

2 Conclusions

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The reference

2.1. On 24 September 1998 the Secretary of State for Trade and Industry made a reference to us under the merger provisions of the Fair Trading Act 1973 (the Act) concerning the proposed acquisition of RACMS by Cendant (see Appendix 1.1 for the terms of reference). The Department of Trade and Industry press notice said that the reference had been made, on the advice of the Director General of Fair Trading (DGFT), because of competition concerns in respect of the market for breakdown insurance.

The companies involved and the merger situation

RAC Motoring Services

2.2. RACMS was formerly the motoring services arm of the Royal Automobile Club (the Club). Until July 1998 its ultimate holding company was the company then named The Royal Automobile Club Limited (RACL), which was effectively the corporate manifestation of the Club. In July, as part of the reorganization designed to pave the way for the sale of RACMS, a new company, RAC Holdings, became the ultimate holding company of RACL, and hence of RACMS. The shares in RAC Holdings were distributed to the life and full members of the Club as they were at 8 July 1998. As a result the Club itself no longer has any ownership interest in RACMS.

2.3. The principal business of RACMS is the provision of insured breakdown services for light vehicles in the UK (see paragraphs 2.30 and 2.31 for the definition of these terms), currently covering around 5.5 million vehicles. It is the second largest breakdown organization in the UK, behind the AA. RACMS also owns The British School of Motoring Limited (BSM) and provides a range of other products and services, primarily for motorists (see paragraph 3.43). Its forecast revenue for 1998 is around £300 million (1997 £269 million). It has some 3,800 employees in total, of whom around 2,300 are directly engaged in the breakdown services operation.

2.4. Some of RACMS's members obtain their eligibility for services by paying an annual subscription, the level of which varies depending on the type of breakdown service required. Others become members as a consequence of a subscription paid by a third party such as a motor car manufacturer.¹ RACMS has a directly employed force of liveried patrols which attend about 80 per cent of its members' breakdowns, the remainder being attended by garage contractors.

2.5. RACMS is a company limited by guarantee. Until recently it was prevented by its Articles of Association from distributing its profits and has been primarily funded by retained surpluses.

Cendant

2.6. Cendant was formed in December 1997 as the result of a merger between two quoted US companies, HFS and CUC. In the year to end-December 1997 it had sales of some \$4.2 billion (£2.5 billion), underlying profits before tax of \$1 billion (£600 million) and at the year-end had around 34,000 employees. (These financial results are as restated following the accounting adjustments referred to in paragraph 2.13.) In the nine months to end-September 1998 its sales were some \$3.9 billion and it made a pre-tax profit on continuing operations of \$770 million.

2.7. Cendant's operations derived from HFS consist primarily of owning and managing a portfolio of consumer brands in the hotel, travel and property industries. The businesses themselves are largely operated by franchisees: Cendant's role is to award franchises, provide support for the franchisees, and promote and develop the brands. In vehicle-related businesses it owns the Avis car rental brand and PHH Corporation (PHH), a fleet management company.

¹In accordance with normal industry usage, we use the term 'member' to refer to subscribers for insured breakdown services and other motorists who are eligible to receive the benefits of those services from the breakdown organization in question, and are treated as members or associate members under the terms of the policy. Except in the case of the AA, they are not members in the sense of being owners of the organization.

2.8. As HFS diversified beyond its original base in the hotel industry it was able to cross-sell services to consumers in a wider range of industries. The principal purpose of the merger with CUC was to increase the scope for such cross-selling.

2.9. The Cendant business primarily derived from CUC is known as alliance marketing. There are three divisions—individual, insurance/wholesale and lifestyle. The individual division directly markets products and services to 34 million members of different programmes. Membership programmes cover such activities as home shopping and travel. One of them, AutoVantage, is a motorists' club with about 5 million members which offers insured breakdown services throughout the USA. The insurance/wholesale division markets packages of services to customers of banks and credit companies. The lifestyle division provides products which are designed to enhance customer purchasing power, notably through the assembling and marketing of books of discount vouchers for services such as restaurants and hotels. The two key features of the alliance marketing business are the provision of an enhanced product offering or discounted price through the co-operation of primary suppliers; and the use of sophisticated computer techniques for analysing customer databases in order to target the cross-selling of different products in the most effective way ('data mining').

Cendant in the UK

2.10. PHH, which HFS acquired in 1997, owns the leading vehicle fleet management company in the UK and in January 1998 Cendant acquired Harpur Group Ltd (Harpur), another leading UK fleet management company. Some of its other brands are also represented in the UK. However, Cendant was looking for a major acquisition in the UK and in April 1998 it bought National Parking Corporation Limited (NPC) for some £1 billion. NPC's main asset was National Car Parks Limited (National Car Parks), the largest operator of private car parks in the UK. NPC also owned Green Flag, which it had acquired in 1984.

2.11. The Green Flag business was founded in Bradford in 1971 as National Breakdown Recovery Services Limited and supplied its services under the brand name National Breakdown. Its aim was to provide insured breakdown services as an alternative to the AA and the RAC group, which had for many years been virtually the only providers of such services in the UK. In 1994 the company decided to rebrand its services as Green Flag. Its breakdown service currently covers about 2.4 million vehicles. Unlike the AA and RACMS it does not have its own patrol fleet but arranges for breakdowns to be attended by contractors from a network of independent garages (garage contractors). Insured breakdown services for light vehicles account for around 80 per cent of Green Flag's turnover. Its other activities comprise breakdown services for heavy vehicles, accident recovery and a range of other assistance services (for example, emergency home assistance and property repairs). Green Flag's turnover in the year to end-March 1998 was £121 million (1997 £112 million) on which it made an operating profit of £[] million (£[] million). These figures include the results of UK Insurance Ltd (UKI), a separate subsidiary of NPC which underwrites Green Flag's insured breakdown services business.

Fraudulent accounting: implications for Cendant's financial position

2.12. In April 1998, shortly after the merger between HFS and CUC, Cendant discovered that there had been fraudulent accounting in former CUC businesses. Subsequent developments are described in some detail in Chapter 3 (see paragraphs 3.86 to 3.118).

2.13. In brief, Cendant appointed independent investigators to look into the matter. Their report, which was made public at the end of August 1998, found that the incidence of fraudulent accounting in the former CUC had been frequent and widespread, with the result

that CUC's profits before tax and unusual charges in the last three years had been overstated by over one-third. All the personnel suspected of involvement in the fraud, or who should have known of it, have been dismissed. Cendant agreed with the US Securities and Exchange Commission (SEC) that new accounts should be prepared covering the three years 1995 to 1997. These accounts were filed at the end of September 1998. As a result Cendant ceased to be in breach of its banking covenants and was again able to access the capital markets. In mid-October the Standard & Poor credit-rating agency announced a revised long-term credit rating for Cendant of BBB. Whilst a downgrading compared with the A rating which applied before the discovery of the fraud, BBB is nonetheless still an investment grade rating. Other credit-rating agencies have reacted similarly.

2.14. Following the disclosure of the fraud in April 1998, Cendant's share price immediately fell from \$35 to \$19. It fell further over the subsequent months, reaching a low point of \$6.5. A number of shareholders have brought claims for damages against the company arising out of these matters. An unfavourable outcome to these actions could have a material adverse impact on Cendant's financial position.

2.15. In a letter to shareholders on 4 November 1998, Cendant said that for the time being the company would change from being a buyer of companies and a seller (issuer) of shares to being a seller of companies and a buyer of its own shares. In pursuit of this strategy Cendant cancelled two planned acquisitions in the USA and has begun to divest businesses which it regards as non-core. Cendant confirmed to us, however, that it still wished to go ahead with the acquisition of RACMS. Cendant has also taken powers to buy back up to \$1 billion worth of its shares. By the middle of December 1998, Cendant's share price had risen to \$19.

2.16. We consider the implications of these events for our inquiry in paragraphs 2.146 to 2.149.

The merger situation

2.17. In late 1995 a new Chief Executive was appointed at RACMS. Membership numbers were falling, the business had moved into loss and the company recognized that fundamental change was needed.

2.18. The new management team has taken a number of steps, selling the company's motor insurance broker subsidiary, acquiring BSM (which it was hoped would prove a fruitful source of new members for RACMS) and adopting a new corporate identity and strategy for the core business. They rationalized the product range, introduced a no-call-outs discount (funded by a price increase) and took action to prevent abuse of the service by a small proportion of members making multiple call-outs. These steps were expected to improve profitability materially.

2.19. Looking ahead, however, RACMS foresaw a heavy and rising requirement for investment to keep the business up to date with technological developments. More fundamentally, it considered that its core activity of providing insured breakdown services was in long-term decline and that it would have to reposition itself to respond to radical changes that would arise from the development of intelligent transport systems (ITS). This would require access to capital markets and the ability to form joint ventures, measures which could not readily be taken under the RAC group's existing structure. The RAC group therefore formed the view that RACMS should be financially restructured. The intention was to wait until around the second half of 1999, when it was expected that an improved record of profitability and growth could be demonstrated, before deciding the best solution.

2.20. In late March 1998, however, the then Chairman of the Club and of RACL wrote to the life and full members of the Club proposing that RACMS be sold, the proceeds to be distributed among those members (some 12,000 people). This letter had not been authorized by the rest of the board and the Chairman was subsequently dismissed.

2.21. However, the Chairman's letter, and the response of the members to it, precipitated a decision by the remainder of the board of RACL to sell RACMS straight away. An auction was held and on 1 May 1998, only five weeks after the date of the Chairman's letter, RACL and Cendant announced that they had entered into exclusive negotiations with a view to Cendant acquiring RACMS at an agreed price of £450 million. There had been five other serious bidders but none was prepared to match the offer which Cendant had made. After carrying out due diligence investigations, Cendant entered into an agreement with RACL on 21 May 1998 for Cendant to acquire RACMS.

2.22. In order to effect the sale in a tax-efficient way the RAC group had to reorganize itself. As mentioned in paragraph 2.2, this was done by the creation of RAC Holdings as the ultimate holding company of RACL and hence RACMS, and by the subsequent distribution of the shares in RAC Holdings to the life and full members of the Club. On 10 August 1998 the members of RAC Holdings voted overwhelmingly to approve a scheme of arrangement under section 425 of the Companies Act 1985 providing for the entire share capital of RAC Holdings to be transferred to Cendant for a consideration of £416 million, equivalent to some £35,000 for each shareholder. Under the agreement Cendant will also pay £17 million to a new company now named the Royal Automobile Club Limited (the new corporate manifestation of the Club) and RACMS will donate £13 million to a charity called The Royal Automobile Club Foundation for Motoring and the Environment Limited. According to a circular sent to the shareholders of RAC Holdings, it is expected that the balance of the total £450 million consideration (around £4 million) would be accounted for by bonuses of around £1,000 per person paid to the staff of RACMS, RAC Motor Sports Association and the Club.

