



## **FirstGroup plc and the Scottish Passenger Rail franchise**

A report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited

**June 2004**

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### **Note by the Competition Commission**

The Competition Commission has excluded from this report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002. The omissions are indicated by [✂].

# The proposed acquisition by FirstGroup plc of the Scottish Passenger Rail Franchise currently operated by ScotRail Railways Limited

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## Summary

1. On 13 January 2004 the Office of Fair Trading (OFT) referred the proposed acquisition by FirstGroup plc (FirstGroup) of the Scottish Passenger Rail Franchise (the Scottish rail franchise) currently operated by ScotRail Railways Limited (ScotRail) to the Competition Commission (CC) for investigation and report. The reference was made under section 33(1) of the Enterprise Act 2002 (the Act). We are required to publish our final report by 28 June 2004.
2. FirstGroup is the leading supplier of bus travel in the UK, accounting in 2003 for about 22 per cent of turnover of local bus services (almost double the figure of ten years previously). It has four bus subsidiaries in Scotland, based in Aberdeen, Edinburgh and two in Glasgow, and estimates that it operates about 35 per cent of the total route mileage of all bus services in Scotland, making it the largest operator of bus services there; over half of those operations are in the Glasgow area. As at April 2004, FirstGroup was also the operator of five passenger train operating companies (TOCs).
3. The Scottish rail franchise accounts for 95 per cent of railway services in Scotland (including night sleeper services to London). The current franchise, granted to National Express Group plc (National Express), was due to end on 31 March 2004. It has, however, now been extended up to 17 October 2004. The new franchise will be for at least seven years, and can be extended to ten. FirstGroup was one of three shortlisted bidders for the Scottish rail franchise, which will be awarded by the Strategic Rail Authority (SRA); the other two were National Express and Arriva plc (Arriva). Toward the end of our inquiry, Firstgroup was declared the preferred bidder for the franchise.
4. The award of a rail franchise is regarded, for the purposes of Part 3 of the Act, as an acquisition of control leading to two or more enterprises ceasing to be distinct (within the meaning of the Act). The current turnover derived from the Scottish rail franchise significantly exceeds £70 million. We have therefore concluded that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation.
5. The effect of the merger would be to combine the operations of overwhelmingly the largest operator of rail services in Scotland with those of the leading operator of bus services in Scotland and in Glasgow in particular. A main concern raised by the OFT in making the reference to us was the possible loss of competition on routes where bus and rail services overlapped (ie where either bus or rail services could be used to travel between two points, and which we term 'overlap flows' below) and whether bus services could be reduced or fares increased on these routes to shift passengers from bus to rail.
6. In assessing the relevant markets affected by the merger, we have considered two sets of customers—fare-paying passengers on the one hand and public authorities, who are also involved in funding and procuring both bus and rail services on the other. We found that rail services and bus services are, for certain people on certain routes and at certain times of the day, potentially substitutable. In our view, it is appropriate to regard point-to-point public transport journeys as the relevant local markets. But certain public transport providers, including FirstGroup itself, provide their services on a network basis and not merely on a point to point basis, since passengers on point to point journeys may themselves be affected, or constrained, by the presence of network operators on their flows. Network markets are also relevant to public sector bodies involved in public transport issues. We also therefore

examined network provision over wider market areas such as the area covered by the SPTE in Strathclyde, the areas comprised in Greater Edinburgh and the Lothians and indeed Scotland as a whole.

7. We found 30 bus routes where revenue from overlap flows account for more than 10 per cent of total revenue on the route, a large enough threshold, in our view, to make it likely that FirstGroup would find it to be in its interest to change the operation of the route to take advantage of the overlaps following the merger. We also considered one route which overlaps with a new rail service that is due to be opened by the end of 2005. We also considered another 16 routes where, although current overlap flows are more limited as a percentage of route revenue, it could be profitable for FirstGroup to reconfigure services as feeder services to railway stations increasing the potential size of the catchment areas, combined, for example, with withdrawal at least in part of direct services; we found that such reconfiguration was likely to be profitable on a number of these routes. Finally, we considered a further eight routes about which similar concerns had been raised by local authorities.
8. Of these 55 routes, we identified 46 where the possibility of adverse effects resulting from loss of competition arose. We found 21 routes in the Glasgow and Edinburgh areas where there are no competitors on overlap flows operating 'in hours'—roughly between 7 am and 7 pm on Mondays to Saturdays—at sufficient frequency to compete effectively with FirstGroup. We believe that competition would be significantly reduced on those routes as a result of the merger. We also identified 27 routes (including many of the 21 routes previously mentioned) on which competition on overlap flows would as a result of the merger be significantly reduced 'out of hours' (typically between 7 pm and 7 am on Mondays to Saturdays and all day on Sundays), when few competitors to FirstGroup operate. We also recognise similar effects would result on at least some of the other possible routes within the 46 we have identified as a consequence of changes in competition on these routes during the term of the Scottish rail franchise. Such effects are likely also to result from the development of new rail services provided for in the franchise.
9. We commissioned an independent survey of public transport users. So far as overlap flows on routes are concerned our conclusion, taking into account the survey evidence referred to above, is that enough passengers would switch from bus to train to make a strategy of diverting passengers from bus to train potentially profitable.
10. In our view, the existing undertakings relating to FirstGroup's bus operations would not be sufficient to prevent the adverse effects which may be expected to result from the merger. It was put to us by FirstGroup that any strategies of increasing fares or reducing frequencies would be calculated to induce new entry or expanded entry by competitors on the affected routes. But, in our view, such potential entry or expansion by an existing operator could not be expected to provide a sufficiently effective source of competition to offset the loss of competition on those routes resulting from the merger, and this would particularly be so out of hours where few competitors currently operate. We consider therefore that it would be profitable for FirstGroup to switch bus passengers from bus to rail by increasing fares, and/or, to a lesser extent, by reducing frequency or rerouting services, and/or by reconfiguring routes. After the merger it would be in a position to do so, and may, in our view, be expected to do so.
11. The merger may therefore be expected to result in a substantial lessening of competition (SLC) on overlap flows on the above routes. The SLC and the consequential adverse effects we have identified would, however, affect only a minority (less than 20 per cent) of passengers on a minority (also less than 20 per cent) of routes operated by FirstGroup in the Glasgow and Edinburgh areas, accounting therefore for less than 5 per cent of its revenue in these two areas.

12. We also concluded that the merger may be expected to result in an SLC in wider public transport network markets in and around the SPTE area, Edinburgh and the Lothians and elsewhere in Scotland. The scope for lessening the competition on a network basis would take two forms. FirstGroup could introduce a multi-modal ticket scheme, confined to its own services, to its own commercial benefit and to the detriment of any schemes open to other bus operators. This could be expected to distort competition between FirstGroup and other operators, and that effect could extend to areas where it does not currently operate, but where it could leverage its control of the rail franchise to extend its bus operation. But even in the case of multi-operator schemes, FirstGroup would be in a strong position to influence the setting of fares on the relevant travelcards, in particular the SPTE ZoneCard, to its own commercial benefit and to the disadvantage of other operators, and it may be expected to do so. In addition, the merger would give FirstGroup an incentive and opportunity to favour its own bus operation in providing information at railway stations, to its own commercial benefit and to the disadvantage of other operators, and it could also be expected to do so.
13. The SLC that would be expected to result from the merger would be expected to have the further adverse effects of higher bus fares, poorer services on overlapping bus routes, and reduction in choice of services available to passengers on overlap routes. Similar adverse effects on other services would result from the effects on the broader network markets noted above.
14. In considering remedies, we have considered the effect of any remedy on relevant customer benefits as defined in the Enterprise Act. We do not believe that any such benefits would be put at risk by the remedies we have put forward. In our view, the SLC and consequential adverse effects we have identified can be remedied by behavioural remedies, rather than requiring the proposed acquisition to be prohibited, or requiring divestment of any of the bus operations of FirstGroup. We have concluded that FirstGroup should be asked to agree undertakings related to fares, frequencies and other aspects of services on the affected routes (if we could not successfully negotiate such undertakings within a reasonable time period, we would have the option of making an order). It should also agree undertakings in relation to multi-modal tickets and the provision of information at stations on other operators' bus services.

## Findings

### 1. The reference

- 1.1 On 13 January 2004, the OFT referred the proposed acquisition by FirstGroup of the Scottish rail franchise currently operated by ScotRail to the CC for investigation and report. The reference was made under section 33(1) of the Act. Our terms of reference are set out in Appendix A. These require us to consider whether arrangements are in progress or contemplation which would result in the creation of a merger situation which may be expected to result in an SLC within any market or markets in the UK. We are required to publish our final report by 28 June 2004.
- 1.2 This document, together with the appendices, constitutes our report which we are required to notify to the main parties under the CC's *Rules of Procedure*. Further information, including non-sensitive versions of main party and third party written submissions, summaries of non-sensitive key arguments of third parties, a report detailing the results of our survey carried out by NOP World Consumer (NOP) of public transport users in the relevant areas in Scotland, and the reports from consultants which we commissioned, as well as our provisional findings published on 28 April 2004 can be found on our web site.<sup>1</sup> We cross-refer to these documents as appropriate.

### 2. The companies

#### *FirstGroup*

- 2.1 FirstGroup is the leading supplier of bus travel in the UK, accounting in 2003 for about 22 per cent of turnover of local bus services (almost double the figure of ten years previously). It has grown rapidly by acquisition, as have other main operators of bus services in the UK. Three companies—FirstGroup, Stagecoach Group plc (Stagecoach) and Arriva—account for just over 50 per cent of bus turnover in the UK; and two other companies—Go Ahead Group plc (Go Ahead) and National Express—for a further 14 per cent.
- 2.2 Following privatization of the rail industry, FirstGroup, along with the other four major bus companies, also acquired train operating franchises. As at April 2004, FirstGroup was the operator of five passenger TOCs:
- (a) First Great Western (Paddington to South Wales and south-west England);
  - (b) Thames Trains (now known as First Great Western Link, with services in the Thames Valley);
  - (c) First North Western (north-west England);
  - (d) TPE (a new trans-Pennine franchise, consisting of intercity routes across the North of England); and
  - (e) Hull Trains (which operates services between Kings Cross and Hull on an open-access basis, outside any franchise agreement).

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<sup>1</sup>[www.competition-commission.org.uk](http://www.competition-commission.org.uk).

- 2.3 In the year ended 31 March 2003, FirstGroup's total turnover was £2.3 billion, with operating profit (before exceptional items and goodwill amortization) of £216 million. The UK bus operations of FirstGroup accounted for revenue of £859 million, and operating profit of £112 million, giving an operating margin of 13 per cent; rail franchises accounted for revenue of £842 million, operating profit of £61 million, and an operating margin of 7 per cent. (US bus revenues account for the bulk of the remainder.)
- 2.4 FirstGroup runs its bus operations through wholly-owned subsidiaries in different parts of the country. It has four bus subsidiaries in Scotland, based in Aberdeen, Edinburgh and two in Glasgow. The companies predominantly operate local services as opposed to long-distance buses or coaches. The financial performance of these subsidiaries is summarized in Appendix B. FirstGroup estimates that it operates about 35 per cent of the total route mileage of all bus services in Scotland, making it the largest operator of bus services there; over half of those operations are in the Glasgow area.

### **ScotRail**

- 2.5 The Scottish rail franchise is currently held by National Express. This franchise accounts for 95 per cent of railway services in Scotland (including night sleeper services to London); other rail operators running services in Scotland are Virgin and GNER, both as franchisees of routes between Scotland and England.
- 2.6 The financial performance of the Scottish rail franchise is summarized in Appendix B. The ScotRail franchise generated turnover for National Express in the year ended 31 December 2002 of £368 million. Public subsidy accounted for over 50 per cent of income, and between 40 and 45 per cent of that subsidy was from the SPTE for services in the Strathclyde area. As we were told in a previous inquiry,<sup>2</sup> the rail network in Strathclyde is the largest suburban network outside London.

## **3. The proposed merger and relevant merger situation**

### ***The current franchise situation***

- 3.1 The current Scottish rail franchise, granted to National Express, was due to end on 31 March 2004. It has, however, now been extended up to 17 October 2004. A draft invitation to tender (ITT) was issued in June 2003, and a formal ITT in October, with further revisions being made by the SRA during the course of our inquiry. Formal bids to operate the franchise were submitted in October 2003, including a tender by FirstGroup. Acquisition of the Scottish rail franchise would not involve transfer of the ownership of the current franchise operator—ScotRail, a subsidiary of National Express—to the successful franchisee; but it would involve the transfer of the incumbent franchise operator's business<sup>3</sup> and the designated property, rights and liabilities of the incumbent franchise operator.
- 3.2 The new franchise will be for at least seven years, and can be extended to ten. The shortlisted bidders other than FirstGroup were National Express (the current franchise holder) and Arriva. (A fourth shortlisted bidder had withdrawn.) Arriva operates buses in areas to the West of Glasgow (including Paisley and Renfrew) and

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<sup>2</sup>*Stagecoach Holdings plc and S B Holdings Limited: a report on the merger situation*, Her Majesty's Stationery Office, Cm 2845, April 1995.

<sup>3</sup>This may constitute the transfer of an undertaking for the purpose of Transfer of Undertakings (Protection of Employment) Regulations, 1981.

National Express in Dundee. On 11 June 2004, FirstGroup was declared the preferred bidder for the franchise.

- 3.3 Although the franchise is to be negotiated by the SRA, the SPTE and Scottish Ministers are closely involved throughout the process. Indeed, about half of the services are operated on behalf of the SPTE, and the SPTE will itself be a party to the franchise agreement, specifying all aspects of the service in its area and setting all fares in its area (see Appendix C).
- 3.4 FirstGroup told us that it had bid for the Scottish rail franchise as part of its general policy of bidding for every rail franchise that becomes available; it wished to have a portfolio of TOCs and rail businesses comprising intercity, regional and commuter services. It did not see any particular attractions in the Scottish rail franchise attributable to its current position as a bus operator in Scotland, although it did believe its experience as a bus operator would enable it to pursue transport integration opportunities, as would its experience with regard to integrated ticketing and provision of information. However, it saw no synergies from the merger; the rail operation and bus operations would, for example, continue to be managed separately within its UK rail and bus divisions. The transport integration schemes that it envisaged would be in association with all Scottish bus operators that wished to participate in them, and in no way exclusive to its own bus operations. FirstGroup would be committed as part of its bid to establish a transport integration group in which all interested bus operators, the SRA, Scottish Executive and the SPTE would be invited to participate.
- 3.5 Various aspects of the franchise are material to the assessment of the effects of the merger. This is particularly so as regards the burden of ‘revenue risk’ on the rail services—namely, if revenue is more or less than expected at the time the tenders are submitted, the extent to which that greater or lesser revenue accrues to the franchisee (the operator of the franchise), or the franchisor. At present, all revenue risk for the services financed by the SPTE is borne by the SPTE—in effect the Scottish rail franchisee is paid the cost of operating the services and all revenue goes to the PTE. In other parts of Scotland, the franchisee currently takes the revenue risk. The ITT indicated that Scottish Ministers wished to have a consistent approach with revenue risk being either taken wholly by the franchisee or by the public sector across Scotland.<sup>4</sup> The choice of how the revenue risk is allocated is important because it will affect incentives on the franchisee to increase rail passengers, possibly by reducing bus services, which we consider further below.
- 3.6 As at the time of this report, there were still two options for the allocation of revenue risk: first, for the franchisee to take all revenue risk; and second, for the sharing of revenue risk between franchisor and franchisee on a ‘cap-and-collar’ basis. The details of the latter approach are given in Appendix C. This would involve a franchisee taking all revenue in a range around its central projection; a proportion of any greater revenue in a band above that range; and a lower proportion of any greater revenue above that band. In the event of lesser revenue than expected, the position would, in effect, be reversed with additional subsidy being supplied by the franchisor (although only from the end of the fourth year of the franchise period). The option, initially included in the ITT, of public authorities bearing all the revenue risk of the Scottish franchise is no longer being considered.

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<sup>4</sup>Franchise bidders were therefore initially required to submit a base case that envisaged the revenue risk being retained by the franchisee and an alternative bid that assumed that the revenue risk would be borne by the Scottish Executive. In December 2003, however, bidders were asked to submit proposals based on sharing of revenue risk on a ‘cap-and-collar’ basis. In March 2004, the Scottish Executive told us that, along with the SRA, it had decided not to pursue further the option of revenue risk being held by the public sector.

- 3.7 Also important in appraising the effect of the merger is understanding which body is in control of fares levels, and how they will be set. The ITT stated that ‘the Authority (SRA), in conjunction with Scottish Ministers, will set regulated fares in Scotland. The SPTE has separately the right to specify fares within the Strathclyde Passenger Transport Area’. Regulated fares in Scotland outside Strathclyde are currently confined to ‘saver’ return fares<sup>5</sup> (or standard day return fares if there were no saver returns in 1995, as is the case for shorter journeys); weekly standard class season tickets; and commuter fares in and around Edinburgh. Such regulated fares account for about 39 per cent of ScotRail passenger revenue outside Strathclyde, but FirstGroup also argued that non-regulated fares are in effect held down by the level of regulated fares. The SRA has recently reviewed its Great-Britain-wide fares policy and intends, inter alia, to relax the level of maximum price increase from RPI–1 percentage point a year to RPI+1 percentage point and to change the regime for the current regulation of ‘saver’ return fares by March 2006. But the ITT stated that such a policy change would not apply directly to the Scottish rail franchise since any new fares policy would be agreed separately with Scottish Ministers; and before Scottish Ministers made any decision on fares, they would wish to consider carefully the outcome of the SRA’s review. For purposes of bidding, the ITT said that bidders should assume that increases in regulated fares (including fares controlled by the SPTE) would be set at RPI+1. Scottish Ministers subsequently decided to apply the RPI+1 increase in regulated fares for three years from January 2004; if this were to change in the remaining period of the franchise, it would be on the basis that the franchisee would not suffer adverse financial effect.
- 3.8 We have noted above that the SPTE can set all fares in the Strathclyde Passenger Transport area.<sup>6</sup> It currently sets all fares for journeys within that area and intends to continue to exercise this right in the future. Its right to set fares will operate independently of the arrangements finally determined for the sharing of revenue risk in the Strathclyde area.
- 3.9 The SPTE also promotes various multi-modal tickets including travelcards (called ‘ZoneCards’, and discussed further below) which include travel on buses as well as trains in Strathclyde, although these are used by only a very small proportion (about [X] per cent) of FirstGroup passengers in the Glasgow area.
- 3.10 The franchise agreement also contains detailed service specifications set by both the SPTE and the SRA, and tenderers are required to specify indicative timetables in accordance with them. They are known as the Service Level Commitments. The franchise agreement also contains detailed specifications of some 39 aspects of quality of service (for example, the condition and cleanliness of trains and stations) with a system of rewards and penalties reflecting performance. These controls are regarded by the SRA and others as notably more prescriptive than those in the current franchise.

## ***Jurisdiction***

- 3.11 In order to decide whether the arrangements in progress or contemplation will result in the creation of a relevant merger situation under Part 3 of the Act, we are required to consider, first, whether two or more enterprises have ceased to be distinct within the meaning of the Act and, second, whether either the turnover test in the Act (namely whether the value of the turnover in the UK of the enterprise being taken

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<sup>5</sup>A low-price turn-up-and-go return ticket for long journeys allowing outbound and return travel on different days (as opposed to low-price tickets, such as Apex and Super-Apex which have to be booked in advance).

<sup>6</sup>And fares for certain services extending up to 25 miles over its boundary.

over exceeds £70 million) or the share of the supply test (ie whether the merger creates or enhances a share of supply of more than 25 per cent of goods or services of any description in the UK or any substantial part of the UK) is satisfied.

- 3.12 As regards the first question, section 66(3) of the Railways Act 1993 (as amended by paragraph 30(8) of Schedule 25 to the Act) provides that where a person enters into a franchise agreement as a franchisee there shall be taken to be brought under his control an enterprise engaged in supplying the railway services to which the agreement relates. The award of a rail franchise therefore constitutes an acquisition of control leading to two or more enterprises ceasing to be distinct for the purpose of section 23(1) of the Act. As regards the second question, as apparent from Appendix B, the current turnover derived from the Scottish rail franchise significantly exceeds £70 million. We therefore conclude that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation.
- 3.13 The effect of the merger would be, therefore, to combine the operations of overwhelmingly the largest operator of rail services in Scotland with those of the leading operator of bus services in Scotland and in Glasgow in particular. In the terms of reference, the OFT said that it believed it is or may be the case that the merger situation 'may be expected to result in an SLC within any market or markets in the UK for goods or services, namely the supply of passenger transport services on point-to-point routes in Scotland' (ie routes between particular stations or bus stops at which passengers start or finish their journeys on a train or bus). The main concern raised by the OFT was that in consequence of the loss of competition on such routes where bus and rail services overlapped (ie where either bus or rail services could be used to travel between two points, and which we term 'overlap flows' below), bus services could be reduced or fares increased to shift passengers from bus to rail. However, the terms of reference require us to consider whether the merger situation may be expected to result in an SLC within any market or markets within the UK, and in doing that we are not confined to those markets specified by the OFT.

## **4. Market definition**

- 4.1 In defining markets, one tool that we have regard to is the 'SSNIP test'.<sup>7</sup> This test entails asking whether it would be profitable for a hypothetical monopoly supplier of a particular product or service to introduce a small but significant non-transitory increase in price (SSNIP). This will depend first on the extent to which customers would reduce usage in response to such a price change and consequently whether there would be increased or decreased revenue as a result of a price change.<sup>8</sup> Second, whether, even if revenue were reduced, a price change would nonetheless be profitable if costs could fall in line with lower output. If such a price increase were profitable and could be sustained, that product or service in question could be regarded as being monopolizable, and would therefore be considered a separate market.
- 4.2 Unlike in most CC inquiries, we have been able to draw on an extensive and complex array of evidence on the price elasticity of demand for different modes of transport. A summary of material relating to the separate price elasticities of bus and rail is presented in Appendix D. As will be apparent from that appendix, these elasticities

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<sup>7</sup>More detail on the way the CC applies this test can be found in the CC's guidelines on merger references (CC2).

