

# 6 Views of the main parties

## Contents

	<i>Page</i>
Introduction .....	134
Cendant .....	134
Background to the bid .....	134
Cendant's business strategy .....	135
Jurisdictional and legal issues .....	136
The market for insured breakdown services .....	136
Direct retail sales channel .....	137
Intermediary sales channel .....	138
Motor manufacturer sales channel .....	140
Mandatory sales channel .....	140
Fleet sales channel .....	141
Green Flag .....	141
RAC Motoring Services .....	142
Plans for the two businesses .....	142
Barriers to entry and expansion .....	144
Future of the RAC Motoring Services liveried patrols .....	145
Garage contractors .....	146
The timeshare exchange market .....	147
Prices .....	147
Quality of service .....	148
Innovation .....	148
Employment .....	148
Benefits from the proposed merger .....	149
Remedies .....	149
RAC Motoring Services .....	150
Background to the bid .....	150
The future role of RAC Motoring Services .....	151
Cendant's bid for RAC Motoring Services .....	152
Jurisdictional and legal issues .....	152
The market for insured breakdown services .....	152
Direct retail sales channel .....	153
Intermediary sales channel .....	154
Motor manufacturer sales channel .....	155
Fleet sales channel .....	155
Barriers to entry and expansion .....	155
Future of the RAC Motoring Services liveried patrols .....	156
Garage contractors .....	157
Prices .....	158
Quality of service .....	159
Innovation .....	159
Employment .....	159
Cendant's financial strength and fitness .....	159
Benefits from the proposed merger .....	160
Remedies .....	161

## Introduction

6.1. This chapter summarizes the views of Cendant and RACMS, the main parties in the inquiry, which were presented in written submissions and at hearings. Views attributed in this chapter to RACMS were given to us on behalf of both RACMS and its ultimate holding company, RAC Holdings (see paragraphs 3.13 to 3.15).

## Cendant

### Background to the bid

6.2. Cendant told us that it operated primarily in three businesses: property, travel and alliance marketing. Its two predecessor companies, HFS and CUC, had been active in Europe before merging to form Cendant. Their merger, and subsequent acquisitions such as NPC, had accelerated Cendant's expansion into Europe, for which the UK was the natural springboard.

6.3. Through its acquisition of NPC, Cendant had gained access to several million regular customers of National Car Parks and about 550,000 Green Flag customers. Green Flag had about 2.3 million members but most had joined through intermediary schemes so it did not own the membership data. This limited the scope for cross-marketing. NPC was an important entry point to the UK consumer market but Cendant always envisaged making additional acquisitions, both to obtain sufficient membership numbers for its cross-selling operations and to purchase a well-recognized brand name in a related market to Green Flag.

6.4. The possibility of purchasing RACMS was unknown to Cendant when it planned the NPC acquisition. But when the opportunity arose, there were obvious attractions. In particular:

- (a) Cendant believed the RAC brand had not been fully developed. Application of Cendant business techniques would realize its full potential.
- (b) There was considerable scope for synergies between RACMS and other Cendant businesses which, if fully realized, would provide cost savings of about £[§] million.
- (c) The RAC brand was differently positioned to Green Flag's. Cendant could therefore offer a choice of breakdown products to customers.
- (d) It would increase Cendant's UK membership by 2.5 million, giving greater scope for data mining (see paragraph 6.12(d)) and cross-marketing.
- (e) Cendant already had experience in the breakdown and wider automotive services market in the USA, through its AutoVantage programmes, and experience of operating broader vehicle-related businesses in the UK, such as PHH. Cendant understood the sector and recognized the scope for expanding RACMS's product offerings [  
*Details omitted. See note on page iv.*  
].
- (f) In the light of the scope for savings and business enhancements, the purchase price for RACMS was attractive to Cendant, providing both the opportunity to enhance its UK vehicle-related business and a bridgehead for further expansion into Continental Europe.

## ***Cendant's business strategy***

6.5. Cendant told us that it was innovative in ways which would provide advantages after the merger. In particular, the business model would:

- (a) enable RACMS to provide a more efficient and greatly enhanced service to its customers;
- (b) enable Cendant to maximize the value of the RAC and Green Flag brands by targeted cross-marketing of both breakdown services to other Cendant customers and other Cendant products to RACMS customers; and
- (c) enable Cendant to achieve further economies of scope in retailing multiple services in the UK, thereby reducing costs both in Green Flag and RACMS.

6.6. Cendant told us that its core skills were in developing and managing consumer brands; cross-selling branded products; identifying and implementing operating efficiencies; and managing consumer databases.

6.7. Cendant had developed a portfolio of strong brands (including the Howard Johnson and Ramada hotel chains, the Coldwell Banker, Century 21 Real Estate Corporation and the ERA franchise system property businesses). It leveraged brands in one area to support and develop brands in other, related business areas.

6.8. In the USA Cendant had consumer membership programmes which had operated for many years in areas such as travel and credit card protection. In return for annual subscriptions, members received benefits sold through affinity networks, mainly credit card companies. Cendant marketed the programme to the affinity partner's members and paid commission to the affinity partner.

6.9. Cendant operated in most European countries but its main European base was the UK where it already had complementary vehicle-related businesses in NCP, Green Flag and the vehicle management business of PHH. Through its alliance marketing division it was also involved in bank account enhancement programmes, credit card protection and accidental death insurance. There were about 4 million members of such programmes in the UK of which 75 per cent were members of credit card protection schemes. The schemes were marketed through, and under the brands of, leading banks. In addition Cendant's US businesses had UK members, for example RCI (a timeshare business) had 200,000 UK members. The Avis Rent-A-Car brand was licensed to a third party in the UK and while Cendant had no direct influence over the business's UK operations, the close relationships of the UK operation, the US licensee and Cendant were very likely to facilitate cross-marketing in the UK.

6.10. RACMS would benefit from these related businesses and would play a significant part in Cendant's further strategic expansion.

6.11. Cendant told us that its methods of multiple brand management and franchising were pro-competitive. It had built up a presence in various markets through acquiring competing brands, then managing them independently in an intensively competitive corporate culture. All subsidiaries were set rigorous performance targets and competed as vigorously against each other as against non-Cendant brands. This benefited consumers, both at retail and wholesale level.

6.12. Cendant told us that cross-marketing the products of one part of the business to customers of another was a key element in its success. It had been, and would continue to be, more successful than many other operators in cross-marketing. Cendant attributed this to four factors:

- (a) Cendant offered customers for one product an opportunity to purchase another product on favourable terms *at the moment of the transaction*, when they were most likely to be predisposed to make another related purchase. This achieved high penetration and take-up rates.
- (b) In each sector, Cendant aimed to acquire (or rapidly develop) at least one strong, well-recognized brand. It was vital to the success of any cross-marketing programme that a customer was offered a product of recognizably high quality.

- (c) The width and depth of Cendant's business allowed it to maximize its chances of offering potential customers exactly the sort of complementary product or service which they were most likely to buy.
- (d) Cendant had considerable expertise in the use of data mining technology, which it defined as the semi-automatic discovery of patterns, associations and changes in large data sets. The larger the data set, the more associations and patterns could be discovered, and the more accurately it was possible to predict the behaviour of a given sample. Cendant told us that data mining could result in improved customer acquisition, retention and loyalty and was particularly useful in identifying opportunities for cross-selling or 'up-selling', that is persuading people who made contact with its sales force to purchase additional products or levels of service.

6.13. Cendant emphasized that, in addition to its own products and services, it also marketed those of third parties. An example was the NetMarket website, a huge on-line shopping mall where consumers could purchase a range of goods and services from a variety of suppliers including Cendant and even some of Cendant's direct competitors.

6.14. Cendant had also established a network of 'preferred alliance' partnerships with other businesses through which it negotiated preferential rates for goods and services and passed on savings directly or indirectly to its business partners and the ultimate customers.

### **Jurisdictional and legal issues**

6.15. Cendant accepted that arrangements are in progress or contemplation which, if carried into effect, would result in the creation of a merger qualifying for investigation within the meaning of section 64(8) of the Act because enterprises carried on by or under the control of Cendant would cease to be distinct from enterprises carried on by or under the control of the RAC or RAC Holdings (of which at least one is carried on in the UK) and the value of assets to be taken over exceed £70 million.

### **The market for insured breakdown services**

6.16. Cendant did not accept that the supply of insured breakdown services for light vehicles in the UK represented a single economic market. It saw a very clear distinction between sales to individuals (which equated with the MMC's definition of the discretionary segment) and at least some aspects of the non-discretionary segments (ie motor manufacturer and mandatory schemes). Non-discretionary offerings of breakdown services bundled with other products did not in any way constrain the prices of discretionary offerings and, therefore, were part of a separate economic market.

6.17. Cendant pointed out that:

- (a) overall, the whole market had grown by almost three-quarters over the last ten years, yet over the same period the direct retail sales channel had declined in relative importance by a third;
- (b) almost half of the total growth in the industry had come from motor manufacturer schemes, which had more than doubled as a proportion of total coverage; and
- (c) the share of coverage provided through intermediary and mandatory schemes had nearly quadrupled.

6.18. About 22 per cent of all insured breakdown services were now given away by motor manufacturers with the sale of a new or used vehicle and a further 6 per cent by banks or insurers with other products. This had obvious implications for the direct retail sales channel, reducing the number of potential customers and increasing the average age of vehicles and thus the risk profile.

6.19. Cendant said that, as well as introducing powerful new alternative suppliers, the move towards providing breakdown services free of charge had increased the volatility of the market by increasing the number of occasions on which individual motorists were likely to reconsider their choice of breakdown services provider.

6.20. Cendant considered that significant changes over the last five years included moves towards increased outsourcing of elements of breakdown service provision by breakdown organizations; the development of a 'wholesale' market, partly as a result of further expansion and evolution of the intermediary and motor manufacturer sales channels; the entry of new players with strong brands into the industry; moves towards 'own-labelling'; the improvement of the AA's already strong position in the two largest sales channels (direct retail and motor manufacturer); and the decline of RACMS, which was losing ground in both channels to the AA.

