

**THE PROPOSED ACQUISITION BY FIRSTGROUP PLC OF THE  
SCOTTISH PASSENGER RAIL FRANCHISE CURRENTLY OPERATED BY  
SCOTRAIL RAILWAYS LIMITED**

**Provisional findings report**

Published: 30 April 2004

The Competition Commission has excluded from this published version of the provisional findings 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 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂].

# Provisional findings report

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

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## **Executive 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.
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, 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 is one of three remaining bidders for the Scottish rail franchise, which will be awarded by the Strategic Rail Authority; the other two are National Express and Arriva.
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 and public authorities, who are also involved in funding both bus and rail services. We found that rail services and bus services are, at least for certain people on certain routes (where the alternative of rail or bus services are available) and at certain times of the day, potentially substitutable. In our view, it is appropriate to regard point-to-point public transport journeys as relevant local markets; but there are also relevant public transport network markets such as the Strathclyde Passenger Transport Executive (SPTE) area, Edinburgh and the Lothians, and, in some contexts, 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 identified 16 other routes where, although current overlap flows are more limited as a percentage of route revenue, it is likely to be profitable for FirstGroup to 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. Finally, we considered a further eight routes where specific concerns were raised by local authorities. Of these 54 routes where the possibility of adverse effects resulting from loss of competition arises, we provisionally identified 24 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 Fridays and Saturdays—at sufficient frequency to compete effectively with FirstGroup. For those routes we believe that competition would be significantly reduced as a result of the merger. We also provisionally identified 31 routes (including many of the 24 previously identified) 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 Fridays and Saturdays and on Sundays), when few competitors to FirstGroup operate. Furthermore, we would expect that other routes might come into being during the term of the Scottish rail franchise with similar characteristics and give rise to similar problems.

8. In our view, neither the existing undertakings relating to FirstGroup's bus operations, nor any constraints resulting from FirstGroup's fare structure would be sufficient to prevent adverse effects which may be expected to result from the merger. Entry or expansion by an existing operator can also not be expected to provide a sufficiently effective source of competition to offset the loss of competition on those routes resulting from the merger, particularly out of hours where few competitors currently operate.

9. The merger may therefore be expected to result in a substantial lessening of competition on overlap flows on such routes. The survey we commissioned suggested that enough passengers would switch from bus to train to make a strategy of diverting passengers from bus to train potentially profitable. We consider 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 would, in our view, be expected to do so.
  
10. We also concluded that the merger may be expected to result in a substantial lessening of competition in wider public transport network markets in and around the SPTE area, Edinburgh and the Lothians and elsewhere in Scotland. After the merger, FirstGroup would account for almost 70 per cent of all revenues from the operation of public transport in Scotland. This 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. This could be expected to distort competition between FirstGroup and other operators, including in areas where it does not currently operate, but where it could leverage its control of the rail franchise to extend its bus operation. It would also 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 would be expected to do so. Finally, it would give FirstGroup an incentive and opportunity to favour its own bus operation in providing information at railway stations, in providing information about its rail services to bus operators, and in joint marketing of services to its own commercial benefit and to the disadvantage of other operators, and it would also be expected to do so.

11. The substantial lessening of competition 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.

## Provisional findings

### 1. The reference

1.1 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). 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 a substantial lessening of competition 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 provisional findings 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, 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

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

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 plc (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 Group plc (National Express)—for a further 14 per cent.

2.2 Following privatization of the rail industry, FirstGroup, along with all the other four major bus companies, also acquired train operating franchises. As at April 2004 FirstGroup was the operator of five passenger train operating companies (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 inter-City routes across the North of England); and
- (e) Hull Trains (services between Kings Cross and Hull on an open access basis, ie not under the terms of a franchise).

2.3 In the year ended 31 March 2003, FirstGroup's total turnover was £2.3 billion, with operating profit of £216 million (before exceptional items and goodwill amortization). The UK Bus operation of FirstGroup accounted for revenue of £859 million, operating profit of £112 million, and 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 operation 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 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 part of routes to and from England.

