Notice of provisional decision to vary Undertakings given pursuant to section 88 of the Fair Trading Act 1973 following the acquisition by FirstBus plc of SB Holdings Limited

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Summary

1. On 24 January 1997 the Monopolies and Mergers Commission (MMC) published its report into the acquisition by FirstBus plc (FirstBus) of 100 per cent of the issued share capital of SB Holdings Limited (SBH).[1] The MMC found that the acquisition operated or may have been expected to operate against the public interest and in 2002 behavioural remedies were put in place capping the fares of FirstBus's operations in Edinburgh and Glasgow and establishing a mileage floor in relation to FirstBus's Edinburgh operations. In 2005 FirstGroup plc applied for release of the undertakings. Following receipt of a report from the OFT, the CC published its provisional decision not to release the undertakings, and to consider instead a variation, in November 2007.

2. Bearing in mind the responses the CC received to that consultation the CC has, in summary, provisionally decided that the undertakings should be varied to:

   (a) allow fares to increase so that revenue rises by no more than whichever is the lower of the CPT (Scotland) index and the CPT (GB-wide) index;

   (b) allow a catch-up adjustment in revenue for each of First Glasgow and First Edinburgh that reflects the difference between revenue and cost (including weighted average cost of capital);

   (c) allow First to spread the catch-up adjustment across an indefinite period; and

[1] CC (1997), *FirstBus plc and SB Holdings Limited: a report on the merger situation,* Cm 3531, is available at: www.competition-commission.org.uk/rep_pub/reports/1997/395firstbus.htm#full.

(d) rebase the mileage floor (which applies only to First Edinburgh) to 75 per cent of 2002 mileage.

3. Appendix 1 to this notice provides a copy of proposed undertakings giving effect to these variations.

Introduction

4. On 24 January 1997 the Monopolies and Mergers Commission (MMC) published its report into the acquisition by FirstBus plc (FirstBus) of 100 per cent of the issued share capital of SB Holdings Limited (SBH).[2] The MMC found that the acquisition operated or may have been expected to operate against the public interest. Although the MMC's recommendation was for a divestiture remedy, the Secretary of State, noting the entry of Stagecoach into the provision of buses in the Glasgow area shortly after the publication of the Competition Commission's (CC) report, decided to pursue behavioural remedies. Specifically, fares in the First Glasgow and First Edinburgh[3] areas were capped in line with the Retail Price Index (RPI) and a mileage floor was introduced into the First Edinburgh area such that First was required to maintain mileage of at least 95 per cent of 2002 levels. These remedies were implemented by means of undertakings given by First in 2002 (the Undertakings).

5. In December 2005, FirstGroup plc (First) applied to the Office of Fair Trading (OFT) for the release of the Undertakings.[4] The OFT submitted a report to the CC in December 2006. The CC considered the OFT's report, and other information submitted directly to the CC by First and published for consultation its provisional decision on First's application on 16 November 2007.[5] The CC's provisional decision was that there had not been a sufficient change of circumstance to warrant release of the Undertakings. However, the CC noted (at paragraph 160) that bus industry costs did appear to have risen at a faster rate than RPI over the period of the fare cap; the CC therefore considered that it was possible that First is now in a position where its fares in the two areas do not allow it fully to recover its costs. Assuming that First was an efficient operator, the CC considered that this could have a negative effect on entry and expansion. The CC also considered that the increases in bus industry costs may also mean that the undertakings have required or will require First to operate services which have been persistently unprofitable and are likely to remain so. The CC therefore said (at paragraph 163) that it would be sympathetic to varying the fare cap such that fare increases were constrained by reference to an index more closely related to bus industry costs than the RPI. The CC also said (at paragraph 165) that it would be sympathetic to varying the mileage floor in such a way as to ensure that First was not required to continue to run services that it could demonstrate had persistently failed to recover their direct costs of operation and were unlikely to do so.

6. The CC received several responses to its consultation. Having reflected on these responses, and having discussed possible variations with First, this notice sets out a further provisional decision for consultation.