<sup>8</sup>If elasticity is greater in absolute value than -1, the percentage reduction in usage would be greater than the percentage increase in prices and revenue would fall.

are quite low, although they may well differ between local areas depending on their circumstances. Also contained in this appendix are our views on the arguments put to us about whether public transport is a separate market from private transport. For the reasons set out there, including the relatively low level of car ownership in Glasgow, we believe that the use of private cars does not provide a major competitive constraint on either bus or rail. In considering the proposed merger of a bus and rail operator, our concern is primarily with the extent to which there is substitutability between bus and rail where they overlap in the particular local circumstances.

### ***Substitutability between bus and rail***

- 4.3 We have considered substitutability between local bus and rail services in a number of previous cases, which are summarized in Appendix E. However, the context of these cases was different from the current case in as far as they primarily related to mergers between bus operators. There are also a number of cases involving a merger between rail services and longer-distance coach services, but the one case involving a merger between local bus and rail operators related to the West Midlands, which has many different characteristics from the areas we are currently considering. We have therefore considered the extent of competition between bus and rail in the areas affected by this merger taking into account the greater body of evidence available to us in the current case as well as its specificity to Scotland and the Glasgow and Edinburgh areas in particular.
- 4.4 During the current inquiry, FirstGroup argued that there were significant differences between bus and rail use in Scotland, which meant that they were not close substitutes for passengers. The bus network, for example, was considerably more extensive than the rail network. In Strathclyde, there are 56 times more bus stops than rail stations. Hence, it argued that, though bus services can provide an effective alternative to most rail journeys, rail can provide an effective alternative to only a small proportion of bus journeys. Moreover, even where there appeared to be overlap between rail and bus (on particular 'point-to-point flows', ie journeys between two points, served by both rail and bus services), FirstGroup said that there were significant differences in the characteristics of the two modes: rail services were usually quicker, but bus services were usually more frequent, and stopped closer to many customers' boarding and disembarkation points. Nonetheless, FirstGroup acknowledged there were overlaps between rail and bus services on specific flows which might be regarded as substitutes for some passengers.
- 4.5 In considering the substitutability between bus and rail, we are concerned with two sets of customers and their associated demand:
- (a) passengers who pay for journeys; and
  - (b) public sector bodies such as the SRA, the Scottish Executive, the SPTE and other local authorities which pay for subsidized services (for example, tendered services and concessionary travel), and also pay subsidies to the operator of the rail franchise.

### ***Passenger demand***

- 4.6 Fare-paying passengers can buy two types of tickets: the first is a ticket (single or return) that is related to a particular route or part of route; and the second is a ticket

that is related to a particular network.<sup>9</sup> FirstGroup bus passengers use more network tickets than single tickets in Glasgow (almost [X%] compared with about [X%]); in Edinburgh, more FirstGroup bus passengers use single tickets than network tickets (just under [X%] compared with somewhat over [X%]).<sup>10</sup> FirstGroup told us that this data underestimated the number of route-specific passengers as many of its passengers that bought a network ticket used this in practice only for return journeys. We accept this.<sup>11</sup> Network tickets, however, also benefit passengers who take, or think that they might want to take, a second or further journey on the same day.

- 4.7 In almost all circumstances, passengers want to travel to a specific destination. In order to travel from his or her origin to a destination, a passenger will use a bus or train from one stop or station to another: the journey between those two points, ie the two stops or stations, is 'a flow'. The passenger may, however, have to use a number of flows if he or she has to change from one bus or train to another, or change between bus and train. A bus 'route' (a service provided by a bus under a particular number) or a train route (usually identified by the termini of the train and, sometimes, the intermediate stations served) will contain many different flows. (In certain cases, a route and a flow may be the same, if a passenger travels the full length of a route.) There may be more than one route serving any one flow, particularly on the main 'corridors' (main roads on to which a number of routes converge from a number of termini): for example, six FirstGroup services and one service of another company operate between Shettleston and central Glasgow.
- 4.8 Even though a passenger may only want to travel on a particular flow and may buy a single or return ticket (where available) valid only for that flow (and possibly for the specific route) on which he or she travels, the passenger may still benefit from having access to an operator's network of routes. The more termini served by an individual operator on a particular stretch of road (depending on the scale of that part of its bus network), the greater the frequency of services available from that operator on that corridor. This is particularly true of main corridors. The attractiveness of that operator's services to passengers will be further improved if return or (in the case of Glasgow) all-day tickets are offered at less than double the single fare. (This is the case for many FirstGroup bus passengers in Glasgow.)
- 4.9 Passengers may also benefit from being able to buy a network ticket, if they want to change to another service. Network tickets may also be used by the same passenger at different times, or be transferable between different passengers, for travel between a number of origins and destinations. These origins and destinations could be within a city such as Glasgow, a region such as Strathclyde or a country such as Scotland. Passengers could carry out these journeys by buying a number of flow- or route-specific tickets or, more likely, they could buy a network ticket.
- 4.10 Passengers who buy flow- or route-specific tickets linking a particular origin and destination are unlikely to change their route in response to a price rise unless there are other routes that pass close to their origin and destination. This demand-side reason suggests that for these passengers there is a narrow market definition based on or around flows or routes, ie linking passenger's origins and destinations.

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<sup>9</sup>A network is a collection of interrelated—overlapping or adjacent—routes in a particular area. It can be defined in relation to a particular operator's services—eg the network of services operated by FirstGroup in Glasgow—or in relation to a wider geographical area, including other operator's services in that area—eg the wider Strathclyde area for which the SPTE's ZoneCard is available.

<sup>10</sup>Concessionary travel and child/student fares account for the bulk of the remainder; there are no FirstGroup return tickets in Glasgow, and they account for only a small proportion ([X%] per cent) of FirstGroup's passengers in Edinburgh.

<sup>11</sup>We found in our survey that about 90 per cent of peak time bus users and about 80 per cent of off-peak bus users needed to use only one bus on their journey.

- 4.11 The same rationale for passengers who buy flow- or route-specific tickets applies to passengers who buy network tickets. They will not use other networks in response to a small price rise on one network unless these other networks include their origin and destination and the same set of flows or routes that they want to use. This suggests that for these passengers the relevant market is a network. The cities of Glasgow and Edinburgh and the areas around them (for example, the travel to work areas, or the operating areas of the FirstGroup bus subsidiaries) are examples of a network, just as Scotland is a network for other, longer-distance rail or coach travellers in Scotland.

### *Role of the public sector*

- 4.12 The demand for bus and rail services is also affected by decisions and actions taken by the public sector, and in this sense public sector bodies can also be regarded as customers. We have noted above that the majority of the franchisee's revenue from the Scottish rail franchise derives from public subsidy. There is also significant public expenditure on bus services, estimated at almost £120 million in Scotland in 2002/03 (somewhat above one-third of the estimated revenue of bus operations in Scotland). This is accounted for by subsidy of 'tendered services' (services not operated commercially, but under contract to local authorities, which seek tenders for doing so); concessionary fare schemes; and the Bus Service Operators' Grant (which has replaced the former Fuel Duty Rebate).
- 4.13 Local authorities and PTEs may seek tenders for non-commercial bus services on a route-by-route basis and/or for a collection of routes or services. Price rises for services operating at a route level (for example, particular tendered services) and services operated at a network level (for example, a collection of tendered services) are unlikely to lead to the public sector using other routes or networks unless these alternatives include the same or similar origins and destinations. At a wider level, the Scottish Executive makes contributions both to the funding of the rail network and to local authority transport policy. Furthermore, given finite budgets, public sector authorities have to make trade-offs between support for services in different parts of the network or between different modes for serving particular communities. These demand-side reasons suggest that the relevant markets for the public sector are also based on or around routes and networks such as the cities of Edinburgh and Glasgow; and, in the context of certain issues involving the Scottish Executive, Scotland as a whole.

### *Supply-side responses*

- 4.14 Supply-side considerations—including whether already-established suppliers could move from one route into another within a short period of time (usually a year) with little additional investment required—suggest that the relevant markets cannot be regarded as consisting of individual flows or routes. Bus companies organize themselves around bus depots and fleets and the wider networks they operate; within these networks, existing operators can easily switch buses between routes.
- 4.15 Entry lags in the bus industry are sufficiently short to make it reasonable to consider at least some entry as a possible supply-side response to the actions of a hypothetical monopolist. But as we discuss below (paragraph 5.54 and following), entry at a route level by a new operator may encounter a number of obstacles. Although there appear to be few regulatory barriers (aside from ensuring safety of vehicles) to a new operator establishing a new route or an existing operator increasing frequencies on an existing registered bus route, of more concern may be

a possible expectation in the industry that incumbents could retaliate to entry, for example by increasing services. Furthermore, as we discuss below, it may be difficult for a competitor to run a small number of services just at the beginning or end of the day in response to a reduction in frequency in those hours by the larger operators. Entry will also be difficult whenever entrants have to compete against return or network tickets which tie passengers into an incumbent operator. This concern may be particularly relevant where the operator offering such tickets has many more services or a much larger network than new entrants.

- 4.16 However, although supply-side considerations may point toward a network market (which we will consider later), we still think it important to analyse some routes or parts of them, particularly overlapping parts of routes.
- 4.17 Supply-side considerations are therefore in our view a further reason to consider substitutability both in the local markets consisting of particular point-to-point flows and in the context of wider networks.

### ***Substitutability in point-to-point flows***

- 4.18 As illustrated in Appendix F, while bus and rail may be regarded potentially as substitutes on routes and flows where they overlap, in some instances they may be used as complements by passengers, for example where bus services are used to travel to rail stations for onward journey by train. For other routes and flows they will be complements in network terms, serving different passenger flows. In some cases, rail services can be both a substitute for and complementary to bus services. For example, a rail service between two stations could be complementary to a bus service that operates as a feeder service, taking passengers to and from the station; but, together with that complementary bus service, that same rail service may be substitutable with a direct bus service between the passengers' ultimate origin and destination. Similarly for local authorities, bus and rail services could be substitutes on some routes and flows and could be complements for others.
- 4.19 Even on overlap flows, the degree of choice between bus and rail could depend on the specific circumstances facing the passenger including the convenience of access to that service (for example, buses serving high streets and residential areas, from which train stations may be distant); whether a direct service is available or whether passengers have to change to another bus or train to travel to their final destination; waiting times, which depend on frequency (the number of buses an hour); journey times; and, of course, fares. These factors are sometimes included in a wider measure of 'generalized cost' of a journey, namely the fare plus the perceived value to passengers of all time spent on the total journey which passengers are generally thought to want to minimize when making their decisions about which modes to use for their journeys. Travelling conditions and reliability may also affect choice between bus and rail. We therefore considered a range of evidence available to us on the extent of substitutability between bus and rail on point-to-point overlap flows.
- 4.20 During the course of the current inquiry we came across a small number of specific instances where we could see evidence of the direct impact of competition and substitutability between bus and rail. First, we were told that an increase in competition between bus operators on services between Cumbernauld and Glasgow had led to a 45 per cent reduction in the number of passengers on rail services between these two places. The SPTE had responded to this competition by introducing a number of discounted rail fares. The route between Cumbernauld and Glasgow, however, is not necessarily typical of most bus and rail services in the areas we are considering. Express bus services between Cumbernauld and Glasgow

use a motorway for most of the journey. Journey times for bus are therefore similar to those by train.

- 4.21 Second, we were told that following the introduction by the Scottish Executive of free concessionary travel on bus services in Scotland, the number of concessionary passengers on train routes where the option of a bus was available fell by about 50 per cent. Clearly, however, availability of free travel creates a rather extreme incentive for some passengers to switch between rail and bus.
- 4.22 Third, we were told that in the period of industrial action on ScotRail services in 2002, which led initially to a deterioration in reliability of services and subsequently to reductions in the frequency of those services, ScotRail's share of ZoneCard revenues, reflecting the use of ScotRail services relative to that of other transport operators in Strathclyde, declined from 45 to 40 per cent.
- 4.23 A degree of competition between bus and rail was also implied by some background material provided by FirstGroup. The First in Glasgow 2003/04 five-year business plan for its bus operations states that 'a significant proportion of the operating area experiences major competition from many modes including rail' (while also referring to long-established competition from other bus operators). [✂]
- 4.24 The OXERA survey of existing literature on elasticities we commissioned noted that there was mixed evidence on cross-elasticities between rail and local bus travel, referring to evidence of a cross-price elasticity of rail demand to bus fares of around 0.45 (ie a 1 per cent increase in bus fares would lead to a 0.45 per cent increase in rail demand). However, two studies of bus and rail demand in Scotland found a smaller elasticity, one of 0.04 to bus fare, the other of 0.14 to bus generalized cost (see paragraph 4.19). FirstGroup reported a survey of estimates of cross-elasticities of rail with respect to bus fares of 0.2 to 0.3; to bus journey time of 0.1; and to bus headways (the typical interval between services) of 0.05. However, cross-price elasticities, like price elasticities, may be expected to vary by area, time of day or purpose of journey, and particularly between areas where there is a meaningful choice between bus and rail travel, and areas where there are no such overlaps. FirstGroup was, however, concerned about the reliability of OXERA's conclusion on fare elasticities, given OXERA's own previous studies suggesting significantly higher elasticities in Scotland. Those higher elasticities were, in our view, out of line with the other studies quoted.
- 4.25 In order to gain more information on passengers' willingness to switch between bus and rail travel, we commissioned NOP to carry out a survey of public transport users in Glasgow, Edinburgh and Falkirk who lived near railway stations and who had access to bus services. The full results of that survey are on the CC's web site. The NOP survey appeared to confirm that both peak and off-peak users choose their mode of travel taking into account frequency, time to get to a railway station or bus stop, journey time, and price (which is consistent with the notion that they try to minimize the generalized costs of travel). That survey showed that:
- (a) up to 48 per cent of public transport users in the areas surveyed may see rail and bus as substitutes for some of their journeys;
  - (b) a substantial proportion of those (23 per cent in the case of bus users) see switching between bus and train as easy for these journeys;
  - (c) on average, bus users believed that switching from bus to train would add a relatively small time increment (about 10 minutes) to those journeys; and

- (d) passengers' decisions to switch between bus and rail occur, in part, when the total station-to-station journey time (including waiting time) of bus rises to that perceived for rail.

In general the results indicate that bus and rail are, at least for certain people on certain routes and at certain times of the day, substitutes.

- 4.26 We also commissioned OXERA to use the results of our survey to infer the likely extent of substitutability within the areas affected by the merger. The OXERA analysis confirmed that some passengers would switch between bus and train if there were changes in the characteristics of the services, in particular their frequency. FirstGroup's economic consultants were concerned that the design of the survey meant that OXERA was unable to estimate price elasticities (as OXERA acknowledged), in that there was not enough variability in prices of using alternative modes of transport; rather, respondents should have been asked to comment on different price alternatives. Respondents, it argued, may also not have been sure about other characteristics of the alternative transport mode to the one they used, biasing estimates of other elasticities. There is, in our view, no evidence to support that concern.
- 4.27 FirstGroup made a number of other comments on the survey. It pointed out that the survey was based on passengers within 2 km of a rail station. Hence, in its view, it could not be applied to all bus users, and it therefore overstated the number of people referred to in paragraph 4.25(a) who might see rail and bus as alternatives. We accept this and indeed we designed the survey in order to target bus/rail users most likely to switch. FirstGroup also noted that respondents were asked to recall a recent journey where they had a choice between bus and rail, rather than a representative journey. This, it felt, would lead to bias, or at least inconsistent responses. FirstGroup also felt that respondents may have replied on the basis of a fairly extreme alternative (ie that the existing mode of travel used was not available) rather than on the basis of whether switching to an alternative was a credible alternative in the face of marginal changes in fares and frequencies. Nonetheless, it accepted that there was a proportion of people who on some occasions did have a choice between rail and local bus travel.

### *Conclusion on substitutability in local markets*

- 4.28 Having access to more information than in the previous CC reports we referred to above, and taking into account the specific characteristics particularly of Glasgow with its extensive suburban rail network and those of Edinburgh and the Lothians, we therefore believe it is valid to regard train and local buses as at least potentially substitutable on some routes; and that control of bus and rail on a flow on which bus services and train services overlap would enhance the position of a hypothetical monopolist on that flow. In our view, point-to-point public transport journeys, including bus and rail services which serve them where they overlap, can therefore be regarded as relevant markets.
- 4.29 The willingness of users to switch between bus and rail also depends, in our view, on the availability of other buses on the same or nearby routes. As we discuss further below, we have found it important to distinguish between substitution possibilities 'in hours' (which we define as roughly between 7 am and 7 pm on Mondays to Saturdays, when most competitors operate), when there are often one or more rival bus operators at or near a particular route, and 'out of hours' (typically between 7 pm and 7 am on Monday to Saturdays and all day Sundays) when many competitors to FirstGroup in the Glasgow area do not operate, although rail services also cease to

operate about 11 pm. Different competitors, however, start or finish services at different times (and sometimes with different times on Saturdays to the rest of the week). In relation to out of hours, our concern is with particular periods in which no bus competitors operate on particular routes but rail services do operate.

## **Network markets**

- 4.30 We noted in paragraph 4.12 the role of local authorities and other public authorities in the bus and rail industry. Local authorities and PTEs are also involved in providing services in relation to information and other facilities for use by bus operators and passengers (for example, bus lanes, bus stops and bus stations); we have also noted the role of the SPT in multi-modal ticketing. In such activities, public authorities are to some extent trying to facilitate the creation of a comprehensive, flourishing and socially inclusive public transport network which includes bus and rail, in part to encourage passengers to use public transport rather than car. This can be seen with their involvement in multi-modal travel cards (for example, SPT's ZoneCard), and in developing local transport strategies and traffic-reduction strategies, and their interest in public transport integration. Although FirstGroup argued that public support for bus and rail tended to be approached separately, the evidence does not in our view support this. In particular we do not think that the SPT treats these two modes of public transport (and their associated networks) independently as evidenced by the local transport strategy: integrated transport planning typically considers public transport networks as a whole, and how the various component networks fit together (as substitutes and as complements).<sup>12</sup> This would suggest that the product market for public authorities at the network level to some extent also includes buses and rail.
- 4.31 We have noted that networks as well as individual point-to-point flows are relevant, to some extent, to passengers. They are also of course highly relevant to operators and affect their ability to compete in local markets. For the large operators, individual routes complement each other, with interdependence in their marketing and scheduling (for example, coordinating routes from different termini along the main corridors, to provide a more frequent and evenly-spaced service); economies of scale in the operation of depots which serve a number of routes; and setting of fares across the networks as a whole.
- 4.32 As we discuss further below in the context of entry, networks are also a potential source of competitive advantage against new entry. We noted comments by FirstGroup that it had been difficult for it to compete in Edinburgh due in part to the extensive network of Lothian Buses plc (Lothian), providing Lothian with a footprint and variety of denser routes, serviced with higher frequencies on its central corridor. We put to FirstGroup extracts of previous Monopolies and Mergers Commission reports<sup>13</sup> about the importance of prepaid tickets and network advantages ([§§]):
- Regarding *prepaid tickets*: 'The existence of season tickets and return fares may provide a barrier to entry ... A network also makes possible a more effective use of prepaid tickets ... By offering travelcards or other prepaid tickets, an operator

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<sup>12</sup>See, for example, the Strathclyde Public Transport Strategy 2000 (<http://www.spt.co.uk/Publications/SPTS2000/index.html>), Keep Glasgow Moving—A Local Transport Strategy 2001–2004 (<http://www.glasgow.gov.uk/landservices/localtransportstrategy>) and the City of Edinburgh Council Local Transport Strategy 2000–2004 ([http://www.edinburgh.gov.uk/CEC/City\\_Development/Transport\\_and\\_Communications/LTSword/Intro/LTSintro.html](http://www.edinburgh.gov.uk/CEC/City_Development/Transport_and_Communications/LTSword/Intro/LTSintro.html)). We noted the statement in the Edinburgh Council Local Transport Strategy 2000–2004: 'The Preferred Strategy requires the introduction of road user charges; impacting directly on traffic levels and providing transport funding. Alternative approaches to investing the funding were investigated. The strategy balances bus, rail and other improvements and a new light rapid transit system, with a target opening date late in the ten-year period.'

<sup>13</sup>Stagecoach/SBH—see footnote 2; and *Stagecoach Holdings PLC and Mainline Partnership Limited: a report on the merger situation*, Her Majesty's Stationery Office, Cm 2782, March 1995.

with a comprehensive network is able to attract customers and can obtain significant market power if a large proportion of passengers use such tickets.’

- Regarding *network advantage*: ‘Such may be the advantages of the network operator that potential entrants may be discouraged from attempting to enter the market ... utilisation of buses and drivers will be maximised ... time spent on the road but not in service will be kept to a minimum ... operational costs both per vehicle and per vehicle mile can be optimised ... greater scope for co-ordinating the timing of services to ensure convenient connections between them and hence to generate more passenger revenue.’

- 4.33 FirstGroup argued in evidence to us that network operators also had some disadvantages. They could not, for example, easily tailor services to the details of a section of route because of the need to keep fare structures simple, to maintain a consistent level of quality, and to make sure there were enough buses and drivers in the right place. Network operators, FirstGroup said, also paid higher costs than small operators for drivers to compensate for shift working, and also for network marketing and higher-quality buses. Nonetheless, FirstGroup accepted that an operator with an extensive network had some benefits through operation of high-frequency of services and network tickets, but not such in its view as to prevent competitive entry or expansion (which we discuss further below).
- 4.34 Finally, this merger is one between a significant bus network and a significant rail network. To some extent, as apparent from our discussion of point-to-point flows above, these networks can be regarded as complementary but also to some extent substitutable (as illustrated in Appendix F). As we discuss further below, this means that there is scope to develop interrelationships between them (for example, integration of services and of ticketing arrangements) that could impact on other bus operators and passengers.
- 4.35 Commenting on our provisional findings that there were broader public transport network markets, FirstGroup argued that there was no basis for defining network markets, either for fare-paying passengers or for local authorities and other public bodies. Indeed, it argued that no competition concerns were raised by the CC in relation to network markets, so it said that we could remove these market definitions from our final decision without affecting our substantive case, and should do so. We noted that it did not regard our provisional findings as to the broader effects of the merger as being dependent on our definition of network markets. Rather, while it believed such concerns had nothing to do with the concentration between a bus network and rail network in a network market, it argued that such concerns should be approached as a matter of leverage from the position in one market or set of markets into another. Nor did it dispute that network markets could be regarded as valid for buses, but it did not accept that there was competition between bus networks and rail networks. In our view, there is an element of competition between bus and rail networks for the reasons set out above. But we also believe it more appropriate to examine the effects of leveraging market power between a bus network and a rail network, for example as a result of multimodal tickets which we discuss below, as arising in the context of network rather than point-to-point markets.
- 4.36 We also therefore regard broader public transport network markets as relevant to our inquiry, of which the prime examples are the SPTE area, given the role of the SPTE; Edinburgh and the Lothians; and, given the extent of the ScotRail network and the role of the Scottish Executive, Scotland as a whole.

