the franchises to operate the Gatwick Express and MML passenger rail services, together with the relevant operating companies, in April 1996;
- (h) Taybus Holdings Limited (TayBus), the major provider of urban bus services in Dundee, for £12.2 million in February 1997; and
- (i) the franchises to operate the Central Trains, NLR and ScotRail passenger rail services, together with the relevant operating companies, in February 1997.

In February 1996 L&CR, a consortium in which NEG had acquired a 17 per cent share for an investment of £5.8 million in March 1995, was awarded the contract to build and operate the Channel Tunnel Rail Link and to operate Eurostar services.

Current activities

3.11. NEG now comprises four main businesses: scheduled coach services, airports, urban buses and railways.

Scheduled coach services

3.12. NEG's scheduled coach business is divided into four separate operations: NEL, Citylink, Eurolines and Speedlink.

3.13. NEL organizes, controls and markets a network of long-distance scheduled coach services in England and Wales, with extensions to parts of Scotland. NEL is discussed further in paragraphs 3.35 to 3.40.

3.14. Citylink operates scheduled coach and inter-urban bus services in Scotland.

3.15. NEL and Citylink together comprise NEG's non-airport UK scheduled coach operations.

¹Reported on in the MMC's Saltire report: see footnote to paragraph 2.45.

3.16. Eurolines (UK) Limited and Eurolines (Nederland) BV are major partners in the Eurolines International long-distance coach organization which provides services to 470 towns and cities throughout Western and Central Europe.

3.17. Speedlink has a range of airport-related services with dedicated ticket offices and lounges within the terminals at Heathrow, Gatwick and Stansted airports. It is also responsible for services under the Jetlink, Gatwick Direct and Flightline names. Speedlink provides scheduled coach services between Heathrow and Gatwick and from centres of population in the South-East and certain railway stations to the three main London airports.

Airports

3.18. EMIA is the fourth-largest regional airport (ie excluding the three London airports) in England in terms of passengers handled. EMIA is situated on an 850-acre site at the junction of the M1 and the M42 extension and close to the M6. The airport primarily serves the cities of Derby, Nottingham, Leicester and Sheffield, but residents of Birmingham, Stoke-on-Trent, Northampton, Lincoln and Peterborough are also within the airport's catchment area. In total some 12 million people live within 90 minutes' travel of the airport.

3.19. Bournemouth International Airport is small in terms of passenger numbers but the site and catchment area are large. In order to develop traffic at the airport NEG has invested £2 million in a runway extension which now enables the airport to handle fully-loaded long-haul aircraft.

Urban buses

3.20. WMT operates the largest single-area bus fleet in Great Britain with about 5,000 employees and 1,700 public service vehicles covering 114 million scheduled vehicle km a year. WMT is the major provider of local bus services in the West Midlands conurbation, carrying 320 million passengers a year in this densely populated urban area of some 2.6 million people. WMT is described further in paragraphs 3.41 to 3.50.

3.21. TayBus provides high-frequency urban bus services in Dundee.

3.22. Highland Country Buses Limited operates local buses in Skye, Lochalsh, Caithness, Fort William and Aviemore.

Railways

3.23. NEG has acquired five franchises to operate railway services under the previous Government's privatization process. Under this process, all the track, station and other infrastructure was transferred to Railtrack and the rolling stock was transferred to three ROSCOs. Passenger train operations were transferred to 25 TOCs. The right to operate the services of each TOC for a period of years, usually seven, was subjected to a commercial tendering process as a result of which successful bidders were granted a franchise and acquired the relevant TOC at net asset value. Each TOC is obliged, *inter alia*, to provide a minimum level of service (known as the PSR), to pay rail access charges to Railtrack and to pay train leasing charges to the ROSCOs.

3.24. NEG's rail interests currently comprise:

(a) *MML*: In April 1996 NEG was awarded a ten-year franchise (subject to investment in new rolling stock) to operate passenger rail services on the Midland Main Line. These are mainly services between South Yorkshire and the East Midlands and London St Pancras.

(b) *Gatwick Express*: Also in April 1996 NEG was awarded a 15-year franchise (subject to investment in new rolling stock) to operate the Gatwick Express services between London Victoria and Gatwick.