2.6 The financial performance of the Scottish rail franchise is summarized in Appendix B. National Express's ScotRail franchise generated turnover in the year ended 31 December 2002 of £368 million. Public subsidy accounts 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

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<sup>2</sup>Stagecoach Holdings plc and S B Holdings Limited: a report on the merger situation, Cm 2845, April 1995.

invitation to tender (ITT) was issued in June 2003, and a formal ITT in October, with further revisions being made by the Strategic Rail Authority (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 does not formally involve transfer of the current franchise operator—ScotRail—to the successful franchisee; but would involve the transfer of the incumbent franchise operator's business (which may constitute the transfer of an undertaking for the purpose of TUPE)<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. As well as FirstGroup, the two remaining bidders are National Express (the current franchise holder) and Arriva (a fourth shortlisted bidder having withdrawn). Arriva operates buses in areas to the West of Glasgow (including Paisley and Renfrew) and National Express in Dundee.
- 3.3 Although the franchise is to be awarded by the SRA, SPTE and Scottish Ministers are closely involved throughout this process. Because about half of the services are operated on behalf of the SPTE, SPTE is a party to the franchise agreement, specifying all aspects of the service and setting all prices in its area (see Appendix C).
- 3.4 FirstGroup told us that it made a 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 to the Scottish rail

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<sup>3</sup>Transfer of Undertakings (Protection of Employment) Regulations, 1981.

franchise because of 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, given also 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, 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 SPTE would be invited to participate.

- 3.5 Various aspects of the franchise are material to the assessment of the effects of the merger, in particular which body accepts the ‘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 SPTE is borne by 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 wish 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.

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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 will 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.

- 3.6 As at the time of this report, two options for the allocation of revenue risk were still being considered. First, for the franchisee to take all revenue risk; and second, for the sharing of revenue risk 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, this would, in effect, be reversed with additional support being supplied by the franchisor, but 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.
- 3.7 Also important in appraising the effect of the merger is understanding which body is in control of fare 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 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. SRA has recently reviewed its GB-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

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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).

apply directly to the Scottish rail franchise for which any new fares policy would be agreed separately with Scottish Ministers; before Scottish Ministers made any decision on fares, they wanted to consider carefully the outcome of the SRA's review. For purposes of bidding, the ITT said that bidders were required to assume that increases in regulated fares would be set at RPI+1 (including fares controlled by SPTE), which Scottish Ministers subsequently decided to apply for 3 years from January 2004; if this were changed in the remaining period of the franchise, under the terms of the franchise the effect on the operator would be financially neutral.

3.8 We have noted above that SPTE can specify all fares in the Strathclyde Passenger Transport Area.<sup>6</sup> It currently specifies all fares for journeys within that area and intends to continue to exercise this right in the future. Its right to specify fares will operate independently of the arrangements finally determined for the sharing of revenue risk in the Strathclyde area.

3.9 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

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

regarded by the SRA and others as 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 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 a substantial lessening of competition 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 a substantial lessening of competition 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 firstly on the extent to which customers would reduce usage in response to such a price change and whether therefore 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 be adjusted to lower output. If such a price increase were profitable and could be sustained, that product or service in question could be

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<sup>7</sup>More detail on the way the CC applies this 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 per cent reduction in usage would be greater than the per cent increase in prices and revenue would fall.

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 apparent in that appendix, these elasticities 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. However, 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 and in the particular local circumstances we are considering.

### ***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> A particular operator's network can be thought of as a collection of interconnected routes. More FirstGroup bus passengers use 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 actually only used this 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

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<sup>9</sup>A network 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 only needed to use one bus on their journey.

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 valid only for that flow (and possibly for the specific route) on which he 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.

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 currently 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, who 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. At a wider level, the Scottish Executive makes contributions both to the funding of the rail network and to local authority transport policy. 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. 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 5.47 et seq), 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 Hence, 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, and whether a direct service is available or 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) and 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 directly examine the 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 2003/4 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 we commissioned noted 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.

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;
- (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 disagreed with aspects of both studies OXERA undertook for us.)

- 4.27 FirstGroup made a number of comments on the survey. It pointed out that the survey was based on passengers within 2 kilometres 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. It 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. 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 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 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 Fridays and 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 Fridays and 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 SPTE 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, SPTE'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 SPTE 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, which seems to be consistent with their behaviour.