## **Conclusion on market definition**

- 4.37 We therefore conclude, in respect of both fare-paying passengers and public authorities:
- (a) It is appropriate to regard point-to-point public transport journeys as relevant local markets. Within the markets for point-to-point public transport, we also distinguish below between in-hours and out-of-hours operations.
  - (b) There are also relevant public transport network markets such as the SPTE area, Edinburgh and the Lothians, and, in some contexts, Scotland as a whole.

## **Market shares**

- 4.38 We have noted above that ScotRail accounts for 95 per cent of rail services within Scotland. Its only rail competition within Scotland is from services operated by GNER and Virgin Cross Country between various cities in Scotland, en route to or from destinations in England. With only minor exceptions (for example, between Motherwell and Glasgow), ScotRail is the only operator of rail services on point-to-point flows which overlap with those of FirstGroup bus services.
- 4.39 We have also noted that FirstGroup is the largest operator of bus services within Scotland. Of the main areas affected by the merger, FirstGroup estimated that it is by some margin the largest bus operator in Strathclyde, with an estimated share of bus kilometres of 43 per cent in 2001/02<sup>14</sup> (this would compare with an equivalent figure of 48 per cent in 1998/99, and one of about 51 per cent implied by the FirstBus/S B Holdings (SBH) report). Within Strathclyde, however, it estimated its own share in the First Glasgow operating area (based on estimated peak vehicle requirements) at 70 per cent. The only previous estimate of FirstGroup's share in the Glasgow area was that of about 89 per cent at the time of the 1997 FirstBus/SBH report,<sup>15</sup> but this is not a like-for-like comparison: the earlier figures related only to the city of Glasgow, and were based on bus miles, not peak vehicle requirements. FirstGroup said that its market share had declined due to the effects of entry. But, if its market share actually has declined, this is also likely to reflect FirstGroup's withdrawal of services from some areas, including parts of Lanarkshire. In figures it quoted to the OFT, the size of FirstGroup's fleet in the Glasgow area had reduced from 1,250 vehicles in 1996 to 1,005 now. In the main overlap flows we are considering, we estimated that FirstGroup's share of services operated is about 80 per cent, which in our view is likely to approximate to that of Glasgow as a whole. FirstGroup did not accept this; but it could not provide us with any better estimate, and also did not regard Glasgow as constituting a sensible market area (in its view the area should be a route or corridor or the travel-to-work area of Greater Glasgow).
- 4.40 Among the other operators in the Glasgow area, Stagecoach operates a number of services within the city of Glasgow and from Cumbernauld, some of which are marketed as Magicbus services with a significantly lower fare structure than those of the main FirstGroup network within Glasgow. Stagecoach considerably expanded its activities in the Glasgow market shortly after the publication of the CC's previous FirstBus/SBH report in 1997. FirstBus provided us with details of 11 routes Stagecoach started operating in that year, and told us that it responded to

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<sup>14</sup>In producing these estimates FirstGroup used its own figures and the estimated totals for Strathclyde (and other parts of Scotland) published in the Scottish Executive's *Bus and Coach Statistics Bulletin*. The Scottish Executive told us that the data in the Bulletin is estimated and that the Department for Transport survey, from which it was produced, was not designed to provide figures for parts of Scotland. The data might therefore be considered as uncertain to a significant extent.

<sup>15</sup>*FirstBus plc and S B Holdings Limited: a report on the merger situation*, The Stationery Office, Cm 3531, January 1997.

Stagecoach's entry on the Magicbus routes by reducing weekly fares to match those offered by Stagecoach. It also began operations in Stagecoach's operating areas in Fife and Ayrshire. Subsequently, FirstGroup told us that Stagecoach reduced the scale of its operations, withdrawing from nine routes, though starting two others. It now operates three services within the city and the Cumbernauld service. Stagecoach also operates services into Glasgow from Ayrshire. Arriva's operations are largely based outside the city of Glasgow, but with services into Glasgow from Paisley and Renfrew. We are also aware of a number of smaller competitors within Glasgow. The largest of these is McKindless, whose operations include three routes largely within Glasgow. Other competitors, however, have a much smaller scale of operations, many running midibuses on one main corridor or operating routes not served by FirstGroup, and these operators offer somewhat lower fares to compete with FirstGroup. Very few of the smaller competitors of which we are aware operate commercial services out of hours—generally before 7 am or after 7 pm on Mondays to Saturdays—although a few more operate services on Sundays (the Stagecoach services within Glasgow also do not operate after about 8.30 pm or 9.30 pm). FirstGroup estimated, for a sample of routes in the Glasgow area, that the out-of-hours market accounted for about [ ] per cent of its total bus passengers.

- 4.41 There are relatively few sections of routes with more than one competitor to FirstGroup. There is also no other operator with a substantial network of services centred in Glasgow, or able to offer network tickets to compete with those of FirstGroup.
- 4.42 FirstGroup estimated the market share of its commercial bus services within Greater Edinburgh and the Lothians at 24 per cent, the bulk of the remaining market being accounted for by Lothian, owned by the city of Edinburgh and other neighbouring local councils. FirstGroup is, however, the main operator between the city of Edinburgh and many of the surrounding areas. It estimated its market share of commercial bus services in Stirling, Falkirk and Clackmannanshire at 87 per cent.
- 4.43 Combining FirstGroup's current share of bus services with ScotRail's share of rail services, following the merger it would account for almost 70 per cent of all revenues (including subsidies) from operation of public transport in Scotland and, on the basis of FirstGroup and ScotRail share of current ZoneCard revenues, a similar figure in Strathclyde.

## **5. Assessment of competitive effects of the merger**

- 5.1 In assessing the competitive effects of the merger, we consider first the extent of overlap between FirstGroup and ScotRail on the local markets identified; secondly the effects of the merger on those overlap flows taking into account prospects for entry or expansion<sup>16</sup> on them; and finally the effects on the broader markets identified above.
- 5.2 Our normal method in these cases is to assess the likely effects of a merger in relation to what is likely to happen in the absence of the merger. In this case, either of the two remaining bidders—National Express or Arriva—would obtain the franchise. In the case of the former there would be no change on the current situation: in the case of the latter, there would be far fewer overlaps than result from the FirstGroup acquisition. In either case, the rail and bus network in the Edinburgh

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<sup>16</sup>We use 'expansion' to mean operation of higher frequencies by competitors on routes they currently operate and extensions to existing services, as opposed to their ability to increase the number of passengers carried on their existing services; and 'entry' to mean the operation of new routes by a new or existing operator.

area and in most of Glasgow would remain in separate hands, and there would be no increase in FirstGroup's current share of the public transport market in these areas, or in Scotland as a whole.

### ***Extent of overlap between FirstGroup and ScotRail***

- 5.3 We consider first the effect of the merger on the local markets identified above. As noted in paragraph 3.13, the main concern raised by the OFT, in its decision document setting out the reasons for the reference to us, was that the merger would result in the loss of competition on a number of point-to-point flows where bus and rail services overlapped (which we have referred to as overlap flows). Our initial concern is therefore with those flows to and from the catchment areas of individual rail stations which overlap with those of FirstGroup bus services.
- 5.4 As discussed in Appendix G, FirstGroup provided details of almost 800 point-to-point overlap flows. It identified any overlaps of bus and train services as follows. For First Edinburgh, in more rural areas FirstGroup listed overlaps where both bus and train serve a settlement regardless of the station/stop locations. In the more urban areas served by First Edinburgh, FirstGroup listed bus services and rail routes as overlapping where broadly speaking the catchment area of a rail station overlaps with the catchment area around the nearest bus stop, using 800 metres for a rail station and 400 metres for a bus stop.<sup>17</sup> Within Glasgow, reflecting the much denser provision of public transport, FirstGroup listed bus services and rail routes as overlapping where broadly speaking rail stations are within 300 metres of a bus stop. It told us that the catchment areas assumed were consistent with those more widely used within the industry. However, where there was an overlap, FirstGroup estimated the number of bus passengers on the fare stage<sup>18</sup> including that stop, even when some of the bus stops in the fare stage were a long way from the rail station. By doing so, FirstGroup believed its analysis exaggerated the degree of overlap between bus and rail services (as, it believed, did other aspects of its methodology for estimating the number of passengers on overlap flows—see also Appendix G).
- 5.5 In its analysis before making the reference to the CC, the OFT made two assumptions which reduced the number of overlap flows to be considered to about 160:
- (a) First, it only considered those overlaps where there were no other existing competing bus operators.
  - (b) Second, it did not consider overlaps where the journey time by bus exceeded that of the train by two times or more (because, in those circumstances, it felt the bus was unlikely to provide an acceptable substitute for the train).
- 5.6 FirstGroup itself put forward a suggestion that we should consider only those flows:
- (a) which generated revenues above a minimum level (FirstGroup examined the effect of adopting a figure of £5,000 a year of bus revenue—a figure at one stage put forward by the CC itself—but went on to suggest that a higher figure of £20,000 would be appropriate);

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<sup>17</sup>ie the station and the bus stop could be up to 1,200 metres apart.

<sup>18</sup>A number of bus stops may be combined into one fare stage for ticketing purposes, with identical fares from and to each stop.

- (b) where the revenue from overlap flows on a route accounted for more than 10 per cent of total revenues on that route (an option we ourselves were considering and discuss below);
- (c) where there was no competitor present;
- (d) where the bus journey time was less than double the train journey time;
- (e) where the level of train fares exceeded that of bus fares and in addition bus services could be diverted away from rail stations so as to encourage passengers in the catchment area of the station to use trains without needing lengthy (taken as more than 5 minutes) rerouting (so that it would be easy and profitable to divert passengers from bus to train); and
- (f) where there were fewer than three fare stages from the overlap flow to the end of the route, allowing scope to increase fares without distorting the general fare structure on the route.

FirstGroup estimated that, allowing for the above factors, only some 3 per cent of overlap flow revenues, on 5 out of 84 bus routes on which overlaps occurred, would give rise to concern.

- 5.7 In analysing the effect of the merger on overlap flows, we considered these and other criteria discussed below in considering whether the merger could result in an SLC.
- 5.8 First, we do not believe that we should apply a de minimis threshold of £20,000 suggested by FirstGroup in paragraph 5.6(a) in deciding which routes to examine. Although it was previously used by the CC, in the Central Trains<sup>19</sup> inquiry, in examining the effects on competition between a rail and coach operator, such a threshold is not in our view appropriate for a local bus service, which individual passengers use more regularly than the coach services considered in the previous report. Regular use means that any adverse effects on individual passengers arising from the use of market power could be significant, even though only a small number of passengers may be affected. Routes will also be made up of a number of overlap flows, and the total effect on the route as a whole could be material (and could exceed £20,000), even though the effect on each individual flow is only limited (and less than £20,000).<sup>20</sup>
- 5.9 Second, we believe that it is the service offered by competitors rather than merely the number of competitors that is relevant in establishing the extent to which the merger could affect competition on any particular route (see paragraph 5.6(c)). In identifying possible routes which give rise to concern, therefore, we have examined all overlap flows, taking into account (as described in paragraph 5.26) the extent and nature of competition from other operators in identifying where concerns are most likely to arise. In particular, as we have noted above and discuss further below, very few operators other than FirstGroup operate out of hours.
- 5.10 Third, we are doubtful whether it is appropriate to distinguish between overlap flows merely on the basis of relative journey time (see paragraph 5.6(d)). As we have noted above, passengers' choice between bus and rail services is likely to be affected by a number of factors (summarized in the concept of generalized cost of a

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<sup>19</sup>*National Express Group PLC and Central Trains Limited: a report on the merger situation*, The Stationery Office, Cm 3774, December 1997.

<sup>20</sup>In one case, for example ([§]), there are over 30 overlap flows, of varying scale, of which 27 are below £20,000. A £20,000 threshold would, in that case, exclude our considering total revenue of about £100,000. Taking the route as a whole the revenues could be as great as the level taken into consideration by the CC in previous bus cases.

journey—see paragraph 4.19). These include not just the journey time spent on a bus or train, but also other components making up total travel time, such as the frequency with which the services operate and the proximity of the bus stop and rail station to passengers' origins and destinations. Quite apart from time factors, relative fares are also relevant. The use of network tickets can make it considerably cheaper to use the services of one operator or one mode, rather than interchange between different operators or different modes and pay separate fares for each leg of the journey. It seems to us therefore that any disadvantages of longer journey time can in practice be offset by other advantages of using bus or train.

- 5.11 The attractiveness of bus use to many passengers despite longer journey times is apparent from the information we saw on the use of bus and rail journeys on different flows. For example, between Clydebank and Glasgow, the bus journey time is between 35 and 53 minutes on four main routes; and the train journey time between 17 and 19 minutes: the bus journey time is generally therefore double the train journey time.<sup>21</sup> Bus return fares on these routes are, however, cheaper than rail fares in the peak (£2.30,<sup>22</sup> compared with £3.20), and free concessionary fares for persons over 60 are also only available on buses; and bus services are considerably more frequent than those of train (24 an hour compared with four). Possibly for these reasons, a large majority of passengers on FirstGroup's figures ([ ] per cent) travel on bus rather than rail (although FirstGroup suggested the figures used to calculate bus passengers on a flow may include an element of overestimation as a result of the limitation of the best available methodology—see also Appendix G). More generally over a significant number of overlap flows, we found the proportion of passengers using bus or train where the bus journey time was more than double rail journey time was similar to that where the bus journey time was less than double rail journey time. We decided therefore not to exclude overlap flows from consideration merely on the basis of differing bus and rail travel times.<sup>23</sup>
- 5.12 We have therefore adopted an alternative approach in considering the extent of local overlaps between FirstGroup and ScotRail. It is not, in our view, meaningful to examine specific overlap flows in isolation from the routes on which the flows occur. Specific overlap flows are often served by a number of bus routes; and most bus (and rail) routes are made up of a myriad number of flows. Although routes can be, and often are, reconfigured (see paragraph 5.17), the scope for any changes by an operator, for example in fares and frequencies, and the constraints on them can best be analysed by reference to an identified route rather than by reference to individual flows within that route, even though our ultimate concern may be with the effect on the overlap flows as such.
- 5.13 We initially used three main criteria in identifying those routes which are most likely to give rise to concern, namely:
- (a) where the percentage of revenues on a bus route accounted for by all overlap flows (of the kind mentioned in paragraph 5.4) on that route exceed 10 per cent;
  - (b) where, in localities outside the Glasgow and Edinburgh city centres, the potential size of catchment areas may exceed those assumed by FirstGroup (see paragraph 5.4) and where there is scope for reconfiguration of services; or

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<sup>21</sup>The difference in journey time is less on other routes between Clydebank and Glasgow which were, however, excluded from FirstGroup's figures.

<sup>22</sup>There are no point-to-point return tickets in the Glasgow area; this is the price of a Firstday ticket, which allows travel on any FirstGroup services in the Glasgow area, but is often purchased as a return ticket.

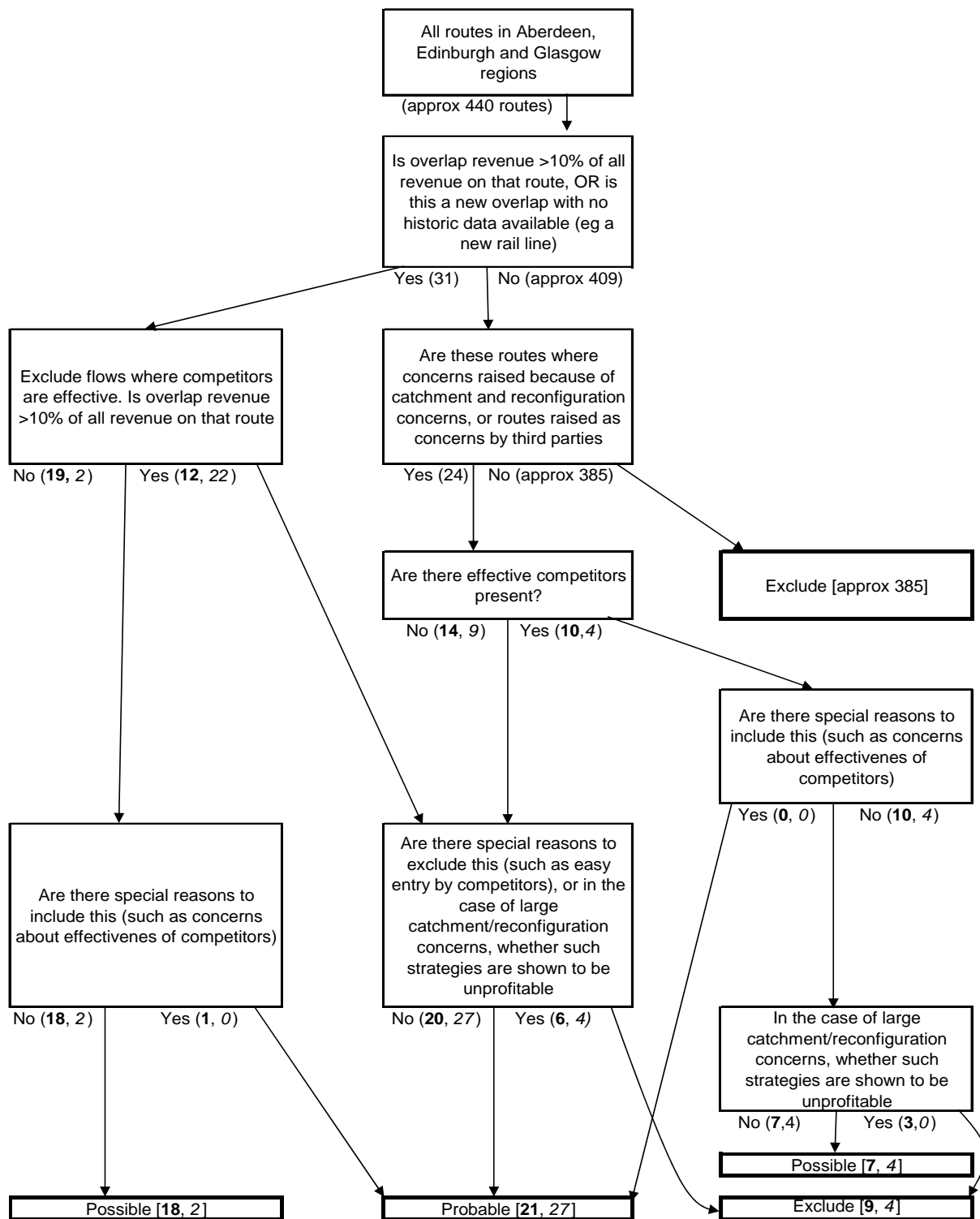
<sup>23</sup>We return to the remaining points—(b), (e) and (f) in paragraph 5.6—in paragraphs 5.14, 5.35 and 5.49.

- (c) where specific concerns about additional routes in the West Lothian area were raised by the local authority, generally giving rise to similar issues to (b).

We then considered other factors relevant to determining the effect of the merger on competition on those routes. Our full analysis is set out in Appendix G, but explained more briefly in paragraphs 5.14 to 5.29 and summarized in Figure 1. As can be seen from Figure 1 and explained further below, of some 440 routes in Glasgow, Edinburgh and Aberdeen, we considered some 55 routes on the basis of the criteria set out above. Nine were excluded, for reasons discussed below. Of the remaining 46 routes we identified some 21 in hours and 27 out of hours (including many of the previous 21) as of probable concern; and 25 in hours, 6 out of hours as of possible concern.

FIGURE 1

**Flow diagram of the steps used to identify routes with probable and possible concerns**



**Notes:**

1. The exercise has to be completed for in-hours and out-of-hours services separately.
2. The numbers on the decision tree diagram indicate the number of routes in each category. Where results differ for in-hours and out-of-hours services, in hours are shown in bold, out of hours in italics. Numbers of out-of-hours routes do not add up to the total of routes, as some routes do not operate out of hours.

Source: CC.

### *Routes with over 10 per cent revenue on overlap flows*

- 5.14 We considered first the percentage of revenues on bus routes accounted for by overlap flows (to which paragraph 5.6(b) above also referred). In general, the number of bus passengers on a bus route who start and end their journeys in places within the catchment area of rail stations is a small fraction of the total number of passengers on the bus route. In most cases it is under 10 per cent whether measured by revenues or number of passengers. Where the overlap flows are relatively insignificant, it would be difficult or even counterproductive to change the operation of a service between the overlap flow points without impacting on the operation of the route as a whole: lower frequency of service, for example, could result in some passengers not making a journey at all. We therefore initially eliminated all routes where the share of revenue from overlap flows was below 10 per cent.
- 5.15 There are 30 routes—listed in Annex 1 to Appendix G—where revenues from overlap flows exceed 10 per cent of the bus revenues of the route. Twenty-three are routes operated by First Glasgow mainly in the Glasgow area and seven by First Edinburgh.<sup>24</sup> In addition, we considered one further route which overlaps with a new railway service due to be opened by the end of 2005, but, as we discuss further below, other new railway services for which there is provision in the franchise could give rise to overlaps on other routes. In total, these 30 routes account for 450 overlap flows:<sup>25</sup> 363 in the Glasgow area and 87 on First Edinburgh routes. The total revenue arising from these 30 routes is £[redacted] million (£[redacted] million on in the Glasgow area and £[redacted] million on First Edinburgh routes); and the total revenue arising from overlap flows is £[redacted] million (£[redacted] million on the Glasgow area and £[redacted] million on First Edinburgh routes). For comparison, in the year to March 2003 the turnover of First Glasgow was £94.3 million and First Edinburgh £36.6 million, and that of FirstGroup's subsidiaries in Scotland as a whole some £150 million. Hence, these overlap flows represented only about [redacted] per cent of the revenue of First Glasgow, and [redacted] per cent of the revenue of First Edinburgh.