2.23. The scheme of arrangement is subject to satisfactory clearance by the competition authorities, the other conditions remaining satisfied and the approval of the High Court. If there is satisfactory clearance by the competition authorities, Cendant would be bound by the scheme as approved by the court. The scheme would also be binding on all the shareholders of RAC Holdings. Cendant told us that court approval would not be sought until the outcome of our inquiry was known but was not expected to give rise to any difficulty. There is no provision in the sale agreement for either party to withdraw unless there is a breach of condition.

2.24. An option agreement also dated 21 May 1998 gives Cendant the right to acquire RACMS from RACL up to 21 April 1999 in certain circumstances, for example if an application is not made to the court by a specified date, the court refuses to approve the scheme or there is a change of control of RACL or RAC Holdings. A sale by RACL to Cendant under the option agreement would deprive the RAC Holdings shareholders of the tax advantages of disposing of RACMS by selling their own shares to Cendant under the main agreement.

Jurisdiction

2.25. Our terms of reference (see Appendix 1.1) require us to report on whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation, as defined in the Act, in that:

- (a) enterprises carried on by or under the control of Cendant will cease to be distinct from enterprises carried on by or under the control of the Royal Automobile Club or RAC Holdings (of which one at least is carried on in the UK); and

- (b) either the value of the assets which will be taken over exceeds £70 million (the assets test) or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK or a substantial part of the UK (the share of supply test).

If so, we have to report on whether the creation of that situation may be expected to operate against the public interest. Section 63(2) of the Act provides that 'enterprise' means the activities, or part of the activities, of a business. Section 65 of the Act specifies the circumstances when two enterprises are to be regarded as ceasing to be distinct. One of the circumstances is where they are brought under common ownership or control.

2.26. As described in paragraph 2.21, Cendant entered into an agreement on 21 May 1998 to acquire RACMS. Cendant told us that it still wished to proceed with the acquisition, in accordance with the terms of the agreement, if it was given clearance to do so following our inquiry on terms which were satisfactory to it. The ultimate holding company of RACMS is RAC Holdings. If the acquisition were to proceed, therefore, it is clear that enterprises carried on by or under the control of Cendant and enterprises carried on under the control of RAC Holdings (though not the Royal Automobile Club) would come under common control and hence cease to be distinct within the meaning of the Act. The business of RACMS is carried on largely in the UK, as indeed are some of the enterprises carried on under the control of Cendant, notably Green Flag.

2.27. RACMS's accounts for 1997 show that the gross value of its assets at 31 December 1997 was some £310 million. There is no reason to believe that their value has fallen substantially since then. The assets test is therefore satisfied.

2.28. We therefore conclude that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation as postulated in our terms of reference.

2.29. Accordingly we have to consider whether the creation of that situation may be expected to operate against the public interest. We describe first the markets which would be affected by the merger before analysing what its effects would be.

The markets affected

2.30. The main overlap between the activities of the merging parties is in the supply of insured breakdown services. These may be broadly defined as the effecting and carrying out of insurance policies which, in return for fixed premiums, ensure that eligible motorists receive the following benefits when required:

- (a) access to a telephone call centre where breakdown services can be requested and arranged; and
- (b) the breakdown services themselves, namely roadside assistance, vehicle recovery and related services

at no further cost to the motorist or the insured (other than the cost of parts).¹ We use the term breakdown organization to refer to an organization which sells insured breakdown services (but not including intermediaries: see paragraph 2.35 (b)).

2.31. There appears to be general agreement in the industry that the provision of breakdown services for heavy vehicles (that is vehicles with a gross laden weight exceeding 3.5 tonnes) is a separate activity from the provision of such services for light vehicles. Both Green Flag and RACMS are involved in the provision of services for heavy vehicles, although it is a minor part of their operations, and we consider that aspect in paragraphs 2.137 to 2.139. Unless otherwise stated, however, the account of the market which follows is concerned with the supply of services for light vehicles.

2.32. We estimate that nearly 20 million light vehicles are covered by breakdown insurance policies (see Table 4.8) (the actual number may be a little lower because some vehicles are covered by more than one policy).² This may be compared with a total of over 26 million light vehicles which were licensed for use on UK roads as at the end of 1997. This suggests that about a quarter of these vehicles are not covered by breakdown insurance. Most of those not covered are likely to be privately owned and the proportion of private motorists without cover is therefore higher, perhaps one-third or more. Market research indicates that members of breakdown organizations tend to be in the higher socio-economic groups. We estimate that the total revenue received by breakdown organizations from the sale of breakdown insurance in 1998 will be around £780 million.

2.33. Breakdown organizations may themselves supply all the main elements of an insured breakdown service, as the AA and RACMS do. It is possible, however, to offer a service while contracting out the supply of call-centre facilities and breakdown assistance to third parties and arranging for the insurance risk to be underwritten by an unrelated insurance company (or Lloyd's). In particular, nearly all suppliers apart from the AA and RACMS use only independent garage contractors to provide roadside assistance, indeed the AA and RACMS themselves use contractors for a minority of their call-outs.

2.34. The scope of breakdown policies varies considerably, the main components being roadside assistance for the vehicle away from home; recovery of the vehicle to a garage or other destination; assistance for a vehicle failing to start at home; meeting the costs of alternative travel or hotel accommodation; and the provision of all these forms of cover for motorists travelling elsewhere in Europe as well as in the UK. The insurance cover may be a specified vehicle (for any driver) or for a specified individual (in any eligible vehicle). Vehicle-based policies may be extended to provide personal cover for a specified individual to drive other light vehicles too, whilst personal-based policies may be extended to cover other members of the household. As a consequence of the numerous combinations available, retail prices also vary widely, ranging from £25 to £40 for a basic roadside assistance policy to around £200 for RACMS's top-of-range policy for a household with two drivers and two cars.

2.35. Ten years ago most breakdown policies were sold directly to individuals. Since then other sales channels have grown considerably. The various channels may be categorized as follows:

¹We also include organized pay-on-use (POU) services within the meaning of the term insured breakdown services: see paragraph 2.35 (e).

²The AA and RACMS supply their direct retail members with personal cover, that is covering a specified individual and not a specified vehicle. With this important exception, most policies, including those issued by the AA and RACMS in the sales channels other than direct retail (see paragraph 2.35), cover a specified vehicle. For the purpose of market analyses based on volume measures, therefore, we have had to make assumptions in converting the numbers of AA and RACMS personal members into estimated numbers of vehicles effectively covered under these policies; see paragraph 4.67.

- (a) *Direct retail*: sales by breakdown organizations directly to individuals without the involvement of any intermediary.
- (b) *Intermediary*: schemes under which a breakdown organization agrees with another commercial organization (usually a financial institution) or other type of body (for example, a trade union, charity or club) to offer insured breakdown services to the customers or members of the intermediary body, normally at a discount to the retail price; the intermediary usually buys the services wholesale and sells them on to its customers/members (but not bundled with other products—see below).
- (c) *Mandatory*: schemes under which a breakdown organization agrees to sell insured breakdown services wholesale to another commercial organization (again, usually a financial institution) which in turn provides them to its customers bundled with another product (typically motor insurance); most of the sales in this channel are accounted for by four schemes operated by major insurance companies.
- (d) *Motor manufacturer*: the wholesale of insured breakdown services by a breakdown organization to a motor car manufacturer which in turn provides them to its customers bundled with the sale of a new or (less commonly) used car; cover is normally provided for between one and three years: thereafter the breakdown organization may have the opportunity to market its services to the user either on a direct retail basis or as part of an intermediary scheme under the motor car manufacturer's name.
- (e) *Fleet*: the wholesale of breakdown services by a breakdown organization to an operator of a vehicle fleet or fleets; the fleet operator may be a specialist fleet management company or an organization managing a fleet for use in its own business or supplying cars for use by its employees. Most fleet operators buy breakdown services on an organized POU basis, that is their agreements with breakdown organizations give their drivers access to a call centre and roadside assistance when a breakdown occurs but payment is made (often at pre-negotiated rates) each time the services are used, with no insurance element (in other words the operator self-insures). In accordance with normal industry usage, we include such arrangements within our definition of insured breakdown services because of their similarity in other respects to the insured product.

In practice there is a wide variety of arrangements and the divisions between sales channels are not always clear-cut.

2.36. Direct retail is still by far the largest sales channel, accounting for about 49 per cent of all vehicles covered by insured breakdown services. Its share has fallen, however, from around 74 per cent ten years ago, reflecting the faster growth of the other channels. Of the other channels, motor manufacturer is the second largest, accounting for about 21 per cent of the total, followed by fleet (13 per cent), intermediary (12 per cent) and mandatory (6 per cent) (see Table 4.9).

2.37. Measured by revenue to the breakdown organizations (Table 4.15), direct retail accounts for a much higher proportion of the total, around 71 per cent, than it does by number of vehicles. The intermediary channel's share, at some 12.5 per cent, is slightly higher on this basis. This is because sales in the three other channels are at lower prices, partly reflecting the fact that the breakdown organization incurs much lower marketing and selling costs than in direct retail. In addition, call-out rates (that is, the annual ratio of call-outs to vehicles covered), are much lower in the other channels, partly because the vehicles are generally newer and hence break down less often and partly because of lower awareness of the existence of the breakdown policy on the part of the drivers. Intermediary schemes fall part-way between direct retail and the other channels in these respects. Finally, in all

channels except direct retail another organization is involved which can exercise buyer power to bring down the prices charged by the breakdown organization.

Market definition

2.38. In order to assess the merger's impact on competition we need to define the market or markets which will be affected. The relevant market is defined as that group of products or services for which there are no close substitutes on either the demand or supply side (see paragraph 4.50).

2.39. As mentioned in paragraph 2.31, there was a consensus among those giving evidence to us that the provision of breakdown services for heavy vehicles is a distinct activity from their provision for light vehicles. This is because of the nature of the equipment required.

2.40. Within the supply of insured breakdown services for light vehicles, we have to consider whether the different sales channels constitute separate markets. The arguments surrounding this issue are set out in paragraphs 4.49 to 4.63. Our view is that the various channels form part of a single market because the services are essentially the same across all channels; organizations capable of supplying through one channel are capable of supplying through them all; and individual motorists may move between channels depending on choice or circumstances.

2.41. Evidently, however, there are significant differences between the channels. Suppliers' shares of sales vary substantially between channels. These mainly reflect differences in the ease of entry and growth which are related, in turn, to the varying importance of brand preferences. In sales channels other than direct retail the suppliers are dealing with corporate or other bodies which may be able to exert buyer-power and hence bring about lower prices to the consumer (implied prices in the case of bundled products).