6.21. Whether all sales to individuals were examined or only the direct retail channel, the AA had maintained well over 50 per cent of this part of the market for the last five years, putting it in a very strong position compared with its competitors. Its share of sales to individuals over that period had consistently been at least double that of RACMS and four times that of Green Flag. While the success of the AA might owe something to consumer inertia, Cendant had little doubt that it was due to the historic strength of the AA brand and the skill with which its value had been maintained through well-designed advertising campaigns.

6.22. Green Flag's share of direct retail sales was the same as it had been six years ago: indeed between 1994 and 1997 the number of vehicles covered by Green Flag's direct retail policies had fallen by 4 per cent. Green Flag did not have a strong consumer brand name or a large customer database. Furthermore, the growth of its sales to individuals through intermediary schemes had slowed: between 1996 and 1997, such sales grew by less than 10 per cent of the average annual growth rate for the preceding five years. Overall Green Flag had remained static in direct retail; established no real presence in the motor manufacturer channel; and just held its own in the intermediary channel.

6.23. We put to Cendant that over the last ten years RACMS had been squeezed between the AA, which had exploited its brand very effectively, and Green Flag, which had competed on a value-for-money strategy. Cendant noted that although Green Flag appeared to have won some members away from RACMS during the period of its most rapid expansion in the late 1980s and early 1990s, there was no more recent evidence of a general movement towards Green Flag from RACMS comparable with the observable movement of RACMS members towards the AA. More generally, as the overall growth of insured breakdown services slowed down during the 1990s, the weakness of RACMS became clearer.

6.24. We also put to Cendant the picture that emerged from the RAC group corporate plan (see paragraph 6.136) of Green Flag and the AA as RACMS's two key competitors. Notwithstanding that RACMS now realized it had overestimated Green Flag's strength in direct retail sales, this perception suggested that Green Flag had punched above its weight and exercised greater competitive influence on the market than might have been expected purely from its market share. Cendant did not accept this analysis. Green Flag had exercised competitive influence in two ways—by competing on price and by innovating—and others were now exerting similar influence. For example, Direct Line and others were competing on price. Direct Line had introduced risk-based pricing and Mondial had pioneered the delivery of breakdown services by dedicated patrols using the brand and livery of motor manufacturers.

### ***Direct retail sales channel***

6.25. Cendant pointed out that the most significant competition in the direct retail channel had been between the AA and RACMS, with RACMS consistently losing ground over the last five years. Green Flag was a distant third with 6 per cent of this sales channel. The AA's share of this channel was growing and Cendant saw no basis for concluding that Green Flag had any significant impact on

conditions of competition between the AA and RACMS. Without the merger, it was more likely that the market strength of the AA and relative weakness of RACMS would operate to the detriment of consumers. To the extent that there was an existing AA/RACMS duopoly, the evidence of the last few years suggested that Green Flag would be unlikely to make any further substantial progress in breaking it down.

6.26. Cendant did not accept the view put to us by RACMS that as many as 90 per cent of all direct retail customers were interested only in having a service provided by liveried patrols. It accepted that the true figure would be high, although it would depend on how the question had been put in market research. The figure was more likely to be around 70 to 75 per cent. Evidence of Direct Line's success over the preceding six months showed that the absence of liveried patrols was not a significant inhibitor of growth.

6.27. Cendant considered the crucial competitive issue in the direct retail sales channel to be brand strength. Green Flag had a better recognized brand than other breakdown organizations apart from the AA and RACMS. However, Green Flag found that there was a strong correlation between levels of marketing expenditure and levels of brand awareness: awareness fell when expenditure fell. Thus Cendant considered that it would not be difficult for others to replicate Green Flag's degree of brand awareness.

6.28. Cendant said that the decision by well-established players in related markets to compete strongly in the breakdown services market was significant because they already had the consumer brand name and existing customer loyalties that would enable them more effectively to challenge the AA and RACMS. The recent entries, to the direct retail sales channel by Direct Line (which claimed to have acquired 70,000 retail members between its launch in May 1998 and late September that year), and to other sales channels by Volkswagen and RSA, were likely to stimulate other, similarly-placed companies to consider entering.

6.29. Cendant argued that there was a significant group of customers who regarded direct retail as their primary and perhaps their only method of buying insured breakdown services, particularly in relation to the AA and RACMS products, partly because of the brand proposition of those products. However, they also considered that there was a degree of substitutability between the direct retail and the intermediary channels.

6.30. We put to Cendant that the data suggested Green Flag had in fact been quite successful in gaining direct retail customers but had been less successful in retaining them. Cendant agreed but added that it was difficult to judge, considering the heavy investment which Green Flag had made in promoting the brand, how successful it had been in acquiring new retail customers profitably. Cendant intended to decrease some of the expenditure on acquiring customers and instead to invest more on activity aimed at retaining customers. However, market research commissioned by Green Flag indicated that retaining customers, especially after their first year of membership, was very difficult in some cases—for example, in one sample group approximately half of those switching from Green Flag to another breakdown organization were 'forced' to do so by virtue of their purchase of a new car or motor insurance policy.

### ***Intermediary sales channel***

6.31. Cendant stated that the intermediaries, as originally conceived by providers of insured breakdown services, were simply inexpensive marketing channels through which a larger number of retail customers could be reached. However, intermediaries increasingly behaved like retailers of any other commodity product or service. Their ability to sell breakdown services at a discount made them a significant pro-competitive force, both by acting as a restraining influence on direct retail prices and by providing a route to market for potential entrants into the direct retail sales channel.

6.32. We put to Cendant that some intermediaries had told us their customers attached importance to the brand name of the breakdown services provider and asked whether Green Flag had found this a difficulty in winning business in the intermediary channel. Cendant said that, while Green Flag

encouraged intermediaries to give prominence to the Green Flag brand in their marketing and promotional activities, there was a trend for intermediaries increasingly to prefer the services to be provided under their own names. Cendant did not consider, therefore, that third parties relied on the Green Flag brand, nor did the AA and RACMS, despite their strong brands, enjoy any particular advantage over other operators in the intermediary channel.

6.33. Asked if it saw the supply of breakdown services through intermediaries as a commodity that sold mainly on price, Cendant agreed that there was a trend towards commoditization and that price was increasingly the major determinant. The challenge was to add value in other ways and Green Flag would benefit from being able to offer a range of Cendant's products and services.

6.34. On the importance of owning customer databases, Cendant said that while ownership presented the best opportunities for cross-marketing and obtaining additional revenues, it was also possible to negotiate access to a database owned by an intermediary (which would then become, in Cendant terms, an alliance partner) in return for commission based on the revenues generated from sales. Cendant stressed, however, that it was not buying RACMS simply for its database, but as a breakdown services business with 5.5 million members and a valuable but significantly under-exploited brand which fitted well with Cendant's existing UK interests.

6.35. Cendant saw the availability of insured breakdown services through third parties as an important development. The more breakdown services providers widened the number of outlets through which the service was distributed, the more potential competitors they created for themselves at the retail level—each with ownership of its own database.

6.36. Cendant believed that this trend, already widespread in Continental Europe, would continue to grow in the UK. The UK financial services market was highly competitive and increasingly commoditized. There were a number of pro-competitive consequences in the breakdown services industry:

- (a) Corporate customers were becoming larger and their bargaining position would strengthen further as more banks and insurance groups merged and more building societies consolidated.
- (b) Corporate customers ensured effective competition and maximized the benefit to themselves by awarding contracts following competitive negotiation or tender. This was increasingly the case with intermediaries (as it had for long been with motor car manufacturers).
- (c) Breakdown services providers would have to compete vigorously for third party schemes to avoid becoming dependent on a small number of contracts. Currently Green Flag's top ten intermediary customers accounted for [§] per cent of its total revenues from insured breakdown services.
- (d) The intermediary's customers were in nearly all cases 'owned' by the intermediary. If the intermediary switched provider, the previous provider could not seek to market to, and retain, the old customers on a direct retail basis. Moreover, just as winning a corporate customer could result in a rapid accretion to premium income, so losing a corporate customer could have rapid negative impact on revenues. For example, the loss of RSA business as a result of the formation of FirstAssist would result in Green Flag losing over £[ § ] of premium income over a two-year period.
- (e) Pricing transparency was reduced. Each third party scheme was individually negotiated and terms were usually kept confidential.
- (f) Banks and financial services companies that currently acted as intermediaries or wholesalers for a breakdown organization might decide to offer the service themselves.

6.37. We put to Cendant that the loss of Green Flag as a separate competitive force in the intermediary sales channel would weaken competition and cause prices to edge upwards. Accepting that there were strong buyers in this channel, Green Flag was easily the biggest supplier by a significant margin.

6.38. In response, Cendant argued that Green Flag's relatively high share of this sector reflected not that 40 per cent of ultimate consumers chose a Green Flag product over others but rather that the intermediary had selected Green Flag on the basis of competitive tendering or negotiation. Large market shares in this sales channel were inherently more vulnerable than in direct retail. Furthermore, after the merger strong intermediary purchasers would have a choice of suppliers, for example Europ Assistance, Britannia, GESA and others, as well as Green Flag and RACMS which were not always invited to tender for the same intermediary business. Cendant also considered that, although the AA did not currently focus strongly on this sales channel—in part because the insurance companies which made up a significant proportion of the corporate customer base perceived the AA as a competitor because of its insurance business—there was no reason why it should not be a viable competitor in this sales channel, particularly where the intermediary was not an insurer.

### ***Motor manufacturer sales channel***

6.39. Cendant noted that when, at the end of the 1980s, motor car manufacturers began to offer breakdown services to purchasers of new cars for between one and three years at no extra charge, this was the first significant bulk purchasing and marked the beginning of a wider wholesale market for insured breakdown services.

6.40. Motor car manufacturers had significant bargaining power. Because of the large number of vehicles involved and the smaller risk of vehicle failure in new cars, manufacturers had been able to purchase coverage at highly competitive rates. Furthermore, they had sought to maximize their bargaining position through rigorous tendering procedures. Four of the top ten manufacturers had switched service providers and in general manufacturers were increasingly ready to switch.

6.41. Cendant also noted that motor car manufacturers were prepared to use unbranded suppliers such as Mondial. Indeed, the growing preference, particularly on the part of Continental European car manufacturers, for the breakdown services to be identified with their own brands actually favoured such suppliers.