### *Wider catchment areas*

- 5.16 Second, we considered routes serving potentially larger catchment areas than those mentioned in paragraph 5.4. We noted above the relatively limited catchment areas used by FirstGroup in identifying overlap flows (although FirstGroup regarded the data calculated on those flows as likely to be overstated). In our view, the size of catchment areas may be expected to vary according to the characteristics of particular locations. For example, some 40 ScotRail stations in the Glasgow area (generally outside the inner city) have free park-and-ride facilities, which we would expect to attract passengers from a much wider area. This would also be the case if passengers travel by bus to a station to continue their journey by rail (or vice versa).
- 5.17 However, the size of catchment areas is also likely to depend on the services available. Passengers may currently prefer to use direct bus services into a city centre from areas at some distance from a local railway station. This will particularly be the case if there are only poor connecting bus services to the railway station; but even if there are 'feeder' services that provide good connections with rail services, passengers may prefer to travel on direct bus services rather than change between bus and train. In certain cases, however, it would be possible to reconfigure bus

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<sup>24</sup>The First Edinburgh routes include two in the Stirling area. One of the other Glasgow area routes referred to in paragraph 5.19 is operated by First Edinburgh, and included in First Edinburgh routes in paragraphs 5.24, 5.25 and 5.31.

<sup>25</sup>An overlap flow which occurs on, for example, two routes is treated twice in these figures.

routes<sup>26</sup> to operate as feeder services to and from railway stations, and withdrawing or partially withdrawing direct services (or by other actions intended to switch passengers from direct services to train, eg by changing fares or service levels).

- 5.18 The operation of buses as feeder services to rail could be regarded as exploiting market power if, for example, it was associated with the withdrawal or partial withdrawal of overlapping services, which currently offer choice. Such exploitation would be especially apparent if passengers were obliged to pay significantly higher fares, particularly over longer distances, for travel by rail rather than bus. (Appendix H shows that rail fares are significantly higher than bus fares over longer distances in the areas we are considering.) Passengers on journeys to intermediate points on the existing bus routes would also be adversely affected by poorer levels of service even if it could be assumed that some journeys on the existing routes were retained. There are, for example, currently frequent direct bus services between different parts of Livingston and Edinburgh, particularly in peak periods. If those services were at least in part replaced by bus services to the two railway stations in Livingston, to connect with rail services to central Edinburgh, there would be a deterioration in services for passengers currently travelling by bus to stops currently served between Livingston and central Edinburgh.
- 5.19 We have therefore considered the effects of the merger on a further 16 routes serving sizeable discrete communities which are at some distance from Glasgow or Edinburgh and which have one or two rail stations. Twelve of these routes were in and around Glasgow, including those linking East Kilbride and Cumbernauld to Glasgow (one of which is operated by First Edinburgh), and four around Edinburgh, for example linking parts of Livingston to Edinburgh. In these cases, the overlaps taken into account by FirstGroup would cover only a small proportion of bus users travelling between those communities and Glasgow or Edinburgh. This is because the majority of bus passengers in these communities are being served by direct bus services from areas outside the assumed catchment areas of the railway stations, but who could, if services were reconfigured to operate as feeder services to and from the railway stations, use trains instead.
- 5.20 FirstGroup acknowledged that in urban areas at some distance from a city centre, some passengers may indeed be willing to incur high costs in order to switch to rail, should bus services deteriorate or become more expensive, and that potential catchment areas could therefore be somewhat wider. Such passengers may be prepared to travel further to a rail station by walking further; by 'park and ride' (although it showed us evidence that there was little spare capacity in station car parks in any of the areas relevant to our inquiry); by 'kiss and ride' (being driven to or from the station by another member of the family); or by 'bus and ride' (using a bus to access the station). However, it believed it important not to exaggerate that effect, particularly given the extent to which, in its view, its analysis of catchment areas had itself already overstated them. It believed the '10 per cent rule' (by which it referred to our approach set out in paragraph 5.14), being based on figures which it believed exaggerated the extent of overlap on routes, was so conservative that there was no need to modify it at all. However, if such a modification was deemed necessary, it believed a modification of the 10 per cent to exclude routes where the percentage of passengers accounted for by overlap flows was less than 9 per cent was more than adequate. None of the 'wider catchment area' routes we were considering would, on that approach, be of concern.

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<sup>26</sup>We use the term reconfiguration to include significant changes to the starting and/or finishing points of services, and the routes they take, including replacing in whole or in part a direct route, for example one operating between a housing estate and the city centre, with a route that operates as a feeder service to a rail station and that requires passengers to continue their journey by rail. This is distinct from more minor rerouting or diversions in which, for example, buses would operate nearer rail stations so as to make it easier for any passenger who wished to do so to transfer to a train.

5.21 FirstGroup's analysis of the potential significance of wider catchment areas in such areas made no allowance for possible reconfiguration of services to become feeder services for rail. It believed no such further allowance was necessary, since it did not believe such a strategy would be profitable. FirstGroup provided a separate analysis looking at the issue of whether there was a profitable opportunity to reconfigure a route. On the basis of the further information supplied by FirstGroup, we have accepted that some of the routes we provisionally identified are not of concern: see paragraph 5.29. However, in our view, there are a number of routes where such a strategy of reconfiguring or partially reconfiguring routes could be profitable, which we discuss in Appendix G. The extent to which this is the case is likely to depend on factors such as the proportion of passengers on a route travelling from the wider catchment areas to city centre destinations themselves served by rail; the extent to which, taking into account withdrawal of direct services or their partial withdrawal and the lower frequency of direct services that would then be offered, they would be prepared to switch to rail; and the higher fares they would have to pay to travel by connecting rail services. FirstGroup's own figures showed that this strategy would be profitable in the case of a few particular routes (although in practice it believed this would not be the case). We believe that on the basis of conservative assumptions about the proportion of passengers who would switch to rail if services were withdrawn or partly withdrawn and the higher fares they would be charged on rail compared to bus, such a strategy would be profitable on a number of routes.

### *Local authority concerns*

5.22 Third, we also included a further eight overlap routes in the Edinburgh area about which specific concerns were expressed to us by the local authority about their continued operation.<sup>27</sup> Most of these routes were express, peak-hour services (some only running once or twice a day) linking Bathgate or Livingston or surrounding areas to Edinburgh, but with little or no overlap on the basis of FirstGroup's overlap measure. The areas served by them would, however, fall within the potentially larger catchment areas considered in the previous paragraph and they would also in our view be potentially vulnerable to reconfiguration as feeder services.<sup>28</sup>

5.23 FirstGroup argued that it would have no incentive to withdraw these services; and that the general conclusions of its analysis of wider catchment area routes, to which we referred in paragraph 5.20—that any reconfiguration of such routes would not be profitable—would also apply to these services. As we discuss in Appendix G, we believe these concerns are valid on a number of these routes.

### *Possible and probable routes of concern*

5.24 In addition to the 31 routes to which we referred in paragraph 5.15, we therefore considered 24 other routes which served potentially wider catchment areas, or about which concerns had been raised by local authorities. The additional 24 routes accounted for a further 99 overlap flows; the total revenue on these 24 routes was about £[redacted] million (£[redacted] million in the Glasgow area and £[redacted] million on First Edinburgh routes). FirstGroup identified revenue on overlap flows on these routes at some £[redacted] million (£[redacted] million in the Glasgow area, £[redacted] million on First Edinburgh

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<sup>27</sup>That local authority was not otherwise concerned about the merger.

<sup>28</sup>One concern, however, related to a particular overlap flow we did not regard as of issue, the particular route serving that flow also serving many non-overlap flows. Concerns were also raised by other public bodies, but generally about routes included above.

routes), although the revenue on overlap flows including the wider catchment areas would exceed this.

- 5.25 In total therefore we initially considered actual and potential overlap flows on 55 routes (31 plus 16 plus 8) where loss of competition between bus and rail as a result of the merger could in principle be exploited by FirstGroup: 35 in Glasgow, about one-third of its First Glasgow routes, and 20, less than 10 per cent, of First Edinburgh's routes. The total revenue on those routes is about £[redacted] million (£[redacted] million in the Glasgow area and £[redacted] million of First Edinburgh) and on the overlap flows identified some £[redacted] million (£[redacted] million in the Glasgow area and £[redacted] million of First Edinburgh). We noted the turnover of the FirstGroup and First Edinburgh operations in paragraph 5.15; overlap routes represent a significant minority of FirstGroup's total revenues in the Glasgow and, to a lesser extent, Edinburgh areas, although the overlap flows are clearly much less significant.
- 5.26 If an effective competitor is present on a route, however, FirstGroup would be less likely to attempt to divert passengers from bus to rail or be able to do so profitably. As noted in Appendix H, other companies operate on somewhat less than one-half of the main overlap flows into central Glasgow and central Edinburgh, but, in the case of Glasgow, other companies generally have a small share of services on each route. However, FirstGroup is often the only operator out of hours, facing competitors on less than 20 per cent of those main overlap flows in the late evening (some competitors' services operate on Sundays but very few in late evenings).
- 5.27 We therefore consider those of the 55 routes without any effective competitors to be potentially problematic. The criteria we have adopted for this purpose are considered further in Appendix G. Briefly, we have taken into account not just the presence of one or more competitors but also whether they operate at sufficient frequency to compete effectively with FirstGroup.<sup>29</sup> As noted above, and discussed in more detail in Appendix G, however, relatively few competitors currently operate out of hours (a number of the FirstGroup routes identified above also do not operate out of hours).
- 5.28 In allowing for the presence of effective competition, we have also adjusted for other factors on a limited number of those 55 routes:
- (a) We included one route (the X1 from Hamilton to Glasgow), where the FirstGroup route operates via the motorway, whereas the competitor's route has a much longer journey time.
  - (b) On the other hand, we excluded two routes. One of these routes (the 55 between Glasgow and Braehead) runs close to an Arriva route, which could easily be diverted were FirstGroup's services to be reduced or fares increased. As regards the other route (the 43/A between Edinburgh and South Queensferry) Lothian could extend its services, or Stagecoach divert off the motorway to pick up passengers. It would therefore require only a relatively minor extension or diversion of the services of a major operator to serve the overlap flows in each case.
- 5.29 Following the publication of our provisional findings, we received a number of comments on the routes we identified at that stage and we have taken these into account in reaching our conclusions. FirstGroup's comments, which we discuss in Appendix G, mainly concerned our inclusion of routes relating to wider catchment

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<sup>29</sup>As noted in Appendix G, in the case of the routes where revenue from overlap flows exceeded 10 per cent of route revenue, we assessed whether that was still the case for those sections of the route without effective competition; in the case of the other routes, we assessed whether there was effective competition on those parts of the route between the broader potential catchment areas and the respective city centre.

areas to which we referred above. On the basis of the information provided by FirstGroup, we accepted that it would not be profitable to reconfigure services on some of those routes serving wider catchment areas, or some of those about which local authorities expressed concern. Generally, a significant proportion of passengers on these services travelled between the localities concerned and points beyond those localities not served by railway stations. The cost savings from reconfiguring those routes would be less than the likely loss of revenue from passengers now unable to travel to or from those other points. As noted in paragraph 5.21 and Appendix G, however, we did believe there would be loss of competition on other such routes.

5.30 However, we also received comments that competition might be reduced on a number of routes in Glasgow about which we were not concerned. Some of those additional routes mentioned to us crossed the centre of Glasgow, and it was suggested to us that there might be a significant loss of competition on one side of Glasgow, even if it were absent on the routes taken as a whole. We examined a number of such services in detail, and found that the '10 per cent rule' we set out above would not have been satisfied on part of the route alone, hence we did not expect a substantial loss of competition on them.

5.31 Of the 55 routes referred to above, nine did not give rise to concern for the reasons set out in paragraphs 5.28 to 5.30. Of the remaining 46 routes, we identified the following number of routes where the loss of competition between bus and rail may have substantial adverse effects (see also Table 6 of Appendix G):

(a) Twenty-one routes (10 in the Glasgow area, and 11 of First Edinburgh) on which there is currently no existing effective competitor (see paragraph 5.26) in hours (or a major competitor that could readily divert or extend its existing services to cover the main overlap flows). These routes account for £[redacted] million revenue in the Glasgow area and £[redacted] million revenue of First Edinburgh; and the overlap flows (as currently identified by FirstGroup, but potentially wider) for £[redacted] million revenue in the Glasgow area and £[redacted] million revenue of First Edinburgh. The total revenue of these routes is about £[redacted] million (some [redacted] per cent of the total turnover of First Glasgow and First Edinburgh combined). The total revenue from current overlap flows on those routes (but excluding revenues from the wider catchment areas referred to above) is about £[redacted] million,<sup>30</sup> less than 2 per cent of the total turnover of First Glasgow and First Edinburgh combined or of FirstGroup's bus subsidiaries in Scotland as a whole.

(b) Twenty-seven routes (including many of the 21 identified in (a)) (21 in the Glasgow area and six of First Edinburgh) on which there is currently no existing competitor out of hours.

However, as shown in Figure 1, another 25 routes would be of concern in hours if there was a loss of effective competition from other bus operators currently operating in hours on these routes. Another six routes would be of concern out of hours if there was a loss of competition from other bus operators currently operating out of hours on those routes. We also therefore regard these as possible problem routes.

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<sup>30</sup>Total route revenues, in hours and out of hours.

## ***Effect of the merger on those overlap flows***

- 5.32 As noted in paragraph 3.5, the extent to which the effects of any loss of competition between train and bus services may affect such services partly depends on the regulatory regime that will be adopted for the rail franchise. We noted in paragraphs 3.7 to 3.10 and in Appendix C the extent of regulation of rail fares and frequency of services and other aspects of a franchisee's performance. Given those regulatory constraints on the rail services, we do not believe that the loss of competition between bus and rail would have a significant effect on those rail services. Nor, given the decision that the franchisee should at least share revenue risk, would it have the incentive to divert passengers from rail to bus, for example by allowing performance on the rail services to deteriorate (in so far as it could do so given the detailed prescription of service levels within the franchise).
- 5.33 We have noted in paragraph 3.13 that a main concern raised by the OFT was that, in consequence of the loss of competition on overlap flows, bus services could be reduced or fares increased to shift passengers from bus to rail. Similar concerns were expressed to us by a number of third parties (see extracts of third party evidence on the CC's web site), some of whom were further concerned that, as a result of any reconfiguring of bus services to serve rail stations, there would be a deterioration or even withdrawal of service to other destinations.
- 5.34 After the merger, FirstGroup would be both the sole or predominant operator of bus services, and the only train operator on the routes and overlap flows we have identified in paragraph 5.31.
- 5.35 There are a number of ways in which FirstGroup could attempt to encourage passengers to switch from bus to rail on the routes in which competition has been significantly reduced; for example:
- (a) by reducing frequencies and/or hours of operation by changing times of the first and last bus when profitability is likely to be lowest and/or reducing other aspects of quality of service on bus services which currently run in parallel with rail services;
  - (b) by selectively increasing bus fares on direct services in the catchment areas of rail stations;
  - (c) by diverting bus routes away from stations where possible in order that passengers in the catchment areas of stations would have to use rail,<sup>31</sup> or
  - (d) by reconfiguring services (as discussed in paragraph 5.17) at least in part, to act as feeder routes to rail stations instead of allowing passengers to travel direct to Glasgow or Edinburgh (the origins or destination of the main overlap flows) by bus and without having to change to a train service.

FirstGroup itself stated that, since acquiring its existing rail franchises in other parts of the country, it had made changes to bus services that overlap with rail services. But it said that these changes were not as a result of common ownership of the services. It added that services had been reduced or withdrawn from some routes in the South-West and in Manchester due to poor commercial performance, ie weak customer demand and/or escalating losses.

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<sup>31</sup>We accept that, since most railway stations are situated on the main bus corridors where bus passengers wish to travel to or from destinations not served by rail, the scope for such diversions is limited (to which paragraph 5.6(e) also refers).

- 5.36 FirstGroup told us that it had no current intention or expectation of making any such changes to its bus services as a result of the merger. It argued that there were a number of practical constraints on doing so, including constraints arising out of the specific characteristics of the main routes with overlap flows. It also said that its rail and bus operations each had strong and different cultures and would be independently run. However, we would expect its bus and rail operations increasingly to seek convergence of common commercial interests and to be alert to the opportunities of making the businesses assist each other whenever possible in order to maximize overall group profits.<sup>32</sup>
- 5.37 In considering whether the merger may be expected to result in FirstGroup making changes on the overlap routes identified above in order to secure a switch of passengers from bus to rail services, we considered first whether passengers would be prepared to switch; secondly, whether it would be profitable for FirstGroup to attempt to bring this about; and thirdly, whether it would be constrained from doing so by the existing undertakings (see paragraph 5.44 and following) relating to its bus operations and other aspects of its fare structure. We then considered whether it would have scope to do so, given the prospect for entry on those routes.
- 5.38 We have noted in paragraph 4.25 that bus and rail, based on the NOP survey of passengers, are substitutable for a significant group of passengers. The survey suggested, for example, that the bus passengers in this group would expect, if they switched to the train, a fairly limited increase in total journey time (on average, only about 10 minutes). Moreover, a substantial proportion (almost 25 per cent of bus users) who saw rail and bus as substitutes for some of the journeys saw switching between them as easy for those journeys. In our view, those findings show that substitution to rail can be secured by relatively small reductions in bus frequency or increases in fares. Overall, we regard the survey as suggesting that enough passengers would switch from bus to train to make a strategy of diverting passengers from bus to train potentially worthwhile, but recognizing at the same time that passengers may switch to other bus operators if they exist.
- 5.39 Whether it would be profitable for FirstGroup to switch bus passengers to rail services depends first on whether FirstGroup would retain some of the additional rail revenues generated.<sup>33</sup> We noted above that the Scottish Executive has recently decided not to pursue the option of the public sector bearing the entire revenue risk (see paragraphs 3.5 and 3.6); but to award the franchise on the basis either of the franchisee bearing the full revenue risk, or of the revenue risk being shared on a cap-and-collar basis between the franchisor and the franchisee. Even on the latter basis, the franchisee would bear all revenue risk in a range around its base projection, and much of the revenue risk in a band around that range. Outside that range, it would bear only a fairly limited proportion of the revenue risk (see Appendix C). However, there would be no additional support for the franchisee for the first four years of the franchise if revenue fell below the base projections. Hence, even under such a cap-and-collar approach the arrangements would still provide an incentive to the franchisee to increase revenues from rail users.
- 5.40 Whether it would be profitable to divert passengers from bus to train will also depend on the extent of the overlap population—ie the percentage of customers that can switch on a route—and the percentage of those passengers that would shift if, for example, the frequencies of bus services were reduced or their fares increased (in

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<sup>32</sup>A similar issue arose in a previous inquiry, the Central Trains merger, during which National Express incorporated as a schedule to the franchise agreement an undertaking not to reduce bus services other than in certain circumstances (see Appendix 3.7 of that report).

<sup>33</sup>Indeed, if revenue risk was fully borne by public sector bodies (an option originally included in the ITT), the reverse could in theory apply—it could be profitable to encourage passengers to switch from rail to buses.

effect, on the cross-elasticity). It will also depend on the number of passengers that may as a result be deterred from travelling by public transport at all (the other main component of own price elasticity of buses), or would switch to other bus operators' services. Finally, it would depend on the relative levels of fares and variable costs as between rail and bus. Increases in passenger numbers do not significantly increase rail costs unless additional coaching stock or services are required, but there are relatively high variable costs for buses, if the level of bus service is adjusted in line with changes in passenger numbers.

- 5.41 FirstGroup noted that, if, as it argued the survey had suggested, a fare increase of 10 per cent resulted in 25 per cent of people ceasing to travel on its buses, only 30 per cent of these would go to rail—7.5 per cent of the total. Hence total FirstGroup revenue would be reduced, unless higher revenue from rail fares offset the loss of bus revenue. This would require rail fares to be almost three times as high as bus fares, which was not the case on any overlap flows. This analysis did not, however, allow for any scope for savings in bus operating costs from frequency adjustment to match lower numbers of passengers. Further, the price elasticity and cross-price elasticity of demand assumed for the purpose were several times higher than any other estimate we had seen. A lower price elasticity of demand (which would be consistent with more general evidence we saw, referred to in Appendix D) would give a significantly different result.
- 5.42 As discussed in Appendix I, we simulated the increase in profit that could be generated, on rail and bus services in aggregate, on a number of the routes shown in Annex 1 of Appendix G, arising from a 10 per cent increase in headway (resulting from a reduction in frequency); and secondly, from a 10 per cent increase in bus fares. In these simulations, we assumed that there would be no constraints on FirstGroup taking such actions: we discuss whether or not there would be any constraints on their doing so below:
- (a) In the examples where we reduced bus frequency, using a range of headway elasticities<sup>34</sup> (from  $-0.25$  to  $-0.40$ ), our calculations showed that there would be a relatively limited number of routes in which the gain in rail revenue from switching passengers from bus to rail, combined with the bus-operating cost savings, would be greater than the loss of revenue resulting from the decline in the number of bus passengers as a result of the lower bus frequencies operated. Moreover, most of the bus-operating cost savings could be achieved irrespective of the merger, and the extra rail revenue, in most cases, would only form a small part of any increases in profits.
  - (b) Our calculations also suggested that it was more likely to be profitable to increase fares than reduce frequencies on FirstGroup's bus services. In the examples where we simulated increases in fares using a range of price elasticities (from  $-0.3$  to  $-1.0$ ), our calculations showed that an increase in fares would be profitable for FirstGroup on most of the routes we considered, since a fare increase would not only generate additional rail revenue as a result of passengers transferring from bus to rail, but also additional bus revenues from those passengers remaining on the bus services and who would pay the increased fare. Most of the increase in profitability would, at lower elasticities, be generated by passengers continuing to use bus services, as many would do. This may suggest scope to increase fares irrespective of the merger, but, nonetheless, the merger would give an additional incentive to raise fares, since it would allow FirstGroup to benefit more from the additional rail revenue that would be generated by the number of passengers transferring to rail which, the

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<sup>34</sup>The effect on demand of an increase in the interval between services.

NOP survey suggested, a significant proportion would do. With higher elasticities, the impact of the merger would be greater. When we used an elasticity of  $-1$ , our calculations showed that FirstGroup would have the incentive to increase fares after the merger, where it did not have before the merger.