- (c) *NLR*: On 6 February 1997 NEG was awarded a seven-year franchise to operate the services of NLR for which it assumed responsibility on 2 March 1997. NLR operates passenger services on the Northampton, North London and West London lines.
- (d) *Central Trains*: On 14 February 1997 NEG was awarded a franchise for seven years and one month to operate the services of Central Trains, for which it assumed responsibility on 2 March 1997. Central Trains provides urban services in the West Midlands and inter-urban and urban/rural services across a wide area of central England and into Wales. Central Trains is described further in paragraphs 3.51 to 3.61.
- (e) *ScotRail*: On 21 February 1997 NEG was awarded a seven-year franchise to operate the services of ScotRail, for which it assumed responsibility on 31 March 1997.
- (f) *L&CR*: NEG holds a 17 per cent share in L&CR (see paragraph 3.10).

With five of the 25 rail passenger transport franchises awarded to it, NEG has more than any other company.

Strategy

3.25. NEG said in its annual report for 1996 that it intended to build on its position as one of the major forces in the UK mass passenger transport services market. Its financial strength allowed it to pursue profitable opportunities, both within the UK and increasingly internationally, as other countries followed the UK's example of privatizing their passenger transport industries. The group's range of activities gave it an additional intermodal perspective when assessing potential opportunities. It would look for opportunities, not only within the areas of its four major divisions, but also in related areas.

Structure

3.26. NEG acts as a holding company, with each subsidiary having a board comprising directors of NEG and its own executive directors. Boards of the subsidiary companies are able to approve capital expenditure projects up to a specified limit as long as they are within budget: outside those parameters group approval is required. NEG told us that it operated on a highly decentralized basis and that only some two dozen people were employed at head office. The corporate structure of the group is set out in Appendix 3.1.

3.27. Having acquired five TOCs, NEG has created a trains division between head office and the subsidiary train companies. Its purpose is to achieve economies by, for example, pooling the purchasing power of the TOCs; to spread best practice techniques; and to oversee compliance with regulatory requirements.

Financial performance

3.28. An analysis of NEG's turnover and operating profit during the five years ended 31 December 1996 is shown in Table 3.1.

3.29. The table clearly shows the impact of diversification away from coaches and into buses, airports and trains. The contribution of trains in 1996 represents the eight months following the acquisition of MML and Gatwick Express.

3.30. The increase in scheduled coach travel turnover in 1994 reflected the first full year's contribution from Citylink, at that time turning over £11.5 million a year. The increase in turnover of 10 per cent in 1996 derived from increased volumes on core UK services of 6 per cent, with the balance from price movements. European coach service margins came under continued pressure from Eurostar services and the low margins on coach services to airports reflected the use of a high proportion of discounted airline tickets.

TABLE 3.1 NEG: analysis of turnover and operating profit, 1992 to 1996

	Years ended 31 December									
	1992		1993		1994		1995		1996	
	£'000	%	£'000	%	£'000	%	£'000	%	£'000	%
Turnover										
Coaching activities:										
Scheduled coach travel	95,175	78.9	99,784	71.8	108,985	64.1	108,280	34.1	119,522	24.8
European coaches	15,153	12.6	23,018	16.6	32,552	19.1	36,878	11.6	36,295	7.5
Airport coach services	6,811	5.6	8,203	5.9	8,956	5.3	12,761	4.0	14,048	2.9
Total coaching activities	117,139	97.1	131,005	94.2	150,493	88.5	157,919	49.7	169,865	35.2
Airports	0	7.722	5.6	19,516	11.5	26,071	8.2	28,615	5.9	
Buses	0	0	0	133,754	42.1	175,587	36.4			
Trains	0	0	0	0	108,481	22.5				
Discontinued activities	3,489	2.9	320	0.2	0		0		0	
Total turnover	120,628	100.0	139,047	100.0	170,009	100.0	317,744	100.0	482,548	100.0
	<i>As % of</i>	<i>As % of</i>	<i>As % of</i>	<i>As % of</i>	<i>As % of</i>					
	<i>£'000</i>	<i>turnover</i>	<i>£'000</i>	<i>turnover</i>	<i>£'000</i>	<i>turnover</i>	<i>£'000</i>	<i>turnover</i>	<i>£'000</i>	<i>turnover</i>
Operating profit										
Coaching activities:										
Scheduled coach travel	4,502	4.7	4,852	4.9	7,631	7.0	6,891	6.4	9,195	7.7
European coaches	1,100	7.3	1,485	6.5	1,537	4.7	1,729	4.7	272	0.7
Airport coach services	643	9.4	723	8.8	689	7.7	1,065	8.3	1,020	7.3
Total coaching activities	6,245	5.3	7,060	5.4	9,857	6.5	9,685	6.1	10,487	6.2
Airports	0	2,152	27.9	6,421	32.9	9,614	36.9	10,303	36.0	
Buses	0	0	0	24,745	18.5	39,418	22.4			
Trains	0	0	0	0	2,097	1.9				
Discontinued activities	69	2.0	40	12.5	0		0		0	
Total operating profit	6,314	5.2	9,252	6.7	16,278	9.6	44,044	13.9	62,305	12.9

Source: NEG.