6.42. Furthermore, manufacturers were increasing the length of warranties (and thus the period of free breakdown cover), further reducing the size of the direct retail sales channel. Increasingly they were considering awarding contracts on a pan-European basis, for which Europ Assistance and Mondial had a natural competitive advantage over all the major UK providers.

6.43. Green Flag had no real presence in the motor manufacturer channel, with only one main contract. Mondial was a considerably more significant competitor, having won four of the last seven tenders. [

*Details omitted. See note on page iv.*

]

### ***Mandatory sales channel***

6.44. Cendant considered this sales channel to be of marginal significance. It was very small, containing only three schemes of any significance (a fourth was in the process of being in-sourced and, Cendant thought, converted into an optional scheme by the intermediary, RSA). All three schemes were for insurance companies which also operated intermediary schemes and the mandatory policies generally gave the ultimate customer an optional opportunity to upgrade the cover. Overall, Cendant considered that this sales channel had more in common with the motor manufacturer channel, given that there was no separate consumer purchase and there were strong competitive constraints on the market behaviour of the leading providers. Entry by consumers to mandatory schemes was, if not completely non-discretionary in the sense that entry to motor manufacturer schemes was, then much less discretionary than entry to direct retail or an intermediary scheme.

6.45. In a hearing, Cendant acknowledged that the mandatory sales channel was important for Green Flag at the moment. However, it was not likely to grow fast. Indeed, Cendant questioned

whether this channel would even continue much longer. Insurance, and particularly motor insurance, was increasingly seen by consumers as a product to be bought on price. If insurers were looking for ways to keep their prices keen, it seemed likely that they would unbundle elements like breakdown services which added to the 'headline' price of their products.

6.46. We put to Cendant that mandatory schemes had more in common with intermediary schemes than motor manufacturer schemes, on the basis that the breakdown services element of a mandatory scheme represented a far greater proportion of the price of a motor insurance bundle than it would with the price of a new car, and therefore was more likely to be a discretionary purchase. Cendant agreed with this, but said that it was true only at the margins. Incident rates in Green Flag's mandatory schemes suggested that customers had a low awareness of their entitlement to breakdown services and therefore that the consumer probably had not exercised discretion in making the purchase.

### ***Fleet sales channel***

6.47. Cendant agreed with us that the schemes whereby fleet operators bought insured breakdown services on an organized POU basis (and these formed the majority of all fleet schemes) should be included within our definition of insured breakdown services because of their similarity in all other respects to the insured product. However, Cendant did not regard fleet schemes as forming part of a wider market or segment.

6.48. We put to Cendant the concern of some fleet operators that the merger would weaken competition by reducing from three to two the number of credible suppliers, given the importance to fleet buyers of dealing with a substantial organization. Cendant began by noting that the provision of breakdown coverage was only a peripheral element within the package of services offered by fleet management companies. Cendant also said that for fleet operators the critical component was service rather than size of supplier. Cendant's own fleet company, PHH, had used Green Flag and the AA and service had always been the main criterion for selection. In any event fleet operators would still, after the merger, be able to choose the AA, Green Flag or RACMS.

6.49. We also put to Cendant the fears expressed to us by two fleet companies about confidentiality: they were competitors of Cendant-owned PHH for fleet management services and after the merger could also be customers of Cendant-owned RACMS/Green Flag for breakdown services. Cendant said that it was used to guarding against the compromise of confidential customer information in its other businesses and had never received any complaints. It was ready to make commitments on confidentiality and to set up mechanisms to ensure that it carried them out; however, as providers of breakdown services to fleet customers, Green Flag and RACMS would probably not even have any relevant confidential information on them.

### **Green Flag**

6.50. Cendant told us that it had analysed Green Flag's development and considered the following factors to be relevant to our inquiry:

- (a) Green Flag's experience showed that it was relatively easy to access or build a national network of garage contractors and appropriate call-centre facilities.
- (b) It was possible for organizations without strong consumer brand names or an existing customer database to enter the market by selling breakdown services to organizations that did have one or both of these advantages.
- (c) Lack of a strong consumer brand or an existing relevant customer database made it more difficult to penetrate further the direct retail sales channel.
- (d) A small but significant proportion of customers looked beyond the AA and RAC brands.

- (e) Other competitors were able to take full advantage of Green Flag's innovative achievement in opening up the market by selling through intermediaries and using a network of contractors to provide the breakdown services.

## **RAC Motoring Services**

6.51. Cendant told us that it had identified a number of factors about RACMS's business which it considered relevant to our inquiry:

- (a) The RACMS business was different from the Green Flag business in that it had an extremely well-recognized brand name, reinforced by 100 years of history; it operated on a larger scale, with nearly three times as many members; and it was substantially bigger, relatively, in direct retail sales. It therefore 'owned' many more of its customers—or at any rate had the right to market its services and those of its affiliated companies to more of them—than did Green Flag.
- (b) Despite these considerable advantages, RACMS had consistently lost customers and market share in nearly all sales channels in recent years. Yet recognition of the RAC brand was still as high as would be expected of an organization with about the same market share as the AA. Cendant had no doubt that more effective management of the RAC brand and assets and application of proven Cendant marketing techniques would reverse this trend.
- (c) Cendant had identified significant cost savings that would arise as a result of synergies between RACMS and other Cendant companies.

6.52. Cendant regarded RACMS as a business with scope to develop, for example:

- (a) in terms of service delivery its speed of response had been slower than other breakdown organizations;
- (b) its well-known brand had not been utilized effectively, in particular the recent repositioning seemed unfocused in terms of presenting an identifiable selling proposition for RACMS and the brand had not been effectively differentiated from the AA;
- (c) it was increasingly inefficient in its use of labour, for example call-centre staff each handled only 3,500 incidents a year compared with Green Flag's 5,100 incidents each a year; and
- (d) it lacked clear, progressive and measurable productivity and performance objectives.

## **Plans for the two businesses**

6.53. Cendant told us that earlier in the acquisition process it had considered dropping the Green Flag brand. However, it was increasingly clear that a significant group of customers preferred a value-for-money service. The Green Flag brand would therefore be retained and differentiated to appeal to such customers. It 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 services 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 offered by RACMS.

6.54. Cendant's and RACMS's call centres could be combined to reduce costs significantly, though it would still be possible to distinguish between calls from motorists who were customers of RACMS, Green Flag or others (intermediaries and motor car manufacturers) and to respond differently as appropriate. [ *Details omitted. See note on page iv.* ]

There would also be rationalization of headquarters activity across the Cendant group in the UK. Functions of PHH and RACMS in supplying accident management services would be combined. RACMS's Europe call centre would be relocated from France to the UK or Ireland. The RACMS and Green Flag IT systems would be combined in a more cost-efficient system. The BSM business would be rationalized and managed more effectively to improve service levels and market penetration. Cendant would be likely to take the RACMS patrol fleet off the balance sheet: see paragraphs 6.72 to 6.77. Finally, there would be more effective marketing of RACMS, Green Flag and other Cendant products using the techniques described in paragraph 6.12.

6.55. Cendant noted the growing importance of ITS. Experience in the USA suggested that competition in the provision of response-centre facilities would come chiefly from major telecommunications operators and call-centre specialists. The level of investment required for providers of insured breakdown services to develop in this area, and to compete with such financially strong market entrants, was only affordable if amortized over a substantial customer base. Cendant expected the merger to achieve sufficient critical mass to support active participation in the telematics market.

6.56. We noted that Green Flag's latest budget, prepared in March 1998, proposed a continuation of the strategy to make Green Flag a major player in the UK assistance business before the turn of the century and that the business goals of its insured breakdown services business were to continue as a dependable and large generator of cash and profits and to become number two in terms of number of members, overtaking RACMS. Cendant told us that it would not be possible for Green Flag to achieve an increase in membership to overtake RACMS in that time-frame, certainly not profitably and certainly not under current competitive pressures. The broad objectives of the plan had originated before Cendant's acquisition of Green Flag and so did not reflect Cendant's strategy of consolidation and its multi-brand approach. Cendant's goal was to become number one in the market and it wanted to do this by taking members from competitors as well as from the uninsured portion of the market. Under Cendant's ownership, Green Flag and RACMS would compete for new contracts.

6.57. We put to Cendant that we had formed the view that Green Flag had been successful in the last 10 to 15 years, building up sales and market share in the face of very strong, entrenched brands yet also making reasonable profits. Cendant said that it generally accepted this view.

6.58. We told Cendant that we found its rather negative analysis of Green Flag's prospects (for example, as set out in paragraph 6.25) was not generally supported by the Green Flag internal documents we had seen. We detected a more bullish view within Green Flag than was now being presented to us by its new owner. Cendant acknowledged that its analysis was harsher and more cautious than Green Flag's. Green Flag had not been so successful in the direct retail channel as in the intermediary channel, [ *Details omitted. See note on page iv.* ]. Moreover the market dynamics had changed in the months since the merger was proposed and the recent advances made by competitors justified Cendant's more cautious approach to Green Flag's prospects.

6.59. Cendant said that, so far as competition with the AA was concerned, there would be a number of additional significant differences between it and the merged company, which would stimulate competition. In particular:

- (a) RACMS and Green Flag would be part of a listed company accountable to shareholders for its performance. The AA as a mutual society had different business incentives.
- (b) The AA's cost structures would be very different from those of RACMS and Green Flag: in particular, the merged company would probably have a significant component of outsourced fleet provision.
- (c) As Cendant companies, both RACMS and Green Flag would have responsibilities to cross-sell other products. Their own product ranges would in turn be cross-sold by other Cendant businesses. Such products were likely to include a broad range of travel and leisure services. The AA's primary other business was motor insurance, which gave access to a different customer base and different forms of selling pressure.

6.60. We asked Cendant to comment on the view that, given the RAC group's restructuring (away from mutuality) and also the strength of the RAC brand, RACMS should, even without the merger, be a tougher competitor than in the past. Cendant said that the RAC group restructuring had been carried out in contemplation of the acquisition. Without the transaction with Cendant, a highly leveraged management buyout was likely. This would make RACMS a much weaker competitor.