2.42. In our view the most important factor which differentiates the various sales channels is the extent to which the end-user chooses which product to acquire. One significant limit on choice is the bundling of breakdown with other services. Moreover end-users are likely to be influenced by different considerations from corporate buyers. In this market, in particular, end-users are likely to place more weight on their perceptions of suppliers' brand names and reputations and less on the terms on which the service is supplied, notably price. On this basis we see the direct retail and intermediary channels as forming a distinct segment of the market, which we refer to as the discretionary segment. The motor manufacturer and fleet channels are clearly non-discretionary as far as the end-user is concerned. The case of mandatory schemes is not so clear-cut since, whilst the end-user does not make a separate, discretionary decision to acquire the breakdown cover, such cover sometimes represents a material element in the bundle of products on offer and may, therefore, influence the purchasing decision. Call-out rates under mandatory schemes are low, however, which suggests low awareness of service availability on the part of the user. Given the restriction on consumer choice which results from products being bundled, we see mandatory schemes as falling more appropriately outside the discretionary segment of the market and as forming a separate small segment on their own, albeit with some similarity to the intermediary sales channel. Thus we see the market as falling into three segments: one discretionary segment, comprising the direct retail and intermediary sales channels; and two non-discretionary, the first comprising the motor manufacturer and fleet sales channels and the second comprising the mandatory schemes channel.

2.43. Competitive forces do not, however, in our view, act in a symmetrical way as between the segments of the market that we have identified. On the one hand competitive conditions in the discretionary segment are likely to flow through to the non-discretionary segments since the services being provided are very similar and most of the purchasers in the non-discretionary segments are sizeable companies able to take an active approach to the procurement of the services. On the other hand competitive conditions in the non-discretionary segments need not flow through to the discretionary segment given the preference of many consumers for services with strong brands.

2.44. Even within the discretionary segment as we have defined it there are significant differences between the two sales channels. In particular the intermediary channel is distinguished from direct retail by the presence of the intermediary party, which brings a block of potential customers and is thereby able to exercise a degree of buyer power. Moreover the intermediary decides what particular range of services should be offered to its customers and at what price. It may also want the services to be provided in its own name, whether exclusively or jointly with the name of the breakdown organization. These differences have implications for our analysis of the merger's effects on competition.

2.45. There is also a geographical aspect to market definition. We received no evidence to indicate that market conditions varied as between different parts of the UK. Cendant told us that motor car manufacturers were beginning to seek tenders for the supply of insured breakdown services on a Europe-wide basis. This applies in only a small minority of motor manufacturer schemes, however. Whilst the provision of European cover is an option offered by many breakdown organizations, their policies are designed for motorists or vehicles based in the UK. We are satisfied that for all practical purposes the market covers the UK as a whole but not any wider geographical area.

Suppliers

2.46. The main suppliers are as follows:

- (a) *The AA*, a members' club, is the clear market leader. Its strength lies above all in the direct retail sales channel but it is also strong in sales to fleet operators and, to a lesser extent, motor car manufacturers. It has chosen not to compete in the other two channels because it prefers to have a direct relationship with its members wherever possible and it sees the intermediary and mandatory channels as absorbing customers who would otherwise be personal members. In practice the AA does have some groups of customers gained through affinity groups but it treats them as personal members (that is, they have personal-based policies and a direct contractual relationship with the AA). Their numbers are relatively small (around [3%] per cent of the AA's direct retail members) and have not changed much in recent years.
- (b) *RACMS* is, equally clearly, the number two player but a long way behind the AA. It competes in all sales channels and its strength is spread across them fairly evenly, although it has been particularly successful in motor manufacturer business.
- (c) *Green Flag*, the third biggest supplier, is the only other significant supplier in the direct retail channel. Having encountered difficulties in building up its direct retail sales beyond a certain level (around half a million members) it was instrumental in developing the intermediary and mandatory channels and these now account for the bulk of its members.

- (d) *Mondial Assistance (UK) Limited* (Mondial) is the UK member of a group of companies owned by two large French insurance companies. It has been in the market for many years without achieving a substantial share but more recently it has concentrated successfully on bidding for motor manufacturer contracts. It supplies services under the name of the motor car manufacturer, in some cases with a small directly-employed force of dedicated patrols in the livery of the manufacturer concerned, although 'topped up' by independent contractors. When the period of cover of a motor manufacturer contract ends (normally after one to three years), Mondial seeks to persuade the motorist to continue taking breakdown cover from Mondial but still in the motor manufacturer's name. Its members in this category, who account for about half of Mondial's total membership, fall in the intermediary sales channel since Mondial is marketing its services through the intermediation of the motor car manufacturer.
- (e) *Britannia Rescue Services Limited* (Britannia) is a subsidiary of the Civil Service Motoring Association Limited (CSMA). Although it markets services to the general public, it has gained most of its members through the CSMA and a few other affinity groups. As a result it has a significant presence only in the intermediary sales channel.
- (f) *Europ Assistance Limited* (Europ Assistance) is 80 per cent owned by Europ Assistance Group, based in France, and 20 per cent by Eagle Star Holdings Plc (Eagle Star), itself now owned by Zurich Versicherungs Gesellschaft (Zurich VG) of Switzerland. Europ Assistance Group, in turn, is owned 60 per cent by an Italian insurance company and 40 per cent by Fiat. The group claims to be the leading supplier of breakdown assistance in Europe. Its sales of insured breakdown services are in the direct retail and intermediary channels.

There are numerous smaller suppliers, the more important of which are described briefly in paragraphs 4.44 and 4.45.

2.47. There have been two potentially significant entrants in 1998:

- (a) *Royal & SunAlliance Group plc* (RSA) markets insured breakdown services for mandatory schemes under the name FirstAssist and now has about 80,000 members.
- (b) *Direct Line Insurance plc* (Direct Line), a subsidiary of the Royal Bank of Scotland, has acted as an intermediary, marketing the insured breakdown services of Europ Assistance, for a number of years. In May 1998 it entered the market itself, although it continues to subcontract certain functions to Europ Assistance. By November 1998 it had some 207,000 members, about 2.3 per cent of total sales in the direct retail channel, including 120,000 which it retained from the period before May 1998. In contrast with other breakdown organizations its prices are related to its assessment of the risk posed by the individual customer.

Market shares

2.48. As shown in Table 4.11, in 1998 the AA had by far the biggest share of the overall market for the supply of insured breakdown services for light vehicles, with 48 per cent of the total measured by sales revenue. RACMS was the second biggest supplier with 29 per cent and Green Flag the third biggest with 12 per cent. Mondial had 3.4 per cent and the remaining suppliers were all at 2 per cent or less. Market shares based on the estimated number of vehicles covered were not very different, the main changes being that Mondial's share on this basis was 5.8 per cent. In general we regard sales revenue as the better basis for measuring market share for our purposes, partly because of the difficulty of estimating

numbers of vehicles covered (see paragraph 2.32) but mainly because revenue gives a better indication of the value of the business to the supplier.

2.49. Table 4.16 shows market shares for individual sales channels in 1998 based on revenue. In the discretionary segment as a whole, the AA's share was 50 per cent and RACMS's 27 per cent, with Green Flag¹ on 12 per cent. In the direct retail channel taken on its own the AA's share was as high as 59 per cent with RACMS on 29 per cent and Green Flag 6 per cent. In the intermediary channel, however, where the AA has chosen not to compete, Green Flag is the leader with 44 per cent and Mondial second with 20 per cent, with RACMS on 15 per cent.

2.50. Other points to emerge from the table are as follows:

- (a) smaller suppliers have a significant presence in the intermediary channel, notably Britannia with 10 per cent;
- (b) Green Flag is the leader in the mandatory channel with 47 per cent of sales;
- (c) Mondial is a significant player in the motor manufacturer channel with 13 per cent of sales; moreover its share is expected to rise to around 20 per cent in 1999 as a result of recent contract awards, notably for the Rover account;
- (d) Mondial has also used its success in converting expired motor manufacturer policies to intermediary business to achieve the second largest market share in this channel at 20 per cent; and
- (e) in the fleet channel the relative shares of the three major suppliers are broadly similar to those in direct retail, whilst smaller suppliers are virtually absent.

The case put by the parties

Cendant's strategy

2.51. Cendant told us that it saw the UK as the natural springboard for Cendant's expansion into Europe. European markets, while not unfamiliar with franchising and cross-marketing, had yet to be exposed to the full scale, range and innovative nature of Cendant's operations. Through the acquisition of NPC, Cendant had acquired access to several million regular customers of National Car Parks and about 550,000 members of Green Flag's assistance programmes. Most Green Flag members had joined through intermediary schemes, however, for which the membership databases were not controlled² by Green Flag. This limited (though did not eliminate) the scope for cross-marketing. Cendant had envisaged that it would need to make additional acquisitions in order to achieve the necessary scale of membership for its cross-selling operations. A well-recognized brand name in a related market was also desirable.

2.52. Against this background Cendant said that the acquisition of RACMS had several attractions for Cendant:

- (a) It would add 2.5 million accessible members to Cendant's membership base giving much greater scope for data mining (see paragraph 2.9) and cross-marketing.

¹For the purpose of market share calculations based on revenue, we treat Green Flag as including UKI (see paragraph 2.11).

²That is, Green Flag has no right of access to the consumer other than for administrative purposes.

Moreover RACMS's brand profile suggested that RACMS members would provide particularly fertile cross-marketing opportunities.

- (b) The RACMS brand was differently positioned from Green Flag, enabling Cendant to offer a choice of products to customers. Cendant intended to continue to maintain both brands in the breakdown services market.
- (c) There was scope for synergies between RACMS and other Cendant businesses which could yield cost savings of over £[§] million a year by the third year.
- (d) The RAC brand was very well recognized, reinforced by its 100 years of history, but had not been fully developed. The recent change of strategy adopted by RACMS had not been well focused to develop an identifiable selling proposition, differentiated from the AA's. Application of Cendant's business techniques could exploit the brand's potential.
- (e) Cendant already had experience of breakdown services and broader vehicle-related businesses, both in the USA and the UK. It could see scope for expanding the RACMS product offerings [*Details omitted. See note on page iv.*].

Given the scope for savings and business enhancements, Cendant was clear that the purchase price which it had been able to agree with the RAC group was an attractive one for Cendant (see paragraph 3.125).

2.53. Cendant submitted that the merger would result in the creation of a vibrant competitive force which would bring a new approach to the marketing and selling of breakdown services in the UK and further stimulate competition in an industry which had changed significantly over the last ten years and was in the process of further change. Cendant claimed that these benefits, and the increased competitiveness of both the RAC and Green Flag brands, would more than compensate for any diminution in competition between RACMS and Green Flag that might result from common ownership of the two brands.

2.54. Cendant said that it was committed to maintaining an RACMS liveried patrol fleet, serving broadly the same proportion of RACMS members' call-outs as now, but not necessarily in its present form. There were significant inefficiencies in the management of the patrol force at present and RACMS's call-out costs had risen far more than Green Flag's in the last few years. (Despite this, we note that RACMS's average costs per call-out were still below Green Flag's in 1997.) Cendant's preferred option was to restructure the patrol force, partly because in its present form it was an underutilized asset which represented a large fixed cost, and partly because of Cendant's preference not to have hard assets (such as fleets of vehicles) on its balance sheet or fixed costs on its profit and loss account.