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

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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.

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 MMC 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 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.’

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<sup>13</sup>Stagecoach:SBH—see footnote 2; and *Stagecoach Holdings PLC and Mainline Partnership Limited. A report on the merger situation, March 1995.*

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 entry (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 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***

4.36 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**

4.37 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.

4.38 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:SBH report). Within Strathclyde, however, it estimates 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 City of Glasgow, and were based on bus miles. FirstGroup said that its market share had declined

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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 are estimated and that the Department for Transport survey, from which they were produced, was not designed to provide figures for parts of Scotland. The data might therefore be subject to considerable uncertainty.

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

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 OFT, the size of FirstGroup's fleet 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 a sensible market definition (which in its view should be a route or corridor or the travel to work area of Greater Glasgow).

- 4.39 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 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 weekdays including 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 [X] per cent of its total bus passengers.

- 4.40 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.
- 4.41 FirstGroup estimates 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.
- 4.42 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 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 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 a 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, 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>16</sup> Within Glasgow, reflecting the much denser provision of public transport, FirstGroup have 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 but if anything 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). Where there was an overlap, FirstGroup estimated the number of bus passengers on the fare stage<sup>17</sup> including that stop, even when some of the bus stops in the fare stage were a long way from the rail station.

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 exceeds 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 also put forward a suggestion that we should only consider those flows:

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<sup>16</sup>ie the station and the bus stop could be up to 1,200 metres apart.

<sup>17</sup>A number of bus stops may be combined into one fare stage for ticketing purposes, and with identical fares from and to each stop.

- (a) which generated revenues above a minimum level, for which FirstGroup showed the effect of adopting a figure of £5,000 a year of bus revenue (a figure at one stage put forward by ourselves), but suggested that a higher figure of £20,000 would be appropriate;
- (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 those of bus fares and bus services could also be diverted away from rail stations to encourage passengers in the catchment area of the station to use trains without needing a lengthy (more than 5 minutes) rerouting (making it 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 five 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 a substantial lessening of competition.

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>18</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. With regular use, 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>19</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 5.23) 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 journey, see paragraph 4.19). These include not just the journey time spent on a bus

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<sup>18</sup>*National Express Group PLC and Central Trains Limited: A report on the merger situation*, Cm 3774, December 1997.

<sup>19</sup>In one case, for example [X], 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.

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>20</sup> Bus return fares on these routes are, however, cheaper than rail fares in the peak (£2.30, 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 to four). Possibly for these reasons, a large majority of passengers on FirstGroup's figures (87 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.

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<sup>20</sup>The difference in journey time is less on other routes between Clydebank and Glasgow which were, however, excluded from these figures.

We decided therefore not to exclude overlap flows from consideration merely on the basis of differing bus and rail travel times.<sup>21</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 5.16), 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 a route rather than by reference to individual flows within that route, even though our ultimate concern may be with the overlap flows as such.

5.13 We have 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 overlap flows (of the kind mentioned in paragraph 5.4) 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 with scope for reconfiguration of services; or
- (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).

Our full analysis is set out in Appendix G, but explained more briefly in paragraphs 5.14 to 5.25.

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<sup>21</sup>We return to the remaining points—(b), (e) and (f) in paragraph 5.6—in paragraphs 5.14, 5.29 and 5.43.

5.14 We considered firstly 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 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 Appendix G—where revenues from overlap flows exceed 10 per cent of the bus revenues of the route. 23 are routes operated by First Glasgow mainly in the Glasgow area and seven by First Edinburgh.<sup>22</sup> In total these account for 450 overlap flows:<sup>23</sup> 363 in the Glasgow area and 87 on First Edinburgh routes. The total revenue arising from these 30 routes is £[redacted] (£[redacted] in the Glasgow area and £[redacted] on First Edinburgh routes); and the total revenue arising from overlap flows is £[redacted] (£[redacted] in the Glasgow area and £[redacted] on First Edinburgh routes).

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 and the nature of the services available. For example, some 40

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<sup>22</sup>The First Edinburgh routes include two in the Stirling area. One of the other Glasgow area routes referred to in paragraph 5.18 is operated by First Edinburgh, and included in First Edinburgh routes in paragraphs 5.20, 5.21 and 5.25.