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[2]CC (1997), *FirstBus plc and SB Holdings Limited: A report on the merger situation,* cm 3531, is available at: www.competition-commission.org.uk/rep_pub/reports/1997/395firstbus.htm#full.

[3]At that time Midland Lowland and Midland Bluebird were separate operations, both under the ownership of FirstBus. The two operations were later combined to form First Edinburgh. References to First Edinburgh throughout this document refer to the combined Midland Lowland and Midland Bluebird unless otherwise stipulated.

[4]The OFT's report is available at: www.oft.gov.uk/shared_oft/mergers_ea02/361227/FirstBus.pdf.

[5]The CC's provisional decision is available at: www.competition-commission.org.uk/rep_pub/notices/remedies_standing_group_sbh_prov_decision.pdf.

Notice of further provisional decision

7. In the light of the responses received to the consultation on its provisional decision, the CC has reflected on two questions:

   (a) whether the responses to the consultation it received caused it to change its view that release was not warranted and that it would instead be sympathetic to a variation; and

   (b) what variation of the Undertakings should be sought.

8. Each of these questions is considered in turn below. In summary, its further consideration of these issues has led the CC to decide provisionally that the Undertakings should be varied to:

   (a) allow fares to increase so that revenue rises by no more than whichever is the lower of the CPT (Scotland) index and the CPT (GB-wide) index;

   (b) allow a catch-up adjustment in revenue for each of First Glasgow and First Edinburgh that reflects the difference between revenue and cost (including weighted average cost of capital);

   (c) allow First to spread the catch-up adjustment across an indefinite period; and

   (d) rebase the mileage floor (which applies only to First Edinburgh) to 75 per cent of 2002 mileage.

Responses to consultation

9. The CC received substantive responses to its consultation from: First, from two other bus operators ([✂] and [✂]) and SPT. First's response to the consultation concentrated on possible variations to the Undertakings and so the points raised are discussed in the next section of this Notice.

10. One of the other bus operators who responded ([✂]) said that it agreed with the CC that the undertakings should be retained in relation to First Edinburgh. It said that the anti-predation undertakings on First were 'certainly the only reason that we have been able to offer our service'. This operator noted that it would like to increase its frequency but was concerned that it would be 'challenged' by First, who would run its buses running ahead of this operator's buses and would offer cheaper fares than this operator was able, 'until [this operator has] to forfeit [its] services because of too little revenue.' This operator went on to say that 'we need undertakings from First that we will not be targeted for elimination and allowed to operate a public service.'

11. The other operator who responded ([✂]) said that it considered that retention of the behavioural undertakings was likely to prove beneficial to other operators, local authorities and customers given that this would mean that First's activities in their operating area would continue to be subject to close scrutiny.

12. SPT responded to the consultation stating that its position remained as it had been expressed to the OFT on 10 October 2007. At this time, SPT had said that that there were no barriers to entry into the West of Scotland and that registered services had increased since the undertakings were put in place, and that it believed competition was evident. However, it also said that the 'quality of certain aspects of the competitive intervention [was] poor'. It went on to say that while it in principle supported the removal of the undertakings it highlighted the risk of additional strain on public

subsidy (particularly concessionary reimbursement). SPT noted that First was generally one of the few operators providing an all-day service and asked that this be taken into account in the review. It also noted the constraints under the *Scotrail* undertakings. However, it further noted First's continued market dominance and the potential for risk of price escalation. SPT said that if the undertakings were to remain, a control over fares that applied an index reflecting bus costs would be more appropriate.

13. With the exception of First's responses, which provided more information on possible variations, the CC did not consider that any of the responses to the consultation contained information or argument that it had not considered in reaching its provisional decision. The CC therefore did not change its provisional decision in the light of any of the consultation responses received. The CC therefore went on to consider possible variations to the undertakings.