3.31. The operating profit margin on turnover in scheduled coach travel has remained flat in the 6.4 to 7.7 per cent range over the last three years. These margins are substantially lower than those of the bus operations, but part of the margin effectively passes to the contracting coach operator whereas the bus operations use NEG's own vehicles.

3.32. Table 3.2 contains a summary of the financial performance of NEG.

TABLE 3.2 NEG: financial performance

	Years ended 31 December					£'000
	1992	1993	1994	1995	1996	
Turnover	120,628	139,047	170,009	317,744	482,548	
Operating profit	6,314	9,252	16,278	44,044	62,305	
PBIT*	6,909	9,488	16,278	44,044	62,305	
Profit before tax	6,818	9,305	15,236	41,538	60,092	
Profit after tax	4,392	6,347	10,212	27,533	41,424	
Average net operating assets#~	(3,911)	24,770	52,023	101,640	160,113	
Average shareholders' funds#	7,556 $\text{\textcircled{D}}$	22,760	40,715	74,738	126,019	
Operating profit as a percentage of turnover	5.2	6.7	9.6	13.9	12.9	
PBIT as a percentage of turnover	5.7	6.8	9.6	13.9	12.9	
PBIT as a percentage of average net operating assets	N/A	38	31	43	39	
Profit after tax as a percentage of average shareholders' funds	58	28	25	37	33	
Earnings per share fully diluted (p)	16.7	16.4	25.2	27.9	32.8	
Closing share price on 24 September 1997 (p)			532			
Historic price: earnings ratio			16.2			

Source: NEG/MMC analysis. Share price information: *Financial Times*.

*Profit before interest and tax.

#Arithmetic means of the year-end figures.

~ Net operating assets comprise fixed assets, current assets and current liabilities excluding cash, borrowings, proposed dividends and unrelated investments.

$\text{\textcircled{D}}$ Year-end figure because the previous year-end figure was negative.

3.33. Whilst the growth in turnover and profits has been substantial, the performance indicators lie in the margin on turnover, return on net operating assets and earnings per share. The last of these has shown consistent growth over the three most recent years, whilst the margin on turnover and the return on assets both fell slightly in 1996. NEG's interim statement for the six months ended 30 June 1997 showed turnover from continuing operations up by 29 per cent; operating profit up 30 per cent; and basic earnings per share up 17 per cent. Passenger volumes on MML and Gatwick Express had increased by 6.5 and 7.7 per cent respectively while volumes on the newly-acquired train operations were up by between 2 and 5.3 per cent since acquisition. All divisions were reported to be trading well in the second half of the year.

3.34. Further financial information is set out in Appendix 3.2 .

National Express Limited

3.35. Until 1993 NEL was the core business of NEG and its history is covered in the history of NEG in paragraphs 3.2 to 3.9.

Operations

3.36. NEL has the only national network of long-distance scheduled coach services covering England and Wales, providing scheduled services linking 1,100 locations over 200 routes. NEL services all of these routes by contracting-in coaches complete with crews for periods ranging from six months to several years. The number of contractors used is around 40 to 45.

3.37. Services operate under the National Express, Flightlink and Express Shuttle brands. NEL is the promoter of all its services, thereby carrying the commercial risk. It designs the routes and timetables, organizes the coaches, operates and monitors a reservation system, sets and monitors quality standards and sets fare levels. All revenues, except for selling commissions, accrue to NEL and the coach operators are paid an amount per mile, negotiated individually with each operator.

3.38. NEL perceives its network to be important: during the first half of 1996, 28 per cent of passengers transferred between coaches during their journey. Arrivals and departures are therefore synchronized whenever practicable so as to minimize waiting times and bus stations are used wherever they are available.

Financial performance

3.39. Table 3.3 contains a summary of the financial performance of NEL.

TABLE 3.3 NEL: financial performance

	<i>Years ended 31 December</i>					<i>£'000</i>
	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	
Turnover	94,288	92,342	97,883	97,773	105,976	
Operating profit/PBIT	3,269	4,043	5,795	5,200	7,166	
Profit before tax	3,213	3,888	5,885	5,356	7,137	
Profit after tax	2,370	2,785	3,936	3,621	4,774	
Average net operating assets*#	9,940	8,826	5,052	6,119	7,107	
Average shareholders' funds*	5,233	6,405	7,434	9,213	8,993	
Operating profit/PBIT as a percentage of turnover	3.5	4.4	5.9	5.3	6.8	
PBIT as a percentage of average net operating assets	33	46	115	85	101	
Profit after tax as a percentage of average shareholders' funds	45	43	53	39	53	

Source: NEG/MMC analysis.