- (c) Both these effects would be more pronounced out of hours when the current level of service is already often lower. As explained in Appendix I, if FirstGroup were to reduce the frequency of its bus services it would be more profitable to do so on out-of-hours bus services as those are less profitable than in-hours services. FirstGroup argued that the contribution of its out-of-hours services was often high: but for a number of routes it cited to us it appeared considerably below that of its in-hours services. The first and, on some routes, last buses of the day may in particular be among the least profitable. A higher proportion of passengers are also likely to switch to rail at off-peak times, given the lack of bus competition.<sup>35</sup> (FirstGroup argued there was more competition from taxis particularly late on Saturday evenings: but taxis are likely to be considerably more expensive for many users unless shared between a number of them.) There would also be scope to target fares increases on out-of-hours bus passengers, for example by restricting the time of availability of day tickets.
- (d) The simulations referred to above did not cover possible reconfiguration of routes, for example to operate as feeder services into train stations combined with—at least in part—withdrawal of direct services. Such reconfiguration of routes would be likely to produce more significant operating cost savings and be profitable to FirstGroup after the merger. FirstGroup argued that passengers did not like to use feeder services, preferring not to transfer between bus and rail, but its assessment of the profitability of such reconfigurations may be expected to change after the merger. Currently, it has little incentive to develop such feeder services, since it would lose some of the revenues currently generated on its bus services to the train operator; following the merger, however, it would retain the revenue of passengers switching from bus to rail. It also argued that its bus routes served intermediate points: but nonetheless there is likely in our view to be scope for at least partial reconfiguration of routes in some cases. As we have noted above in the context of routes serving potentially wider catchment areas, and discuss in more detail in Appendix G, there are a number of such routes where, in our view, reconfiguration or partial reconfiguration of services into feeder services would be profitable for FirstGroup.

- 5.43 The analysis in paragraph 5.42 does not take into account the effect of constraints on FirstGroup. There is no countervailing buyer power in the local markets affected by the merger given the deregulated nature of the bus industry, but we now consider other possible constraints: in particular, various undertakings which currently apply to FirstGroup's bus operations in the areas we are considering and other aspects of FirstGroup's fare structure. We then consider possible competitive entry.

### *Current undertakings*

- 5.44 A number of undertakings, as detailed in Appendix J, were given by FirstGroup following the FirstBus/SBH inquiry in 1997.<sup>36</sup> The undertakings were not given until 2002, although the OFT has stated that FirstGroup acted within the spirit of the

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<sup>35</sup>However, since rail services do not operate from Glasgow between 11 pm and 5 am, FirstGroup's network of night buses in Glasgow would not be affected by the merger.

<sup>36</sup>These undertakings were required as an alternative to divestment of a number of FirstBus depots and associated routes, as recommended in that report.

intended undertakings in the interim. They include a fares cap—a requirement that a basket of fares will not increase by more than the increase in the Retail Price Index—in the operating areas both of First Glasgow and First Edinburgh, other than the City of Edinburgh itself. FirstGroup has also undertaken not to change a range of related matters without the OFT's consent, including fare stages and zones, peak fare periods and their terms and conditions. The undertakings also included a package of anti-predation undertakings, a requirement not to reduce its commercial mileage by more than 5 per cent, and constraints on operation of tendered services. The anti-predation undertakings do not apply in Strathclyde and Edinburgh.

- 5.45 We considered the extent to which these undertakings would prevent any action to encourage passengers to switch from bus to rail. The only aspect of the undertakings applicable to the Glasgow area is that relating to fares. As noted in Appendix J, the undertakings appear to have had the indirect effect of limiting changes in the structure as well as the level of FirstGroup fares. All fares of a particular value in Strathclyde have increased by the same amount, so that any increase in fares on a particular overlap route would currently be accompanied by an increase in fares of that amount extending to many non-overlap routes. FirstGroup told us that, for the purpose of calculating the permitted fare increase, all fares of the same type or value were deemed to change by the same amount. This may be the way the undertaking has worked to date in practice and both the OFT and FirstGroup have interpreted and applied it that way. But it is far from clear that the wording of the undertaking explicitly requires this, or that the undertakings could not be applied in a different way if FirstGroup wished to do so.
- 5.46 As applied to date the fares undertakings would make it difficult to target an increase in fares to a particular route, or to an overlap in a particular route. The undertakings also require an increase in average fares on one route to be offset by a reduction elsewhere, in order to remain within the permitted increase in the overall level of fares in each of the operating areas (the First Glasgow and the First Edinburgh areas). This could significantly reduce the profitability of an increase in fares on individual routes. However, reducing fares elsewhere would attract extra passengers (and thus extra revenue), offsetting some of the loss from lower fares. At higher elasticities (where the incentive to switch passengers is greatest) the reduction in fares would have a minimal impact on profitability, and we estimated that at an elasticity of  $-1.0$  FirstGroup could retain most of the extra profits shown in Appendix I.
- 5.47 Fares only recently introduced, including the £2.50 FirstDay peak tickets and £2.20 off-peak tickets, are not covered by the undertakings. Nor do the undertakings apply to services in Edinburgh. Hence, for example, fares on overlap flows between neighbourhoods around Edinburgh, such as Livingston, and Edinburgh itself are not formally included in the regulated bundle of fares, but only fares up to the boundary of Edinburgh, although FirstGroup told us that in practice the fares were set for the whole flow, so that the fare for the whole flow was regulated. Similarly, the restriction on FirstGroup reducing bus services applies to its operations around Edinburgh as a whole, but not to the element of the services extending into Edinburgh, such as part of the overlap services we have to consider, although Edinburgh being the main destination in the area, such services are indirectly covered by the undertakings. Formally, the anti-predation undertakings would also apply on overlap services only up to the boundary of Edinburgh, but in practice are likely to extend to any services on those routes.
- 5.48 The undertakings would, in our view, constrain FirstGroup's ability to increase fares to some extent on some routes. There is, however, nothing in the current undertakings to prevent reduction of individual services, or their reconfiguration, as

might occur if FirstGroup tried to attract passengers from bus to rail. FirstGroup has asked the OFT to review and recommend release of these undertakings and FirstGroup suggested that we consider the effects of the current merger without reliance on them because of the uncertainty as to how long they would continue in force. We are not in a position to form an expectation as to whether the undertakings would or would not be retained during the period of the franchise. Even if retained, the undertakings would at most only partly prevent FirstGroup exploiting the loss in competition between bus services and rail. If they were removed, the scope to do so would be greater.

### *Fares structure*

- 5.49 FirstGroup's ability to increase fares on overlap flows in a targeted way may also be constrained by the existing fares structure, its preference for a small number of common price bands across its network (FirstGroup told us that, as a network operator, it tended to market simple network-wide fare schemes), or the potential for customers on overlap flows to buy tickets to stops beyond where they wish to alight. However, as in part acknowledged by FirstGroup (see paragraph 5.6(f)), we do not think this would prevent fare increases if they would clearly be in FirstGroup's financial interest, particularly at the end of routes where the impact on other fares on the routes would be less.
- 5.50 FirstGroup also argued that the current flat rate FirstDay tickets—of £2.20 in off-peak periods and £2.50 in peak periods—constrained its ability to increase single fares on specific routes or overlap flows. However, it could in several cases limit the geographical area covered by its network tickets accordingly (or perhaps their availability). We have also noted that these tickets are not currently covered by the undertakings. In our view, therefore, the fare structure would not be a sufficient constraint to prevent fare increases on the parts of the overlap routes identified above.

### *Entry and expansion*

- 5.51 Whether the loss of competition between bus and rail as a result of the merger on the routes identified above could be exploited by FirstGroup is also, however, subject to the prospects for entry and expansion of existing operators on those routes.
- 5.52 All parties to whom we spoke agreed that the prospects of entry on train services are very limited, given, for example, lack of track capacity in urban areas for operation of competing services, particularly at peak times. The absence of a franchise subsidy for competing services is also likely to prevent entry.
- 5.53 We have noted above the scope for increasing fares or reducing frequencies on those bus routes or parts of routes affected by the merger or for reconfiguring those routes. FirstGroup argued that entry and, even more so, expansion into bus routes was easy, and that it was likely to occur if it tried to divert passengers from bus to rail. It based this conclusion on what it saw as evidence that entry was common, that there were no substantial (non-cost) barriers to entry, and that entry costs were low. In appraising the effectiveness of potential competition from other bus operators to prevent any of the above actions by FirstGroup resulting from this merger, we consider first the previous extent of entry in the areas affected by the merger; second, the possible barriers to entry; and finally, the incentives and prospects for entry should FirstGroup act in such a way as a result of the merger.

## *Previous extent of entry*

- 5.54 FirstGroup told us that nine new operators had entered Glasgow since 1996. As noted in Appendix K, there had been new entry, or expansion by over a dozen existing operators, on almost 300 of the overlap flows in the Glasgow and Edinburgh areas in the last three years. However, we think that this data may exaggerate the impact of entry. First, in over 90 per cent of these cases, FirstGroup made no change to its services in response (except where it increased the level of service to accommodate growing passenger numbers) and described entry as having no measurable effect on its operations (which, it subsequently explained to us, meant that, although such entry did adversely affect its profitability, it could not identify any positive responses to that entry that would improve its profits). The only significant response to entry that it made were in two cases in Edinburgh where it introduced limited stop services, matching Lothian prices and reducing journey time, to attract longer-distance passengers from Lothian. Lothian responded by increasing frequency and using new vehicles.
- 5.55 Second, we also noted recent exit from the market, although, on FirstGroup's figures, significantly less than the scale of entry and expansion. In particular, we noted in paragraph 4.40 some nine routes in Glasgow from which Stagecoach had withdrawn since 2000. Further, entry by smaller operators in Strathclyde has generally been confined to tendering for subsidized services or providing commercial services on the main corridors and in the hours of heaviest bus demand, in several cases with midibuses of relatively low capacity but by which operators can provide reasonable frequency of service. There has also been relatively little entry by new operators in the last three years. FirstGroup told us that of 43 operators in Glasgow, only three had entered in the last three years, and 38 had entered more than five years ago. In the area around Edinburgh, most entry has been on routes not served by FirstGroup or tendered services. Of 30 operators in that area, only one had entered in the last year, and 24 had entered more than five years ago.
- 5.56 As evident above, most of the new entrants, moreover, do not operate evening or (to a somewhat lesser extent) Sunday services.
- 5.57 Further we note that there has been no successful entry in the Glasgow and Edinburgh areas on a large-scale or network basis (with the possible exception only of McKindless in Glasgow, which operates three routes), ie through operating a competing network of services rather than merely competing on individual routes. There have, however, been two unsuccessful attempts at entry on a large-scale or network basis—by Stagecoach in Glasgow and FirstGroup itself in Edinburgh—which we discuss further below.

## *Barriers to entry*

- 5.58 As discussed in Appendix L, there are outside London no legal barriers to entry or expansion (other than in relation to safety of bus operations) and relatively limited costs.<sup>37</sup> However, in previous reports, the prospect of retaliation by the incumbent has been regarded as a main deterrent to entry. FirstGroup told us that it had no reputation for predation, as further shown by the scale of entry that had occurred. Some smaller operators that we talked to told us that they had either had no problem with FirstGroup's response to new entry; or, even though frequencies had been

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<sup>37</sup>The need to register new services 56 days in advance does, however, give the incumbent advance warning of new entry. If an existing operator runs a 'frequent' service (every 10 minutes or more frequently), it is not required to register any increase in that service.

increased (which we noted FirstGroup attributed to growth in overall business rather than response to any new entry), still found it profitable to enter main corridors due to the volume of bus passengers on them. However, about one-half of the operators from whom we heard expressed concern to us that there would be retaliation if they entered the territory of major operators, namely FirstGroup in this case.

- 5.59 We have noted that FirstGroup responded to entry by Stagecoach, one of the major operators, in Glasgow by lowering the price of its weekly tickets, and also by establishing services in Stagecoach's main operating areas in Fife and Ayrshire. There have also been reports of recent 'bus wars' in Edinburgh ([REDACTED]), complaints by Lothian to the OFT of anti-competitive conduct by FirstGroup, [REDACTED]. We note that the OFT subsequently concluded that FirstGroup had not infringed the Competition Act. However, in our view, an aggressive response to entry by lowering fares or increasing frequency could be a deterrent to entry, creating a reputation for 'tough' responses to entry (or at least to large-scale entry) whether or not it can be regarded as being predatory or in breach of the Competition Act 1998.
- 5.60 In this context we also noted the statement in the First Scotland East 2003/04 business plan: [REDACTED]. FirstGroup told us that this did not amount to more than ensuring that it was adequately informed of entry and would consider the implications for its business and how best to address it. It would not, however, let anyone undermine its business and would do everything it could within the constraints of the Competition Act 1998. It told us that it had reacted to entry by small operators, both by improving services on the affected routes, and by monitoring services overall to ensure that passengers get a good enough deal in terms of price and quality that an entrant would not be able to offer them anything more attractive. There had been one example of responding to entry by reintroducing a direct service.

#### *Implication of the merger on response to entry*

- 5.61 We have expressed the general concern that a bus operator with a rail network may have incentives to raise bus prices in order to push customers into using the rail network. Under certain circumstances, joint ownership of the dominant bus operator and the rail franchise may also create additional pressures for the bus operator to act to deter entry to an overlap flow. It may seek to prevent entry by selectively cutting prices. The next paragraphs explain why this may be financially advantageous for a bus operator such as FirstGroup.
- 5.62 In the Strathclyde PTE region there are more than 100 other bus operators, who generally offer a small number of services on routes that may or may not also be served by FirstGroup. Though the market share of these operators may be growing—the evidence is unclear on this point—it makes little sense for FirstGroup selectively or generally to try to cut prices or increase frequencies to reduce the success of these smaller operators.
- 5.63 If, however, a new entrant took revenue from both FirstGroup's bus operations and its rail franchise, the impact on FirstGroup might be much more severe. A particular concern would be that a lost £1 of rail revenue would reduce FirstGroup's profit by the full amount because the costs on the rail operation are essentially entirely fixed. A new entrant on a route with both FirstGroup bus and FirstGroup rail operations would provide the company with a more difficult decision as to whether to react.
- 5.64 We believe that there is a plausible case that FirstGroup would actively signal to its smaller competitors (which it usually tolerates without aggressive retaliation) that entry on to bus/rail routes would be responded to very much more assertively than

entry on to other routes. Its aim would be to demonstrate that its complaisant policy would only continue on routes not also covered by rail.

- 5.65 The obvious way of signalling would be to reduce prices, perhaps to the level of the competitor, an action which FirstGroup does not normally seem to take when faced with new competition. If FirstGroup did this, it might make the competitor's operation at best marginally profitable and the competitor would eventually exit the market. This is a strategy of market signalling to deter entry on a small number of routes on which competition might be particularly damaging to FirstGroup because it would lose both bus and rail revenue.
- 5.66 If FirstGroup systematically, clearly and unambiguously reacted to entry on bus/rail routes in the same way each time a competitor started operations, then the rest of the bus operators would quickly understand that entry would be tolerated (at least to some extent) on bus-only routes, but that FirstGroup would react strongly to any entry on routes on which it had both bus and rail operations. It might take three or four episodes of assertive retaliation, but the smaller operators would eventually understand the message being given by FirstGroup. They would then stick to competing against the bus routes only.
- 5.67 The number of routes on which FirstGroup operates buses currently without effective competition and would also provide the rail service is relatively small as a fraction of FirstGroup's total routes in Strathclyde (for example, the ten referred to in paragraph 5.31, out of over 100 in Glasgow) and elsewhere. A strategy of effective retaliation on these routes would thus be feasible. Importantly, it is also sustainable. Existing bus operators would see the incentive to remain out of areas which FirstGroup is actively defending. Sufficient routes will be available to them elsewhere fully to recoup their fixed assets investment. There is therefore no need for an elaborate and long-lasting war of attrition in which FirstGroup would have to force the competitors out of the market completely.
- 5.68 FirstGroup argued that there would be no change in incentives to deter entry through selective price cuts. Among its arguments, it said that just as for rail, for every £1 revenue lost on a bus, it lost £1 in profit. We find it difficult to accept this argument, given the scope to reduce costs by reducing frequencies of bus services in circumstances where there are no actual or potential effective competitors on the route, and for which there is no scope on rail. It also believed fewer passengers would switch from rail to bus than from bus to bus given the current different profile of such users and the reasons for their choice of mode shown in the NOP survey. That may not, however, be the case in the future if FirstGroup were to attempt to switch passengers from bus to rail, which we believe it would have scope to do. The acquisition would therefore in our view create additional pressures to deter entry on bus/rail routes and may result in a loss of competition, because it will lower the chance of competitive new entry on these routes.

### *Barriers to network entry*

- 5.69 Entry on a network basis would seem necessary if a new entrant is to withstand responses on individual routes or compete with the network tickets offered by FirstGroup,<sup>38</sup> but it would clearly have significantly greater costs. The difficulty of network entry is confirmed by the failure of FirstGroup itself, the largest bus operator

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<sup>38</sup>As discussed in Appendix M, The Transport Scotland Act (2001) empowers local authorities to determine joint ticketing arrangements, but the extent to which local authorities wish to make use of this provision and the terms on which any such scheme would operate remain untested.

in the UK, to enter the Edinburgh market on a large scale, where the incumbent, Lothian, a much smaller company but with a strong position in its local market, appears successfully to have defended its position by increases in frequencies and fares reductions (albeit at some financial cost to itself). The difficulty of network entry is further shown by the failure of Stagecoach, the UK's second largest bus operator, to enter Glasgow on a significant scale, and its subsequent withdrawal from a number of the new services it set up in the Glasgow area. FirstGroup itself attributed its problem in entering the Edinburgh market partly to the strength of Lothian's network (although, it told us, it was more concerned with the tactics Lothian employed in response). In our view, Stagecoach's difficulty in entering the Glasgow market can also be attributed (at least in part) to the strength of FirstGroup's network in Glasgow, and to the difficulty of any operator in establishing a new network in competition with a strong network incumbent.

### *Barriers to entry by smaller operators*

- 5.70 FirstGroup argued that the difficulty or otherwise of entry at the network level had little bearing on the impact of the transaction on competition. If there was entry on to a route, even from a small operator, that would in its view be an effective constraint on its ability to harm passengers as a result of the merger. In our view, the ability of small operators to enter or expand their activities, and the effectiveness of their doing so, is likely to be reduced by their inability to offer the same frequencies of service as FirstGroup, or offer network tickets. FirstGroup accepted that network operators had some advantages, but, in its view, they were not such as to prevent entry, since some passengers were prepared to pay a lower price to travel on a small operators bus. But in our view the competitive advantages of FirstGroup reduce the profitability of entry to such competitors.

### *Barriers to out-of-hours entry*

- 5.71 Entry is likely to be particularly unattractive out of hours. As well as the disadvantages listed in the previous paragraphs, we were told by a number of parties that it was easier to attract drivers if they were not required to work in the evenings or Sundays, and the costs of employing drivers were also lower as a result. But the number of passengers and profitability of services is also likely to be less out of hours; hence entry is likely to be less attractive out of hours than in hours even if FirstGroup should reduce its operation at such times. FirstGroup argued that the contribution from out-of-hours services was such that, were it to reduce service levels, it would leave an opportunity for another operator to put on a bus which earned incremental revenues in excess of incremental costs. But the current reluctance of almost all smaller competitors to operate out of hours shows, in our view, that this is implausible as regards not only entry out of hours by operators on to new routes, but also operators of in-hours services expanding to provide out-of-hours services on their existing routes.

### *Incentives and prospects for entry*

- 5.72 Our concerns in paragraph 5.35 were that the merger would give FirstGroup the ability to cause passengers to switch from bus to rail by increasing fares, reducing frequency or reconfiguring services on particular routes or part of routes.
- 5.73 A limited increase in fares on only part of a route is unlikely to result in a significant loss of passengers to other competitors given the far greater frequency of service

currently operated by FirstGroup on most of the overlap flows (FirstGroup often accounts for over 80 per cent of services on these flows). Further, the fares of smaller competitors are already generally below those of FirstGroup without significantly eroding FirstGroup's share of the market. That is likely to remain the case even if FirstGroup's fares were increased further, since a new entrant (or an existing competitor expanding its services) would not be able to offer comparable frequency, and most passengers are unlikely to wait longer for a competitor's service on both their outward and return journeys. It cannot therefore be assumed that if FirstGroup were to raise its fares on part of a route, existing competitors would not choose to raise their fares equally. Finally, FirstGroup would also retain the competitive advantage of its network tickets, even if it increased their prices in certain areas.

- 5.74 The percentage of passengers who would be deterred from using FirstGroup services as a result of a fairly limited fares increase is itself unlikely to be sufficient to sustain an expansion by an existing operator. For example, we estimated that some [redacted] passengers on the 204/5/15 routes would switch from bus to rail in response to a 10 per cent fares increase on the maximum price elasticity assumed. Our survey suggested that about half as many passengers would switch to bus competitors as would switch to rail. But even if as many switched to competitors as to rail, they would only amount to about [redacted] passengers a day, or less than half a dozen passengers an hour. If fares were about £[redacted] per passenger, revenue of about £[redacted] an hour would fall far short of the likely cost figure of £[redacted] to £[redacted] an hour needed to operate a service. It is also uncertain whether a new entrant would be attracted on to a route in such circumstances.
- 5.75 FirstGroup argued that, in the circumstances following the merger we were envisaging, a reduction in frequency in order to switch passengers to rail would create a gap in services which entrants could easily fill. We acknowledge that such a reduction in frequency by FirstGroup may, in principle, appear to present a greater incentive for a new entrant or existing operator to expand services; and this may be a further reason to expect a fares increase rather than frequency reduction to be the more likely result of the merger. However, new competitors would remain disadvantaged by the factors we have set out above. Those include the lower fares they generally have to charge; the advantage to FirstGroup of its network cards; and the greater frequency of service which FirstGroup would continue to offer on most overlap flows. In addition, for the reasons we have set out in paragraphs 5.61 to 5.68, they face the risk that FirstGroup could restore its previous level of service or fares shortly after they had entered, closing the window of opportunity that their initial actions had opened and making entry unprofitable. The incentive for competitors to enter or expand their operation is therefore limited. In general, we regard it as unlikely that the possibility of new entry or expansion would be sufficient to resolve the problems created by the merger.
- 5.76 FirstGroup argued that operators of services in hours on a route would have no difficulty in extending their operation into the out-of-hours periods. Where there was an in-hours operator on a service, therefore, potential entry by that operator on to out-of-hours services on these routes would deter FirstGroup from attempting to divert passengers from bus to rail out of hours. Among FirstGroup's arguments was that out-of-hours services are profitable, hence would attract entry: but as we have noted in paragraph 5.42(c), this is only after excluding contribution to overheads, without which the services would be considerably less profitable. FirstGroup's arguments also related only to running services continuously until they stopped (or when the train stopped) and not for services with a gap, ie another operator stopping services at 7 pm and then recommencing operations two or more hours later. As noted above, smaller operators also have to charge lower fares, and any increase in

their cost from working out of hours would reduce their margin: one of the main operators in the area told us that it was simply too costly for it to operate out-of-hours services. And, as we have noted, few of the smaller competitors currently operate out of hours. Of the main competitors, even Stagecoach's Magicbus service, for example, only operates from Glasgow up to between 7.30 pm and 9 pm in the evenings (although some longer-distance services run later); McKindless up to about 6 pm to 6.30 pm. We find it implausible that FirstGroup has not unwittingly left gaps in its out-of-hours services, but there is no evidence of smaller competitors or larger competitors such as Stagecoach or McKindless finding profitable niches by exploiting such gaps, suggesting that most are not interested in doing so or otherwise deterred from doing so.