6.61. We put to Cendant a possible scenario in which the merged RACMS and Green Flag initially competed vigorously with the AA. One result of such a struggle could be that other suppliers would withdraw and a comfortable duopoly would then emerge. Cendant said that the merged company would continue to compete. Its growth would have to come from the AA. Furthermore, if the AA and Cendant both generated high returns, more competitors would be attracted to enter the market since barriers to entry were low.

6.62. We also put to Cendant the proposition that the market after the merger would be less attractive to new entrants. Cendant noted that to the extent that barriers to entry existed in the industry, they mostly related to brand strength in direct retail: the merger would not make that any more of an obstacle for new entrants. If anything, the merger appeared to have encouraged new entrants, since its announcement in May 1998, to pursue their entry strategy with increased enthusiasm (for example, Direct Line; Cendant noted also the competitive refocusing of the AA). Cendant also commented that under the ownership of any group like Cendant, RACMS would be a more viable competitor and so a merger would enhance competition against a very strong market leader. In fact Cendant's ownership would make RACMS especially competitive because of the investment it would make in human resources and technology, in addition to the particular skills Cendant would bring to the enterprise.

## **Barriers to entry and expansion**

6.63. Cendant submitted that technical barriers to entry were low and that the recent history of the industry indicated successful entry and growth in all sales channels except, until recently, direct retail. In this sales channel, the strength of the AA brand, and to a lesser degree the RAC's, had been a barrier to expansion for those providers of breakdown services which did not have comparative advantages in the direct retail sector. This was now changing through the entry of competitors with consumer brands in related markets or a large customer database.

6.64. On the three components required to provide insured breakdown services, Cendant made the following comments:

- (a) *Call centres.* Rapid technological development over the last decade and the massive increase in call-centre operators meant that this capability was no longer a unique advantage to RACMS and the AA. Many major banks and insurers now had such facilities. They could be established with minimal investment and if necessary could be outsourced.
- (b) *Network of garage contractors.* It was not necessary to have a force of directly employed, liveried patrols. Setting up a network of garage contractors was relatively easy, even for small players. Set-up costs were low and there were numerous existing players to whom the function could be outsourced. There were approximately 2,000 to 3,000 contractors in the UK, most of a sufficiently high quality to provide a service for breakdown organizations. Capacity was not a problem, not least because it was available to be bought from organizations such as Europ Assistance. Payments were usually on a per-job basis, minimizing the fixed costs of the breakdown organization.
- (c) *Insurance.* The insurance function was not a significant barrier to entry, even for suppliers of insufficient size to provide it efficiently on their own, since cover could easily be arranged through numerous brokers or underwriters.

6.65. As set out in paragraphs 6.27 to 6.29, Cendant had a different view of barriers in the direct retail channel. The AA brand was extremely strong and its reputation had been well-maintained and strengthened by expensive and sophisticated advertising. Separate advertisements for breakdown

services and insurance had jointly contributed toward strengthening the AA's brand image. The RAC brand was also well recognized but lacked the AA's coherence and focus. Green Flag and other entrants had found it difficult to expand in the direct retail channel because their brands lacked such consumer recognition. Direct Line's was the first attempt to enter the direct retail channel by a new player with real consumer brand strength in a closely-related market. The success of this venture to date might well encourage other potential new entrants in a similar position to enter the market.

6.66. Cendant added that traditional notions of brand and brand extension were eroding fast: for example, high street retailers were now selling financial services. So in the intermediary sales channel it was quite possible to use a brand which was not connected with breakdown services or cars.

6.67. Cendant did not accept the view of a third party that Direct Line's current half-price offer to people taking its motor insurance was a sign that its drive to sell breakdown services was proving less successful than it hoped. For the first time, Direct Line was appearing in the market research as one of the reasons why Green Flag customers were not renewing.

6.68. We asked Cendant why, if barriers to entry were so low, no competitor other than Green Flag seemed have been particularly successful. Cendant said that there was no pattern of consistent Green Flag success across the whole market, which suggested that it was not a competitor on anything like the scale of RACMS, let alone the AA. There were other competitors developing very successfully in their chosen niches: Mondial, for example, had already far exceeded the performance of Green Flag in its impact on the motor manufacturer sales channel.

6.69. Cendant did not expect the competitiveness of Green Flag to be diminished as a result of the merger. But even if this were to happen, market conditions were now such that other players such as Direct Line would soon assume whatever role Green Flag might have fulfilled as a significant competitive force on pricing or service innovation. Direct Line's advertisements were already clearly and successfully targeting the mass market of AA and RACMS customers. Factors such as risk-based pricing were going to affect the market whether or not the merger took place. Asked whether it was too early to judge Direct Line's ability to replicate Green Flag's success, Cendant acknowledged that in six months it was difficult to assess ultimate success. However, Cendant thought it was entirely likely that others would follow Direct Line's lead: its success would engender more rather than less competition. Direct Line had been quoted in the press in June 1998 as saying that, contrary to its expectations, the market for breakdown services was not dogged by inertia and apathy; indeed the reverse seemed to be true.

6.70. We put to Cendant the concern of third parties that the increased strength of the merged group would make it much easier to make life difficult for the smaller players, for example by competing on price in the short term. Cendant pointed out that the small breakdown organizations had been in the market for some time, were operating at low scales now, but were owned by powerful parent companies that could if they wished follow Direct Line's example. It also questioned whether such a tactic would be profitable, since the low entry barriers meant that it would be easy to re-enter when prices rose again.

6.71. We asked Cendant to what extent a requirement to invest in modern technology in breakdown vehicles could become a barrier for new entrants wanting to use garage contractors. Cendant contended that there was not the same need for sophisticated technology in a contractor network as in a liveried fleet. The main requirement was for efficient communications systems: telephone, fax or RAM mobile data system. Cendant also observed that both RACMS and the AA had invested heavily in technology but had to recover the investment by charging more to customers for premium services. The provision of such premium telematics services might in the future be one of the points of differentiation between the RACMS and Green Flag brands.

### **Future of the RAC Motoring Services liveried patrols**

6.72. Cendant told us that it was committed to maintaining an RACMS patrol fleet, serving at least broadly the same proportion of RACMS's 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. Cendant's preferred option was to restructure the patrol force, partly because the fleet in its present form 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 full-time employed staff on its payroll.

6.73. Cendant told us that 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: 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 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 after the merger in order to maximize cost efficiency and quality of service.

6.74. 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 be little changed.

6.75. 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 RACMS livery, franchised patrols would be exclusive to Cendant and would largely do RACMS call-outs, although they might exceptionally attend Green Flag customer breakdowns as well. But an operator with an RACMS franchise might have several vehicles, some in RAC livery and some not: Cendant would not prevent such franchisees from working for other breakdown organizations.

6.76. We put to Cendant the strong doubts expressed by contractors about the viability of having a number of vehicles reserved for only one category of work. They needed maximum flexibility to deploy their resources most efficiently at times of peak pressure. Cendant responded that contractors might view this differently if they realized that the liveried vehicles would come with a commitment to a stream of business or geographic exclusivity.

6.77. Cendant told us that there had been no talks with the TGWU or the workforce itself about contracting-out but it was well known that franchising was likely following the merger and no concerns had been expressed about this prospect.

## **Garage contractors**

6.78. 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).

6.79. We asked why Cendant proposed to do this when the data suggested that contractors were more expensive than patrols. Cendant said that there were two important differences between the Green Flag and RACMS models: the variable costs of contractors as opposed to the fixed costs of a patrol force; and different call-out rates (Green Flag's was lower than RACMS's). Cendant's strategy would be to preserve the essential characteristics of the two brands (one patrol-based and one contractor-based). This might mean reduced profit in the short term but this was acceptable in the interests of achieving Cendant's strategic objective of having two viable breakdown services brands.

6.80. We raised with Cendant the fears of many contractors that breakdown organizations were moving towards wanting exclusive arrangements with the bigger contractors. Cendant emphasized that

the purpose of franchising part of the RACMS 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. This would be contrary to the nature of the 'franchise environment' which Cendant operated in its other businesses: this model only worked so long as both sides saw it as beneficial. Asked how it would respond if, for example, the AA started tying up contractors in this manner, [ *Details omitted. See note on page iv.* ]. It believed there were sufficient good-quality contractors to choose from. If necessary it would be prepared to give an undertaking not to enter into agreements of this kind (see paragraph 6.101).

6.81. As regards rates of remuneration, Cendant's plans for the merged group envisaged a reduction in contractor costs as a result of enhanced buyer power but the saving was put at [  $\approx$  ] 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 that paid more.

### **The timeshare exchange market**

6.82. We put to Cendant the representations from Interval, which operated 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 5.164). Cendant submitted that Interval did not currently offer breakdown services as part of its service packages for timeshare customers and that take-up of breakdown services by timeshare customers was in any event not high. Furthermore, Interval already enjoyed considerable protection under a recent ruling by the US Federal Trade Commission about the terms on which Cendant must compete with it in the timeshare market.

### **Prices**

6.83. In describing to us Green Flag's pricing and discount policies for retail sales over recent years, Cendant said that the AA list prices acted as a ceiling on what other suppliers could charge and Green Flag had to offer a sufficient discount to the AA price. Questioned about this at a hearing, Cendant told us that Green Flag had now moved away from being a discount brand (for which the discount had to be significant, perhaps [  $\approx$  ] per cent below the AA price) to become a value-for-money brand which meant setting list prices just below the AA (which produced a very significant discount for households with more drivers than cars). However, the market was changing quickly and Green Flag had to take account of other factors besides the AA. For example, in order to meet the threat from Direct Line with its low, risk-based pricing strategy, [ *Details omitted. See note on page iv.* ]. However, Green Flag would not follow other players to the extent of incurring unacceptably high acquisition costs for unprofitable customers.

6.84. We observed that, in general, prices for direct retail sales had risen more slowly in the past few years than in the late 1980s and early 1990s. We put to Cendant that the AA and RACMS had reacted to Green Flag's sales growth by holding down prices. Cendant did not accept this. The steeper price rises of the late 1980s and early 1990s occurred in a period in which direct retail call-out rates rose slowly; and the market itself had changed so much in recent years that it would be simplistic to say that Green Flag had had a significant effect in its own right on constraining prices in the direct retail sales channel.