2.55. The structure of the fleet following the merger had not been determined but was likely to involve some or all of the following elements:

- (a) continued direct employment for some patrols in areas of heavy utilization of the service: it would, however, be necessary to improve utilization levels, for example by introducing more flexible working practices;
- (b) large-scale subcontracting: some of the larger businesses in RACMS's contractor network could be given the opportunity to acquire RACMS liveried vehicles and employ members of the patrol force: this model would suit large towns and heavily used motorway routes; and

- (c) small-scale subcontracting: individual members of the patrol force, alone or in small groups, would be offered the chance to operate as self-employed, liveried operators: this model might be well suited to rural areas.

The exact combination would be determined post-merger in order to maximize cost efficiency and quality of service. (Cendant said that the subcontracted elements of the patrol force might be set up as franchisees, but this had not been decided. For ease of reference in our report, we use the terms franchisees or franchised patrols to refer to these subcontracted elements, as distinct from independent garage contractors.)

2.56. Cendant did not expect much change in the size of the patrol force as a result of the merger and thought the volume of work placed with garage contractors would also be little changed.

2.57. We asked Cendant if it envisaged that franchised patrols, whether they had previously been direct RACMS employees or garage contractors, would be required to work exclusively for Cendant. Cendant told us that, when operating in RAC livery, franchised patrols would be exclusive to Cendant and would largely do RAC-branded work, although they might exceptionally attend Green Flag customer breakdowns as well. But an operator with an RAC franchise might have several breakdown vehicles, some in RAC livery and some not: Cendant would not prevent such franchisees from working for other breakdown operators.

RAC Motoring Services' perspective

2.58. RACMS said that its business was built on providing breakdown services predominantly through a dedicated patrol force with the skills and technical resources to sort out the motorist's problems speedily at the roadside. The investment needed to provide such a service was considerable and increasing. The limited scale of RACMS's operations made it increasingly difficult to fund such investment. RACMS and Green Flag, though the second and third players in the breakdown service market, trailed far behind the AA and even together would still be significantly smaller than it. The merger would enable cost savings to be made through integration of the two businesses, while Cendant had skills in database management to market a range of products and services to the RACMS database of customers. The merger would thus put RACMS in a position to compete more effectively with the AA. (See also paragraph 2.19.)

Commentary on aspects of Cendant's proposals

2.59. In this section we comment on three aspects of Cendant's plans which are important to the assessment of the merger's likely impact, namely the future of the RACMS patrol force; the intention to maintain both the RAC and Green Flag brands; and the issues of cross-selling and cross-subsidy.

Future of the RAC Motoring Services' patrol force

2.60. As regards the first of these, we believe there are incentives on grounds of both quality and cost for Cendant to retain and, indeed, expand the liveried patrol force.

2.61. As regards quality, while there are disagreements within the industry concerning the measurement of performance, we are satisfied that—on a like-for-like basis—the patrol

forces of the AA and RACMS repair a higher proportion of broken-down vehicles at the roadside (fix rates) than do garage contractors (including those used by the AA and RACMS themselves to top up the resources of their patrol forces). Against this, some breakdown organizations which depend solely on contractors have been found to achieve faster average response times in reaching breakdowns (average time to attend) than the AA and RACMS. Recently, however, the AA claims to have been able to match the 35-minute average achieved by Britannia and Green Flag and RACMS is not far behind, at around 40 minutes.

2.62. Besides objective measures of service quality there is clear evidence from surveys that many consumers prefer to receive service from a liveried patrol rather than a contractor. This is partly a matter of perceived security (particularly for women) and partly a feeling that a contractor may have a vested interest in transporting a broken-down vehicle to his own garage in order to generate repair work for which the motorist can be charged (in addition to the call-out charge which the contractor receives from the breakdown organization). Some consumers also believe that a breakdown organization can exercise more effective quality control over services provided by its own workforce than over services provided by contractors. Consequently the use of the patrols is a factor that would allow the AA and RACMS to charge a premium price for their insured breakdown services compared with the offerings of other suppliers (leaving aside the particular position of Mondial in the motor manufacturer channel).

2.63. The liveried patrols are also strongly associated with the brand images of the AA and RACMS. They are the principal visible expression of the brand and their widespread presence on the roads serves as a valuable form of advertising.

2.64. As regards cost, it appears that, once a breakdown organization reaches a certain size in terms of number of members, it is cheaper to deal with the bulk of call-outs through a dedicated patrol force than through contractors. It is difficult to ensure that the costs of the different organizations are calculated on a comparable basis. Nevertheless it appears that RACMS, despite operating in a less commercial environment than Green Flag (and despite the inefficiencies which RACMS acknowledged had developed in the last few years), achieves a lower average cost per call-out (£[£]) than Green Flag (£[£]). The AA's figure is similar to that of RACMS. The AA told us that its costs would be about 50 per cent higher if it had to contract out all its work (compared with about 13 per cent which is contracted out at present). There are indications, therefore, that Cendant could make significant cost savings from expanding the RACMS patrol force in order to deal, not only with a higher proportion of RACMS call-outs, but with many of Green Flag's as well.

2.65. We believe that in the longer term Cendant, faced with a golden scenario of being able to reduce costs in this way while also providing a product which could command a premium price, would find itself under commercial pressure to do so even though that is not its currently stated intention. Given the new structure of the RACMS patrol force envisaged by Cendant (see paragraph 2.55), this would most likely be achieved by an increase in the use made of the franchisees, who would no doubt be eager to take on a bigger proportion of the merged group's call-outs. This might have consequences for the network of garage contractors and we consider the implications of these in paragraphs 2.128 to 2.136.

2.66. Some independent contractors expressed doubts to us about the commercial feasibility of running a mixed fleet of vehicles, some in RAC livery and some not. Given that there would be limitations on the range of jobs for which the liveried vehicles could be used, there was a risk that some capacity would be underutilized. It seems to us, however, that given a reasonably substantial workload of RACMS call-outs, this would not be a major problem: contractors would have to ensure that they had the right balance of liveried and non-liveried vehicles to minimize underutilization. In order to maintain flexibility, liveried

vehicles would probably represent a lower proportion of franchisees' fleets than RACMS call-outs would represent as a proportion of their workloads.

Cendant's intention to maintain both the RAC and Green Flag brands

2.67. The second aspect of Cendant's plans which we comment on is the stated intention to maintain both the RAC and Green Flag brands. At present the values associated with the RAC brand (ie consumer perceptions of the brand's qualities) are trustworthiness, reliability and experience, whereas Green Flag is perceived as a relative newcomer which provides a no-frills service at discount prices. RACMS's membership profile is similar to the AA's. Green Flag's members, in comparison, are younger and less concentrated in the higher socio-economic groups. It is for these reasons that Cendant sees the Green Flag brand as differently positioned from the RAC brand, giving Cendant scope to win a wider range of customers through pursuing a two-brand strategy than would be possible with the RAC brand alone.

2.68. Cendant said that the Green Flag brand would be differentiated from the RAC brand in several ways: through service delivery by non-liveried contractors; through vehicle-based pricing which made Green Flag cheaper than the AA and RACMS for some categories of customer; and through the broader positioning of the brand as against the premium position of the RAC brand. Green Flag would continue to offer a full range of breakdown products, rather than concentrating on the lower-priced options, but might offer a different range of Cendant's other products and services, as 'added-value propositions', compared with those which RACMS would offer.

2.69. We do not doubt that Cendant would keep both brands, differentiated in this way, at least for a time. It would, however, lose certain potential economies of scale in doing so. In particular, as noted in paragraph 2.65, it would sacrifice some economies that could be gained from expanding the patrol force, and it would incur much higher marketing costs from having to advertise and promote two brands instead of one. In order for these extra costs to be justified by the ability to tap a wider range of customers, it would in our view be necessary for Cendant to segment the market as much as possible in order to minimize the extent to which the two brands were fishing in the same pool.

Cross-selling and cross-subsidy

2.70. The third aspect which we comment on is Cendant's policy of cross-selling different products and services to customers on its databases. Some competing breakdown organizations expressed concern that Cendant might subsidize its breakdown services in the interests of expanding the numbers of customers to whom it could sell other things.

2.71. Cross-selling is a widespread commercial practice. We see nothing intrinsically adverse in the exploitation of a brand developed in one market to sell products in another. As for the possibility of cross-subsidy, we believe that Cendant would be able to increase RACMS's customer numbers without extensive price cutting, for example through better marketing and selling techniques. We do not therefore see it as very likely that Cendant would adopt a policy of cross-subsidizing breakdown services from profits on its other activities (see also paragraph 2.102).

The public interest

2.72. In examining the merger's impact on the public interest, we begin with some general remarks about the merger's effect on the insured breakdown services market and on

RACMS before addressing in detail the likely effects on competition in that market and on garage contractors. We then consider a number of other aspects—effects on other markets and on employment, Cendant’s financial position and prospects, and the benefits of the merger—before drawing our overall conclusions. Our focus is mainly on the changes which the merger would bring about compared with the present situation. It cannot be assumed, however, that in the absence of the merger the present situation will continue unchanged; indeed we believe that is most unlikely. It is also necessary, therefore, to consider what would be likely to happen if the merger did not go ahead and to assess the merger’s likely effects compared with the most likely alternative scenarios.

2.73. The merger would bring together the second and third largest suppliers of insured breakdown services. In broad terms the merged group would have some 40 per cent of total supply, whether measured by number of vehicles covered or by turnover. This would still be well behind the AA’s share of around 48 per cent.

2.74. We note that even without the merger the market is highly concentrated. As shown in Table 4.17, the value of the Herfindahl-Hirschman Index (HHI), a conventional measure of concentration, is around 3,350 when market shares are measured by sales revenue and around 3,200 on the basis of number of vehicles. Levels of the HHI above 1,800 are often seen as indicating a high degree of concentration and increases of more than 100, in even moderately concentrated markets, as raising prima facie concerns. The effect of the merger would be to increase significantly the present degree of concentration. The addition of Green Flag’s 12 per cent market share to that of RACMS would mean that the HHI would rise to around 4,000 on the value measure and 3,900 on the volume measure. The effect of the merger on the structure of the market would then be to leave only an 11 to 13 per cent share not in the hands of the two leading suppliers, a strongly duopolistic market structure.

2.75. The nature of RACMS has already been changed following RACL’s decision to accept Cendant’s offer. Until the reorganization in July 1998, RACMS had been run on a not-for-profit basis, being a company limited by guarantee with no power to distribute its profits (see paragraph 2.5). As a result of the reorganization RACMS is now a private commercial company ultimately owned by shareholders and the restriction on distributing its profits to its corporate members has been removed. In future we expect RACMS to be run for profit. This fundamental change was made in preparation for the sale of RACMS to Cendant but we would not expect it to be unwound even if the merger did not proceed.