<sup>23</sup>An overlap flow which occurs on, for example, two routes is treated twice in these figures.

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). Even where this does not currently occur—if, for example, there are currently no such ‘feeder’ services that provide adequate connections with rail services or if passengers prefer to travel on direct bus services rather than change between bus and train—in certain cases it would be possible to reconfigure bus routes<sup>24</sup> to operate as feeder services to and from railway stations. Hence, the potential effect of the merger could extend into such wider potential catchment areas.

- 5.17 The operation of buses as feeder services could be regarded as exploiting market power if, for example, it was associated with the withdrawal or partial withdrawal of overlapping services, reducing choice. The exploitation would then be especially apparent if passengers were obliged to pay significantly higher fares, particularly over longer distances, for travel by rail rather than bus; passengers on journeys to intermediate points would also be adversely affected by poorer levels of service even if 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 substituted 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.

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<sup>24</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 substituting 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 requiring 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 to make it easier for any passenger who wishes to do so to transfer to a train.

5.18 We have therefore considered the effects of the merger on a further 16 routes serving sizeable discrete communities at some distance from Glasgow or Edinburgh and with 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 used by FirstGroup would only cover a small proportion of bus users travelling between those communities and Glasgow or Edinburgh, the majority of bus passengers in these communities 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.

5.19 Third, we also included a further eight overlap routes (excluding one which related to one of the routes considered in the previous paragraph) in the Edinburgh area about which specific concerns were expressed to us by the local authority about their continued operation (although that local authority was not otherwise concerned about the merger). 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 analysis. The areas served by them would, however, fall within the potentially larger catchment areas considered in the previous paragraph and they would also be vulnerable to reconfiguration as feeder services.<sup>25</sup>

5.20 These additional 24 routes accounted for a further 99 overlap flows; the total revenue on these 24 routes was about £[redacted] (£[redacted] in the Glasgow area and £[redacted] on First Edinburgh routes). FirstGroup identified revenue on overlap flows on these routes at

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<sup>25</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.

some £[redacted] (£[redacted] in the Glasgow area, £[redacted] on First Edinburgh routes), although the revenue on potential overlap flows would exceed this.

5.21 In total therefore we considered actual and potential overlap flows on 54 routes (30 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: 34 in Glasgow, about one-third of its First Glasgow routes, and 20, about one-sixth, of First Edinburgh's routes. The total revenue on those routes is about £[redacted] (£[redacted] in the Glasgow area and £[redacted] of First Edinburgh) and on the overlap flows identified some £[redacted] (£[redacted] in the Glasgow area and £[redacted] of First Edinburgh). 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 £151 million. Overlap routes therefore represent a significant proportion of FirstGroup's total revenues in the Glasgow and, to a lesser extent, Edinburgh areas.

5.22 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 profitably to do so. 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, generally with 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 (though some competitors' services that do not operate late evening do operate on Sundays).

5.23 We therefore consider those of the 54 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 the frequency with which they operate.<sup>26</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).

5.24 In allowing for the presence of effective competition above, we have also adjusted for other factors on a limited number of the routes.

(a) We added 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 removed 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 regard 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.

5.25 Of the 54 routes referred to above, we have provisionally identified a number of routes where the loss of competition between bus and rail may have substantial adverse effects:

(a) 24 routes (11 in the Glasgow area, and 13 of First Edinburgh) on which there is currently no existing effective competitor in hours (or a major competitor that could readily divert or extend its existing services to cover the main overlap

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<sup>26</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 in the broader potential catchment areas.

flows). These routes account for £[x] revenue in the Glasgow area and £[x] revenue of First Edinburgh; and the overlap flows (as currently identified by FirstGroup, but potentially wider) for £[x] revenue in the Glasgow area and £[x] revenue of First Edinburgh—ie total route revenue of about £[x], and total revenue from such overlap flows on those routes of £[x].<sup>27</sup>

- (b) 31 routes (including many of the 24 identified in (a)), (25 in the Glasgow area and six of First Edinburgh) on which there is currently no existing competitor out-of-hours.