Possible variations to SBH undertakings

14. The CC noted in its provisional decision (at paragraph 157), that it had not seen evidence that demonstrated an increase in the competitive constraint faced by First sufficient to restore the competitive constraint lost as a result of the merger. The CC therefore considered that the undertakings continued to generate benefits by protecting consumers from fare increases and reductions in service quality (by reductions in mileage). However, the CC considered that the fare cap in its current form was likely to be resulting in distortive effects in the First Glasgow area and in the First Edinburgh area, as a result of having constrained increases in First's fares to below increases in bus industry costs. The CC also considered it likely that the mileage floor in its current form was resulting in additional distortive effects in the First Edinburgh area to the extent that it requires First to run services that have been persistently unprofitable and are likely to remain so. However, the CC did not consider that these distortive effects justified the release of the undertakings given that the competitive constraint lost as a result of the merger did not appear to have been restored. Rather, the CC considered that they might be dealt with by means of a variation to the existing undertakings.

15. Given the nature of the distortive effects of the Undertakings, the CC considered two possible variations, first in relation to the fare cap and second in relation to the mileage floor. Each is discussed in turn below.

Variation of the fare cap

16. The Undertakings place a cap on First's revenue in the First Glasgow and First Edinburgh areas so that revenue in one year cannot exceed revenue in the previous year inflated by the RPI. Bus industry costs appear to have risen at a faster rate than RPI over the period during which First's fares have been capped, and so the CC noted in its provisional decision (see paragraph 160) that it considered it possible that fares in the two areas were at levels that did not allow First fully to recover its costs. This led the CC to consider two aspects of the fare cap. First, the CC considered how the fare cap might be varied to allow fares in the future to rise in line with changes in bus industry costs and second whether and how First might be permitted to make a 'catch-up' adjustment so as to ensure that fares at the start of any varied cap were at an appropriate level, ie one which allowed First to recover its costs. Each of these aspects is discussed in turn below.

17. The CC has provisionally decided to vary the fare cap so that First will be permitted to increase fares by whichever is lower of the CPT (Scotland) and the CPT (GB) in

each year. The CC has also provisionally decided to allow First to make a catch-up adjustment to fares reflecting the fact that that the fare cap to date has not allowed fares to rise in line with bus industry costs. The catch-up adjustment will be equal to the difference between current revenues and current costs and First will be permitted to spread it over an indefinite period.

Options for fare control in the future

18. Ideally, the index chosen for the purpose of controlling fares in these undertakings would be off-the-shelf, would reflect movements in transport industry costs, would reflect Scottish-specific factors and would not be capable of influence by First. In its provisional decision, the CC had identified four possible indices that it considered might be used as the basis for a fare control that would permit First to increase fares so as to recover (efficiently-incurred) costs; none of the respondents to the consultation suggested that the CC should consider any further indices. It is clear that none of the four indices fulfilled all the criteria set out above, and so the CC weighed the advantages and disadvantages of each. Table 1 summarizes these.

TABLE 1 **Options for fare control index, advantages and disadvantages**

Option	*Advantages*	*Disadvantages*
CPA	Off-the-shelf Transport-specific	Not actually related to cost at all (used to index TfL contract prices) Has risen at similar rate to RPI over time and so may not solve problem
CPT (GB)	Off-the-shelf Bus and coach-specific (very largely bus-specific) Based on actual industry costs Majority of services giving rise to cost bases used for this index are not subject to regulation	GB-wide therefore not reflective of Scottish factors Does not exist pre-2002 (so cannot observe long term, and cannot use for one-off adjustment) Appears to have increased at a faster rate than First's actual costs (Glasgow 02/03–03/04 and Edinburgh 02/03–04/05)
CPT (Scotland)	As above Scotland-specific	Scottish nature of index means dominated First's own costs (and significantly affected by the costs of the regulated services)
CC index*	Calculated from off-the-shelf indices	Only transport-specific element is weighting, underlying indices not transport related Not Scotland-specific

Source: CC.

*The 'CC index' consisted of the average of the average earnings index, the DERV price index, and the RPI weighted according to the proportion of First's costs accounted for by labour, fuel and other costs respectively.

19. Out of the four options discussed above, the CC considered that there was little reason to favour the CPA. The CPA was calculated and used by Transport for London (TfL) in its contracts and so is transport-specific, but it was not a cost index. Moreover, since it has moved in a very similar way to RPI over recent years, adopting the CPA as the basis for the fare cap seemed unlikely to provide a better index more in line with changes in bus industry costs.