2.76. Under the new structure RACMS has one principal activity, the supply of insured breakdown services, and a few other activities, the most important of which is BSM. Following the merger it would be a relatively small part of a diversified US group of companies. Given the nature of Cendant as a company which seeks to gain maximum advantage from its involvement in different industries (market synergies), we can expect that Cendant would operate RACMS in such a way as to maximize its contribution to group performance and not as the largely stand-alone activity which it is at present.

2.77. We turn now to address the merger’s likely effects on competition in the supply of insured breakdown services. Consistent with our conclusion on market definition (see paragraph 2.42) we look first at the discretionary segment, then at the two non-discretionary segments.

Effects on the discretionary segment

2.78. The discretionary segment covers two forms of supply: direct retail and sales to (or via) intermediaries. Whilst we believe these two forms of supply are best considered together for the most part, we also need to take account of the differences between them. In particular

the involvement of intermediaries brings an element of buyer power to bear while also providing greater opportunities for smaller suppliers which lack the brand strength of the AA and RACMS.

2.79. Table 4.8 shows that the discretionary segment as a whole accounts for 12 million vehicles, some 60 per cent of the total market for insured breakdown services measured by number of vehicles covered (84 per cent by sales revenue—see Table 4.15). The AA has 51 per cent of sales in this segment by number of vehicles, compared with the RACMS's 22 per cent and Green Flag's 12 per cent. All other suppliers have 15 per cent between them, the largest being Mondial with 5 per cent and Britannia with 3 per cent (see Table 4.10). On the basis of sales value RACMS's share rises to 27 per cent, with the AA on 50 per cent and Green Flag on 12 per cent (see Table 4.16). The increased share for RACMS on this measure arises because of its high average revenue from direct retail customers.

2.80. Shares are significantly different, however, as between the two forms of supply within the discretionary segment (see paragraph 2.49). The AA, which is very strong in direct retail, does not sell through intermediaries, leaving the field open (at least for the present) to other suppliers. Green Flag has been particularly successful in selling through intermediaries and has 39 per cent of this form of supply, measured by vehicles covered. Mondial has 26 per cent as a result of its success in retaining motor manufacturer customers after the expiry of their cover under the motor manufacturer scheme. RACMS has 14 per cent and Britannia 13 per cent, whilst others have 8 per cent (see Table 4.10). On the revenue basis the shares of Green Flag and RACMS are somewhat higher, and the shares of Mondial and Britannia somewhat lower, than they are on the volume basis (see Table 4.16). The merged group would have 53 per cent of total intermediary sales by volume and 59 per cent by value.

2.81. Cendant and RACMS submitted that the merger's overall effect on competition in the discretionary segment would be favourable. Their arguments, which are set out more fully in Chapter 6, may be summarized as follows:

- (a) Most direct retail customers wanted a patrol-based service: RACMS put the proportion at 90 per cent, Cendant at 70 to 75 per cent.
- (b) Green Flag, although successful in selling to intermediaries, had not been an effective competitor to the AA and RACMS in direct retail sales, nor in recent years had it been an innovator.
- (c) The key element in direct retail sales was the dominance of the AA.
- (d) RACMS had been losing ground to the AA and would continue to do so if the merger did not proceed.
- (e) The merger would strengthen competition by creating a bigger, more powerful second force owned by a vigorous newcomer whose motive would be to grow the number of its customers.
- (f) Cendant would preserve customer choice, and a degree of inter-brand competition, by retaining RACMS and Green Flag as separate brands.
- (g) There were recent and prospective entrants who were well placed to provide an independent source of competition to the big two patrol-based operators.

(h) Direct retail customers had the option of switching to intermediaries, a fast-growing sales channel, to take advantage of their buyer power.

(i) The new market structure would not be, or become, a comfortable duopoly.

We consider each of these points in turn and then draw our conclusion on the merger's effect on the discretionary segment.

Consumers' desire for a patrol-based service

2.82. RACMS's argument in paragraph 2.81(a) was based on the fact that the combined share of direct retail sales held by the AA and RACMS had been around 90 per cent for many years. It is misleading, however, to look at the direct retail channel in isolation. It is reasonable to suppose that many motorists buying breakdown cover through intermediaries and mandatory schemes would be direct retail customers were it not for the development of those channels. If the direct retail, intermediary and mandatory channels are taken together, the combined share of sales (in value terms) held by the AA and RACMS has fallen from 86 to 76 per cent since 1988. Survey evidence suggests that the proportion of consumers who would insist on or prefer the AA or RACMS is well below 90 per cent.

2.83. It is clear that, for the reasons given in paragraph 2.62, many consumers prefer to receive service from a liveried patrol force. We believe, however, that the proportion who would not consider a contractor-delivered service is well below 90 per cent; moreover the proportion in this category has clearly changed. Whilst possession of a liveried patrol force provides the AA and RACMS with an element of protection from competition by suppliers such as Green Flag which rely on contractors, this is not so important a factor as RACMS sought to argue.

Green Flag's effectiveness as a competitor

2.84. As regards paragraph 2.81(b), it is the case that Green Flag's direct retail sales have been broadly static since 1993 in absolute terms and have fallen slightly (from 6.6 to 6.1 per cent) as a proportion of total sales (by value) through this channel. This is despite the company's continued heavy investment in advertising and promotion, notably through a four-year sponsorship of the England football team which ended after the World Cup in the summer of 1998. Over the period 1992 to 1997 Green Flag's spending on media advertising accounted for 28 per cent of the industry total, far higher than its share of total sales to individuals.

2.85. On the other hand, Green Flag's sales through intermediaries have continued to grow, although the rate of growth has tailed off since 1995. These sales overtook its direct sales in 1994 and now represent 56 per cent of its total sales (by value) in the discretionary segment of the market. Its estimated sales in the intermediary and mandatory channels together in 1998 were nearly three times as great as its direct retail sales measured by number of vehicles covered, although only 1.5 times by value.

2.86. Analysis of Green Flag's sales data shows that it experiences high rates of 'customer churn'. In recent years about 20 per cent of its direct retail members and 30 per cent of its intermediary members (that is, the end-users recruited through intermediary schemes) have not renewed their membership. Survey evidence indicates that about a quarter of those not renewing did not intend to join any breakdown organization while 30 per cent rejoined Green Flag after a short break. For those joining another organization the AA was the most popular choice followed by RACMS and Autonational, a small supplier which

competes mainly on price. Reasons for switching were divided evenly between involuntary—that is, those who acquired cover from another organization as a result of buying a car or a bundled motor insurance/breakdown policy—and voluntary. It is evident that Green Flag has to win substantial numbers of new customers each year simply in order to maintain a given level of sales. Thus in the year to March 1998 Green Flag enrolled 121,000 new direct retail members. Expressed as a proportion of its membership in the previous year (22 per cent) this compares favourably with the performance of RACMS, which enrolled 210,000 new members in 1997 (equivalent to 12 per cent of its membership in 1996) and the AA, which enrolled 750,000 new members in 1997 (13 per cent of its 1996 membership numbers).

2.87. There are indications in the internal documents of Green Flag and RACMS that each has seen the other as a key competitor. Green Flag's budget strategy for 1999 included the aim of becoming number two in the market, overtaking RACMS, although Cendant told us at a hearing that this should be seen as a long-term aspiration. A five-year plan drawn up in 1996 by the (then) new RACMS Chief Executive noted that towards the end of 1995 RACMS's most profitable customers were being won by Green Flag and, to a lesser extent, the AA. The document referred to the AA and Green Flag together as RACMS's two key competitors. RACMS told us at a hearing that it had overestimated Green Flag's presence in direct retail sales and that the main battle for such sales was between the AA and RACMS as the two patrol-based operators.

2.88. The AA told us that for many years, when the only suppliers had been itself and RACMS, competition had been at a low level. With Green Flag's entry the market had become much more competitive. The AA saw Green Flag as a skilled competitor which had used marketing techniques not previously used by the AA and RACMS. Its impact had been far above the level indicated by its market share and in recent years the impetus for competition had come much more from Green Flag than from RACMS. In response the AA had started to focus on improving value and service quality for its members. It would not have done so just in response to RACMS.

2.89. Price trends give some support to this picture. Prices to direct retail customers rose significantly in real terms in the late 1980s and early 1990s but increases were much lower between 1993 and 1998 (see Table 4.27). The Mintel 1998 report on 'Vehicle Recovery Services' commented that the 'strength of the leading operators has now been undermined by a new generation, led by Green Flag, which has concentrated on offering core services at very competitive rates. This has had the effect of stunting price rises'.

2.90. Evidence from consumer research carried out in 1996 suggested that the price sensitivity of demand for RACMS services was still low at that point. It was partly as a result of that research that RACMS sharply increased prices in 1997 as part of its plan to introduce a £25 no-call-outs discount. The number of new direct retail members enrolling with RACMS in 1997 fell, [*Details omitted. See note on page iv.*] (see Table 4.19). It would not be correct to attribute these changes solely to the price increases, not least because they were associated with changes in RACMS's product range, nor are the changes in enrolments and renewals very large in proportion to the total membership. Nonetheless there is an indication here of a degree of resistance to price increases which are seen as being above the norm and this tends to lend weight to the view expressed in the Mintel report.

2.91. The current five-year plan of the RAC group, most recently revised in spring 1998, includes measures designed to reduce the excessive number of call-outs by a small proportion of RACMS members. Such overuse, the plan commented, made RACMS's prices uncompetitive against Green Flag (that is, because of the need to recover the call-out costs), whilst the AA had already reduced the number of call-outs allowed per member. This indicates that

competitive pressure from the AA and Green Flag combined had helped cause RACMS to reduce its costs.

2.92. As to service standards, the AA told us that Green Flag had succeeded in establishing 'time to attend' as the main measure of service quality and had claimed that, with an average of 35 minutes, it was providing a service which was perceived not only as cheaper than the AA's and RACMS's but also, in this key respect, better. (This claim was based on a *Which?* report in 1996.) The AA had recognized the need to improve its performance in this and other respects and had cut its average time to attend from 43 minutes in 1997 to 33 minutes in 1998 (see Table 4.32). RACMS's performance on this measure has been steady at around 40 minutes for the past four years.

2.93. We were told that Green Flag's main innovations had been to introduce the whole concept of a breakdown service provided by a network of independent contractors and to play a major role in opening up sales through intermediaries, where it has consistently had easily the largest share. In this regard we note that prices to end-users buying from or through intermediaries are lower than direct retail prices. RACMS—though not the AA—has competed for this intermediary business. Thus the development of intermediary sales has caused RACMS to offer lower prices to the benefit of substantial numbers of individuals who would otherwise have been potential direct members. In 1997 RACMS's estimated average realized revenue from intermediary schemes was only 75 per cent of the equivalent figure for direct retail sales (see Table 4.25). This may, of course, be partly due to a different mix of policy cover.