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

5.26 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 above and in Appendix C the extent of regulation of rail fares and frequency of services and other aspects of its 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 franchise prescription).

5.27 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

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<sup>27</sup>Total route revenues, in hours and out of hours.

evidence on the CC's web site), some of which 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.

5.28 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 5.25 above.

5.29 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 first and last bus when profitability is likely to be lowest and/or 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 buses away from stations where possible in order that passengers in the catchment areas of stations would have to use rail;<sup>28</sup> or
- (d) by reconfiguring services (as discussed in paragraph 5.16) 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 has made changes to bus services that overlap with rail services. But it said that these changes were not as a result of common ownership. It added that

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<sup>28</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) above also refers).

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.

5.30 FirstGroup told us 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 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 act in their common commercial interests and be alert to the opportunities of making the businesses assist each other whenever possible in order to maximize overall group profits.<sup>29</sup>

5.31 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 consider 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 5.38 et seq) relating to its bus operations and other aspects of its fare structure. We then consider whether it would have scope to do so, given the prospect for entry on those routes.

5.32 We have noted in paragraph 4.25, based on the NOP survey of passengers, that bus and rail 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

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<sup>29</sup>A similar issue arose in a previous inquiry, the Central Trains merger, during which National Express incorporated a schedule to the franchise agreement not to reduce bus services other than in certain circumstances (see Appendix 3.7 of that report).

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.

5.33 Whether it would be profitable for FirstGroup to switch bus passengers to rail services depends firstly on whether FirstGroup would retain some of the additional rail revenues generated.<sup>30</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 the revenue risk being shared 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 most 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.

5.34 Whether it would be profitable to divert passengers from bus to train will also depend on the extent of the overlap section—ie the percentage of customers that can switch on a route—and the percentage of those passengers that would shift if, for example,

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<sup>30</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.

the frequencies of bus services were reduced or their fares increased (in 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. And finally it would depend on the relative level of fares and of variable cost of rail and bus. Increases in passenger numbers do not significantly increase rail costs unless additional coaching stock or services are required, but there are high variable costs of buses, if the level of service is adjusted in line with changes in passenger numbers.

5.35 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 if frequency were adjusted as a result of lower numbers of passengers. Further, the price elasticity and cross-price elasticity of demand it used 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.

5.36 As discussed in Appendix I, we simulated the increase in profit that could be generated, on rail and bus services in aggregate, on ten of the routes shown in Appendix G, as a result firstly, of a 10 per cent increase in headway (resulting from a reduction in frequency); and second, for 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>31</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 attracting 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 it would be 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 revenue as a result of passengers transferring from bus to rail; but also additional bus revenues from 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>31</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 for all ten routes 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, as would be expected, 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 the route for which it gave us information 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>32</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). There would also be scope to target fare increases on out of hours bus passengers, for example by restricting the time of availability of day tickets.
- (d) The simulations we undertook did not cover possible reconfiguration of routes, for example to operate as feeder services into train stations combined, for example, at least in part with 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

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<sup>32</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.

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 to be scope for at least partial reconfiguration of routes in some cases.

5.37 The analysis in paragraph 5.36 does not, however, 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 weak regulatory structure of buses, 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 entry.

### *Current undertakings*

5.38 As detailed in Appendix J, a number of undertakings were given by FirstGroup following the FirstBus:SBH inquiry in 1997.<sup>33</sup> The undertakings were not given until 2002, although OFT has stated that FirstGroup acted within the spirit of the intended undertakings in the interim. They included a fare 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, but excluding 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

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<sup>33</sup>These undertakings were required as an alternative to divestment of a number of FirstBus depots and associated routes as recommended in that report.

than 5 per cent, and constraints on operation of tendered services, all of which undertakings excluded both Strathclyde and Edinburgh.

- 5.39 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 those undertakings applicable to the Glasgow area is that relating to fares. As noted in Appendix J, as well as the fare cap, the undertakings appear to have had the effect of indirectly 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; and hence any increase in fares on a particular overlap route could on that basis only be part of an increase in fares of that amount extending to many non-overlap routes. This does not appear to be an explicit requirement of the undertakings although both OFT and FirstGroup have applied it that way. 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: but it is far from clear that the wording of the undertaking requires this, or they could not be applied in a different way if FirstGroup wished to do so.
- 5.40 As applied to date the fare 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 Glasgow, significantly reducing the profitability of an increase in fares on individual routes.