20. The CC index was related to movements in categories of costs that go to make up bus industry costs. However, it used RPI as a proxy for moves in 'other' costs and First expressed scepticism as to whether this would be accurate given that other costs include items such as 'insurance', the cost of which it said had increased at a faster rate than RPI in recent years. First also expressed concern, for example, that

the CC index used the average earnings index as a proxy for transport labour costs as transport labour costs only made up a small proportion of the basket of labour costs included in the average earnings index and the average earnings index might not therefore be a close proxy for transport labour costs.

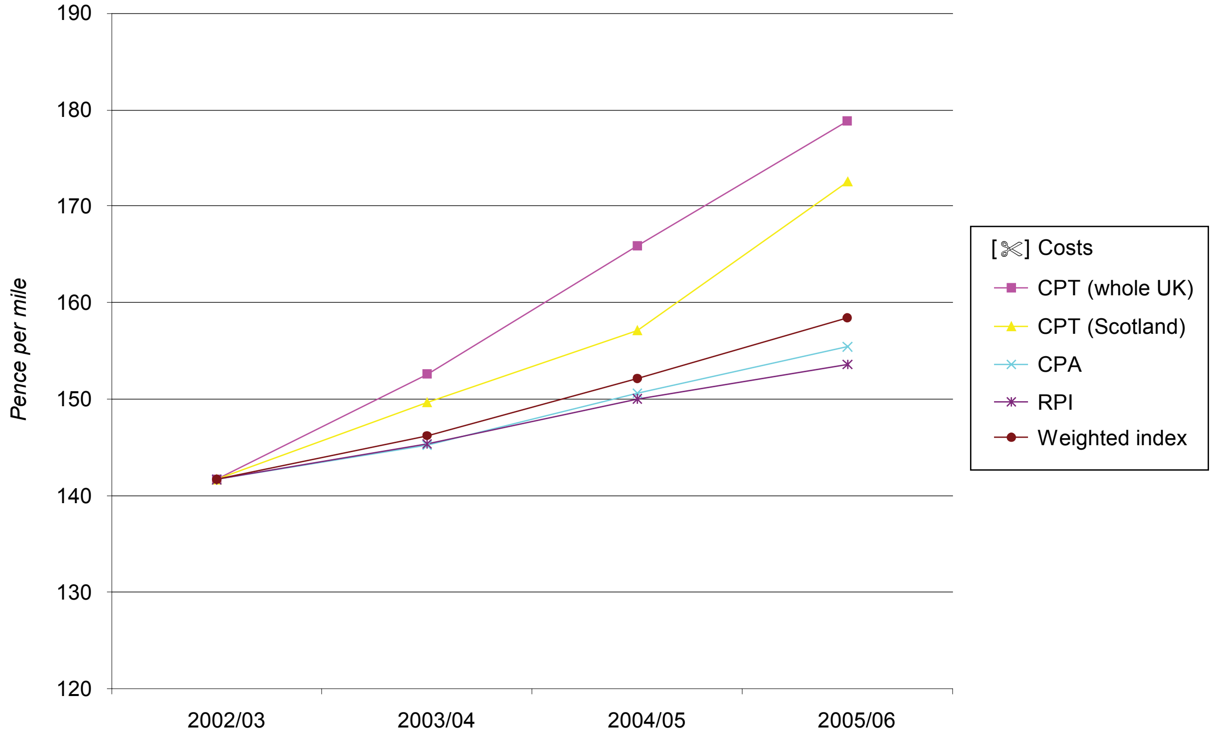
21. The CPT (GB) and CPT (Scotland) indices had a significant advantage over the CC index as they were both transport-specific and cost-related. Superficially, the CPT (Scotland) index appeared to have the further advantage of being Scotland-specific but the CC was concerned that First's size relative to other bus and coach operators in Scotland would mean that First's own costs accounted for too high a proportion of the CPT (Scotland). The CC considered that this would allow First substantially to pass on to passengers increases in its own costs, thereby reducing the incentive it faced to keep costs under control.