2.94. Green Flag's major innovations were made some years ago. In recent years the company's principal innovation has been the introduction of a £10 rebate for members whose breakdowns are not attended within an hour. This move, designed to reinforce consumer perceptions of Green Flag as an organization which can be relied on for a rapid response, does not appear to have had a big effect on Green Flag's sales, although it is an element in its success in getting members to focus on 'time to attend' as the main measure of service quality. It is, however, of a lower order of magnitude as an innovation than those referred to in the previous paragraph. Mondial appears to have been the most innovative supplier in recent years with its approach to the motor manufacturer channel and subsequent success in retaining customers under a form of intermediary scheme.

2.95. It is too soon to observe any impact from Green Flag's acquisition by Cendant, particularly since Cendant is waiting for the outcome of its bid for RACMS before determining and pursuing its own strategy for the UK market in insured breakdown services. Given that Green Flag is already generally well managed, ownership by Cendant is unlikely to make a huge difference to Green Flag's performance. We expect, however, that Cendant, with its greater access to capital and expertise in brand management, will strengthen Green Flag's marketing. Cendant may also be able to increase Green Flag sales by cross-selling with other Cendant group products.

2.96. Assessing the importance for competition of one player in a market is inevitably, in part, a matter of judgment. Taking account of the evidence outlined above, our view is that Green Flag has been an important force in increasing the competitiveness of the discretionary segment. Whilst the evidence of the AA must be viewed in the light of its opposition to the merger, we accept the contention that the presence and competitive strategy of Green Flag helped shake up the market and the comfortable duopoly which had for long existed between the AA and RACMS. Given the huge inherited strength of the AA and RAC brand names, Green Flag's achievement in building a market share of 12 per cent, while earning a reasonable rate of profit, is creditable. Although it has not been a particularly innovative force in recent years and its share of direct retail sales has stagnated, we believe it is still a

significant competitive force, not least given the continuing growth in intermediary and mandatory sales, and that it would remain so if the merger did not proceed.

The dominance of the AA

2.97. Turning to paragraph 2.81(c), we accept that, for most consumers who want a liveried patrol service, the choice of supplier lies largely between AA and RACMS. The AA is strongly entrenched as market leader, and its share of direct retail sales has held steady over the last ten years whilst RACMS's has fallen. Green Flag has shown, however, that the AA's behaviour can be influenced by a smaller competitor with an innovative approach and some effective marketing ideas. Despite its more alert performance over the last few years, we believe that this is still the position today and that the AA, with its lack of profit orientation, would be vulnerable if faced with a commercially sharp competitor. This might change over time if it decided to abandon its mutual status (see paragraph 5.5).

RACMS's position vis-à-vis the AA

2.98. On paragraph 2.81(d), RACMS has indeed lost ground to the AA over the last ten years in direct retail, the gap in share of sales (on the volume measure) widening from 33 to 38 percentage points from 1988 to 1997. RACMS has tried to counter by growing sales through intermediary schemes; even so the gap in total sales in the discretionary segment was 28 percentage points in 1997 (see Appendix 4.4).

2.99. But this is not due solely to the AA's greater size and a virtuous spiral of falling unit costs allowing price reductions. RACMS acknowledged to us that it lost its way by failing to differentiate itself from the AA, hence the introduction of a new Chief Executive in 1995 and the launch of a new strategy. Whilst the new strategy has not been an unmixed success, it is showing some signs of turning the tide (stabilization in overall membership and a sharp rise in profitability). It is true that there are economies of scale in this industry—for example, from the ability to deploy a patrol force over a larger part of the country, from increased purchasing power and from the ability to spread capital investment and marketing costs over a wider membership base—but these are not such as to give the AA an overriding advantage. RACMS also has great strengths, notably its brand name and reputation and its skilled patrol force. We do not believe that the proposed merger is the only way for RACMS to compete successfully with the AA.

2.100. It is necessary at this point to consider what would be likely to happen if the merger did not proceed. Given the expectations that have been raised among the shareholders of its parent company, and the reorganization which has already taken place to prepare for the sale of the business, it appears to us inevitable that RACMS would still be sold, probably to a financial institution or trade buyer, although a flotation might also be an option. Indeed it had been the RAC group's intention for some time to review the options for the future of RACMS in the fairly near future (see paragraph 2.19), once it had been able to demonstrate an improved financial performance. Given the interest shown by several parties when the company was put up for auction in April 1998, we have little doubt in the ability of RACMS to find a new owner which could marshal the necessary financial and managerial resources to take on the AA. Any such new owner would have the motivation and opportunity to cut costs, focus marketing and fund necessary investment, and could be expected to make RACMS a more effective competitor.

2.101. For the above reasons our expectation is that, whether the proposed merger goes ahead or not, RACMS will be able to compete successfully with the AA.

The creation of a stronger second force

2.102. With reference to paragraph 2.81(e), it appears to us that Cendant, because it already owns Green Flag and because of its particular skills and assets, is in a position to create a potentially stronger competitor to the AA than anyone else in the short term. We believe Cendant would aim to grow its customer base but:

- (a) Cendant told us that its first priority would be to realize the cost savings upon which its £450 million bid for RACMS was predicated;
- (b) thereafter Cendant would aim to achieve annual growth in cash flow of [§<] per cent from RACMS. It is therefore unlikely to follow a price-cutting strategy, indeed it told us that it would compete instead by improved marketing and offering 'value-added services'; and
- (c) there may be some short-term risk to service quality as a result of the likely restructuring of the RACMS patrol force.

2.103. Thus, although we accept that the proposed merger would be likely to create a more effective competitor to the AA, at any rate in the short term, it is likely that to a substantial degree the benefits would not filter through to the consumer. We deal with our expectations in the longer term when we come to consider the possibility of a duopolistic structure emerging (see paragraph 2.112).

The two-brand strategy

2.104. As regards paragraph 2.81(f), we have already commented on Cendant's stated intention to maintain both the RAC and Green Flag brands. We concluded that the most profitable strategy for Cendant would be to segment the market, differentiating the brands as much as possible and thus minimizing competition between the two (see paragraph 2.70). In particular we do not expect that they would compete for significant intermediary accounts.

Entry

2.105. Turning to the question of recent and prospective entrants (paragraph 2.81(g)), the entry of Direct Line is a potentially important development. The company appears to have the necessary ingredients for success in the direct retail channel: a well-known brand name in a related field; a large (2 million) existing customer base in its motor insurance business; experience of the breakdown services market through its role as an intermediary over many years; and a distinctive strategy based on risk-related pricing. It built up sales at a rate of about 14,000 a month in the first six months after its launch as a direct supplier. Continuation of this rate of progress, added to the customers it had already acquired as an intermediary, would give it 250,000 to 300,000 direct retail customers by May 1999, a year after its launch. This may be compared with Green Flag's 540,000 direct customers and would represent a significant impact on the market. Direct Line told us that it was winning most of its new customers from the AA and RACMS, although some were people who had not previously had breakdown cover.

2.106. A degree of caution must be exercised, however, for the following reasons:

- (a) Direct Line will not necessarily continue to grow its customer base at the initial rate: the AA commented that those joining in the first few months would be the easiest to recruit because they were obviously disposed to switch to a new supplier.

- (b) Customers have to be retained as well as recruited. It is impossible to say at this stage how successful Direct Line will be in this regard.
- (c) Direct Line has invested a substantial sum (around £5 million) on its launch as a breakdown organization. It has also given 50 per cent discounts for breakdown cover to its existing motor insurance customers as a promotional offer. It remains to be seen whether the costs will be justified by the size and profitability of the business won.
- (d) Direct Line told us that, despite its heavy advertising, only 15 per cent of the customers recruited in the early months were not already its motor insurance customers.
- (e) Direct Line does not intend to target the intermediary channel, where Green Flag is market leader. It is unlikely, in any case, that it would be seen as an acceptable supplier by other financial institutions.

In view of these factors it is unlikely that Direct Line will achieve the same presence as Green Flag in the discretionary segment as a whole, even if its entry into the direct retail channel is successful. We do not believe that Direct Line can be relied on to bring sustained competitive pressure to bear on the AA and RACMS/Green Flag, at least in the short- and medium-term future.

2.107. On the general subject of entry, it is not difficult to assemble the physical components needed to offer an insured breakdown service (insurance underwriting, call-centre facilities and a network of breakdown contractors). The barriers to entry consist of the need for brand strength and the ability to recruit customers. The history of the last 10 to 15 years indicates that, in the direct retail channel, entry in itself is not difficult but building up sales to a significant level is much harder. This appears to be due to consumers' need for reassurance in buying what they see as a form of emergency or distress service and the great advantage that the AA and RAC brands enjoy in this regard.

Consumers' ability to switch to the intermediary channel

2.108. This brings us to the point in paragraph 2.81(h). Faced with the difficulty of building direct retail sales, Green Flag and other smaller breakdown organizations have sought to develop the intermediary channel, taking advantage of the brand names and customer lists of the intermediary organizations. This has succeeded to the extent that about a fifth of sales in the discretionary segment are now made through intermediary schemes.

2.109. Green Flag is the leading supplier to the intermediary channel. RACMS is the third biggest supplier and the AA does not compete. The merged group would have over 50 per cent of intermediary sales, whether measured by numbers of vehicles covered or by revenue. Mondial and Britannia are the other significant suppliers but both are niche players, Mondial with its focus on retaining customers initially acquired through motor manufacturer schemes and Britannia not having expanded far beyond its CSMA base. Europ Assistance also has a small presence. Entry barriers are lower than in the direct retail channel. Nonetheless some intermediaries attach importance to the brand name of the breakdown organization which supplies services to their customers, and all are likely to look for a supplier with a proven record of service and a good reputation. Moreover financial institutions which enter the market as breakdown organizations are unlikely to be seen as acceptable suppliers by competing institutions.

2.110. The merged group would be in a strong position to increase the already high proportion of sales which RACMS and Green Flag achieve in these channels. Cendant would be able to deploy the two brands to the maximum commercial advantage. RACMS would be a stronger performer under Cendant's ownership, with a lower cost base. Although we believe that the merged group would not compete on price against other suppliers in the direct retail channel, it is more likely to do so in the intermediary channel: this part of the market is more price sensitive; moreover the way it operates, through competitive bidding or negotiations for contracts, makes it easier to compete on price without undermining the price structure for other sales. Given the attractions of increasing membership numbers in this way, we would expect Cendant to follow such a strategy, particularly through the Green Flag brand. While consumers might gain some short-term benefits as a result, the longer-term effect would be to make the market less competitive by marginalizing the smaller suppliers, particularly since, as we have already indicated, we believe that the merged group would use the two brands to cover the market more widely without competing with each other. The ability of the intermediaries to exercise buyer power depends on there being credible alternative suppliers. For the reasons set out above, we believe that the merger would weaken the position in this regard and that the merged group would dominate the intermediary sales channel.

2.111. It is, in any event, important to remember that direct retail remains by far the biggest channel, with four times as many vehicles covered as in the intermediary channel, despite the more favourable prices available through intermediary schemes. Intermediary sales are growing faster than direct retail but the relativity between them is changing only slowly. Even though we see them as being in the same segment of the market, there is a 'stickiness' in the extent to which competitive conditions in one channel feed through into the other which we cannot ignore. The point is demonstrated by the continuing ability of the AA to refrain from competing in the intermediary channel.