5.77 In our view, the prospects of operators of services in hours expanding their services to operate out of hours are insufficient to deter FirstGroup from diverting passengers from bus to rail in those periods by increasing bus fares, or reducing or withdrawing the bus services available. We would not expect reduction in frequency or withdrawal of, for example, the first or last buses to attract new entry or expansion by existing operators at those times.

5.78 In our view, therefore:

- (a) While there are examples of new entry, all recent new entrants are small operators.
- (b) Entry and expansion also appear to have had very little effect on FirstGroup.
- (c) The main barriers to entry in the bus markets we are considering are the threat of retaliation, the existence of network operators and the costs to become such an operator. These barriers apply in particular to large-scale entry and expansion, but in our view are likely to continue to deter entry by both small and large operators on the routes we are considering in the circumstances following the merger.
- (d) Very few competitors to FirstGroup currently operate out of hours, and even on those routes where there is competition in hours, we regard the competitive constraint provided by entry or expansion out of hours as weak, at best.

5.79 We concluded above that neither the existing undertakings relating to FirstGroup's bus operations nor any constraints resulting from FirstGroup's fares structure would be sufficient to prevent adverse effects resulting from the merger. With the exception of the two routes referred to in paragraph 5.28(b)—where an existing service by one or more major operators could without difficulty be diverted or extended to compete with FirstGroup—in our view, entry (or expansion by an existing operator) or the possibility thereof would also not be expected to provide a sufficiently effective source of competition to offset the loss of competition between bus and rail resulting from the merger.

### ***Conclusions on effects of the merger on overlap flows***

5.80 We discussed in paragraphs 5.24 to 5.31 55 routes where we were concerned that the merger could result in a loss of competition. Of these:

- (a) Thirty routes had flows on which rail services and FirstGroup's bus services overlap and which accounted for more than 10 per cent of total revenue on the route, making it likely that FirstGroup would change the operation of the route

because of overlaps following the merger. A further route overlapped with a new rail service to be opened shortly.

- (b) Sixteen routes currently had more limited overlap but we were concerned on a number of these routes that FirstGroup could reconfigure services as feeder services to railway stations increasing the potential size of the catchment areas, combined with withdrawal at least in part of direct services (or other actions intended to switch passengers from direct services to train, eg by changing fares or service levels).
- (c) Eight routes, mentioned by a local authority, gave rise to similar concern that they could be reconfigured as feeder services.

5.81 Of these 55 routes, we believe there are a number of routes where the likelihood of adverse effects resulting from loss of competition on point-to-point public transport journeys arises:

- (a) Twenty-one routes where there are no competitors on those flows operating with sufficient frequency to compete effectively with FirstGroup in hours.<sup>39</sup>
- (b) Twenty-seven routes (including many of the 21 identified in (a)) where there are no competitors on those flows operating with sufficient frequency to compete effectively with FirstGroup.

In determining whether there would be a likelihood of adverse effects resulting from loss of competition on those 55 routes, we included one route where the competitor took a much longer journey time than FirstGroup; but excluded two where an existing service by one or more major operators could without difficulty be extended or diverted to compete with FirstGroup. In determining the effect on competition on routes serving potentially wider catchment areas, we excluded those routes where there would be no scope for FirstGroup profitability to reconfigure these routes to switch passengers to its rail services, given the pattern of traffic on those routes. This reduced the potential number to 46. From that 46 we applied the criteria set out in (a) and (b).

5.82 In our view, FirstGroup may be expected, on overlap flows on those routes (including potential overlap flows to which paragraph 5.80(b) and (c) refers), and as a consequence of the loss of competition between bus and rail resulting from the merger:

- (a) to increase fares; and/or
- (b) to a lesser extent to reduce frequencies or reroute services away from rail stations in those limited cases where it may have scope to do so; and/or
- (c) to reconfigure routes to act as feeder services to rail stations combined with withdrawal at least in part of direct services.

5.83 We have, however, noted in paragraphs 5.55 and Appendix K that there has been some exit by competitors in the areas affected by the merger, and we would expect some changes in the level of competition on some of those routes to continue in future. Such adverse effects would therefore result not only on those routes referred to in paragraph 5.81 (a) and (b); but also on any additional routes among the 46 identified which come to have the characteristics in future referred to in paragraph

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<sup>39</sup>See also footnote to paragraph 5.27 on the application of this criterion.

5.81 (a) and (b) as a result of reduction in competition on the overlap flows over the period of the franchise in hours or out of hours. Such changes in competition could also have the effect of removing routes on which a substantial reduction in competition is expected to result from the merger; although, as discussed above, we believe there are no significant prospects for entry on such routes taken as a whole, it is possible entry may occur in a small number of cases. (We would not expect the other factors set out in paragraph 5.81 to be subject to such material changes). In Table 6 of Appendix G, therefore, we list both the 'probable' routes where we currently expect an SLC immediately to result from the merger; but also other 'possible' routes where we would expect an SLC to occur if there was a reduction in effective competition on them. We identified a further 25 routes in hours and six routes out of hours where we would expect in at least some cases (although we can obviously not identify which) the merger to give rise to adverse effects, as a consequence of changes in the level of competition from other bus operators currently operating at these times on those routes.

- 5.84 In our provisional findings, we considered that the extent of adverse effects could also be subject to change as a result of changes in bus or rail routes, or from housing, industrial or other developments. Subsequently, however, we accepted FirstGroup's arguments that in the event of it introducing new bus services, it would be unlikely then to attempt to switch traffic from them on to rail; and also now consider that the scope for significant changes in overlaps from housing and other developments is likely to be limited. We would, however, expect adverse effects to result from the development of new rail services during the period of the franchise (compared with the operation of such services by a franchisee other than FirstGroup), giving rise to additional overlaps between FirstGroup's rail and bus services. We have included one bus route which overlaps with a new rail service to be opened shortly, but there is provision for other such developments in the franchise which would result in overlap flows on routes not included in the list of 46 routes to which we have referred above.
- 5.85 Such adverse effects would be expected to arise on only a minority (less than 20 per cent) of bus routes in the Glasgow and Edinburgh areas, and affect only a minority of passengers on these routes (somewhat less than 20 per cent of those in Table 4 of Appendix G). But we regard the overlap flows giving rise to such effects as relevant markets in their own right, and within these markets there is an SLC. In our view the merger may therefore be expected to result in an SLC in particular markets for point-to-point public transport, namely point-to-point overlap flows served by the routes referred to, and on at least some other routes we have identified which, as a consequence of changes in competition from other bus operators during the term of the Scottish rail franchise, may come to have the characteristics set out in paragraph 5.81 (a) and (b). They may also be expected to result on routes other than those included above from development of new rail services over the period of the franchise.

### ***Broader effects on competition***

- 5.86 We concluded above that the relevant markets for analysing the effects of the merger were not only the local markets identified, of routes or parts of routes linking particular origins and destinations, but also broader public transport networks in areas such as the SPTE area, Edinburgh and the Lothians, and Scotland as a whole. We now consider whether the merger may be expected to result in an SLC in such broader markets. The broader issues raised by the merger may, indeed, potentially raise more serious concerns than those related to overlap flows considered above.

- 5.87 A source of serious concern from a number of other bus operators and the SPTE was the ability of FirstGroup as a result of the merger to offer bus/rail tickets usable only on FirstGroup bus and rail services. Passengers with multi-modal tickets, available at less than the price of separate rail and bus tickets and usable only on FirstGroup services, could in consequence choose not to use other bus operators' services. But additionally, if a FirstGroup multi-modal ticket were available on significantly better terms than a multi-operator ticket, the attractiveness of multi-operator ticketing schemes could be much reduced. Effectiveness of competition from other operators could be reduced and entry further inhibited as a result. Several parties also expressed a concern that FirstGroup could leverage its control of rail to strengthen or extend its bus operations not only in the Glasgow, Edinburgh and Aberdeen areas where its operations were currently based, but also in areas where it currently operated on a limited basis such as Ayr, and in other areas where it currently had no operations. Additional bus operations which it might develop in the future in other areas of Scotland could, it was said, benefit from integrated ticketing with the rail network or access to other arrangements on preferable terms for passengers to transfer between FirstGroup's own bus and rail services.<sup>40</sup>
- 5.88 The ITT for the Scottish rail franchise requires FirstGroup to participate in multi-operator, multi-modal ticketing schemes specified by the Authority. The main schemes currently included are the SPTE ZoneCard and SESTRAN's one-ticket (see Appendix M). We noted above that the current multi-modal ZoneCard ticket currently accounts for a very small share of FirstGroup's own bus passengers—about [X] per cent—partly because many passengers do not currently wish to transfer between bus and rail, but also, it was suggested to us, because the price compared unfavourably with those of FirstGroup's own Firstday, Firstweek and Firstcard bus tickets. FirstGroup also currently participates in Plusbus (tickets which combine rail travel to and from a particular locality with bus travel within that locality). Plusbus is an independently-operated scheme operated by a company called Journey Solutions. It is open to all bus operators, but in practice not all operators participate. Such multi-operator schemes must satisfy conditions set out in the block exemption.<sup>41</sup> These include a requirement that all operators be allowed to participate in such schemes on non-discriminatory terms. But there would be no such requirement on single-operator schemes in which only FirstGroup and its own subsidiaries participated.
- 5.89 The franchise agreement would not prevent FirstGroup from offering its own multi-modal scheme, confined to its own operations. Hence, it would be in a position to offer its own tickets at fares that could make unattractive any multi-operator ticket in which it participated. There was also concern that it would be able to sell multi-modal tickets on its own bus services, which other bus operators could not do. FirstGroup told us that it had no current intention of introducing a multi-modal scheme confined to its own services and that it would be willing to give an undertaking not to do so. However, circumstances, perspectives and people change, and companies can generally be expected to act in what they believe to be their best financial interest, as would be the case if, for example, introduction of a multi-operator scheme attractive to passengers were to prove difficult. We were told that in south-west England a

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<sup>40</sup>There was also some concern on this general point expressed by the CC in the Central Trains report as regards interchangeable tickets in the West Midlands: but National Express undertook as a franchise obligation to participate in the PTE scheme and not to introduce any new multi-modal ticket without the agreement of the PTE. We also noted that the OFT concluded in the recent case of FirstGroup plc/Thames Trains that, given the limited take-up of existing schemes in the areas of overlap, the conditions imposed by SRA and the lack of competitor concern, an SLC from FirstGroup introducing its own multi-modal schemes was unlikely. In the case of Arriva plc/Wales and Borders Rail Franchise, however, the OFT stated that Arriva had the ability to introduce its own multi-modal arrangements and deny third party bus operators access to them, possibly foreclosing bus routes into rail stations. Several third parties had raised concern that it might do so; and the OFT believed there was a real possibility of its doing so and of thereby harming competition. It therefore proposed an undertaking that any multi-modal scheme be open to any bus operator on the same terms as Arriva.

<sup>41</sup>See the Competition Act 1998 (Public Transport Ticketing Schemes Block Exemption) Order 2001 (SI 2001/319).

multi-modal ticket had been introduced, but it was one in which no other operators had so far wished to participate. Once it is an operator of both buses and trains in large parts of Scotland, an intermodal ticket for use on its own services is likely to be attractive to FirstGroup's passengers and commercially beneficial to itself. Not only would it generate additional revenue from passengers encouraged to use both its bus and rail services, but also cost savings if it encouraged passengers on some routes to choose to switch from bus to rail. In our view, FirstGroup would (unless formally restricted from doing so) have the incentive and opportunity to introduce its own scheme and this would be to the detriment of any schemes open to other bus operators, so distorting competition between FirstGroup and those other operators, and it may be expected to do so.

- 5.90 After the merger, FirstGroup would receive 67 per cent of revenue distributed by the SPTE to participants in its ZoneCard scheme. FirstGroup's position will, however, to some extent be that of managing agent for the rail services in the SPTE area, should the merger proceed, rather than that of an operator in its own right. Whatever the position on revenue risk, the SPTE will continue to set fares and determine the level of service. Hence, merely adding FirstGroup's share of passenger revenue in this way to some extent exaggerates the strength of its position. FirstGroup itself argued that there would be no disadvantage to other operators from its position. It believed the SPTE had a strong position as the promoter of ZoneCard, the tendering authority and as a stakeholder in the ScotRail franchise, setting rail fares in its area and also choosing the preferred bidder. FirstGroup said that it was itself well aware of the importance of transport integration and was at the forefront of promoting integrated ticketing and committed to extending the benefits of ZoneCard. Finally, FirstGroup said, ZoneCard represented a small percentage of other operators' revenues, so there was little scope to disadvantage them anyway.
- 5.91 We were told that ZoneCard fares and pricing were currently set by informal 'consensus'. In our view, FirstGroup would be in a strong position to influence the outcome in its interest and to the disadvantage of other operators and it may be expected to do so. Indeed, FirstGroup acknowledged this problem and suggested that some of the share of the voting rights it would hold as the rail franchisee be spread among other operators (subject to wider changes in the organizational structures and administration to improve transparency of the agreements and voting rights).
- 5.92 A further concern, raised with us by Lothian, was that the merger should be seen in the context of FirstGroup being one of two bidders for operation of the Edinburgh tram scheme which would give FirstGroup a larger and more extensive Edinburgh network. There is very little overlap between the proposed tram and ScotRail stations, but the concern would appear to relate primarily to FirstGroup's possible position as operator of rail, bus and tram services in Edinburgh, and its ability to provide integrated tickets excluding and to the detriment of other operators. However, the tram scheme is unlikely to be operational until 2009 and the concerns to some extent would arise irrespective of the ScotRail merger we have to consider. Even if there would be no requirement on FirstGroup as a possible operator of the tram to ensure that any multi-modal ticketing scheme is available to other operators, the concerns arising from the merger we expressed above would be equally applicable in the context of a rail/bus/tram ticketing scheme in Edinburgh as to a rail/bus scheme in Edinburgh or elsewhere. Toward the end of our inquiry, moreover, it was reported that one of the other bidders had been named as the operator of the proposed tram scheme.
- 5.93 During the current inquiry, concern was expressed about the unwillingness of ScotRail at present to accept advertising of competing bus services. It is also

relevant to note points made by the Central Trains report of 1997. That report referred to the further possible ‘interactions’ between bus and rail services of:

- (a) information to passengers—the rail operator (National Express in that case) could provide information at its stations about its own bus services but not others;
- (b) information to other National Express companies, for example passenger flows and ticket sales, survey results, planned timetable changes of commercial value to other transport operators but only supplied to its own subsidiaries; and
- (c) joint marketing only of its own services.

Most of these points were, in the event, addressed in a schedule National Express had inserted in its Central Trains franchise agreement.

- 5.94 The draft franchise agreement is expressed so as to require the franchisee to provide information on other rail services and on other matters such as the SPTE may specify, but with no explicit requirement to provide information on other operators’ bus services.<sup>42</sup> Although, as operator of the franchise, FirstGroup may have an interest in encouraging use of other operators’ bus services that are complementary to the Scottish rail services or to its own bus services, it is unlikely to be in its interest to provide information on services which compete with its own. In the absence of constraints such as the contractual agreement included in the Central Trains franchising agreement, we believe there is an incentive and opportunity on FirstGroup to favour its own bus operations in providing such information. This we expect it to do, to the disadvantage of its competitors.
- 5.95 In our provisional findings, we also expressed concern that FirstGroup would be unlikely to treat its competitors on equal terms with its own bus operations in providing information on its rail services. Such information would include statistical information about passenger flows and ticket sales; survey material available to FirstGroup’s rail operations in Scotland, including, for example, information about passenger origin and destination and mode of transport such as bus used in travelling to a station; planned timetable changes; or other operational information, for example advance and real-time information about service disruption which could indicate opportunities of which bus operators could take advantage. However, given the nature of the information concerned, we are now of the view that the value of such information to FirstGroup and the competitive advantage it may derive from it are likely to be relatively limited and insufficient to result in an SLC. Nor do we see any effect of the merger on joint marketing of services as sufficient to result in an SLC (other than in the context of ensuring adequate information on other operators services at railway stations); in many parts of the areas we are considering, SPTE or local authorities provide a considerable amount of joint marketing of bus services.
- 5.96 There was also some concern that, with the scale of public subsidy for the operation of the Scottish passenger rail services, FirstGroup would be in a position to cross-subsidize its bus services to the disadvantage of its competitors. But the scale of subsidy for the Scottish passenger rail services in part reflects its operating cost, and the process of competitive tendering for the franchise is intended to ensure that no

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<sup>42</sup>In Schedule 3 to its bid, FirstGroup has committed to supporting existing PlusBus schemes (of which there are about 20 in Scotland, but including only Glasgow Central and Glasgow Queen Street stations in the Glasgow area) with appropriate bus maps at all relevant stations, to include a gazetteer of local areas served by bus, a map showing validity of PlusBus and other relevant integrated tickets, a diagram showing access to bus services in the local vicinity and the display of Traveline promotional material. Wherever possible, train information desks will provide local bus information and all stations will support appropriate bus network maps and fares information in readily visible locations.

excess profits arise from its operation. FirstGroup is already a large and profitable company, and the cash flow of the Scottish rail franchise is likely to be small—significantly less than 5 per cent—relative to the current cash flow of FirstGroup as a whole. Although FirstGroup acknowledged that an element of cross-subsidy between bus services was intrinsic to the operation of the bus industry, we do not believe the merger as such increases the risk of cross-subsidy to the detriment of its competitors.

- 5.97 A further concern raised with the OFT (but not us) was that FirstGroup could favour its own bus operations in supplying replacement bus services when rail services were suspended, to the detriment of its competitors. FirstGroup told us, however, that its rail company policy was to put rail replacement bus services for planned maintenance work to open tender (for which its own companies could tender), in a process which ultimately had to be approved by Network Rail (and in some cases the SRA) who in most cases paid the cost of such services. In relation to unplanned maintenance and daily ‘emergency’ disruptions, it operated a list of preferred contractors. It periodically went out to tender and entered into contracts with various bus operators who were likely to be able to respond quickly in emergency situations. Finally, it said that unplanned replacement bus services were a relatively small proportion of rail replacement services elsewhere in the UK.
- 5.98 The SRA estimated that the maximum annual requirement was likely to be of the order of ten call-offs against a set of framework contracts. It also noted that it would be a breach of the franchise for a franchise operator to enter into any arrangements or contracts in connection with the franchise agreement on anything other than an arm’s length basis and it expected that contractors would be used on a strictly minimum cost basis. Given the small scale of such services and the rules imposed by the SRA, we do not regard the issue as giving rise to concern.
- 5.99 A more general concern relates to FirstGroup’s position in public transport in Scotland and areas within Scotland, particularly Strathclyde, as a result of the merger. We have noted, for example, that FirstGroup would account for almost 70 per cent of the revenue of public transport services in Scotland following the merger, and also for a similar percentage of public transport services in Strathclyde.
- 5.100 We considered the concern of some third parties as to whether FirstGroup could use that position to acquire greater leverage with regulators or government bodies in Scotland, to the detriment of other operators. FirstGroup argued that it would not be in a position whereby it could abuse its position and influence the regulators to act in a way that might lead to an SLC in any relevant market, because:
- (a) there were too many regulators to ‘capture’ and in any event they were not common to both bus and rail save for the Scottish Executive, the SPTE and the Health and Safety Executive (HSE), of which the HSE’s role in particular was clearly not open to influence; and
  - (b) looking in some detail at the roles played by the Scottish Executive and the SPTE (and in particular at the sources of public funding controlled by them), it was clear that in each case the funds were awarded through an open and transparent process, and either they had no discretion as to which operator received those funds or there was no competition between bus and rail for a particular fund. Hence, the merger would change nothing.
- 5.101 Of equal concern, however, to any influence FirstGroup may wish to exert over the regulatory bodies was the concern that the regulatory bodies themselves, in particular the Scottish Executive and the SPTE, might prefer to deal with one main

supplier of public transport services rather than a multiplicity of competing operators. Hence, the regulatory bodies might develop a common interest with FirstGroup in limiting the activities of smaller bus operators. Such effects could therefore extend significantly wider than the current areas of overlap between FirstGroup's bus operations and the Scottish passenger rail services, to other areas where competitors might currently provide commercial or tendered services.

- 5.102 It would in our view be misconceived to regard FirstGroup's share of almost 70 per cent of revenues to which we referred above as indicative of its importance in the Scottish public transport market. Although it would bear some revenue risk in operating the rail franchise, its role is to a large extent that of a contractor, subject to tight specification of its performance. Both the Scottish Executive and the SPTE would be in a strong position to resist FirstGroup exerting any undue influence, and they themselves possess considerable countervailing power, given their role in specifying and funding ScotRail services. Moreover, we would expect both the Scottish Executive and the SPTE to resist giving undue influence to any predominant supplier of public transport services. In addition to the legal obligations under which they must both operate, it is in their interest to ensure that they obtain value for money by maintaining strong and effective competition to FirstGroup.
- 5.103 There was also concern that the SPTE and other local authorities may wish to consider 'quality contracts' for bus services (see Appendix M), which could limit competition in, and potential entry to, the bus market—in effect, reregulating parts of the bus market—possibly as part of a general policy of transport integration. In this context there was similar concern that they could be more predisposed to work with an established large operator for that purpose. In particular, if this occurred with a main supplier of public transport services such as FirstGroup, competition could be reduced.
- 5.104 Legislative provision for quality contracts is only recent. We understand that there are as yet no applications for quality contracts in Scotland, which have to be approved by Scottish Ministers. Before approving a scheme, Scottish Ministers must be satisfied that it is both needed to implement the local authority's relevant policies, in the absence of other effective means of delivering transport services, and in the public interest. The Scottish Executive told us that it was originally envisaged that in the first instance these provisions would probably be used in limited geographic areas. Should quality contracts be introduced and approved, moreover, there is also uncertainty as to whether their approval would be directed at an exclusive contract for operation of a network of services by one operator, which could adversely affect competition, or (as in the case of franchising of bus operations in London) at a system of franchising individual routes to individual operators. But we also see little reason to expect that the merger itself would result in the widespread development of quality contracts in such a way as to result in any enhancement of the position of FirstGroup and to the detriment of competition. FirstGroup, on the other hand, argued that the prospect of quality contracts would itself discourage it from taking advantage of any loss of competition resulting from the merger, but we are also not persuaded that there is a sufficiently strong prospect of local authorities introducing quality contracts in such a way as to safeguard against it doing so.
- 5.105 There was also concern that public sector bodies may give preference to rail over bus services, possibly redirecting public sector support from the provision of bus services to rail services. However, it is difficult to see how the merger in itself would give rise to such concerns. For example, were the SPTE to have a strong preference for rail over bus services, it would currently be in a position, irrespective of the merger, to reduce the funding of tendered bus services. But the SPTE would also in

our view not wish to put at risk its objective of ensuring social inclusion in the public transport services available, as such a policy would do.