22. First told the CC that it considered transport costs in Scotland moved in a broadly similar way to transport costs across the UK as a whole. First said that where the CC had a choice between a UK- or GB-wide transport-specific index (eg CPT (GB)) and a Scotland-specific index (eg the CC index using Scottish versions of AER, DERV and RPI) it would have a strong preference for a GB-wide transport-specific index. First's concern in this regard was that the index should accurately reflect transport costs as opposed to proxy costs for transport costs from a particular geographic location.

23. The CC noted that the CPT (GB) index during some years had increased at a faster rate than First's costs (see Figures 1 and 2). In relation to First Edinburgh it appeared that First's costs had risen at a slower rate in 2002/03 and 2003/04. In relation to the First Glasgow area the discrepancy was less; it appeared that First's costs rose at a slower rate than the CPT (GB) in 2003/04 but thereafter appeared to have risen at the same rate (ie the slope of the lines is the same). This meant that there was a gap between the level of fares that the CPT (GB) index would have produced over the period of the fare cap for First Edinburgh and the level fares First Edinburgh would have charged if fares had kept pace with costs; the difference between these two for the First Glasgow area was smaller.

FIGURE 1

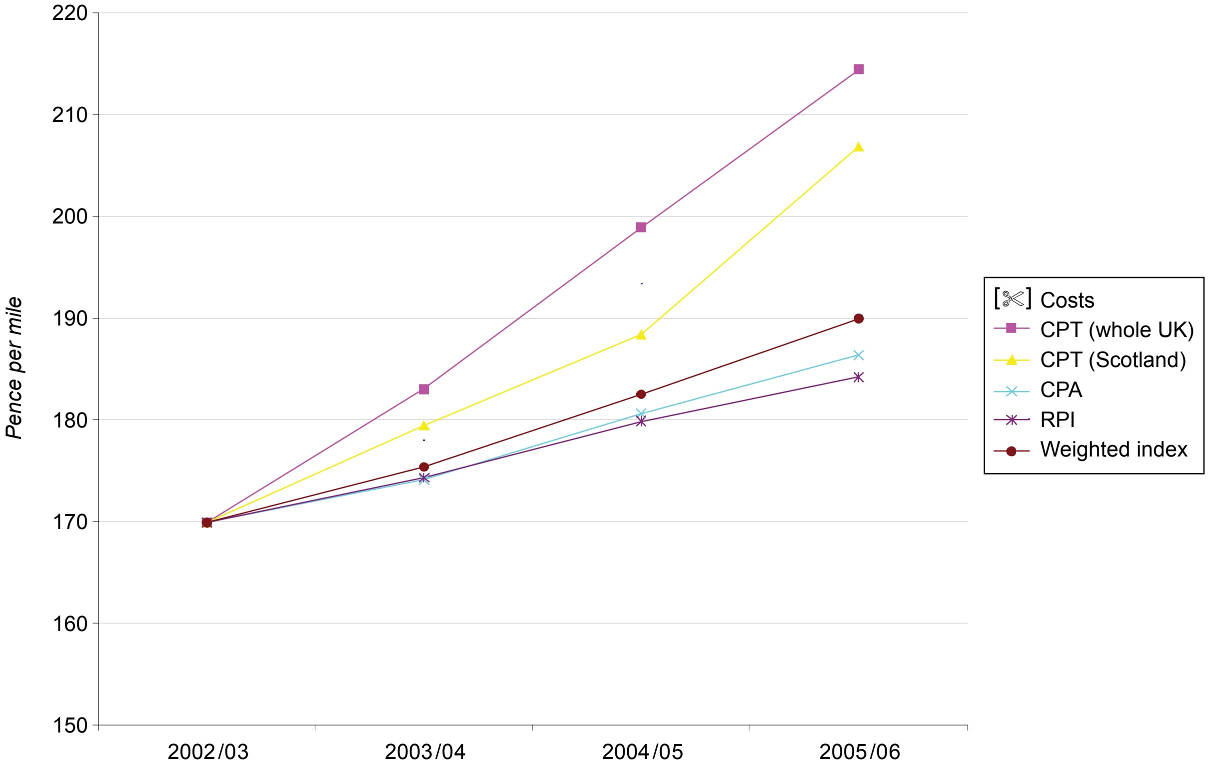
Cost indices and First Edinburgh costs over time



Source: CC analysis.