6.85. Cendant told us that its goal was to grow the value of its businesses, subject to making a reasonable return, and to maximize gross contribution per customer. Cendant did not seek to increase profits in the short term simply by raising prices. Such an approach would run entirely counter to Cendant's business philosophy, which was always to be the price/value leader in any market segment it entered.

## Quality of service

6.86. We noted that the AA took seriously Green Flag's challenge on establishing 'time to attend' as a major criterion of service quality. The AA had taken action to improve its own average time to attend and objected to what it saw as Green Flag's misleading advertisements on the subject, securing a decision from the Advertising Standards Authority in its favour. We put to Cendant that this demonstrated Green Flag's impact on quality of service. Cendant acknowledged that Green Flag had made an impact but pointed out that there were many alternative influences on quality in the market, for example several other breakdown organizations, such as Britannia and Direct Line, had now followed Green Flag's lead in prioritizing speed of attendance at breakdowns; and the AA appeared to be trying to establish roadside fix rates as a key performance indicator. It was likely that a stronger RACMS would have more impact on the AA than would Green Flag under any circumstances. Cendant was well placed to strengthen RACMS, at the same time as it ran Green Flag as its value-for-money brand.

6.87. We put to Cendant that, since the AA and RACMS patrols achieved higher fix rates than did garage contractors, any franchising or subcontracting of RACMS patrols after the merger could result in a reduction in service levels. Cendant said that there were difficulties in defining fix rates and in comparing them on a like-for-like basis. After making allowances for these factors, it estimated that the Green Flag fix rate was about 60 per cent, around ten percentage points below RACMS's (for patrols and contractors combined). It did not follow, however, that subcontracted service delivery after the merger would by its nature be inferior. Any franchised or subcontracted elements of the RACMS liveried patrols would be subject to the same rigorous technical specifications and quality control standards as the wholly-owned and -employed patrols. Furthermore, it would not be in Cendant's interests to maintain a network which underperformed the perceived market leader on fix rates if such rates were to become a key measure of service quality.

## Innovation

6.88. Cendant acknowledged that Green Flag had been a significant innovator in the past. It had led the way with setting up and training a network of garage contractors and introducing new routes to market, particularly the intermediary sales channel. However, much of the more recent innovation was coming from others. Direct Line, for example, had been innovative in introducing risk-based pricing. This was likely to lead to a competitive market where real prices did not rise but suppliers had to provide more and more value; and Mondial had introduced breakdown services for motor car manufacturers using the manufacturers' own livery.

6.89. While not denying that Green Flag had played a role as innovator, Cendant did not accept that that role could not be filled by others after the merger. Green Flag's success today was more a symptom than a cause of dynamic change in the market. The future competitiveness of the market, and in particular the direct retail channel, would be more secure in the longer term if RACMS was run more efficiently and its product offering differentiated and enhanced in the ways proposed by Cendant. Furthermore, Cendant would contribute to innovation through investment in technology and make the benefits available to both the RACMS and Green Flag brands. This would in turn exert pressure on all the other competitors to become more effective.

## Employment

6.90. Cendant told us that efficiency gains from the merger would result in some job losses but it was too early to give firm estimates. [

*Details omitted. See note on page iv.*

]

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

[

*Details omitted. See note on page iv.*

]

6.92. [

*Details omitted. See note on page iv.*

]

## **Benefits from the proposed merger**

6.93. Cendant submitted that the proposed merger would have no adverse effects on competition but would give rise to a vigorous, cost-efficient, competitive force that would apply highly successful sales techniques and strategies from Cendant's experience in the USA.

6.94. Green Flag and RACMS would become distribution channels for a very much wider range of Cendant products. The consumer's subscription to either organization would buy access to an ever-increasing range of value-added services. The increased potential contribution from each consumer would incentivize RACMS and Green Flag to win business. Cendant believed that the number of UK consumers able to benefit from these services would automatically increase by several million if the merger went ahead. These developments would have a positive influence on the overall conditions of competition in the UK market for insured breakdown services. These benefits outweighed any notional loss of competition between RACMS and Green Flag. There would be no loss of consumer choice: Green Flag would remain distinct as a differentiated value-for-money brand and would continue to compete with existing suppliers.

6.95. There was no history of co-operation between players in the industry and Cendant intended, in accordance with its business philosophy, that the merged company would compete strongly with the AA and others. Cendant aimed to stop the loss of business from RACMS and regain customers whenever possible, in particular from the AA. This was essential if RACMS and Green Flag were to achieve Cendant's objective of maximizing its customer database in the UK.

6.96. The industry was changing rapidly. The growth of motor manufacturer and intermediary schemes at the expense of direct retail; the increasing desire of third parties such as motor car manufacturers to promote their own brands; the entry of players with strong consumer brands from other markets; the introduction of risk-based pricing; and the development of new technology all put existing competitors under pressure to innovate and compete strongly.

6.97. Cendant firmly believed the proposed merger would not operate against the public interest. On the contrary, it would operate in the public interest by giving customers the opportunity to take advantage of broader product offerings and by leading to the introduction of techniques that would create a more dynamic competitive force which would stimulate a strong competitive response from the AA and new and growing market players.

6.98. We put to Cendant the view that, in light of its need to restore investor confidence as soon as possible, it might seek short-term returns from RACMS. Cendant said that its market credibility would be built up gradually over time and it was not in the business of inflicting damage on RACMS for a quick return. RACMS was a substantial long-term investment. Cendant's goal in the medium term was to realize £[§<] million synergies and thereafter to grow the cash flow by [§<] per cent a year.

## **Remedies**

6.99. On the hypothetical basis that the proposed merger was held to be against the public interest, Cendant was asked about a number of possible remedies. Its views on these are set out below.

6.100. On the possibility of being required to divest Green Flag, [

*Details omitted. See note on page iv.*

].

6.101. Cendant said that it was prepared to give an undertaking not to enter into agreements or arrangements with garage contractors that required the contractors to work exclusively for Cendant (whether under the Green Flag or RAC names) or to give Cendant undue priority over other suppliers of breakdown services. Cendant confirmed that such an undertaking would apply also to the business of contractor/franchisees (where those franchisees also did unlicensed business). However, Cendant pointed out that neither Green Flag nor RACMS had any exclusive arrangements now and it was not part of the business plan to do so in the future.

6.102. Given the obvious difficulty of preventing the use of purchasing power in a commercial situation, we asked Cendant how such undertakings might be made to work in practice. Cendant suggested that one method might be through a code of practice that could be enforceable either through undertakings or under the provisions of the new Competition Act.

6.103. As to Cendant giving an undertaking that the merged group would continue to offer an annual average of some specified percentage of its call-outs to garage contractors, Cendant said that it would continue to use contractors for a similar percentage of the merged company's business as at present (100 per cent for Green Flag and over 20 per cent for RACMS). However, it would be hard to give an undertaking as to a specific proportion.

6.104. On the possibility of giving an undertaking that RACMS and Green Flag operations would continue to negotiate terms and conditions with garage contractors as entirely separate activities, Cendant said that while it intended to manage and promote the two brands separately, such an undertaking would not allow the synergy benefits to be derived from combined purchasing power after the merger.

6.105. Cendant saw no difficulty with giving an undertaking that it would continue to manage and promote Green Flag as a separate brand, since that was its intention anyway. Asked for how long such a commitment might be made, Cendant said that it would not make business sense to commit itself to a period longer than three to five years, but it was willing to give an undertaking for a period that everyone could agree was reasonable.

## **RAC Motoring Services**

### **Background to the bid**

6.106. RACMS told us that for some time the RAC group had faced a predicament. The RACMS business was built on providing breakdown services predominantly through a network of dedicated patrols with the skills and technical resources to solve the motorist's problems speedily and effectively at the roadside.

6.107. The investment required to provide such a service was considerable and increasing: for state-of-the-art call-centre and dispatch facilities to support the patrol force; and for developing software solutions to equip patrols to diagnose and fix faults in the electronic equipment characteristic of modern cars. Additionally, in the future heavy investment would be required in telematics.

6.108. The costs of such investment had ultimately to be borne by RACMS's members. If RACMS was to provide industry leading standards of service, enabling it to compete effectively with the much larger AA, it would have to build its subscriber base to amortize its IT software and other investment costs over a larger number of subscribers.

6.109. A new Chief Executive arrived in late 1995 when the business was facing a loss, having budgeted a profit, and fairly fundamental changes were recognized to be needed. The group's small motor insurance broker (RAC Insurance Brokers Ltd) was identified as being sub-scale and was sold in 1996 to Guardian Direct. The RAC group considered, but due to insufficient financial resources was unable to proceed with, the acquisition of Green Flag. Instead, it acquired BSM, which made a limited contribution to solving RACMS's problem of scale by presenting opportunities to extend the membership base to include newly-qualified drivers. BSM's skills and technology were also of potential application to RACMS's insured breakdown services business.

6.110. However, RACMS recognized that its core market, insured breakdown services, was in cyclical decline. It therefore sought to expand its horizons to include non-traditional activities: to focus more on mobility issues and the associated technology. And RACMS came to recognize that, after 100 years of mutuality, it needed to restructure so as to have access to capital markets, to be able to establish joint ventures and to attract world class players as partners.

### ***The future role of RAC Motoring Services***

6.111. As far as the future was concerned, RACMS emphasized the importance of ITS which were being developed using advanced information, communications and control systems linked to homes and cars. The Government placed priority on the development of systems to achieve optimal use of congested roads and of intermodal transport (as set out in its White Paper, *A new deal for transport: better for everyone*).

6.112. RACMS saw a need to reposition and to invest to be able to respond to the radical changes that ITS would bring and to its members' increasing concern with mobility issues: delayed and disrupted journeys, traffic congestion, and availability of car parking and interconnections.

6.113. Until recently, RACMS's core business had been to provide help with roadside incidents once they had occurred, through the call centre and liveried patrol system. That activity—on which the RAC brand, identity and reputation were based—would continue.

6.114. But RACMS believed that it must also be in a position to provide multimedia call-centre services to the mobility market. If it did not do so, RACMS believed that evidence from overseas markets (especially the USA and Germany) showed that it risked relegation to the status of subcontractor to the telematics service providers. If successful, it could increase its customer base (notably among the more affluent users of journey information services), and cross-market other products to customers on the database.