- 5.106 A further possibility we considered was that FirstGroup would be in a position to threaten deterioration in its bus services in negotiating increased subsidies for ScotRail, possibly at the expense of other bus operators. However, we believe that public bodies, such as the SRA, the Scottish Executive and the SPTE, would have significant countervailing power to resist any such abuse by FirstGroup of its position (and we saw no evidence that FirstGroup had any intention of using its position in this way). The SRA, moreover, has shown in other parts of the country that it is prepared to withdraw franchises from TOCs if necessary.
- 5.107 An alternative possibility was that the merger could give FirstGroup an incentive to withdraw commercial bus services, possibly as part of operating integrated bus/rail services, in the expectation of their being tendered and FirstGroup successfully tendering for them. Any increased subsidy that may result could, given funding restrictions, result in reductions in subsidy to other operators including in areas where FirstGroup does not operate. FirstGroup told us that since January 2002 there had been a number of tenders ([redacted]) that were required as a result of deregulation or changes to commercial services run by First Edinburgh; most ([redacted]) of those tenders were subsequently awarded to FirstGroup. No tenders had been required in that period as a result of changes made by First Glasgow to its commercial services. However, First Edinburgh only won a minority of all the tenders it bid for ([redacted] per cent), and First Glasgow an even smaller proportion (only [redacted] per cent). Other operators do therefore compete effectively for tendered services in both Strathclyde and the Edinburgh area, and if FirstGroup did withdraw commercial services, it would not necessarily be in a strong position to win any tenders to operate them under contract to local authorities. We also see little scope or incentive on local authorities in awarding tenders to favour FirstGroup as a result of the merger.
- 5.108 The broader concerns we have raised above result from the effect of the merger on wider, public transport network markets. We have noted in paragraph 5.69 particular difficulties in network entry to bus markets; and there is no prospect of network entry to rail. The wider effects of the merger would, indeed, in our view inhibit entry to the markets affected.
- 5.109 In our view, therefore:
- (a) the merger would enable FirstGroup to introduce its own multi-modal ticket scheme, confined to its own services, to its own commercial benefit and to the detriment of any schemes open to other bus operators, and distorting competition between FirstGroup and other operators, and it could be expected to do so (paragraph 5.89);
  - (b) the merger would put FirstGroup in a strong position to influence the setting of fares of multi-modal travelcards, in particular ZoneCard, to its own commercial benefit and to the disadvantage of other operators, and it could be expected to do so (paragraph 5.91); and
  - (c) the merger would give FirstGroup an opportunity to favour its own bus operation in provision of information at stations, to its own commercial benefit and to the disadvantage of other operators, and it could be expected to do so (paragraph 5.94).

## ***Conclusions on substantial lessening of competition***

5.110 We have concluded that:

- (a) The merger may be expected to give rise to an SLC in particular markets for point-to-point public transport journeys; we expect this to occur on 21 routes serving point-to-point overlap flows in hours and 27 routes out of hours (including many of the 21 routes identified). On these routes FirstGroup would as a result of the merger be in a position to switch bus passengers from bus to rail by increasing fares and/or to a lesser extent by reduction in frequency or rerouting of services, and/or by reconfiguration of routes while, for example, reducing direct services, and, in our view, would be expected to do so. Furthermore, we would expect that such adverse effects would also result in at least some cases on 25 other possible routes we have identified in hours and six out of hours as a consequence of changes in the level of competition from other bus operators on those routes during the term of the Scottish rail franchise. They would also be expected to result on routes other than those we have specifically identified from development of new rail services.
- (b) The merger may be expected to give rise to an SLC in wider public transport network markets in the SPTE area, Edinburgh and the Lothians, and elsewhere in Scotland, in that:
  - (i) the merger would enable FirstGroup to introduce its own multi-modal ticket scheme, confined to its own services, to its own commercial benefit and to the detriment of any schemes open to other bus operators and distorting competition between FirstGroup and other operators, and it may be expected to do so;
  - (ii) the merger would put FirstGroup in a strong position to influence the setting of fares of multi-operator, multi-modal travelcards, in particular the SPTE ZoneCard, to its own commercial benefit and to the disadvantage of other operators, and it may be expected to do so; and
  - (iii) the merger would give FirstGroup an opportunity to favour its own bus operation in the provision of information at railway stations, to its own commercial benefit and to the disadvantage of other operators, and it could be expected to do so.

The SLC that would be expected to result from the merger would be expected to have the further adverse effects of higher bus fares, poorer services on overlapping bus routes and reduction in choice of services available to passengers on overlap routes, with similar adverse effects on other services resulting from the effects on the broader network markets noted above.

5.111 In reaching these conclusions, we took into account comments received on our provisional findings, and have amended the scope of some of them in the light of these comments. We also considered whether provisions of the Competition Act would be sufficient to ensure that no such effects would result from the merger. While the Competition Act will deter anti-competitive conduct by FirstGroup, we do not believe it would prevent the merger having the effects set out above. The conclusions set out in paragraph 5.110 would also be the same were we to assume that the Secretary of State is going to release FirstGroup from the undertakings referred to in paragraph 5.44 or were we to assume that she is going to retain the undertakings. However, for the reasons set out in paragraphs 5.45 to 5.48, we would expect the extent to which competition would be reduced and the magnitude of the resulting

adverse effects to be greater were she to release FirstGroup from the undertakings. We are not in a position to come to a view on how the Secretary of State is most likely to act.

5.112 We are therefore required to consider whether action should be taken for the purpose of remedying, mitigating or preventing the SLC or any adverse effects which may be expected to result from such an SLC which we have identified in paragraph 5.110.

## **6. Relevant customer benefits and proposed remedies**

6.1 This section of the report covers the proposed remedies that have been identified to address the SLC and adverse effects resulting from that SLC set out in paragraph 5.110. The questions on which the CC is required to decide, having found an SLC, are set out in section 36(2) of the Act. We must seek to achieve as comprehensive a solution as is reasonable and practicable to the SLC and any resulting adverse effects.

6.2 We may also have regard to the effect of any remedy on relevant customer benefits.<sup>43</sup> We describe our consideration of relevant customer benefits in paragraph 6.3 and Appendix N before turning to consider possible remedies.

### ***Relevant customer benefits***

6.3 During the course of the inquiry, a number of third parties argued that the merger between a main bus operator and the predominant rail operator in Scotland may assist transport integration. Others, however, argued that transport integration did not require common ownership of bus and rail operations, and in this respect no benefits might be expected as a result of the merger. We also note that requirements to promote transport integration were specified in the ITT for the Scottish rail franchise, and would apply to any successful franchisee. FirstGroup believed that higher service quality for passengers, materially over and above the minimum standard imposed by the ITT, and better transport integration would result from the merger; but, in our view, even if such benefits may result from the merger, they would not be put at risk by the remedies we put forward below, nor did FirstGroup argue that would be the case.

6.4 We noted in paragraph 4.5 that we regard public sector bodies who procure the provision of transport services as customers. We accordingly considered whether we should take into account the extent to which FirstGroup offered better terms than other bidders for the operation of the franchise. FirstGroup itself argued that, having been chosen as the preferred bidder for the franchise, it could be concluded that its bid was the best and most advantageous for passengers and the public bodies involved. The passenger benefits it believed would result from the merger would themselves better achieve the policy objectives of public bodies, including passenger growth; and the public bodies would also benefit from other aspects of the better terms it offered. However, while any such benefits might be put at risk by prevention

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<sup>43</sup>Section 30 of the Act defines 'relevant customer benefits'. These are limited to benefits to relevant customers in the form of (a) lower prices, higher quality or greater choice of goods or services in any market in the UK (whether or not the market or markets in which the SLC has, or may have, occurred or (as the case may be) may occur); or (b) greater innovation in relation to such goods or services. A benefit is only a relevant customer benefit if the CC believes that (a) the benefit has accrued as a result of the creation of the relevant merger situation concerned or may be expected to accrue within a reasonable period as a result of the creation of that situation; and (b) the benefit was, or is, unlikely to accrue without the creation of that situation or a similar lessening of competition. Relevant customers are customers at any point in the chain of production and distribution and are therefore not limited to final customers and include future customers. In this case, customers accordingly extend to agencies procuring transport services.

of the merger, they would not be adversely affected by the remedies we envisage below.

### ***Proposed remedies***

- 6.5 We noted above that the SLC we identified in particular markets for point-to-point public transport journeys would affect only a minority of passengers and operate only on a minority of routes. The SLC we identified in wider public transport network markets would also affect a relatively small part of FirstGroup's bus revenues in Scotland, or those of other operators, given that only a small proportion of passengers use both bus and rail services in any one journey. Since any structural undertakings would, at their minimum, be likely to involve divestment of a package of routes and flows significantly wider than those on which competition issues have been identified, and having found a set of behavioural remedies we believe would be effective, structural remedies would in our view be disproportionate in this case.
- 6.6 In the remedies statement we noted that various means might be used to give effect to behavioural remedies. These included:
- (a) the obtaining of a new set of undertakings from FirstGroup, further to the current undertakings given by FirstGroup following the FirstBus/SBH Monopolies and Mergers Commission Inquiry in 1997;
  - (b) a recommendation to the OFT to advise the Secretary of State for Trade and Industry to retain or vary the current undertakings;
  - (c) a recommendation to FirstGroup and the SRA that appropriate provisions be included in the Scottish rail franchise agreements; and
  - (d) a recommendation to the Office of the Rail Regulator that appropriate provisions be included in FirstGroup's passenger train operating licence.
- 6.7 The current undertakings to the Secretary of State were given so as to remedy the adverse effects of the FirstGroup acquisition of SBH in 1997. Those undertakings accordingly addressed a different merger situation from that which we are now considering.<sup>44</sup> Hence, it would not be appropriate to regard their retention or variation as a remedy to the SLC we believe would arise from the current merger. We also believe it inappropriate that provisions be included in the Scottish rail franchise agreement to address the SLC we have identified. The SLC which is our concern relates primarily to the effects of the merger on bus services, and although the provisions incorporated in the NEG Central Trains franchise appear to have been successful, this is not the most appropriate means to remedy adverse effects expected to result primarily on bus services, for which the SRA has no formal responsibility. Similarly, we do not believe it appropriate to include such provisions in FirstGroup's passenger train operating licence. We have therefore focused on appropriate undertakings (or orders that we could make) under the Enterprise Act.
- 6.8 We now consider possible behavioural remedies. In our remedies notice, we invited views on:
- (a) remedies to restrict FirstGroup's ability to raise bus fares, reduce bus frequencies, reduce the number of bus services, reduce bus service quality,

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<sup>44</sup>The present merger may nonetheless be relevant to the OFT in deciding whether or not to advise the Secretary of State for Trade and Industry to retain or vary the current undertakings.

change last/first bus times, and reconfigure bus routes on routes on which we identified an SLC;

- (b) remedies to restrict FirstGroup's ability unfairly to disadvantage other established players or new entrants by reducing bus fares, increasing bus frequency, and increasing the number of bus services on routes on which we identified an SLC;
- (c) remedies to restrict FirstGroup's ability to damage competition from other bus operators through the introduction and/or administration of a multi-modal ticket; and
- (d) remedies to ensure the provision of information by FirstGroup as rail operator to the public about services of other bus and rail operators serving its stations.

6.9 In a subsequent remedies consultation document, we put forward some more detailed possible remedies relating to bus fares, frequency, rerouting and capacity on overlap routes; provisions for monitoring compliance with and authorizing change in any such remedies; and remedies relating to multi-modal tickets and information. Our final decision on remedies takes into account comments received on these documents.

### **Overlap flows**

6.10 We have identified in paragraph 5.110(a) an SLC on a number of point-to-point overlap flows, and concluded that FirstGroup may be expected to attempt to shift passengers from bus to rail on those flows by raising fares or reducing the level of service (by which we include frequency or rerouting or reconfiguring such routes). The objective of the remedies we put forward on overlap flows below is to ensure that FirstGroup cannot customize fares increases or other action to such flows or routes. FirstGroup for its part told us that it too believed that the appropriate remedy on fares was to maintain a level of relativity between those overlap flows subject to a remedy and those other overlap flows on the network.

6.11 Although the SLC we identified relates to point-to-point journeys, the sheer number of problem point-to-point overlaps means that, for a remedy to be reasonable and practicable, it is likely to be necessary to impose restrictions on behaviour by reference to a route or part of a route. In Appendix G, we identify 'probable problem routes' where there is currently no effective competition from other bus operators on overlap flows, and where an SLC between bus and rail is currently expected to occur. But we also identify a number of 'possible problem routes' where an SLC between bus and rail would occur if there were to be a reduction in effective competition between buses: see also paragraph 5.83 above. The remedies could potentially apply to all the specific routes identified in Appendix G as possible problem routes; a problem route *will* actually have the behavioural restrictions applied to it.

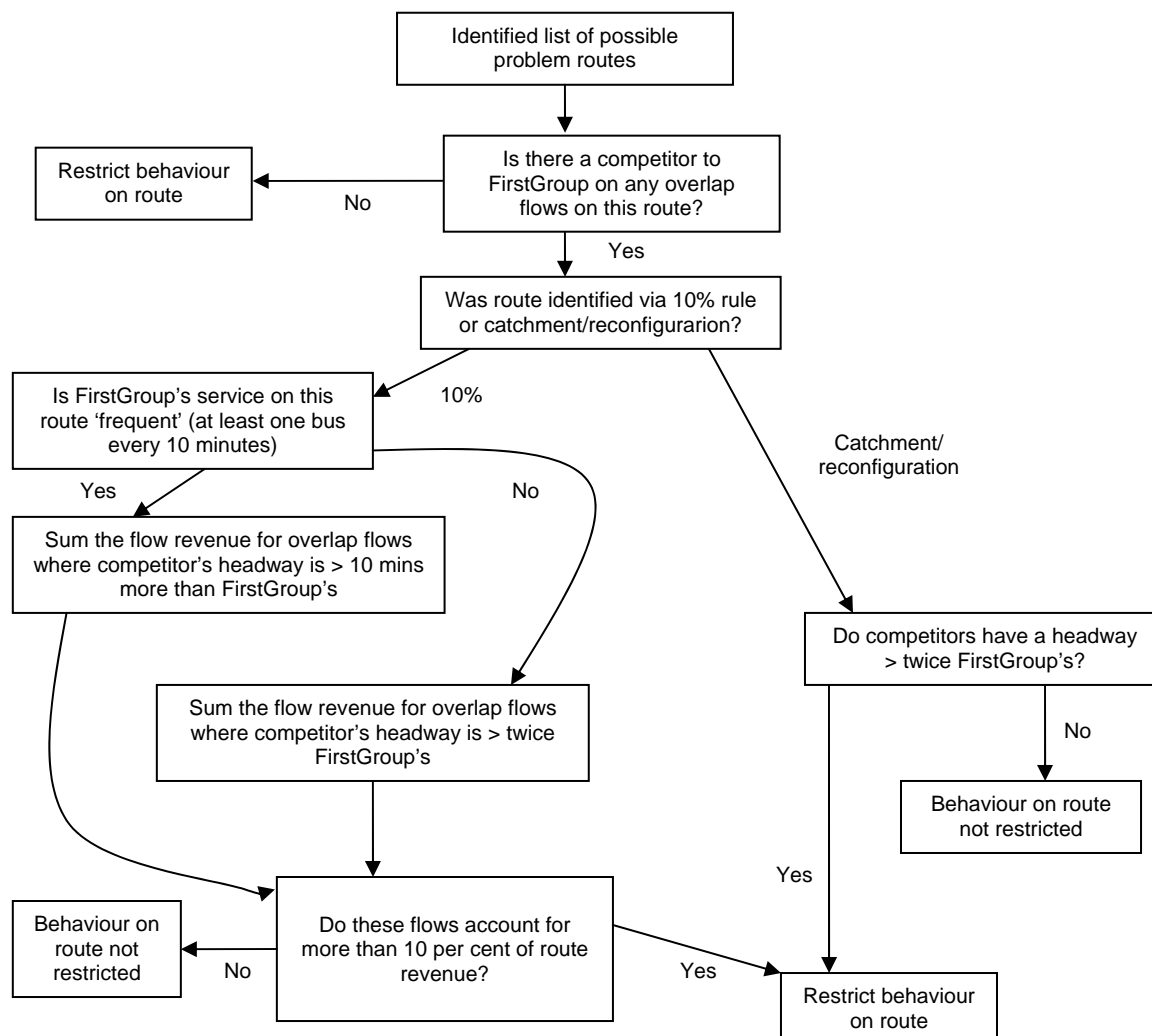
6.12 Before we get to detailed remedies, we set out in Figure 2 the rules for judging which of the 46 potential routes set out in Table 6 of Appendix G are to be treated as 'possible' or 'probable' or not. The criteria are:

- (a) There is not effective competition, either in hours (which for simplicity in the context of remedies we have taken as Monday to Saturday, 7 am to 7 pm) or out of hours (7 pm to 7 am Monday to Saturday, and on Sunday when both FirstGroup buses and ScotRail trains are running on the overlap flows) where this means:

- (i) for FirstGroup's 'frequent' services—ie for this purpose at least one bus every 10 minutes: the expected headway of the services operated by the competitor is more than 10 minutes greater than the expected headway of FirstGroup's services; or
  - (ii) for FirstGroup's services which are not 'frequent' services: the expected headway of the competitor's service is more than double the expected headway of FirstGroup's services; and
  - (iii) the services taken into account for the purposes of assessing effective competition are all those on the given overlap flow for FirstGroup and for all competitors, and not just those for particular service numbers, or for individual competitors.
- (b) In the case of the relevant routes listed in Table 6(i) of Appendix G, the above condition as to effective competition would be limited to routes where overlap flows account for more than 10 per cent of total revenue on the route; in the case of the relevant routes serving potentially wider catchment areas listed in Table 6(ii) and 6(iii) of Appendix G, the condition would apply to services between the wider catchment areas as a whole and the Glasgow or Edinburgh city centres as appropriate (so that when we refer to 'overlap flows' in the context of remedies, we include both categories of overlap flow).
- (c) FirstGroup should be required to appoint a monitor (see paragraph 6.24) who, among other things, will apply the rules in the flow chart to all the possible and probable problem routes at six-month intervals, and advise the OFT of any routes that need to move into or out of the scope of restrictions, to reflect the application over time of the criteria we have suggested. The undertaking would give the OFT the authority to amend the routes covered as appropriate. If at any point FirstGroup wishes to have a route removed from (or added to) the scope of restrictions, it can apply to the OFT who, on the basis of information provided by the monitor using the rules set out in the flow chart, will decide whether a route should be moved out of (or into) the scope of restrictions outside the six-monthly review.
- (d) When the OFT and the monitor review a route, they will apply the rules set out in the flow chart to the given route separately for the in-hours and out-of-hours periods. Where it is practicable to do so, behavioural restrictions will apply to the problem time of day only.
- (e) Routes will be identified by service number. Those routes listed as possible problem routes must retain the same service numbers through the lifetime of the undertakings. However, if FirstGroup wishes to split an existing problem route into separate services, they would be judged as if it were a single service, and the application of the 10 per cent rule to both parts of the route would be treated as satisfying the 10 per cent rule (this follows a suggestion made by FirstGroup itself).

FIGURE 2

**Diagrammatic representation of criteria to determine 'probable problem routes'**



Source: CC.

- 6.13 At the outset, therefore, the remedies would apply to those routes listed as 'probable' in hours or out of hours respectively in Table 6 of Appendix G. We refer to those routes to which the remedies would apply at the outset and subject to future reviews, in whole or in part, as 'controlled routes'.
- 6.14 We noted in paragraph 5.84 that additional geographical overlaps may also result from new rail services introduced over the period of the franchise and to which the franchise refers. The effect of the merger is that such services would be operated by FirstGroup, rather than by another franchisee, reducing the competition to FirstGroup's bus services that would otherwise have developed. We have included in the 46 'possible routes' one bus route overlapping with a rail service which is expected to be opened by the end of 2005, but there are a number of other services that could be opened subsequently. As and when new rail routes/services are confirmed, FirstGroup should therefore notify the OFT and the monitor and provide appropriate data on the relevant bus overlap flows. This would include the application of the '10 per cent rule' to specific overlap flows, as based on the percentage of revenue of the relevant route before the opening of the rail services. The monitor

should then apply the criteria we have used to assess whether these new overlap flows are probable problems (ie the competition rule set out in paragraph 6.12(a)) to determine whether any of those 'new' bus overlap flows should be caught by the undertakings; if so, the OFT should have authority to add them to the list of controlled routes. Any new rail routes should be subject to notification and analysis even where there is a demonstrable 'nil effect' under the CC's criteria. (FirstGroup itself made similar proposals to the above.) We acknowledge the possibility that the potential catchment areas served by such rail services may be wider than those assumed by FirstGroup in its analysis of overlap flows; but we do not anticipate that, in the light of the plans set out in the franchise, the effect would be as significant as with the services to the new towns of East Kilbride, Livingston and Cumbernauld about which we have been concerned.