5.41 Fares only recently introduced, including the £2.50 FirstDay peak tickets and £2.20 off-peak tickets, are not covered by the undertakings. Moreover the undertakings also do not 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, hence the fare for the whole flow was regulated. Similarly, the restriction on FirstGroup reducing bus services applies to their 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.

5.42 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 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.

### *Fare structure*

5.43 FirstGroup's ability to increase fares may also be constrained by the existing fare 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 to buy tickets to stops beyond where they wish to alight. However, as in part acknowledged by FirstGroup (see paragraph 5.6(f)), these constraints are unlikely to apply, for example, at the end of routes where the impact on other fares on the routes would be less. 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, if fares were increased at the end of routes, it could in several cases limit the geographical area covered by its network tickets accordingly. We have also noted that these tickets are not currently covered by the undertakings. In our view, therefore, there would be scope despite its fare structure for Firstgroup to increase fares on parts of the overlap routes identified above.

### ***Entry and expansion***

5.44 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.<sup>34</sup>

5.45 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 subsidy for competing services is also likely to prevent entry.

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<sup>34</sup>We use 'expansion' to include 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 include the operation of new routes by a new or existing operator.

5.46 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 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*

5.47 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 (by which it subsequently said it meant it could not identify 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.

5.48 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 4.39 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.

5.49 As evident above, most of the new entrants, moreover, do not operate evening or (to a somewhat lesser extent) Sunday services. 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 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.

5.50 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*

5.51 As discussed in Appendix L, outside London, there are no legal barriers to entry or expansion (other than in relation to safety of bus operations) and relatively limited costs.<sup>35</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 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.

5.52 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 [§], complaints by Lothian to the OFT of anticompetitive conduct by FirstGroup [§]. As at the time of our provisional conclusions, the OFT was expected to announce its conclusions on this investigation shortly, but we note that an aggressive response to entry by lowering fares or increasing frequency could be a deterrent to entry, creating a

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<sup>35</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 service every 10 minutes or more frequently, it is not required to register any increase in that frequency.

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.

5.53 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 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.

5.54 Acquisition of the Scottish rail franchise would, in our view, give FirstGroup a further incentive to deter and react to any entry. Such entry would now not only affect the profitability of its bus services but also its rail services particularly on overlap flows. We noted above the generally small extent to which rail costs vary with number of passengers. Any loss of rail revenue to competing bus services would potentially therefore have a pronounced effect on FirstGroup's profitability. Hence, if a bus operator noticed that FirstGroup's overlap flow was being badly served by FirstGroup's bus operation, it would need to evaluate even more carefully FirstGroup's response to any entry onto that overlap, and the prospect of such entry would itself be further reduced.

5.55 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>36</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 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 fare 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.

5.56 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

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<sup>36</sup>As discussed in Appendix M, The Transport Scotland Act (2001) gives provision for 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.

bus. But in our view the need to offer lower fares than FirstGroup itself disadvantages such competitors, and reduces the profitability of entry to them.

5.57 Entry is likely to be particularly unattractive out of hours when smaller operators would not have the current advantage of lower driver costs from limiting the hours of operation of their services. FirstGroup argued that the contribution from out of hour services was such that, were it to reduce services levels, it would leave an opportunity for another operator to put on a bus which earned incremental revenues in excess of incremental costs. But given the current reluctance of almost all smaller competitors to operate out of hours, we believe this implausible.

#### *Incentives and prospects for entry*

5.58 Our concerns in paragraph 5.29 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.

5.59 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 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. Finally, FirstGroup would also retain the

competitive advantage of its network tickets, even if it increased their prices in certain areas.