*Average figures for net operating assets and shareholders' funds are arithmetic means of the year-end figures.

#Net operating assets comprise fixed assets, current assets and current liabilities excluding cash, borrowings, proposed dividends and unrelated investments.

The table shows that NEL's turnover remained essentially flat, and therefore declined in real terms, between 1992 and 1995 but improved in 1996. Margins on turnover have improved steadily, except for a temporary setback in 1995, so that the return after tax on shareholders' funds has held up relatively strongly.

3.40. Summaries of NEL's balance sheets and profit and loss accounts since 1992 are shown in Appendix 3.3.

West Midlands Travel Limited

History

3.41. Prior to its privatization in 1991, WMT's business consisted of the bus operations of WMPTA. In accordance with the Transport Act 1985, which was designed to deregulate the supply of local bus services and to facilitate the privatization of publicly-owned bus undertakings, the bus operations of Centro had been transferred into a new company whose shares were held by WMPTA. WMT was formed by management and employees to acquire the company. This transaction was completed on 4 December 1991 for a purchase price of £71 million, of which £19.7 million was deferred. Following privatization, all the issued share capital was owned by employees with directors and senior managers holding less than 10 per cent of the total.

3.42. The WMPTA fleet at that time numbered some 1,800 public service buses, mostly double-deckers, operating an extensive network of services throughout the West Midlands. There were 5,700 employees. During its first months in private hands WMT was barely profitable but its performance rapidly improved (see paragraphs 3.49 and 3.50). In 1994 it acquired two local bus operators adding 65 vehicles to its fleet, and a third operator to the west of London as a prelude to bidding (unsuccessfully) for London bus operators which were about to be privatized.

3.43. In the year ended 31 March 1995 several acquisitions were made, mostly of other bus businesses, for an aggregate consideration of £37 million of which £25 million was funded by additional borrowing. The acquisitions, which added some 900 buses to the fleet, operated in north-east England and in Essex.

3.44. In April 1995 NEG made a recommended offer to acquire the entire issued share capital of WMT, based on a share exchange with a cash alternative of £2.12 per ordinary share, valuing the company at £248.3 million. The offer became unconditional on 26 April 1995. This transaction was achieved by the issue of NEG shares, with very few staff opting for the cash alternative. The WMT employee share ownership plan continues to operate. NEG told us that it was philosophically committed to the concept of employee involvement. In addition to the WMT Employee Share Option Plan, NEG operates an Employee Share Save Scheme. As a result, approximately 30 per cent of NEG's total share capital is held by employees.

3.45. After becoming part of NEG, WMT sold the bus operations in Essex and the North-East as non-core businesses, but in February 1997 it acquired TayBus which operates urban bus services in Dundee.

Operations

3.46. WMT operates the largest single-area bus fleet in Great Britain, covering nearly 500 routes throughout the West Midlands. This is a densely populated area with a population of some 2.6 million people. WMT operates at least 18 hours a day, seven days a week. Its services are provided as to 94 per cent on a commercial basis with only 6 per cent being operated as tendered services and subsidized by Centro. In 1996 WMT carried almost 318 million passengers. As at 31 December 1996, WMT operated 1,665 vehicles and employed about 5,000 people. In 1996 WMT's buses were rebranded as Travel West Midlands with a new livery.

3.47. WMT told us that its policy was to provide frequent, high-quality services across its network, charging low fares. On five of its corridors, buses are scheduled to run every two minutes and, on a further five, every three minutes. Since the acquisition by NEG, WMT has embarked on a fleet replacement programme, adopting environmentally cleaner vehicles with low floors at pavement level enabling wheelchairs and buggies to be wheeled on and off. There is also an experimental fleet of buses powered by compressed natural gas. During 1996 WMT spent £18 million on replacement vehicles. It

told us that it intended to spend £[*] million annually for the subsequent five years to modernize its fleet completely.

3.48. Fleet replacement has also begun at TayBus with new, low-floor vehicles planned to extend to the entire fleet over four years.