6.115. To establish this position, RACMS needed to update and reposition the RAC brand and identity (a process which had already begun) and develop closer ties with motor manufacturers in order to develop joint products and obtain access to an installed base of customers (including motor manufacturer and fleet customers as well as direct customers). It also needed to find partners with access to capital, relevant technology and information products and services with whom to co-operate in the provision of ITS. The RAC group's current strategic plan provided for capital expenditure in this area of some £[§<] million over five years.

6.116. RACMS was unclear to what extent it could successfully make the transition on its own. Whilst it had the benefit of established experience and reputation, its ability to generate profit to support investment and to attract the right partners ultimately depended on the quality and loyalty of its customers—including for this purpose not only the direct retail customer but also the motor manufacturer and fleet customers where RACMS's longer-term position was uncertain.

6.117. In addition to the uncertainties associated with the new ITS market and the wider competitive pressures RACMS was likely to face in that market, it also faced the competitive threat of the AA.

6.118. The AA had already announced its intention to develop a position in the ITS market, and had taken a major step in that direction. The AA enjoyed several competitive advantages. Its existing customer base, especially in the important direct retail channel, was much larger than RACMS's. The AA was therefore better able to support investment in IT and systems. Furthermore, the AA brand was strong, and it already had a range of journey assistance and other products (such as motor and home insurance and home assistance) available to be cross-marketed.

6.119. RACMS told us that it faced a stark choice. The status quo was no longer an option. Without the critical mass of membership which the merger would bring, RACMS would be unable to take on the AA on the same playing field as in the past without changing very dramatically the nature of the business, its services and its levels of employees.

### **Cendant's bid for RAC Motoring Services**

6.120. RACL originally planned to wait at least another 18 months to demonstrate a more compelling track record of profit improvement and growth before deciding the best solution for RACMS. However, in March 1998 there was a boardroom row that led to the dismissal of the then Chairman and precipitated a review of the options open for the future of RACMS. Following full consultation with the relevant members of the Club, the board initiated an accelerated auction process, which included potential trade buyers and institutional and financial buyers. By the end of April 1998, Cendant had emerged as the front runner, both in terms of price and the best fit for the business. Cendant's cash offer, which valued RACMS at £450 million, was considered to represent full value.

6.121. The sale process comprised two stages: a reorganization stage and a disposal stage. The reorganization stage had been effected in July 1998. The disposal stage would not take effect until after the regulatory process had been completed, during which time the total consideration payable by Cendant would increase by an agreed interest-related adjustment calculated from mid-September 1998 up to the effective date of the disposal stage.

6.122. RACMS judged that benefits would result from applying Cendant's skills in call-centre operation; from integrating some RACMS and Green Flag activities (call centres and back-office functions); from applying Cendant's skills in database management to promote cross-selling to RACMS customers; and from increasing RACMS's critical mass (adding approximately 2.5 million customers to the RACMS database and approximately 1 million additional incidents a year to be managed).

### **Jurisdictional and legal issues**

6.123. RACMS accepted that arrangements are in progress or contemplation which, if carried into effect, would result in the creation of a merger qualifying for investigation within the meaning of section 64(8) of the Act because enterprises carried on by or under the control of Cendant would cease to be distinct from enterprises carried on by or under the control of the RAC or RAC Holdings (of which at least one is carried on in the UK) and the value of assets to be taken over exceed £70 million.

### **The market for insured breakdown services**

6.124. RACMS agreed that there was a single market for insured breakdown services but it was not homogeneous. It was divided into several sections with substantial differences between them according to categories of customer or distribution: direct retail, intermediary, mandatory, motor manufacturer and fleet schemes. However, RACMS did not accept that the direct retail and intermediary sales channels constituted one 'discretionary' segment. It argued that this approach would not take account of the differences between, on the one hand, direct retail sales to individuals and, on the other hand, sales to intermediaries which acted as wholesale buyers of insured breakdown services.

In effect these intermediaries branded and sold insured breakdown services themselves, in competition with breakdown organizations for sales to individuals.

6.125. RACMS pointed out that, while it and Green Flag were the second and third players in the market for insured breakdown services, each trailed far behind the dominant player, the AA. Over the market as a whole, the AA covered half as many vehicles again as RACMS, generated 1.6 times the revenue and had three times as many patrols on the road. The discrepancy in size and resources between the AA and Green Flag was even more marked. Together, RACMS and Green Flag were still significantly smaller than the AA, whether measured in terms of revenue, membership or market share.

6.126. RACMS considered that the largest and most important part of the overall market was the provision of insured breakdown services to direct retail customers, ie individuals. This sales channel represented the core of the business of each of the AA and RACMS. But in this channel, the dominance of the AA was even more marked: it had 63 per cent of sales, while RACMS had just 27 per cent, down from 35 per cent a decade ago. Yet the current RAC group strategic plan had identified this sector as being the core of its business, and reversal of its declining fortunes as vital to its longer-term future. Green Flag was not a significant player in the direct retail channel: its market share had been stuck at 5 per cent for the last five years and it had a different customer profile from the AA and RACMS.

6.127. RACMS argued that to look at the transaction in terms of putting together the second and third largest suppliers of insured breakdown services was simplistic and misconceived. In the vital direct retail channel, the proposed merger would not create a stable duopoly: the AA remained too powerful. But it would help to arrest the decline that RACMS had previously faced as the second player in a quality-driven market.

6.128. RACMS considered that there was dynamic competition and change in the market, particularly in sales to corporate customers or to individuals through intermediaries. These indirect sales channels had grown over the last five years by over 70 per cent so as to account for nearly half the total market (by number of vehicles covered). Across the whole of this part of the market, there was evidence of dynamism. Suppliers of insured breakdown services were astute in developing new products and routes to market. Customers had and exercised countervailing market power.

### ***Direct retail sales channel***

6.129. RACMS was concerned that continued decline in membership numbers would eventually undermine the credibility and viability of the liveried patrol force, which was an integral part of its product offering and which already was not ubiquitously available throughout the UK. It would also put at risk the exemption which RACMS enjoyed from the need to maintain solvency margins on its Class 18 insurance business, as defined in the Insurance Companies Act 1982: see Appendix 4.1.

6.130. RACMS told us that a number of features combined to represent its service-based selling proposition in addressing the direct retail channel, including:

- (a) brand association, linked to traditional standards of quality of service and courtesy;
- (b) efficiency of the call-centre service;
- (c) emphasis on repair at the roadside to get the motorist on the way again, rather than on towing to a garage for repair (RACMS achieved levels of roadside repair of around 70 per cent of incidents attended, which it thought was 10 to 15 percentage points higher than the level normally achieved by garage contractors);
- (d) provision of breakdown services by a liveried patrol (roughly 80 per cent of incidents were attended by patrols rather than by the contractors upon whom RACMS relied to supplement its service. A particular attraction was safety and security); and

- (e) price was not a key determinant in the decision of the individual member whether or not to take RACMS membership.

6.131. The selling proposition of RACMS inspired a high degree of loyalty among direct subscribers: over 80 per cent of individual subscribers renewed each year, and of those who did not, a significant proportion left the market for insured breakdown services altogether.

6.132. In all those respects, RACMS's selling proposition corresponded more closely with that of the AA than with Green Flag and other competitors. By contrast, the selling proposition of suppliers of insured breakdown services other than the AA and RACMS tended to emphasize speed of response and price rather than the values identified in paragraph 6.130.

6.133. RACMS's market research showed that the AA and RACMS were both seen to offer a significantly higher quality of service than Green Flag; Green Flag was seen to offer better value for money (though in the overall ranking of priorities, this was less significant than other factors); and all three organizations scored equally well on speed of response.

6.134. Of subscribers leaving RACMS and switching to another provider, over 50 per cent switched to the AA, and vice versa. This was at least twice as high as the levels of switching from the AA or RACMS to Green Flag or any other provider.

6.135. This combination of factors led RACMS to conclude that, for a majority of retail customers, the choice of service provider effectively rested between the AA and RACMS. Those for whom price was particularly significant, and for whom service standards and the values and benefits associated with attendance by a liveried patrol were not so strong, were a minority—perhaps a floating 10 per cent of total direct retail customers—which appeared to be broadly static in overall terms. For this 10 per cent, who preferred a no-frills or cheap-and-cheerful service, the selling proposition represented by Green Flag and others was particularly attractive.

6.136. So while RACMS competed head to head with the AA for the 90 per cent, it did not believe it was in direct competition with Green Flag in this sector. This was despite a section in the RAC group five-year plan, drawn up in 1996, which noted that RACMS's most profitable customers were being won by Green Flag and, to a lesser extent, the AA, and referred to these as RACMS's two key competitors. RACMS told us in a hearing that it now realized it had overestimated Green Flag's presence in the direct retail channel: Green Flag's sales had effectively been stagnant in this channel over the last five years.

6.137. RACMS did not accept that removing Green Flag from the market would open up the way for the re-establishment of the old duopoly between the AA and RACMS. The duopoly was not stable but asymmetric. The AA's brand was much more prominent in the market place than the RAC brand. The AA had three times as many liveried vehicles and achieved economies of scale and scope in marketing and advertising costs by applying both to insurance as well as insured breakdown services. Furthermore the AA could amortize its investment in technology over a much wider membership base. For the crucial 90 per cent of direct retail customers who wanted a patrol-based service, the situation currently tended towards monopoly in favour of the AA, which had shares of sales of 63 per cent by volume and 67 per cent by value. RACMS therefore saw no issue of concern in the direct retail sales channel.

### ***Intermediary sales channel***

6.138. RACMS estimated that, of the 17.7 million vehicles covered by insured breakdown services, some 2.1 million were covered by or through financial institutions. This number was growing rapidly. Green Flag had been particularly successful in developing this sales channel.