The possibility of a duopolistic structure emerging

2.112. On paragraph 2.81(i), the two main suppliers would between them have nearly 90 per cent of sales in the discretionary segment if the merger proceeded. In the short term they would have different interests from each other, which might reduce the risk of duopolistic behaviour. In the medium to long run, however, the AA and Cendant would be likely to find themselves more equally matched and operating under similar cost conditions. Further gains in market share for either of them would have to come mainly from the other. In the absence of a strong third force we would expect that their shared interest in maintaining a high-priced market would be likely to prevail.

Conclusions on the discretionary segment

2.113. To sum up our assessment of the merger's effects on the discretionary segment, we are clear that Green Flag has been, and still is, an important competitive force in this part of the market. Its loss as an independent third force would significantly weaken competition (see paragraph 2.96).

2.114. The merger would create a potentially stronger second force to compete with the AA, at least in the short term. This is not, however, so important a consideration as might appear at first sight. The AA is not so powerful and efficient that only a merger between its two largest rivals could provide an adequate counterweight to it (see paragraphs 2.97 and 2.100). Rather, we believe that RACMS has great strengths of its own. Now that it is being managed in a more commercial manner and is owned by shareholders, we would expect it to be able to compete successfully against the AA whether the merger goes ahead or not (see paragraph 2.101).

2.115. One other aspect we have addressed is whether competition from smaller suppliers or from recent entrants would offset the loss of Green Flag as a separate force. While Direct Line and Mondial, in particular, are potentially effective competitors in their chosen parts of the market, the history of the industry leads us to expect that neither these nor other players would be able quickly to attain a position comparable with that achieved by Green Flag in the direct retail sales channel. The barriers represented by the brand strengths of the two market leaders and the heavy marketing expenditure needed to build direct retail sales would be formidable (see paragraph 2.107). The market remains highly concentrated and the merger would make it even more so. Moreover we have formed the view that the merged group would dominate the intermediary sales channel (see paragraph 2.110).

2.116. We expect that, in the longer term, the relationship between the AA and the merged group would become duopolistic and that their shared interest in maintaining a high-priced market would prevail (see paragraph 2.112).

2.117. We believe, therefore, that the weakening of competition resulting from the merger in this segment of the market would on balance have adverse consequences in the medium to long term. There would be less downward pressure on prices than if RACMS and Green Flag remained in separate ownership. In the same way there would be a reduced impetus for improved service quality and for the leading suppliers to find innovative ways of gaining competitive advantage.

Effects on the non-discretionary segments

Mandatory schemes

2.118. As stated in paragraph 2.35(c), the mandatory segment consists largely of schemes under which four substantial insurance companies offer a bundled product which embraces both motor insurance and breakdown cover. From the suppliers' standpoint, therefore, the segment has some similarity with the intermediary sales channel, where some of the leading wholesale customers are also insurance companies. Moreover as with the intermediary channel, the AA chooses not to compete. Indeed the share of supply of mandatory sales held jointly by the merging parties (85 per cent by sales revenue) is higher than for any other sales channel. It would be misleading, however, to see this in isolation: Mondial, Britannia and Europ Assistance, which are suppliers in the intermediary channel, might also be seen as credible suppliers for mandatory schemes, subject to some of the qualifications expressed in paragraph 2.109. Moreover RSA has recently entered this part of the market, with a service under the name FirstAssist (see paragraph 4.45).

2.119. The main difference between the intermediary and mandatory channels is that brand strength has less importance in mandatory schemes because the purchase is not a discretionary one by the end-user. To that extent, barriers to entry are lower in this channel. In other respects, however, our analysis of the merger's effects is similar as between the two channels. We therefore take the view that the merger would weaken competition in the mandatory sales channel with the same effects as those outlined in paragraph 2.117.

Motor manufacturer schemes and fleet buyers

2.120. Green Flag's share of sales to motor manufacturers is, and always has been, small (currently about 4 per cent by sales revenue). RACMS is the leading supplier, with the AA a strong second. However, the most striking development recently has been the expansion of

Mondial, whose share of sales is expected to rise to about 20 per cent in 1999 as a result of recent successes (see paragraph 2.50(c)).

2.121. The motor manufacturer channel is characterized by the presence of strong buyers which use competitive purchasing techniques. Although prices have been low compared with other sales channels, the business is attractive to breakdown organizations. This is partly because costs are also low: customer acquisition costs are well below those for direct retail sales, as are call-out rates (see paragraph 2.37). In addition there is usually an opportunity, when the period of cover of the motor manufacturer scheme ends, for the breakdown organization to seek to recruit the motorist as a direct retail or intermediary member.

2.122. Green Flag told us that it [

Details omitted. See note on page iv.

] is [☞] a potential competitor in this part of the market. In our view the merger would cause the loss of this potential competition since we do not believe that Cendant would allow its two brands to compete keenly for the same accounts. However, given the factors described in the previous paragraph, and the development of Mondial as an effective third force, we have no major concerns about the merger's impact in this channel.

2.123. The structure of supply to fleet buyers is similar to the direct retail channel, with the AA by far the leading supplier, RACMS in second place and Green Flag, at around 7 per cent by value, being the only other supplier with a significant presence. The reason for this structure in the case of fleet sales appears to be due partly to brand strength and preference for a liveried patrol service and partly to fleet buyers' view that only a substantial operator would be capable of meeting their needs.

2.124. Three large fleet operators expressed concern to us that the merger would weaken competition for their business among suppliers and put upward pressure on prices. Two of these operators also expressed a fear that, if they placed their business with the merged RACMS/Green Flag, confidential information about them might be passed to their main competitor, PHH, which Cendant already owns. One of them was also concerned that PHH would be able to buy breakdown cover on preferential terms from within the Cendant group.

2.125. In assessing these comments we need to take account of buyers' natural reluctance to see a reduction in the number of suppliers even if the competitive situation would remain strong. In this case, however, there are some grounds for sharing the concerns expressed. Mondial is concentrating its efforts on the motor manufacturer segment, whilst Direct Line is focused on direct retail sales. Other small suppliers appear not to be seen as having credibility by fleet buyers.

2.126. Although fleet buyers have potential purchasing power by virtue of the number of vehicles they operate, there would be a modest, but not insignificant, weakening in their position as a result of the merger. As we have said, we do not believe that the separate continuation of the RAC and Green Flag brands under the same ownership would prevent a real reduction in competitive choice. Substantial fleet operators are, however, familiar with the motor industry. If they were to find themselves disadvantaged by a weakening in competition, we believe they would be well placed to seek out and foster alternative sources of supply. We note that there are no significant barriers to entry into the non-discretionary segments of the market in terms of physical resources or investment requirements. In this respect we see a distinction between fleet buyers, on the one hand, and the buyers in the intermediary channel on the other. We therefore consider that the merger would not have adverse effects in the fleet channel.

2.127. As to the concern expressed about confidentiality, Cendant told us that it was used to dealing with this issue. It would be prepared to give assurances to customers about the protection of their information and to set up systems to ensure they were kept. We take the view that it would not be in Cendant's interests to jeopardize its reputation as a supplier of breakdown services by misusing information for the benefit of PHH. Nor are we persuaded that PHH's ability to obtain breakdown cover on favourable terms would confer a significant competitive advantage on it.

Effects on garage contractors

2.128. It is difficult to predict with confidence what the merger's effects on the workload of garage contractors would be. Cendant told us it expected that contractors would continue to service all Green Flag call-outs and broadly the same proportion of RACMS's call-outs as now (that is, about 20 per cent). We estimate that Green Flag and RACMS together currently account for about half of all the jobs which contractors do for breakdown organizations and about a quarter of their total breakdown business after allowing for uninsured work.

2.129. The position is complicated, however, by Cendant's plans to contract out part of the RACMS patrol force, probably through franchising. Some existing garage contractors are expected to become franchisees and to employ RACMS patrol members alongside their existing work. The consequences of this development are inevitably uncertain but it is likely to lead to the franchisee-contractors becoming closely oriented to the merged group.

2.130. Other breakdown organizations expressed fears that Cendant would become a dominant purchaser of contractors' services. This would enable it to enter into exclusive agreements with many of the better contractors. Alternatively Cendant might drive down the rates which RACMS and Green Flag paid to contractors: this would cause contractors to increase charges to other customers. As a result, they maintained, the ability of other suppliers to compete effectively in the supply of insured breakdown services would be compromised.

2.131. Cendant emphasized that the purpose of franchising out part of the patrol force would be to reduce fixed costs and increase flexibility. To enter into exclusive agreements with contractors would pull in the opposite direction because it would entail giving minimum workload guarantees and the whole of an exclusive contractor's costs would have to be recovered from Cendant business. Apart from requiring the liveried resources of franchisee-contractors to be used solely to service RACMS call-outs (subject, possibly, to the occasional exception for Green Flag), Cendant had no intention of seeking exclusive agreements with contractors. If necessary it would be prepared to give an undertaking not to enter into agreements of this kind.

2.132. As regards rates of remuneration, Cendant's plans for the merged group envisage a reduction in contractor costs as a result of enhanced buyer power but the saving was put at [⌘] per cent. Cendant argued that in order to secure good service from contractors it would need to pay competitive rates, otherwise the contractors would give priority to organizations which paid more.

2.133. We can see some theoretical attraction for Cendant in exclusive agreements. They would enable the merged group to build a closer relationship with contractors and to differentiate its services from those of other breakdown organizations which depend on contractors, whilst depriving competitors of access to some of the best contractors. The strength of the merged group as a buyer of contractors' service would be such that, if it chose to press for exclusive agreements, the impact on the breakdown services market could be significant. For example, it is likely that, in those circumstances, the AA would also seek

to sign up a network of high-quality contractors through exclusive agreements. (The AA's current experiment with agreements which give it the right to reserve some of the capacity of particular contractors for its own use at times of peak demand might be the first signs of a move in this direction: see paragraph 5.20.) Although entry barriers in garage contracting appear low, this would have undesirable consequences in terms of weakening the position of smaller breakdown organizations, at least in the short term.

2.134. In the light of Cendant's evidence, however, we do not expect that it would seek to require contractors—other than any which might solely operate vehicles in RACMS livery as a result of franchising—to work exclusively for the merged group.

2.135. Apart from the AA's pilot study involving the reservation of particular vehicles (see paragraph 5.20), we did not come across any evidence of the main players making exclusive agreements with garage contractors. We have found that the proposed merger could not be expected to result in Cendant making such agreements and it would be beyond the scope of this reference for us to investigate the matter any further. Nevertheless, we do consider this to be a matter of potential concern. We suggest that the DGFT keeps it under review. If it comes to his attention that such exclusive agreements are being used in the industry and are having adverse effects, he should consider using his powers under the Fair Trading Act 1973 or (if then available) the Competition Act 1998.