Financial summary

3.49. Table 3.4 shows a summary of WMT's financial performance during the five years since privatization.

TABLE 3.4 WMT: financial performance

	£'000					
	<i>4 months ended 31.3.92</i>	<i>Years ended 31 March 1993</i>	<i>9 months ended 1994</i>	<i>Year ended 1995</i>	<i>31.12.95</i>	<i>31.12.96</i>
Turnover	43,297	150,801	151,733	179,567	152,710	178,460
Operating profit	1,912	11,491	15,292	29,072	18,951	38,297
PBIT	1,912	11,491	15,292	29,072	17,996	32,794
Profit before tax	1,058	9,583	14,445	26,402	15,530	31,950
Profit after tax	658	5,642	9,925	19,040	8,635	21,375
Pro forma profit after tax ^Đ	658	5,642	9,692	17,403	7,107	21,259
Average net operating assets* [#]	53,266~	39,811	26,686	32,841	36,372	32,777
Average pro forma shareholders' funds* ^Đ	(718)~	2,103	9,799	21,141	29,081	38,247
Operating profit as a percentage of turnover	4.4	7.6	10.1	16.2	12.4	21.5
PBIT as a percentage of turnover	4.4	7.6	10.1	16.2	11.8	18.4
PBIT as a percentage of average net operating assets	N/A	29	57	89	69	100
Pro forma profit after tax as a percentage of average shareholders' funds ^Đ	N/A	268	99	82	39	56

Source: NEG/MMC analysis.

*Average figures for net operating assets and shareholders' funds are arithmetic means of the year-end figures.

[#]Net operating assets comprise fixed assets, current assets and current liabilities excluding cash, borrowings, proposed dividends and unrelated investments.

~ The figures for average operating assets and shareholders' funds in 1992 are the period-end figures because this was the first period as WMT.

^ĐPro forma figures for shareholders' funds and profit after tax have been calculated on the basis that goodwill has been written back and amortized at 5 per cent annually.

Note: The returns on average net operating assets and on shareholders' funds for the nine months ended 31 December 1995 have been annualized by adding to the profit for the period one-quarter of the corresponding figure for the previous full year.

3.50. During its first four months in private hands, to March 1992, WMT achieved a turnover of £43 million and a PBIT of £1.9 million representing a margin on sales of 4.4 per cent. Within three years, PBIT had reached more than 16 per cent of sales, acquisitions had been made, and by 31 March 1995 all the deferred consideration had been paid. Operating margins fell during the following nine-month period but were up to 21 per cent for 1996. This margin is high by the standards of the bus industry (see paragraphs 7.8 and 7.9 for NEG's comments on WMT's profitability). Further information is set out in Appendix 3.4.

*Figure omitted. See note on page iv.

Central Trains Limited

History

3.51. In 1982 the passenger rail business of BRB was reorganized into three divisions: InterCity, Regional Railways and Network SouthEast. In April 1994 certain activities operated by Regional Railways Central profit centre were transferred to Central Train Operating Unit and at the same time the ownership of, and responsibility for, most of the associated infrastructure and rolling stock passed to Railtrack and the ROSCOs respectively. On 12 November 1995 the business of Central Train Operating Unit and most of its assets and liabilities were transferred to Central Trains, a wholly-owned subsidiary of BRB. Central Trains was acquired by NEG on 14 February 1997 (see paragraph 3.62).

Operations

3.52. Central Trains generally operates short trains of up to three vehicles over a diverse network covering some 2,400 route km. These services call at 314 stations in an area bordered by Liverpool and Grimsby to the north, Cardiff to the south and Pwllheli and Great Yarmouth to the west and east respectively. Central Trains estimated that the total number of passenger journeys made on its services in the year to 31 March 1997 was about 30 million.

3.53. Central Trains leases 251 stations from Railtrack, the more important of which are Birmingham Snow Hill, Kidderminster, Leamington Spa, Lincoln, Loughborough, Nottingham, Nuneaton, Shrewsbury, Telford and Worcester (two stations). Manchester Piccadilly and Birmingham New Street are operated by Railtrack so that access charges are payable. However, because of the significance of Birmingham New Street to its operations, Central Trains has contracted with Railtrack to manage the operations at platform level and the dispatch of trains itself. Central Trains provides access to other TOCs at 51 of its leased stations, and has access to 64 stations leased by other TOCs. A map of its routes is at Figure 4.3.

3.54. Central Trains' leased rolling stock comprises 354 vehicles which provide an average of more than 1,150 services a day. The fleet consists of 41 electric multiple unit (EMU) and 116 diesel multiple unit (DMU) train sets, in each case providing a margin over anticipated daily needs to include maintenance cover. Units can be coupled to form longer trains if required.