6.139. As to the workings of competition in this sales channel, RACMS pointed out that many of the features of the longer-established motor manufacturer schemes were present: for example, formal tender procedures and use of the intermediary's brand or dual branding. In reselling unbundled insured breakdown services at retail level, some intermediaries were competing with breakdown organizations'

direct retail sales efforts. RACMS told us that for some intermediaries it was important that their brand should not be confused with that of the breakdown organization. However, where an intermediary used its own brand for breakdown services supplied by RACMS (on the grounds that the intermediary's brand was pre-eminent), the RAC brand had the credibility to back up the intermediary's branded product.

6.140. Given the countervailing strength of the major customers, the frequent switching of service provider, and the absence of barriers to entry (see paragraph 6.151), RACMS considered that no issue of competitive concern arose in the intermediary sales channel.

### ***Motor manufacturer sales channel***

6.141. RACMS said that, for providers of insured breakdown services, the expansion of motor manufacturer schemes from the late 1980s brought greatly increased volumes of customers, a matter of particular importance for RACMS with its commitment to a service-based operation relying on a dedicated patrol force and its dependence on a core direct retail channel which was largely static and in which it had steadily been losing share. Claims in respect of new and well-maintained cars were low, which kept down the cost of service under a motor manufacturer scheme.

6.142. The interrelationship with the direct retail sales channel was complex. On the one hand, there were opportunities to convert the motorist to an individual policy once the car came out of a motor manufacturer scheme. On the other hand, extension of motor manufacturer cover for more than one year, or to cover second-hand cars, cut into the available market for direct retail sales.

6.143. RACMS noted that Green Flag had little presence in the motor manufacturer sales channel. While RACMS was a leading supplier, it faced strong competition not only from the AA but also from Mondial and Europ Assistance. Within the motor manufacturer channel overall, the balance of negotiating advantage was clearly held by the manufacturers because of their size, financial resources and the importance of the outlet which they represented for insured breakdown services. RACMS considered that the degree of dependence on the motor car manufacturers by insured breakdown services suppliers was likely to increase with the advent of ITS. Furthermore, motor manufacturers typically put their requirements out to periodic tender, usually specifying exacting service and performance criteria. Pricing had moved from a simple discount off list price to a more sophisticated risk- and utilization-based system. Increasingly, manufacturers required a service with bespoke elements, for example manufacturer's brand and/or vehicles, and were inclined to buy on a Europe-wide basis.

6.144. RACMS argued that, given the countervailing strength of the major customers, no issue of competitive concern arose in the motor manufacturer channel.

### ***Fleet sales channel***

6.145. RACMS said that this sales channel was relatively small and characterized by the fact that the fleet operator typically bought only the call-centre and breakdown services, without any element of insurance cover, and dealt on a POU basis. RACMS noted that Green Flag had no significant presence in this sales channel.

### **Barriers to entry and expansion**

6.146. RACMS told us that until about ten years ago, call-centre services were not readily available because of the sophisticated technology required. However, advances in technology meant that less skill was now required in call-centre operations, and they were increasingly used in many applications (for example, sales and customer services for utilities, financial institutions and specialists in direct selling). They were available to be purchased or rented on a bureau basis. Where the call-centre function extended to command and control of an in-house patrol force, the technology and skills were much more complex and thus less readily available.

6.147. RACMS considered that there were a number of competitors, besides Green Flag, able and willing to provide a competitively-priced product relying on a garage contractor network. While Green Flag might be the largest of these suppliers, it suffered from a level of customer churn much greater than RACMS, and had not increased its direct retail customer base over the last five years.

6.148. There was choice available for the cost-conscious individual customer from effective competitors in the direct retail channel, including relative newcomers such as Direct Line, Kwik-Fit and Autonational. RACMS considered Direct Line to be a serious threat. Moreover, even taking into account the significant marketing costs Direct Line had had to invest in a short time to extend its brand from a related sector, RACMS believed there were plenty of other brands that were sufficiently elastic to embrace the breakdown services market.

6.149. Furthermore, the consumer could seek a better value offering via the intermediary channel from a financial institution or affinity group, which could pass on the benefit of a negotiated price from one of a number of providers, allowing savings on the individual list price.

6.150. We put to RACMS that, while initial entry might not be difficult, expansion beyond a certain fairly low level of activity could be very difficult without a good brand, and quite difficult even with a good brand. This appeared to be borne out by the number of niche players whose market shares had remained comparatively low over some years.

6.151. RACMS argued that barriers to entry were low in the indirect sales channels, where there was greater consumer acceptance of an unbranded product or of a brand not naturally associated with the product area than in direct retailing (for example, Gullivers Road Assure, being marketed through members of the National Federation of Retail Newsagents). Customer acquisition costs were also lower, because intermediaries were able to exploit their own customer databases. The new entrant could outsource the call-centre function to a specialist bureau and the breakdown services to a network of garage contractors. Product distribution could be via a telesales operation or other route.

6.152. In the direct retail channel, brand and national credibility were crucially important. RACMS considered that, where the service was provided by a liveried fleet, this constituted a significant barrier to entry in the biggest sales channel—the 90 per cent of total direct retail sales for which RACMS was struggling to compete effectively against the AA.

6.153. We put to RACMS a possible scenario in which the merged company initially competed vigorously with the AA and others as Cendant sought to expand its customer base for cross-selling. One result of such a struggle could be the withdrawal of smaller suppliers. After a time the two leaders might see it in their interests not to compete so keenly. RACMS thought this scenario most unlikely to arise. If prices rose, the result would be to attract in new competition: say, from a utility or mobile telecommunications operator with an existing brand, customer franchise and call-centre expertise.

6.154. We asked RACMS whether a requirement to invest in modern technology in breakdown vehicles could become a barrier for new entrants wanting to use garage contractors. RACMS did not see why this should be the case. The equipment typically used by contractors (CD-ROM, battery-testing equipment, diagnostic equipment) was fairly highly developed by an industry with its own brands and equipment standards.

## **Future of the RAC Motoring Services liveried patrols**

6.155. RACMS told us that, since the RAC and Green Flag brands were perceived by consumers as representing quite different products, it made sense to retain the differentiation after the merger, particularly where this related to patrols. Fix rates were higher for patrols than for contractors and customers were more satisfied with patrols. RACMS said that there was every indication that a well-trained, patrol-based force, working to high service standards, was a very well-received and important marketing advantage. RACMS noted that it was difficult to make direct cost comparisons between itself and Green Flag, given the differences in operations, products and customers. However, RACMS acknowledged that there had been a significant increase in its costs per call-out over the period 1994 to 1997. In particular, RACMS noted that overall job volumes (particularly in direct retail) had declined

since the introduction of the cap on the maximum number of call-outs per policy. This, given that the patrol force was a fixed resource, had resulted in a drop in productivity. RACMS hoped that the merger would reverse this decline. In the absence of the merger, RACMS said that it would have to continue to consider how to reduce the number of patrols. RACMS had partly begun to address this problem by introducing more flexible working arrangements. In addition, the growth in corporate business had brought about a decrease in call-out rates (newer vehicles were more reliable) but an increase in the proportion of costly recoveries (newer vehicles were more difficult to fix).

6.156. RACMS said that the retention of the patrols after the merger could occasionally result in a situation where a Green Flag customer would be attended by an RACMS patrol, if that was the most effective means of providing service to that customer. But RACMS saw little difference between that and providing a patrol-based service to some of its corporate customers. The challenge would be to find the right balance between three ways of providing assistance at the roadside: wholly-owned resources (RACMS patrols operating as they did now); managed resources (self-employed RACMS patrols and/or garage contractors operating under a franchise arrangement); and contracted-out resources (independent garages operating as they did now for Green Flag and also RACMS).

6.157. [

*Details omitted. See note on page iv.*

]

6.158. No decisions had been taken as to the optimum balance between the three types of resource described in paragraph 6.156 and there were no firm plans, other than Cendant's stated intention to move the patrol vehicles off the balance sheet. However, RACMS envisaged that the managed resource might evolve as follows. A garage contractor might have a fleet of, say, 30 vehicles. Ten of these could be RAC-branded vehicles containing the full range of testing and diagnostic equipment found in a vehicle owned by RACMS; these would be used only for call-outs from the merged company. A further ten vehicles, equipped identically, would be painted and deployed as the contractor determined. The remaining ten would be specialist recovery vehicles. Some of the larger contractors were already starting to establish operations comprising the latter two elements. We put to RACMS the strong doubts expressed by contractors about the viability of having a number of vehicles reserved for only one category of work. They needed maximum flexibility to deploy their resources most efficiently at times of peak pressure. RACMS said that contractors would make commercial decisions as to the mix of vehicles that would maximize utilization. RACMS explained that, in any event, the cost of running a vehicle was mileage-related and a large proportion of the cost was variable (the principal component being fuel).

6.159. RACMS had an open mind as to exactly how franchises might be structured but thought it would be a question of balance between the wholly-owned resource, the managed resource and the contractors. As to whether the franchisees would be required to work exclusively for RACMS (and perhaps also Green Flag), RACMS said that there could be a case for exclusive franchises in areas where a workload could be guaranteed. Outside those areas, it would be uneconomic to maintain exclusivity.

6.160. RACMS acknowledged that franchising the patrol fleet could jeopardize the exemption it currently enjoyed from Part II of the Insurance Companies Act 1982, relating to the solvency margin test (see Appendix 4.1). There could also be implications for RACMS's position in respect of VAT vis-à-vis payments to garage contractors if they became franchised.

## **Garage contractors**

6.161. We put to RACMS the concern of some third parties that the merged company would be in a very strong position as a buyer of contractors' services and could use that strength to disadvantage

smaller competitors, for example by forcing the best contractors into exclusive arrangements, or to insist on RACMS/Green Flag receiving priority for its call-outs.

6.162. RACMS estimated that business from breakdown organizations accounted for only about 20 per cent of contractors' total workload. Therefore contractors would have no incentive to exclude themselves from the remaining 80 per cent. RACMS thought it would be very difficult, in present market circumstances, for a supplier of breakdown services to enter into an exclusive contract while at the same time maintaining the necessary flexibility. There was no question of competitors being deprived of access to the network because there were sufficient numbers available (about 3,000). Furthermore, barriers to entry to contracting were low, so unmet demand for their services could be satisfied. As to contractors being required to give priority to call-outs from RACMS/Green Flag, this would simply not work in practice. There was no way of monitoring and enforcing such a requirement. As independent contractors, they would make their own commercial judgements.