2.136. As regards the concern that Cendant might cut the rates of its payments to contractors for call-outs (see paragraph 2.130), we do not believe that Cendant's buyer-power in relation to contractors will be such as to free it from the need to pay a market rate for their services, albeit towards the low end of the range which is likely to exist. Moreover, unless exclusive agreements become widespread, the market is likely to remain competitive. It would not, therefore, follow that contractors could recoup any loss of income resulting from lower Cendant payment rates by raising charges to other insured customers.

Effects on breakdown services for heavy vehicles

2.137. Breakdown services for heavy vehicles are supplied largely through organized POU arrangements. The two elements of service, therefore, are call-centre facilities and roadside attendance. Both Green Flag and RACMS provide the former, arranging for contractors to provide the latter. The contractors are garages and dealers specializing in heavy vehicles, some large operators of heavy vehicle fleets and some vehicle manufacturers.

2.138. The main customers of the POU services provided by Green Flag and RACMS are vehicle manufacturers, who in turn arrange for drivers of their vehicles to be able to access the services when a breakdown occurs. Green Flag's principal customers are Iveco-Ford and Scania, whilst RACMS's are Leyland-DAF and Mercedes. However, RACMS is about to lose the [⌘] business because [⌘] intends to provide its own service.

2.139. Concern was expressed to us by two dealers that the merger would eliminate competition between the two leading suppliers of breakdown services for heavy vehicles. We note, however, that the AA is also a supplier, albeit on a smaller scale. Moreover given the limited scope of the breakdown service which Green Flag and RACMS are providing, entry barriers are low. It would not be difficult for the larger vehicle manufacturers to set up a service themselves, as [⌘] is doing. Smaller manufacturers could make arrangements with a call-centre operator, of which there is no shortage. We are not troubled, therefore, by the merger's impact in this market.

Effects on the timeshare exchange market

2.140. We received representations from Interval International Limited (Interval), which operates in the timeshare exchange market, that the merger would restrict its choice of suppliers of insured breakdown services and thus weaken its ability to compete with Cendant in the timeshare exchange market (see paragraphs 5.162 to 5.166). We note, however, that Interval does not at present offer breakdown services as part of its service packages for timeshare customers. It does not seem to us that the offer of breakdown services is a major element affecting competition in the timeshare exchange market and we consider that the issue does not justify our making a separate public interest finding.

Effects on employment

2.141. Part of the £[§] million savings which Cendant would expect to realize if the merger proceeds is due to planned reductions in employee numbers. It foresees reductions arising from rationalization of call centres and marketing and IT functions, and from [§] [§]. Cendant said that the overall effect was difficult to assess at this stage but would probably be of the order of [§] jobs (about [§] per cent of the combined total of the two organizations). There would also be [§] *Details omitted.* See note on page iv.]

2.142. We discussed earlier the likely consequences of the contracting out of part of the RACMS patrol force. Cendant and RACMS told us that there had been no talks with the Transport and General Workers' Union (TGWU) or the workforce itself about this but it was well known that franchising out was likely following the merger and there was no groundswell of concern about this prospect. RACMS showed us the results of a recent survey of its employees, carried out by MORI, which showed that morale was high despite the uncertainties of the current situation. The TGWU told us that the merger would be of substantial benefit to RACMS's members, customers and employees: it believed the additional volume of work would protect 200 patrol jobs and 300 support jobs.

2.143. We received two anonymous letters appearing to be from RACMS staff members, one of which said it was sent on behalf of 'concerned RAC patrols'. This letter argued that franchising out of RACMS patrols would lead to their demise, since it would become more economical to use contractors.

2.144. It is not clear to us that patrol jobs would be protected by the merger. In view of Cendant's statements that contractors would be likely to perform about the same proportion of RACMS jobs as now, and that it sees the need to improve the efficiency of the patrol force, some reduction in numbers seems likely. It is also likely that there would be a mismatch between patrol members willing to become franchisees (or to join franchisee-contractors) and the patrols which Cendant would want to franchise out. Moreover the terms and conditions applying to employees of franchisee-contractors could be expected to be quite different from those applying to RACMS employees and in some respects (for example, as regards pension arrangements) less attractive. On the other hand franchising would open up new possibilities for the employees affected.

2.145. In considering effects on the public interest we have to take into account that the likely reduction in the number of jobs brought about by the merger, and the changes in the nature of some jobs which would remain, are the other side of the coin of efficiency gains. RACMS itself recognizes the need for efficiency improvements in the patrol force and it appears to us likely that some of the changes which Cendant has in mind to introduce would take place even if the merger did not proceed. [§] *Details omitted. See note on page iv.*

] On balance, therefore, we do not see the merger's consequences for employment, in themselves, as being contrary to the public interest.

Cendant's financial position and prospects

2.146. We summarized in paragraphs 2.12 to 2.15 the discovery of fraudulent accounting in the former CUC and subsequent developments. We have addressed two issues arising from this episode: first, whether Cendant was tainted by the fraud and should not be accepted as a fit and proper organization to acquire RACMS; and secondly, whether its financial position and prospects had been damaged to the extent that it might not be able to fund the RACMS business properly if the merger proceeded.

2.147. On the first point, it is clear that the fraudulent activities all took place within former CUC businesses. Cendant assured us that all the employees concerned had left. All the former CUC board members have also left, with the exception of one non-executive. It appears to us that the former HFS management, which is now in sole charge of Cendant, acted very properly following the discovery of the fraud. Clearly the SEC has closely supervised the process which Cendant has undertaken to cleanse the company of the effects of the fraud and to re-establish its reputation.

2.148. As regards the financial outlook, Cendant continues to generate substantial amounts of cash. Its gearing is low and it has curtailed its acquisitive instincts pending the full restoration of confidence. We attach importance to the views of the credit-rating agencies, which will have carried out exhaustive investigations, that Cendant's debt continues to qualify for an investment grade rating. This is despite the uncertainty which hangs over Cendant as a result of the lawsuits (see paragraph 2.14) and which is unlikely to be resolved for some time.

2.149. For the reasons set out in paragraphs 2.147 and 2.148, we are satisfied that Cendant should not be seen as an unsuitable acquirer of RACMS on grounds of probity or financial position.

Benefits of the merger

2.150. Cendant submitted that the merger would benefit competition for the reasons summarized in paragraph 2.53. In particular the merger would result in the creation of a stronger competitor to the AA; would bring new value-added services to consumers; and would bring more motorists, who were currently uninsured, into the market for insured breakdown services.

2.151. We have considered these arguments in addressing the merger's effects on competition. They have to be weighed against the adverse effects which we believe would flow from the loss of Green Flag as a separate competitive force.

2.152. Some of the cost savings which Cendant envisages are attributable to the bringing together of RACMS and Green Flag and, to a lesser extent, other parts of the Cendant group. This applies in particular to the rationalization of call centres and IT functions and [*Details omitted. See note on page iv.*]. Some of the other savings, for example from improving the efficiency of the patrol force, would be likely to be achieved without the merger, at least in part. Efficiency gains resulting from the merger should be accounted as benefits to the public interest only to the extent that they might be expected to flow through to consumers. That in turn would be affected by the merger's overall impact on competition, and in view of our conclusions in that regard we believe that most of the benefits would not flow through (see paragraph 2.117).

Conclusions

2.153. It will be evident that our principal concerns about this merger surround competition in the discretionary and mandatory segments of the market in insured breakdown services for light vehicles (see paragraphs 2.113 to 2.119).

2.154. As regards the other segments of that market, we believe that competition for motor manufacturer business will still be keen (see paragraph 2.122). Although we are less sanguine about supply to fleet operators, we believe the buyers would be able to safeguard themselves against the effects of any weakening in competition for their business (see paragraph 2.126).

2.155. The merger would put Cendant in a strong position as a buyer of contractors' services and we would regard any move on its part to enter into a network of exclusive agreements as potentially damaging to competitors in the supply of breakdown services. It is not, however, our expectation that Cendant would adopt such a policy (see paragraph 2.134).

2.156. We do not believe that the merger would cause adverse effects in the supply of breakdown services for heavy vehicles (see paragraph 2.139). Nor do we see the merger's consequences for employment as contrary to the public interest (see paragraph 2.145).

2.157. We have carefully considered the ramifications of the accounting irregularities uncovered by Cendant and subsequent developments. Whilst doubts remain as to the full consequences because of the outstanding lawsuits, in our view these doubts are not such as to justify a conclusion that Cendant would be an unsuitable acquirer of RACMS (see paragraph 2.149).

2.158. We have taken the view that, despite a short-term sharpening of competition for the AA, the overall effects of the merger would be on balance to weaken competition and that this would have adverse consequences in the medium to long term (see paragraphs 2.117 and 2.119). The merger offers the prospect of some efficiency gains but, in view of our finding on the competition effects of the merger, we believe that the benefits are unlikely to be passed on to consumers. In any event we consider that the harm which the merger would cause to competition outweighs the value of the expected efficiency gains.

2.159. We conclude that the merger may be expected to operate against the public interest with the following specific adverse effects, namely that in the supply of insured breakdown services for light vehicles prices would be higher, service quality lower and innovation reduced compared with the situation which would otherwise exist. These adverse effects would apply in the discretionary and mandatory segments of the market which together account for some 85 per cent of total revenue from the supply of these services.

Recommendations

2.160. Where we have found that a merger situation operates or may be expected to operate against the public interest, we are required by section 72(2) of the Act to consider what action, if any, should be taken for the purpose of remedying or preventing the adverse effects which we have identified and may, if we think fit, include recommendations as to such action.

2.161. The adverse effects which we foresee would result from the bringing together of the second and third largest suppliers of insured breakdown services for light vehicles, and the consequent loss of the dynamic benefits of competition. There are no behavioural under-

takings which could remedy this loss: in particular, we do not believe that an undertaking by Cendant to operate the RAC and Green Flag brands separately would be an adequate substitute for competition between them as independent businesses in separate ownership.

2.162. The supply of insured breakdown services for light vehicles is by far the main activity of both RACMS and Green Flag. A remedy which entailed only the divestment by Cendant of part of one of the two companies is not, therefore, practicable. We conclude from this that the only adequate remedy is for RACMS and Green Flag to be kept in separate ownership.

2.163. We have not, however, formed the view that Cendant would be an unsuitable owner for RACMS. It would therefore be acceptable for Cendant to acquire RACMS as long as it was prepared to divest Green Flag. We put this possibility to Cendant on a hypothetical basis at our two hearings with the company. [

Details omitted. See note on page iv.

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2.164. Against this background, we recommend that, before acquiring RACMS, Cendant should undertake to divest Green Flag, in a manner and to a party approved by the DGFT, such divestment to take place within six months of the undertaking being given. The divestment should include all the elements of Green Flag which are necessary for it to continue to be an effective competitor in the market for insured breakdown services for light vehicles. Depending on the circumstances, the sale might also need to include UKI, NPC's in-house insurance company which underwrites Green Flag's insured breakdown services business. If Cendant is not prepared to give such an undertaking, the merger should be prohibited.