FIGURE 2

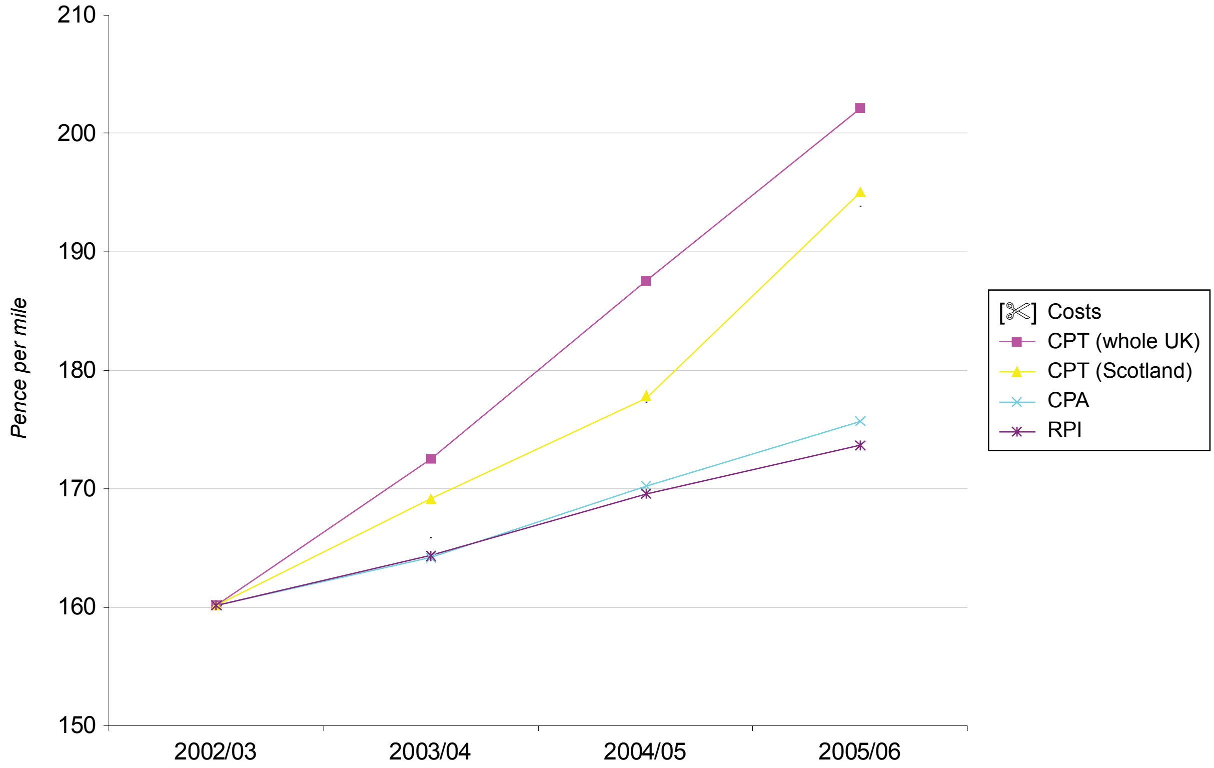
Cost indices and First Glasgow costs over time



Source: CC analysis.

FIGURE 3

Cost indices and First Edinburgh and First Glasgow blended costs over time



Source: CC analysis.

24. First did not suggest any specific factors that would account for the discrepancy in the First Glasgow area in 2002/03, taking the view that the conformity of the years from 2003/04 bore out the appropriateness of the CPT as a proxy for changes in First Glasgow costs. First suggested several factors that might explain the discrepancy in the First Edinburgh area. It argued that the tightness of the fare cap had constrained its fares and its costs below the competitive level. It noted that [✂]. It also noted that in 2006/07 its costs (not shown in the charts above) rose at a faster rate than the CPT, suggesting that earlier years should not be taken as indicative of its costs persistently undershooting the CPT.