5.60 The percentage of passengers who would be deterred from using FirstGroup services as a result of a fairly limited fare increase is itself unlikely to be sufficient to sustain an expansion by an existing operator. For example, we estimated some [X] passengers on the 204/5/15 would switch from bus to rail in response to a 10 per cent fare increase on the maximum price elasticity assumed. Our survey suggested 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 [X] passengers a day, or less than half-dozen passengers an hour. If fares were about £[X] per passenger, revenue of about £[X] an hour would fall far short of the likely cost figure of £[X] to £[X] an hour to operate a service. It is also uncertain whether a new entrant would be attracted onto a route in such circumstances.

5.61 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, because it would create a gap in services which could more easily be filled; and this may be a further reason to expect a fare increase rather than frequency reduction to be the more likely result of the merger. However, new competitors would remain disadvantaged by FirstGroup's network cards and the greater frequency which it would continue to offer services on most overlap flows. We have also noted that few of the smaller competitors currently operate out of hours and 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.

5.62 The incentive on competitors to enter or expand their operation is therefore limited. In addition 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. Nor can it be assumed that if FirstGroup were to raise its fares on part of a route, existing competitors would not chose to raise their fares equally, rather than try to compete through increasing their frequencies. In general, therefore, we regard it as unlikely that the possibility of new entry or expansion would be sufficient fully to resolve the problems created by the merger.

5.63 Thus:

- (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 more to large scale entry and expansion.
- (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.

5.64 We concluded above that neither the existing undertakings relating to FirstGroup's bus operations nor any constraints resulting from FirstGroup's fare structure would be sufficient to prevent adverse effects resulting from the merger. With the exception of the two routes referred to in paragraph 5.24(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***

5.65 We referred in paragraph 5.25 to 54 routes where the possibility of adverse effects resulting from loss of competition on point-to-point public transport journeys arises.

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.
- (b) Sixteen routes currently had more limited overlap but there are concerns that FirstGroup could reconfigure services as feeder services to railway stations increasing the potential size of the catchment areas, and combined with withdrawal at least in part of direct services.
- (c) Eight routes had given rise to similar concerns as in (b) from a local authority.

5.66 Of these 54 routes:

- (a) We have provisionally identified 24 routes where there are no competitors on those flows operating with sufficient frequency to compete effectively with FirstGroup in-hours.<sup>37</sup>
- (b) We have provisionally identified 31 routes with no effective competitors out of hours following the merger; and
- (c) In making those provisional assessments we have allowed for other factors including one route where the competitor took a much longer journey time than

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<sup>37</sup>See also footnote to paragraph 5.23 on the application of this criterion.

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.

5.67 There may, however, be other factors related to these specific routes we will wish to take into account in reaching our final conclusion. At the moment, however, we regard these 24 routes in hours and 31 routes out of hours as being those where the merger might be expected substantially to reduce competition.

5.68 In our view, FirstGroup may be expected, on overlap flows on those routes (including potential overlap flows to which paragraph 5.65(b) and (c) refers), and as a consequence of the loss of competition between bus and rail resulting from the merger, to increase fares, and/or 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 reconfigure routes to act as feeder services to rail stations combined, for example, with withdrawal at least in part of direct services. Such adverse effects would result not only on routes currently having the characteristics set out in paragraphs 5.65 and 5.66; but also on any additional routes with those characteristics that came into being as a result of changes in overlap flows (for example, from changes in routes or rail services, or from housing, commercial or other developments) over the period of the franchise. Such adverse effects would be expected to arise on only a minority of bus routes in the Glasgow and Edinburgh areas, and affect only a minority of passengers on these routes. But we regard the overlap flows giving rise to such effects as relevant markets in their own right, and within these markets there is a substantial lessening of competition. In our view the merger may therefore be expected to result in a substantial lessening of competition in particular markets for point-to-point public transport, namely point-to-point overlap

flows served by the routes referred to, and additional routes that might come into being during the term of the Scottish rail franchise with the characteristics set out, in paragraphs 5.65 and 5.66.

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

5.69 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 a substantial lessening of competition 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.

5.70 A source of serious concern from a number of other bus operators and 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 area 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>38</sup>

5.71 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 [§<] 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, 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>39</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 participate.

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<sup>38</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 part of its franchise 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, a substantial lessening of competition from FirstGroup introducing its own multi-modal schemes was unlikely. In the case of Arriva plc/Wales and Borders Rail Franchise, however, 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 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>39</sup>See the Competition Act 1998 (Public Transport Ticketing Schemes Block Exemption) Order 2001 (SI 2001/319).