3.55. Central Trains operates three groups of services: inter-urban, urban/rural and urban PTE. These provided respectively 50.9, 26.3 and 22.8 per cent of its total passenger revenues in the year to 31 March 1997. All Central Trains' local services in the West Midlands are operated on behalf of Centro which specifies a level of services within the PSR, sets fare levels, retains all revenues (subject to incremental revenue-sharing-see paragraph 4.9) and carries the commercial risk. This is within a regime whereby costs are fully reimbursed by direct grant from the Government subject to Centro keeping its fare increases in line with the Office of Passenger Rail Franchising (OPRAF's) fare schedule. Central Trains' cost-recovery claim in respect of these services for the year ended 31 March 1996¹ was for some £60 million, of which £15.7 million was recovered in the form of fares.

3.56. All Central Trains' services, other than Centro services and those operated under contract to Nottinghamshire and Leicestershire County Councils, operate under the Central Trains brand. The Centro and local authority trains are operated under their own respective brands. Central Trains leases six train depots from Railtrack and has an arrangement with Anglia Railways Train Services Limited at a seventh enabling its employees to operate there. Two of the seven depots are equipped to carry out both

¹This was the last full year of operation under the previous section 20 arrangements.

running and heavy maintenance. Under the terms of its leases, Central Trains is responsible for running maintenance but the heavy maintenance is the responsibility of the ROSCOs. Central Trains undertakes some work under contract to ROSCOs but does not carry out significant amounts of work for other TOCs.

3.57. As at 31 March 1997 Central Trains employed 2,515 staff, of which 543 were drivers, 499 were conductors and 394 were engaged in maintenance and cleaning.

Financial performance

3.58. Table 3.5 summarizes Central Trains' financial performance historically in so far as information is available.

TABLE 3.5 Central Trains: financial performance summary

	<i>£ million</i>		
	<i>Years ended 31 March</i>		
	<i>1995</i>	<i>1996</i>	<i>1997*</i>
Revenue:			
Non-Centro services	45.0	49.2	[
OPRAF incentive scheme	N/A	N/A	
Centro incentive scheme	N/A	N/A	
Other#	<u>14.9</u>	<u>15.3</u>	
Total	<u>59.9</u>	<u>64.5</u>	
Costs:			
Operating costs	(95.5)	(92.9)	
Railtrack charges (including performance regime)	(120.1)	(121.3)	
Rolling stock lease charges	(31.6)	(33.8)	
Total	<u>(247.2)</u>	<u>(248.0)</u>	
Operating loss	(187.3)	(183.5)	
Bonds, interest receivable and exceptional items	<u>0.0</u>	<u>0.0</u>	
Loss before financial support	(187.3)	(183.5))]
Financial support~ ₤	<u>0.0</u>	<u>0.0</u>	<u>195.8</u>
Profit/(loss) before tax	(187.3)	(183.5)	[()
Tax	<u>0.0</u>	<u>0.0</u>	
Profit after tax	<u>(187.3)</u>	<u>(183.5)</u>	
		<u>0</u>	
Profit before tax as percentage of turnover (including financial support)	N/A	N/A	
Fares collected on behalf of Centro	14.6	15.7]

Source: OPRAF Indicative Bid Invitation and NEG.

*Draft.

#Includes income from train maintenance, car parking and retailing.

~ Represents the total of receipts from OPRAF and Centro.

₤The amount of financial support shown above differs from the figure of £198.1 million referred to in paragraph 3.60 as having been claimed by BRB. This is a consequence of negotiations over the completion accounts which were still continuing as we reported.

Notes:

1. Revenue from Centro services has been excluded from Central Trains' income in the above table because it is for Centro's account.

2. Figures for earlier years are not available.

3.59. Historical information is incomplete, primarily because until 31 March 1994 Regional Railways Central was a vertically integrated profit centre of BRB's Regional Railways division, operating both

rolling stock and infrastructure as well as trains, and there was no statutory audit requirement applicable to individual operating divisions. Total revenue figures exclude revenue collected on behalf of Centro because that revenue is not part of Central Trains' commercial operations.

3.60. NEG told us that the average amount of subsidy which it would receive under the franchise agreement was £152.9 million in constant 1997 prices, about £45.2 million less than the subsidy claimed by BRB for the year ended 31 March 1997 of £198.1 million (since revised by NEG to £195.8 million). The amount declines year by year over the life of the franchise: in its first full year of ownership by NEG Central Trains is contracted to receive total financial support of £187.5 million and in its last year £132.6 million—a reduction of 33 per cent from the final BRB claim. Centro's element of subsidy remains constant at 29 per cent throughout the term of the franchise. These figures are at February 1997 values and are to be adjusted for inflation in accordance with movements in the RPI. The financial support claim by BRB for 1996/97 included £7.6 million of administered profit and a Centro element of £60 million (which was partly offset by Centro fares collected of £15.6 million).