25. In support of its argument that its costs had been constrained to too low a level as a result of the fare cap (and in the First Edinburgh area also the mileage floor), First said that [✂]. The CC noted that First Edinburgh (ie Midland Bluebird Ltd and First Edinburgh Ltd) was subject to 4 public inquiries in relation to the condition and operation of its buses from 2003 to the beginning of 2008.[6] First Glasgow (First Glasgow No 1 Ltd and First Glasgow No 2 Ltd) over the same period was subject to one public inquiry. By way of comparison, Arriva in Scotland was subject to three public inquiries (relating to Arriva Scotland West) over the same period. Neither Stagecoach nor National Express were subject to any public inquiries over this period. First suggested that this data [✂].

26. First also argued that the Undertakings—which in the First Edinburgh area also contain a mileage floor—had forced it to focus on cost cutting rather than growth, and

[6] First Edinburgh Ltd and Midland Bluebird Ltd were both called to each of these inquiries.

this was bound to have had a distorting effect on First's costs over time. This point appeared to the CC to be closely related to the point about quality of service, discussed in the previous paragraph.

27. First also noted that an advantageous fuel hedging agreement had kept its costs in the First Edinburgh areas lower until the end of 2004/05 than would otherwise have been the case. It should be noted that, in principle, it could be argued that if First manages to control its costs in this way passengers should benefit (as would be the case in a competitive market). However, it could also be argued that looking at costs immediately before and after the end of a particular hedging arrangement (and especially a strongly advantageous one) may not provide a best indicator of long-term trends in cost over time.

28. Given that it considered the CPT to be a reasonable basis for governing its fares in both the First Glasgow and the First Edinburgh areas, First said that it saw no reason to have fare controls using different indices in the two areas.

29. Overall, the CC considers that, of the four indices discussed above, there would be significant advantages in using one of the CPT indices as the basis for the fare cap in the future. This is because the CPT index is both cost-related and specific to the bus and coach industry. In principle, the CC is attracted to the use of the CPT (Scotland) index as this has the further advantage of being Scotland-specific. However, it considers that the use of the CPT (Scotland) alone, a significant proportion of which is based on First's own costs in Scotland, would reduce the incentive on First to keep its costs under control. The CC has therefore provisionally decided that the fare cap in the future should be based on whichever of the CPT (Scotland) or the CPT (GB) is the lowest. This would ensure that fares were permitted to rise in line with the CPT (Scotland) index only to the extent that this index is lower than the CPT (GB), otherwise fares would be permitted to rise by the CPT (GB), thereby removing any scope for First to pass on increases in its own costs to passengers to the extent that those costs have increased at a faster rate than the GB average.

30. The CC has provisionally decided that this approach should be used both for the fare cap applying both to First Glasgow and to First Edinburgh. Although First Edinburgh's costs have moved in a different way over time to those of First Glasgow, the CC considers that First Edinburgh's costs are likely to have been affected by the restructuring in 2002/03 and also by the effect of the mileage floor in the undertakings (which does not apply to First Glasgow). The CC sees no reason why a one-off restructuring in the First Edinburgh area should affect fare control in the future and it is difficult to know what the effect of the mileage floor is likely to have been on pence-per-mile costs (running more mileage may have artificially depressed these costs but if the additional mileage is relatively high cost, it may inflate the average cost). The CC also considers that applying the same index to both areas would have the further advantage of simplicity.

'Catch-up' adjustment

31. Given that fares have since 1997/08[7] been constrained by RPI and given that it is clear that First's costs (and industry costs) have risen at a faster rate than RPI over time, the CC said in its provisional (at paragraph 160) decision that it would consider allowing a one-off adjustment to fares aimed at ensuring that current fare levels were sufficient to allow recovery of efficiently incurred costs. In considering this issue the

[7]Although the Undertakings were not accepted until 2002 First has abided by the fare control in the First Glasgow area since September 1997 and in the First Edinburgh area since February 1998.