6.163. We put to RACMS that, since the liveried patrols were more cost-effective at RACMS's scale of operation than the use of contractors (see paragraph 6.155), it would seem logical to enlarge the patrol force after the merger and withdraw work from the garage contractors. RACMS said that there was no reason to think that a significant proportion of the merged company's breakdown services, and particularly recoveries, would not continue to be resourced from the existing contractor network. There was no realistic prospect of the merged company removing all its work from the network. There could be changes in arrangements at peak periods in areas of high demand, and there would remain a level of work above which it would be uneconomic to staff for and that work would continue to go to contractors. Equally, contractors would continue to be used in remote areas.

6.164. We put to RACMS the concern of some third parties that the merged company would use its market power to cut rates to contractors, who would then try to restore their margins at the expense of the smaller suppliers. RACMS said that it currently spent £44 million a year with contractors and its main preoccupation was to ensure that they had sufficient levels of training and equipment to enable them to provide good-quality service. There was no reason to believe this would change. Moreover, the determinant of prices in the contractor market was availability of competing contractors. The merged company would have a continuing and strong interest in the preservation of an independent contractor network that would continue to be available to competitors and to the uninsured sector of the market, which represented around one-third of the total UK vehicle parc.

## **Prices**

6.165. RACMS told us that prices per vehicle for insured breakdown services in parts of the market other than direct retail were substantially lower than prices in the direct retail channel. This reflected the countervailing power of commercial purchasers and intermediaries negotiating for the benefit of their customer base, as well as higher costs for the service provider to acquire direct retail customers and, because of higher average call-out rates, to serve them.

6.166. The 1998 version of the RAC group five-year plan, originally drawn up in 1995, included measures designed to reduce the excessive number of call-outs made by a small proportion of members. Such over-use, the plan commented, made RACMS's prices uncompetitive against Green Flag's, which enjoyed a much lower call-out rate, while the AA had already reduced the number of call-outs allowed per member.

6.167. RACMS told us that its direct retail selling prices were essentially aimed at covering costs, though they also needed to be competitive, taking into account brand strength and product offering. Asked if the change in status (away from mutuality) would lead to a different pricing philosophy, RACMS said that over the past two or three years it had realized it needed to generate substantial surpluses to be able to invest in the business. Over the last seven or eight years, it had priced at a slight premium to the AA and felt very comfortable with that position. RACMS believed it had the edge over the AA in terms of technological leadership and that this supported the premium pricing.

## **Quality of service**

6.168. RACMS emphasized to us the service quality of its liveried patrols. In certain circumstances it was not effective (either in terms of cost or time) to deploy a patrol and therefore RACMS also used garage contractors. RACMS did a lot to train contractors to a high standard, but found that the RACMS patrol customer satisfaction index was some 25 points higher than the RACMS contractor index. RACMS occasionally found that in periods of peak demand its members would rather wait longer to see a patrol than see a contractor more quickly.

## **Innovation**

6.169. RACMS did not regard Green Flag's introduction of a £10 rebate for non-attendance within one hour as a particularly significant innovation, since the market standard was now moving away from 'time to attend' towards 'time to wheels rolling again'. It considered that Green Flag had been innovative only in its initial stages, in expanding from regional to national coverage and in providing breakdown services through a network of garage contractors.

6.170. RACMS thought the most recent important innovation had been the selling of insured breakdown services, a discretionary product, alongside mandatory products such as motor vehicle insurance (as was done, for example, by Direct Line). RACMS believed it too had been innovative in introducing a form of no-claims discount and in taking the lead on exploiting new technology.

## **Employment**

6.171. RACMS had not had substantive discussions with Cendant on the detailed employment implications of the merger, [

*Details omitted. See note on page iv.*

].

6.172. RACMS had not had formal discussions with the TGWU about the possibility of franchising the patrols, but there was wide anticipation among the workforce that such arrangements were being considered. RACMS did not expect opposition to an arrangement whereby franchising would be offered to those who found it attractive but not imposed on those who did not.

6.173. RACMS had tried to keep staff and union informed and briefed. Cendant had given assurances to safeguard fully the existing employment and pension rights of the staff of RACMS. The executive management team was expected to move with the business.

## **Cendant's financial strength and fitness**

6.174. RACMS told us that it had made the greatest possible efforts to ensure that it understood Cendant's ability to complete the transaction. When the accounting irregularities within Cendant first became known, RACMS had sought and obtained confirmation from Cendant and its financial advisers that funds were available to complete the acquisition. Since then, close liaison had been maintained, including explanations from Cendant direct to the extraordinary general meeting of the shareholders of RAC Holdings. Cendant's financial advisers had given RACMS a positive assurance that Cendant could complete the transaction.

6.175. RACMS was monitoring the validity and security of the loan notes which Cendant had offered for the consideration as an alternative to cash. These were to be guaranteed for the first 12 months. Regarding the possible effects on Cendant of the many legal actions brought against it in the USA, RACMS had been told by Cendant that class actions were generally settled.

6.176. RACMS had also considered closely whether Cendant, having uncovered large-scale fraud, might not be a fit and proper organization to have control of RACMS or might harm the RAC brand name. RACMS had been reassured to learn that the fraud had been exclusively in the former CUC rather than HFS, that only HFS senior executives were now in positions of responsibility within Cendant, and that the process of rebuilding Cendant's reputation and share value was well under way.

### **Benefits from the proposed merger**

6.177. RACMS argued that the proposed merger would boost its attempt to develop its position as a call-centre service provider to the mobility market. Cendant had widely recognized skills in call-centre management. Synergies would be obtainable through integration of RACMS call-centre operations with those of Cendant and Green Flag, and through integration of back-office functions.

6.178. Savings in the dispatching process would be realized through the efficient use of RACMS's expertise in dispatching an owned patrol force and Green Flag's expertise in dispatching garage contractors. The considerable training of contractors by RACMS and Green Flag would assume greater significance and importance to the merged company in the context of franchising or managed resource (see paragraphs 6.155 to 6.160). Both insured and uninsured consumers would benefit from the increased proportion of the contractor fleet (albeit a small proportion) capable of delivering through high-quality services backed by high levels of investment in technology and training.

6.179. Cendant had skills at database management to market a range of products and services that would be made available to RACMS customers. The merger would put RACMS in a position to compete more effectively with the AA.

6.180. Cendant had proven competencies in the management and exploitation of databases and brands. These skills would be integral to making a successful move into the provision of call-centre services for the mobility market and to attracting partnership deals.

6.181. The range of products and services available or potentially available from Cendant would provide enhanced cross-selling opportunities. For example, it would be possible to link PHH fleet management services with an RACMS journey support mobility service, linked with guaranteed parking from National Car Parks on arrival. Green Flag's home assistance product could also be provided as part of a portfolio of services. Future opportunities would arise from Cendant's other activities such as car rental (Avis) or hotel services (Ramada).

6.182. The greater scale of the combined RACMS/Green Flag business would more readily support necessary investment in information and systems technology. Successful commercialization of the new service required building up a critical mass of members, enabling amortization of costs over a broader base of members. The greater size of the combined customer base would assist in this process. The Green Flag brand would assist in obtaining service partners.

6.183. The commitment from the merged company to continue with separate branded products would more than meet the wish of consumers in the direct retail sales channel to have both RAC and Green Flag branded offerings available. The merged company's ability to achieve this would be enhanced by the ability to provide a more efficient and tailored mechanism for delivering breakdown services at the roadside. This would not only improve quality but also provide a more economically viable basis for both branded products.

6.184. The transaction would help to broaden the consumer proposition made available to motorists by RACMS so as to enable it to maintain the tradition of service excellence that had been the hallmark of the RAC brand for over 100 years.

6.185. We put to RACMS concern expressed by the AA that after the merger the various uses of the term 'RAC' could cause confusion in the public's mind. RACMS said that as part of the restructuring already undertaken, the traditional and institutional parts of the business (namely the Club and the Royal Automobile Club Motor Sports Association Limited) had been separated out from RACMS. They were now very clearly differentiated. There was no plan or intention to transfer any

real or implied use of the word 'Royal' to the new organization. All these changes had taken place regardless of the merger.

## **Remedies**

6.186. On the hypothetical basis that the proposed merger was held to be against the public interest, RACMS was asked about a number of possible remedies. RACMS, while noting that these were decisions for Cendant, gave views as set out below.

6.187. On Cendant being required to divest Green Flag, RACMS considered that this would remove the fundamental rationale for the merger and there must be doubt that Cendant would proceed with the acquisition.

6.188. RACMS said that breakdown organizations did not currently have exclusive arrangements with contractors and it saw no indication that this was likely to change in the future. On that basis, exclusive arrangements with contractors would not be high on the agenda for the merged business and RACMS could see no particular difficulty with Cendant being asked to give an undertaking that it would not enter into agreements or arrangements with garage contractors that required the contractors to work exclusively for Cendant (whether under the Green Flag or RACMS names) or to give Cendant undue priority over other suppliers of breakdown services.

6.189. RACMS objected both on practical grounds and in principle to Cendant giving an undertaking that the merged group would continue to offer an annual average of some specified percentage of its call-outs to garage contractors. The merged company would wish to achieve the most cost-effective use of the liveried patrol force. Any regime that set quotas would be liable, if it bit, to result in sub-optimal use of the resource and would be difficult to change as the business evolved. It would also be unattractive from the point of view of competition regulation and difficult to police.

6.190. RACMS considered that it would be both impracticable and ineffective for Cendant to give an undertaking that the RACMS and Green Flag operations would continue to negotiate terms and conditions with garage contractors as entirely separate activities and that such terms and conditions negotiated by the RACMS entity would not refer to or depend in any way on the activities of the Green Flag entity and vice versa. Furthermore RACMS questioned whether there was a real problem in terms of undue economic dependence by garage contractors that would justify such a remedy.

6.191. RACMS had no problem with Cendant giving an undertaking that it would continue to manage and promote Green Flag as a separate brand. Indeed, there was every reason for Cendant to do this.

P G CORBETT (*Chairman*)

J A REES

A ROBINSON

J K ROE

J D S STARK

P A BOYS (*Secretary*)

23 December 1998