3.61. Central Trains' balance sheets as at 31 March 1996 and 1997 are set out in Appendix 3.5.

The merger situation

Award of the franchise

3.62. On 11 June 1996 the Franchising Director issued an invitation to potential bidders to apply for pre-qualification for the right to provide the passenger rail services of Central Trains. On 18 September 1996 pre-qualifiers were provided with an information memorandum giving details of the business and invited to submit non-binding indicative bids to provide the services for seven years under a franchise agreement. On 28 October 1996 NEG submitted an indicative bid. It was shortlisted [*Details omitted. See note on page iv.*] and on 17 January 1997 it submitted its final bid. On 11 February 1997 NEG was informed that it was the preferred bidder. Final due diligence then took place, the franchise agreement was entered into on 14 February 1997 and on the same date NEG acquired the entire issued share capital of Central Trains for its net asset value of £1. NEG assumed responsibility for the operation of Central Trains' services on 2 March 1997.

3.63. In the course of negotiations, Centro raised concerns that it had already expressed to the OFT relating to various aspects of the competitive environment in the West Midlands in the event of the franchise being awarded to NEG. NEG considered that most of these were issues which either did not arise from the merger or were appropriately addressed in the franchise agreement. Nevertheless, in tripartite negotiations with OPRAF and Centro NEG agreed to be bound by further assurances which were incorporated into the franchise agreement as Schedule 14 (see also paragraph 3.79).

3.64. [*Details omitted. See note on page iv.*]

TABLE 3.6 Central Trains: net present cost of bids received for the franchise

£m,
1997 prices

[*Details omitted*
See note on page iv.]

Source: OPRAF.

3.65. [*Details omitted. See note on page iv.*]

3.66. OPRAF told us that in evaluating the bids it had regard, first, to the level of subsidy required and, second, to the level of services promised by the bidder. NEG's bid required the lowest subsidy while guaranteeing a high level of services.

Rights and obligations arising from the franchise

3.67. An overview of the rail industry and the privatization process is set out at Appendix 3.6. Taking on a franchise involves four significant financial commitments and an operational commitment:

- to pay to, or receive from, the Franchising Director annual sums in exchange for the right to operate the services as specified;
- to lease the majority of rolling stock requirements from one or more of three ROSCOs;
- to pay track access charges to Railtrack, some 90 per cent of which are fixed whilst the balance varies with train mileage;
- to lease certain stations and depots from Railtrack; and
- to comply with the PSR which establishes a minimum service framework specifying service characteristics including frequency of trains, stations to be served, maximum journey times, first and last trains, weekend services, through services, and load factors and/or peak train capacity. Centro's requirements form part of the franchise agreement and are specified in similar terms to those for OPRAF routes. However, additional contractual requirements for Centro services include a maximum passenger standing period of 15 minutes at peak hours and zero at other times; maximum proportions of standing to seated passengers at various times; and certain rolling stock specifications.

3.68. There are several other requirements of a franchise. A TOC's ability to increase certain ticket prices, primarily Saver and weekly season tickets, is restricted. Such restrictions are not universally applied to all TOCs but are tailored to suit each TOC's business environment. NEG told us that some 29 per cent of Central Trains' fare revenue, excluding that from Centro services, was currently subject to fares regulation.

3.69. Each franchisee is required to produce its own Passenger's Charter which must be at least as good as that previously provided by BRB: NEG told us that in most cases franchisees had improved on the BRB version by committing themselves to higher standards of punctuality, reliability or passenger compensation for poor service. Further details are contained in paragraphs 3.72 to 3.75.

3.70. In addition, Central Trains' franchise agreement commits it, *inter alia*, to:

- (a) provide no less than the current number of train miles annually for the life of the franchise;
- (b) provide an additional 212,000 train miles (341,000 train km) a year on evening and Sunday services on Centro routes, subject to the agreement of Railtrack and Centro;
- (c) provide an entirely new service between Wolverhampton and Walsall for seven days a week;
- (d) provide an entirely new hourly service between Rugeley and Stafford between 08.00 and 18.00 on weekdays and Saturdays from May 1998, subject to Railtrack's approval;
- (e) procure expenditure of £1.25 million during the first three years of the franchise on improving security and accessibility at stations;
- (f) increase staffing at Centro stations including Duddeston and Stourbridge Town;

- (g) provide a new bus link between Sandwell and Dudley station and Dudley town centre on weekdays and Saturdays for a minimum period of two years;
- (h) provide a freephone taxi-ordering service initially under a 12-month pilot scheme from Stamford, Hinckley and Kidderminster stations;
- (i) spend £10,000 a year throughout the franchise period on promoting park-and-ride facilities at locations to be agreed with Centro; and
- (j) improve the existing Passenger's Charter by raising Central Trains' punctuality standard from 90 per cent to at least 91 per cent from 30 September 1997. The reliability standard (proportion of scheduled services run) will be similarly increased from 99 to 99.5 per cent.