5.72 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: 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 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.

5.73 After the merger FirstGroup would receive 67 per cent of revenue distributed by the SPTE to participants in its ZoneCard scheme. Given however that FirstGroup's position will 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, merely adding its

share of passenger revenue in this way may exaggerate the strength of its position. FirstGroup itself argued that there would be no disadvantage to other operators from its position. It believed SPT 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 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 the ZoneCard. Finally, FirstGroup said, ZoneCard represented a small percentage of other operators' revenues, so there was little scope to disadvantage them anyway.

5.74 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. [✂]

5.75 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 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. However, shortly before this report was finalised, we saw reports that one of the other bidders had been named as the operator of the proposed tram scheme.

5.76 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.
- (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 franchise agreement.

5.77 The franchise agreement requires the franchisee to provide information on other rail services and on other matters such as the SPT may specify, but with no explicit requirement to provide information on other operators’ bus services.<sup>40</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 or to treat its competitors on equal terms with its

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<sup>40</sup>[redacted]

own bus operations in providing information on its rail services, or in joint marketing of services. 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 provision of information. This we would expect it to do, to the disadvantage of its competitors.

5.78 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. That concern was partly related to the scale of subsidy for the Scottish passenger rail services, but this reflects its operating cost, and the process of competitive tendering for the franchise is intended to ensure no 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 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.

5.79 A further concern raised with the OFT (but not ourselves) 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.

5.80 The SRA estimated that the maximum annual requirement is 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 arms length basis and it expected 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.

5.81 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.

5.82 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 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 a substantial lessening of competition 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, 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 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.

5.83 Among the concerns we considered were that the regulatory bodies, in particular Scottish Executive and the SPTE, might prefer to deal with one main supplier of public transport services rather than a multiplicity of competing operators and might therefore 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 may currently provide commercial or tendered services.

5.84 FirstGroup's importance in the Scottish public transport market is, in our view, also to some extent exaggerated by its share of almost 70 per cent of revenues to which we refer above. Although it would bear some revenue risk in operating the rail franchise, its role is primarily 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 of 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.

- 5.85 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 doing so there was 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.
- 5.86 Legislative provision for quality contracts is only recent. We understand 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.

5.87 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.

5.88 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 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 train operating companies if necessary.

5.89 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.

5.90 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 5.55 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.

5.91 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 would be expected to do so (paragraph 5.72);

- (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 would be expected to do so (paragraph 5.74); and
- (c) the merger would give FirstGroup an opportunity to favour its own bus operation in provision of information at stations, in provision of information about its rail services to bus operators, and in joint marketing of services, to its own commercial benefit and to the disadvantage of other operators, and it would be expected to do so (paragraph 5.77).

***Provisional conclusions on substantial lessening of competition***

5.92 We have therefore concluded that:

- (a) the merger may be expected to give rise to a substantial lessening of competition in particular markets for point-to-point public transport journeys, our current assessment being that this would occur on 24 routes serving point-to-point overlap flows in-hours and 31 routes out-of-hours. 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. Furthermore, we would expect such adverse effects would also result on additional routes that came into being during the term of the Scottish rail franchise with the characteristics set out in paragraphs 5.65 and 5.66; and
- (b) the merger may be expected to give rise to a substantial lessening of competition 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 would 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 would 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, in the provision of information about its rail services to bus operators, and in joint marketing of services, to its own commercial benefit and to the disadvantage of other operators, and it would be expected to do so.

The substantial lessening of competition 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.

5.93 The conclusions set out in paragraph 5.92 would be the same were we to assume that the Secretary of State is going to release FirstGroup from the undertakings referred to in paragraph 5.38 or were we to assume that she is going to retain the undertakings. However, for the reasons set out in paragraphs 5.39 to 5.42 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.

- 5.94 We are therefore required to consider whether action should be taken for the purpose of remedying, mitigating or preventing the substantial lessening of competition or any adverse effects which may be expected to result from such a substantial lessening of competition, and also having regard to the effect of any action on any relevant customer benefits (as defined in the Act) in relation to the merger.