- 6.15 FirstGroup argued that, for those routes serving wider catchment areas (explained in paragraph 5.16 and following) any remedy should be confined to a requirement not to terminate the route at intermediate stations. In its view, it was only because of its ability to shorten those routes in this way that its calculations suggested that a reconfiguration of some of those routes would be profitable. In our view, however, there would be scope to switch passengers from bus to train by changing fares or service levels, and hence it is necessary to apply remedies relating to such factors to all such routes.
- 6.16 FirstGroup also argued that since we were proposing objective criteria to assess whether routes should or should not be controlled, it should be permitted to make that assessment itself in the first instance, and then to act on the basis of whether or not controls on a route should be lifted (or imposed), subject, however, to subsequent review by the monitor. We were not persuaded that this would be a desirable approach, since it would make enforcement difficult and any enforcement proceedings would be cumbersome and expensive. Our proposals above allow FirstGroup to apply to the OFT between six-month reviews if it believes a route should be moved into or out of the scope of the restrictions, and we do not believe the requirement to do so would cause unreasonable delay.

## **Fares**

- 6.17 In its response to our consultation document, FirstGroup noted that the CC's concern was that incentives would change on overlap flows on controlled routes, but that there would be no change in incentives on routes or flows where there was no overlap with rail. It argued therefore that the appropriate remedy would be to maintain an appropriate relativity between fares on overlap flows and on non-controlled flows. For this purpose, comparison should be made between the controlled overlaps and a basket of comparable fares from elsewhere in its network; and the controlled fare must be the same or less than what was charged on a percentage of the other flows in the basket. The percentage was to provide an element of flexibility (originally it suggested 80 per cent but subsequently suggested a lower figure of 60 per cent). FirstGroup argued that a fares cap, such as changes in fares being linked to changes in the RPI or some other index, in contrast, would be disproportionate and go beyond the restrictions needed to address the concern identified.
- 6.18 We accept that there would be a number of disadvantages in relating fares to any RPI, bus fare or bus cost index:
- (a) To restrict increases in each individual fare to increases in any index would be a relatively inflexible approach, preventing possibly desirable changes in fare levels (if, for example, there are changes in costs) or structure.

- (b) Given that fares tend to increase in discrete 5p steps, the permitted increase in fares would have to be rounded to the nearest 5p. Some fares (and maybe in the first year all fares) could not increase at all, if the increase in the index was a relatively limited one.
- (c) Hence, the index may in practice have to be applied to an average of a 'basket' of fares on problem routes significantly increasing the complexity of the remedy. Moreover, controlling a basket of fares rather than individual fares would also give FirstGroup excessive flexibility to target particular overlap flows.
- (d) Use of any index other than the RPI could conflict with the current undertakings as long as they remain in force. Although there may be scope under the undertakings to change fares by different amounts, to apply a bus fare index to some fares would require (or allow) a decrease (or increase) in other fares relative to the RPI elsewhere. This would result in arbitrary changes in relative fares, possibly even for identical journeys using different routes.

To relate fares on problem overlaps to those elsewhere would, on the other hand, be a means by which competitive pressures on other routes and flows could be taken into account.

6.19 There are two points which it may be helpful to make at this stage as regards fares relativity and its role in any scheme on remedies. First, our objective in defining, and then imposing, an appropriate relationship between fare levels on the problem overlap routes and fare levels on the rest of the FirstGroup network has to be distinguished from the policy objectives behind the fares undertakings imposed as a condition of FirstGroup's acquisition of SBH. The undertakings in the SBH acquisition were designed to meet concerns over competition among bus operators on the relevant networks. The undertakings we propose below will, by contrast, be focused upon the deployment by FirstGroup of its particular position as a network rail operator and network bus operator at the specific points where bus and rail catchment areas overlap. Hence, although the SBH undertakings while they subsist will coexist with the new undertakings, the two sets of undertakings will be intended to correct problems of a different scope and of a different nature. Secondly, the extent of the problem overlap flows and the remainder of the FirstGroup network are themselves a factor in the correct design of remedies built round relativity of fare levels. We have emphasized in the report the relatively minimal extent of the overlap problem flows as compared with the size of the overall FirstGroup network and the adverse effect which our remedies have to address arising from the significance of fare levels to individual passengers on those flows and not from any overall quantitative measure. We have taken this asymmetry into account in designing the detail of any undertaking on fare levels and have been concerned to ensure that a remedy intended to prevent an adverse effect on the overlap areas does not have a consequential adverse effect on the remainder of the network by unduly constraining the ability of fare levels to reflect normal competitive pressures.

6.20 In principle, therefore, we find it more attractive to relate fares on controlled overlaps to comparator flows elsewhere rather than to relate them to an index. But we believe there would be considerable practical problems in identifying a large and representative enough sample of comparable flows for each problem route taken individually for that purpose. Hence, we believe that for all problem flows the comparison should be made with the population of all non-controlled flows (excluding tendered services) in the Glasgow or Edinburgh regions as the case may be.

6.21 In our view, undertakings covering the following should apply to every fare on overlap flows on the routes initially identified as 'probable' in Table 6 of Appendix G, and any of the routes listed that might become 'probable' in future:

- (a) Where a route falls under the scope of this remedy, all fares and all ticket types offered for use on the problem overlaps (ie fares relating to point-to-point journeys from one end of an overlap flow to the other on the problem routes but including network or zonal tickets which may be used on these flows) at problem times of day (ie in hours or out of hours or both, depending on the times of day to which the SLC we have identified applies on particular routes) will be controlled. If a fare applies to, or a ticket type is only available for use on, overlaps which are not problem overlaps and/or for times of day during which FirstGroup faces effective competition, the fare/ticket type will not be subject to control.
- (b) For each fare level, there will be a set of 'comparator fares', consisting of all fares on non-tendered non-controlled routes (ie routes not listed in this report as either possible or probable problem routes in the given area, which in May 2004 were at the same level). Thus, for a 70p fare on any of the problem flows (both the 'possible' and 'probable' problem routes), the set of comparator fares will consist of all fares on non-controlled routes which were 70p in May 2004. We accept FirstGroup's suggestion that the set of comparator fares should not change as fare levels change during the period of the undertakings (except for any flows between which services may be withdrawn). If a particular fare was a 70p fare in May 2004, it would therefore remain in the comparator set for fares that were 70p on problem routes in May 2004 for the lifetime of the undertakings. FirstGroup suggested that monitoring would be easier if fares on controlled overlaps were related to fares on controlled as well as uncontrolled routes: but we believe it would be appropriate only to use non-problem routes for this purpose since they would not be affected by the merger. We also do not believe it would be significantly more difficult to confine the comparators to non-controlled routes, since this reduces the number of comparator fares used.
- (c) The controlled fare must be such that 75 per cent of the fares in the comparator basket are at the same level or above at any point in time for the duration of the remedies.
- (d) (Non-price) terms and conditions of all the ticket types usable on the controlled routes will not be permitted to change unless the same change is made to all equivalent ticket types on the comparator bus network.
- (e) New ticket types introduced elsewhere on the network should be introduced on problem flows with the same prices, terms and conditions as on the comparator flows.
- (f) Fare stages should not change on any routes in the relevant region without OFT approval, which approval should not be given if this would result in fare increases targeted mainly on the problem routes.
- (g) Fares remedies will apply separately to routes in the First Glasgow region and the First Edinburgh region (each region to be defined by an appropriate list of counties).

We considered whether we should apply requirements relating to minimum as well as maximum levels of fares, to prevent FirstGroup reducing fares should a new entrant start services on a particular overlap flow (the problem we identified in paragraphs

5.61 to 5.68). Given that the entry of an effective competitor would allow a relaxation of the undertakings, the incentives on FirstGroup to react in such a way would, we think, be much reduced.

### ***Level of service***

6.22 In our remedies consultation paper, we put forward the option of a requirement to maintain current timetables in order to ensure that FirstGroup could not, by reducing levels of service, switch passengers from bus to rail. However, we accept that this would be unnecessarily inflexible. Hence we prefer the following remedies to restrict reductions in frequency or other aspects of levels of service of particular bus routes on overlap flows:

#### *Frequency*

- (a) FirstGroup should not be permitted to increase scheduled headway in any hourly period (aggregated as appropriate) on any problem route during a problem time of day (in hours or out of hours) from current levels by more than 5 minutes (as FirstGroup itself suggested). A modification of that approach would be appropriate for those services in West Lothian which operate only a few services in peak hours each day, for example to require maintenance of a particular number of departures in a particular period of time.
- (b) To simplify monitoring/compliance, this remedy should apply at the route level or to frequencies between the furthest points of problem overlaps on a route. FirstGroup was concerned that because of variation of frequencies along length of a route, headways should be considered for separate overlap flows: but our approach would allow current variations in such headways to be maintained. If, when the undertakings are being negotiated, FirstGroup produced evidence that this approach was nonetheless insufficient to resolve the problems they foresaw, we would consider it.

#### *Capacity*

- (c) A minimum bus capacity will be set for each hourly period on each problem route, specified as a minimum size (in seat number) of bus that should be run on the route. Different minima might be needed to reflect the use of buses with different capacities at different times of day.
- (d) Smaller buses could be used as emergency substitute buses with reference, for example, to no more than a small number of services per day, or days per year (such as ten).

#### *Route reconfiguration*

- (e) A remedy for reconfiguration is necessary for two purposes. The first is to prevent FirstGroup seeking directly to divert passengers from bus to rail by withdrawing or partially withdrawing direct services between, for example, residential areas and the respective city centre, or in other circumstances rerouting services away from the areas served by railway stations. The second is to counter any means by which FirstGroup might seek to deter passengers from using bus services by significantly increasing journey times. FirstGroup initially suggested that existing route mileage on controlled flows be benchmarked and should not increase by more than 10 per cent, subject to a de minimis of 500 metres. In our view this could allow substantial rerouting on

longer overlap flows (compared, for example, with the bus catchment areas it assumed of only 300 metres). Our final proposals are to a large extent based on subsequent suggestions put forward by FirstGroup to meet that concern. In our view, FirstGroup should not be allowed to reconfigure any problem routes, unless route reconfiguration does not result in the distance on each individual problem overlap increasing by more than 10 per cent or 2 kilometres, whichever is the less. In addition, the distance at the end of each overlap flow to the relevant railway station should not increase by more than 400 metres; and there should also be no rerouting of more than 400 metres of any problem route within the wider catchment areas (in East Kilbride, Cumbernauld or Livingston and the areas to the west of Livingston as appropriate) we have identified on certain routes. A limit of 400 metres on any such rerouting would significantly limit any extra walking distance faced by passengers.

#### *First and last bus times*

- (f) First and last bus times will be controlled on all problem routes. We accept the suggestion of FirstGroup that the controls should operate as follows:
- Where the bus starts earlier or finishes later (at each end of the overlap flow) than the overlapping rail service, FirstGroup must operate a bus at least as early as the first train and at least as late as the last train as appropriate.
  - Where the overlapping rail service starts earlier or finishes later than the bus FirstGroup must ensure that first bus times are not later than they are currently and that last bus times must not be earlier than they are currently, as appropriate.

6.23 Undertakings on service covering the matters listed above should apply both to in hours and out of hours on those services identified in Table 6 of Appendix G as of concern in both periods; and in hours or out of hours only to those services identified in that table as of concern in hours or out of hours respectively.

#### *Monitoring*

6.24 In order to ensure the effective administration of the undertakings covering the matters set out in paragraphs 6.17 to 6.19 as a remedy for the SLC and the adverse effects resulting from it, the task of ensuring compliance with the undertakings would, in our view, benefit from the involvement of a monitor with the additional benefit of local knowledge about the areas affected. We therefore propose that:

- (a) FirstGroup should agree to draw up a shortlist of possible monitors. The OFT will appoint one of the candidates taking due consideration of value for money. If the OFT does not approve any of FirstGroup's shortlist, the OFT will draw up its own list of candidates from which it will make its appointment.
- (b) The monitor will work to a mandate approved by the the CC and on the basis of terms and conditions approved by the OFT; if the monitor and the OFT find the mandate should be altered in some way, they should ask us to do so. We think it entirely reasonable that FirstGroup should bear the cost of the monitor who should have whatever level of support the OFT deems appropriate.
- (c) Every six months the monitor will be responsible for:

- advising whether any routes should move from the possible to the probable list and vice versa; and
  - advising on compliance with the above undertakings aimed at addressing problems on overlapping flows (including biannual spot checks on FirstGroup's actual behaviour on a specified number of problem routes to assess compliance with remedies addressing problems on overlap flows).
- (d) The monitor should also be involved in reporting on FirstGroup's compliance with one of the undertakings in relation to broader effects of the merger on competition which we discuss below (namely that of information on other bus operators services at stations).
- (e) FirstGroup should undertake to provide the monitor and the OFT with such data as is necessary effectively to monitor compliance with these undertakings. This will include such data as either the monitor or the OFT think is necessary to check or verify data provided for monitoring purposes. We set out in Appendix O our first assessment of what we see as the information required for this purpose.

In response to the above points, FirstGroup objected to a six-monthly monitoring or review of routes, regarding 12 months as adequate. However, we were not persuaded of its arguments on this point; we noted, for example, that FirstGroup makes changes to its services more than once a year (there were, for example, a number of changes in January 2004, with more likely in July). We regard a six-monthly monitoring process as necessary to check the impact of such changes.

### *Providing for other changes*

6.25 FirstGroup suggested that, as with the undertakings given by National Express to Centro, the undertakings should be subject to a number of qualifications to allow management of the network in response to changes in exogenous factors and to avoid inadvertent breaches—for example, legal changes, material changes in land use, or transport policy, competitive action by other bus operators, material changes in demand, or material changes in traffic congestion. Our remedies above already provide an element of flexibility and we believe no further provision for change is necessary on the face of the undertakings. We note that there is provision in the Enterprise Act 2002 for the OFT to monitor and keep under review the effectiveness of any undertakings and to consider from time to time whether they remain appropriate. FirstGroup can also request that the undertakings be varied or released. The OFT can recommend that the CC should vary or release the undertakings in the event that, by reason of any change of circumstance, they are no longer appropriate. In general, therefore, we do not consider it necessary or appropriate to allow any further mechanism for change. While it will be for the OFT to consider in light of the facts and circumstances at the time whether there has been a change of circumstances such that the undertakings are no longer appropriate, we would anticipate that factors beyond the control of FirstGroup which have an ongoing effect on their ability to comply with the undertakings, such as legal, regulatory or fiscal changes, or changes in local authority transport policy which have a major effect on the revenue of the company, are examples which could be regarded as a change of circumstances for these purposes. We would, however, accept that there should be some provision in the undertakings for the undertakings not to apply in exceptional temporary circumstances which are beyond the control of First Group, such as a major incident.

## **Broader effects on competition**

- 6.26 We also identified in paragraph 5.110(b) an SLC in broader network markets, associated with multi-modal tickets, and various issues relating to information. The set of remedies we set out below should be applied across the whole of the Scottish rail franchise area.
- 6.27 In the consultation paper we proposed a remedy whereby FirstGroup must not introduce a First-exclusive multi-modal ticket anywhere in the Scottish rail franchise area. As noted above, FirstGroup agreed to give an undertaking not to introduce a multi-modal ticket confined to its own services. However, it expressed concern that such a requirement, particularly if the undertaking were so expressed as to make its offering of any multi-modal tickets conditional upon other operators agreeing in the event to participate, could prevent it offering RailLink through tickets. These are through tickets between a railway station and a town not on the rail network, but including travel on a connecting RailLink bus service from that town to a rail station. FirstGroup is required to offer such tickets under its franchise bid. On the first four such schemes that are specifically provided for in the franchise bid, FirstGroup would be the only bus operator. FirstGroup also pointed out that the current revenue from such tickets on similar schemes is very limited and having two bus operators would not be likely to be viable; it therefore suggested that such tickets be excluded from any remedy, but in our view this could be detrimental to other operators if any schemes did become more successful in future.
- 6.28 We would not, however, wish to deter FirstGroup from offering tickets on particular routes where no other bus operator would wish to participate in such a scheme. In our view, therefore, FirstGroup should be required to ensure that other actual or potential bus operators (where present) in Scotland are invited to participate in a public transport multi-modal ticketing scheme on terms that are fair, reasonable, and no less favourable than the terms on which the FirstGroup bus operator participates in the scheme.
- 6.29 We also proposed in the remedies consultation paper a requirement that FirstGroup should participate in local authority supported multi-operator multi-modal ticketing schemes and use its best endeavours to ensure their success. FirstGroup argued that this could oblige it to support some proposed schemes which stood little chance of commercial success; there was also a requirement under the terms of Schedule 2.5 of the franchise to participate as the rail operator in a limited number of such schemes notified by the SRA. FirstGroup also argued that it had no incentive not to support such schemes and no such remedy was necessary: but we are not confident that this would always be the case. In our view, FirstGroup should undertake to continue to support existing multi-modal multi-operator ticketing schemes, including Zonecard and one-ticket, and to support the multi-modal ticketing schemes specified in the franchise agreement, as both a bus operator and a train operator, and to use its reasonable endeavours to ensure their success.
- 6.30 We also proposed in the remedies consultation paper a requirement that FirstGroup must not discriminate at the point of sale between its tickets and any multi-operator multi-modal ticket. FirstGroup accepted such a requirement, but subject to it being practical to sell particular types of zonecard on buses: in particular, it believed it would not be practical to sell on buses any tickets requiring photo ID. This we accept, and therefore propose that FirstGroup will, as far as is reasonably practicable, provide factual, accurate and impartial advice about its and its competitors' multi-modal tickets, and will sell such tickets on an impartial basis at the point of sale (charging equivalent commission rates as for sales of FirstGroup company products and comparable competitors' products) provided always that it is recognized that

certain types of ticket can be sold only from certain locations (for example, photocard tickets can only reasonably be sold 'off-bus').

- 6.31 We also put forward in the remedies consultation paper remedies relating to FirstGroup's influence as a result of the merger in the setting of fares of multi-operator multi-modal tickets to disadvantage competitors and advantage FirstGroup. As we have noted above, the current Zonocard scheme does not have a formal mechanism for setting terms and conditions, which are currently set 'by consensus', in which, in our view, it would be difficult to limit FirstGroup's role. It is, we think, desirable that there should be more formal arrangements for such schemes, as well as a limitation on FirstGroup's influence over the setting of terms and conditions of multi-operator, multi-modal ticketing schemes.
- 6.32 FirstGroup expressed concern about handing over to its competitors too much control over the pricing of Zonocard, since they may seek a price cut for Zonocard, which could be attractive to them if it diverted significant passengers making multi-modal journeys from FirstGroup-only tickets to Zonocard. Should that occur, the operator of the Scottish rail franchise would suffer a loss of revenue from the rail part of the journey, without the significant changes in volume enjoyed by bus operators. In the absence of the merger, such a price cut would have been resisted by the rail operator and any remedy, in FirstGroup's view, should avoid creating conditions that allow the bus operators to force such a move on rail. Taking into account this trade-off, FirstGroup proposed a voting rule that would make it impossible for FirstGroup to impose price increases thereby addressing the competition concern, while giving FirstGroup a veto, thereby preventing undue price cuts.
- 6.33 We see merit in such an approach. FirstGroup had suggested a cap on its voting rights of 45 per cent, with a simple majority rule for changes to terms and conditions, and a qualified majority rule of 70 per cent for changes in price. However, we considered that a 45 per cent share of rights would enable it to obtain a majority of votes with only limited support from a small number of other operators. In our view, FirstGroup should undertake not to participate in new multi-modal multi-operator ticketing schemes in which FirstGroup's votes exceed 40 per cent of the total (with any votes forgone by FirstGroup reallocated among other operators in proportion to their revenue weights) on the basis of a simple majority rule for non-pricing decisions, but in which a qualified majority of 65 per cent could be allowed for decisions on ticket prices.
- 6.34 We considered to what extent the requirement in the previous paragraph could be extended to existing schemes (such as Zonocard). We accept that FirstGroup is not in a position itself to determine the terms and conditions of operation of such schemes. To require FirstGroup not to participate in such schemes unless the requirements we have put forward are introduced would put at risk the operation of such schemes. As regards existing schemes, FirstGroup proposed and we accept that it undertakes to use its reasonable endeavours to procure that the operation of such schemes be changed to be formal, well-defined and transparent and subject to the voting rights set out in the previous paragraph; such reasonable endeavours would include tabling proposals to amend the working of such schemes and seeking to establish support for them.

### **Information**

- 6.35 We also expressed concern about the provision of information at rail stations on other bus operators' services, and in the remedies consultation paper proposed a requirement that FirstGroup must use its reasonable endeavours to display

information about other operators' bus services with equal prominence to its own: it would be the monitor's job to see whether it is doing this.

### *Duration of remedies*

6.36 All the remedies listed above will remain in place for as long as FirstGroup operates the Scottish rail franchise, unless a successful application is made under the Enterprise Act for variation or release.

### **Summary of proposed undertakings**

6.37 In our view, undertakings under the Enterprise Act would be a proportionate and effective remedy for the SLC and the resulting adverse effects we have identified. (Our aim is for such undertakings to be agreed before the date on which FirstGroup is to start operating the franchise. If we could not successfully negotiate undertakings from FirstGroup to give effect to these measures within such a time period, we would be ready to make an order if necessary.) In summary these would therefore require:

- (a) a limitation on each fare charged on each overlap flow during a problem time of day in the routes identified with reference to that on other routes (paragraph 6.21);
- (b) a restriction on reduction in the level of service on those flows (paragraph 6.22);
- (c) FirstGroup to ensure that other bus operators in Scotland are invited to participate in a public transport multi-modal ticketing scheme on terms that are fair, reasonable, and no less favourable than the terms on which the FirstGroup bus operator participates in the scheme (paragraph 6.28) and to support and use its reasonable endeavours to ensure the success of all such schemes (paragraph 6.29);
- (d) FirstGroup to provide factual, accurate and impartial advice about its and its competitors' multi-modal tickets and to sell such tickets on an impartial basis at point of sale where practical to do so (paragraph 6.30);
- (e) a restriction on FirstGroup's influence over the terms and conditions of multi-operator, multi-modal ticketing schemes (paragraphs 6.33 and 6.34); and
- (f) FirstGroup to use its reasonable endeavours to display information on other operators' bus services with equal prominence to its own (paragraph 6.35).

We also believe that a monitor should be appointed to ensure the effective administration of these undertakings.

6.38 Since we believe such undertakings would be effective in remedying the SLC and consequential adverse effects of the merger we have identified, we continue to believe it should be neither necessary nor desirable to impose structural remedies, either of disallowing the merger, or relating to divestment of any of FirstGroup's bus operations or assets.