3.71. NEG is required to maintain Central Trains as a discrete business so that it can readily be transferred to another franchisee if necessary.

Subsidies and incentives

3.72. Under the franchise agreement NEG will receive the annual subsidy payments referred to in paragraph 3.60. There are also performance incentive arrangements between TOCs and other parties. That with OPRAF is based on punctuality measured against benchmarks, performance above or below which results in payments to or by the TOC. In Central Trains' case, a similar arrangement exists with Centro which, in addition, results in payments for short formations. The arrangement with Railtrack is also based on benchmarks, except that responsibility for late trains is determined whenever practicable between Railtrack and a TOC. If Railtrack's benchmark exceeds the average train lateness for which it is responsible, it collects an incentive payment from the TOC; if the reverse occurs, the TOC collects from Railtrack.

3.73. Where PTE services are operated, a Service Quality Incentive Regime (SQUIRE) applies whereby payments are made to or by the franchisee depending on performance in delivering a wide range of quality measures such as hours of station staffing, station cleanliness, passenger information provision and security against benchmark levels. The maximum annual penalty under the benchmark scheme is £652,000 in Central Trains' case, which is based on an estimate of the profit levels which might be sought by a franchise operator. The maximum incentive payments for exceeding the benchmarks are only half the maximum penalties at £325,833. In addition, penalties can be levied where identified faults are not rectified within a certain period.

3.74. Where revenue is passed to a PTE, as in the case of Centro, a Ticket Inspection Incentive Regime (TIRE) applies which is designed to encourage franchisees to be diligent in reducing ticketless travel on PTE-supported services where the revenue is passed directly to the PTE.

3.75. Such incentive schemes are applied by OPRAF where the Franchising Director believes the market is too weak to motivate the relevant franchise operator to respond adequately to customer demands for a punctual and reliable train service and/or where there is little or no incentive to collect fares on behalf of a PTE. All the above schemes apply to Central Trains.

Competition issues

3.76. The invitation to tender advised interested parties to give consideration to the possible application of UK and EC competition law to their tender. NEG said that it had satisfied itself that the transaction did not have an EC or EFTA dimension under the EC Merger Regulation (Council Regulation 4064/89) because each of NEG and Central Trains achieved more than two-thirds of its EFTA/EC turnover in the UK.

3.77. Under section 66(3) of the Railways Act, the acquisition of a passenger rail franchise is treated as the acquisition of control of an enterprise for the purposes of the Fair Trading Act. The estimated gross assets transferred to NEG at completion were £[*] million and NEG told us that the final figure would not exceed £[*] million. The transaction was not therefore a merger situation qualifying for investigation under section 64(1)(b) of the Act. The application of the share of supply test under section 64(1)(a) of the Act is discussed in Chapter 2.

3.78. During the bidding process for the franchise, OPRAF had made clear to NEG that it would be required to satisfy the Franchising Director that any competition issues which might be identified as arising from its interests in other forms of public transport services in the West Midlands would not jeopardize or delay the award of the franchise to NEG. [

Details omitted. See note on page iv.

]

3.79. As mentioned in paragraph 3.63, NEG also gave assurances, which were incorporated in the franchise agreement at Schedule 14, to meet concerns which Centro had expressed about the consequences of NEG owning companies which provided high proportions of both bus and train services in the West Midlands. NEG told us that it had willingly given these assurances because the fundamental principles behind them were very similar to those it already applied in running the WMT business. The full text of the Schedule is set out at Appendix 3.7.

3.80. Further details of NEG's views are given in Chapter 7.

3.81. The DGFT subsequently recommended to the Secretary of State that NEG's acquisition of the Central Trains franchise should not be referred to the MMC and that no undertakings in lieu of a reference were required. The Secretary of State, however, announced on 22 May 1997 that, after carefully considering the DGFT's advice, she had concluded that the merger should be referred to the MMC because it raised competition concerns in the supply of public passenger transport services in the West Midlands which warranted a thorough investigation.

*Figures omitted. See note on page iv.