CC has considered what would be the appropriate amount of a catch-up adjustment and also how that catch-up adjustment should be implemented. Each is discussed in turn below.

Calculating the catch-up adjustment

32. The CC considers that the fact that bus industry costs have risen over the period of the fare cap at a faster rate than RPI means that First will have been under considerable pressure throughout the period of the fare cap to date to keep its costs under control. The CC is therefore satisfied that First's actual costs provide a reasonable basis for the calculation of the 'catch-up' adjustment.[8]

33. Given that the CC's concern in allowing an adjustment to current fares is to ensure that First's revenues are sufficient to cover efficiently incurred costs, and given that the CC is satisfied that First's actual costs are likely to be efficiently incurred, the CC has provisionally decided that the catch-up adjustment should be equal to the difference between current First's revenues and its current costs (including the weighted average cost of capital (WACC)). Since separate fare caps apply to First Glasgow and First Edinburgh, the CC has provisionally decided that separate catch-up adjustment amounts should be calculated for each of these operations.

34. First has provided calculations showing, in percentage terms, the catch-up adjustments that could be applied to First Glasgow and First Edinburgh fares on the basis of the CC's preferred approach. These calculations have been performed using the companies' statutory accounts. Each company received revenue not only from services regulated under the Undertakings but also from other services outside the scope of these Undertakings, but the catch-up adjustment has been calculated on the basis of the proportion of revenue and costs attributable to services regulated under these Undertakings. This has been achieved by multiplying total costs and revenue for each company by the percentage of revenue accounted for by services regulated by these Undertakings. The results are set out in Table 2.

TABLE 2 **Catch-up adjustments for First Glasgow and First Edinburgh**

	First Glasgow *£k*	*First Edinburgh* *£k*
Turnover	113,940	43,907
Costs	107,199	43,015
Costs*		
Economic profit (loss)		
Total regulated fare revenue		
Percentage of turnover accounted for by fares regulated under Undertakings	✄	
Catch-up adjustment amount		
Catch-up adjustment percentage (range)	[3–6%]	[7–10%]

Source: First.

*WACC.

[8]Had the CC not been satisfied that First had faced a strong incentive to keep costs under control it might have favoured calculating the catch-up adjustment by applying retrospectively an appropriate index to fares and calculating the difference between the level of fares had that index been used from the beginning of the fare cap and the current level of fares.

Implementing the catch-up adjustment

35. The simplest means of implementing any catch-up adjustment would be to allow First a fare increase in the first year of the rebased fare cap equal to whichever is the lower of the CPT (Scotland) index or the CPT (GB) index *plus* catch-up adjustment, with fare increases in subsequent years limited to whichever was the lower of the CPT (Scotland) index or the CPT (GB) index. This approach would see First recover the full amount of the catch-up adjustment in the first year of the revised control. However, First argued strongly that such an approach would be commercially impractical. It argued that if it attempted to raise fares by the full amount of the catch-up adjustment in one year, passenger demand would fall unacceptably. First would therefore prefer to spread the adjustment over a number of years, thereby reducing the impact on passenger demand.

36. The fare cap contained in the Undertakings is not a cap on fares as such; it controls First's total revenue (in relation to First Glasgow and First Edinburgh separately). First is permitted to raise fares in year one provided that the gross yield from the increase (calculated per fare type as the increase in pence per fare multiplied by the number of that fare sold in year zero) as a percentage of total revenue in year zero is not greater than the RPI for year zero. Figure 4 illustrates in red the path along which revenue would be allowed to increase if the CC permitted First to make a one-off upfront adjustment in fares in 2008 so that revenues covered cost, and thereafter permitted revenue to rise by a specified index (in accordance with the CC's provisional decision whichever is the lower of the CPT (Scotland) and the CPT (GB)). If First were to choose not to make a major adjustment to fares in 2008 but chose instead to spread that increase over a number of years, its revenues would in all years be below the red (permitted revenue) line. This is so even though the effect of spreading the catch-up over time means that First's revenue rises in an individual year by more than the specified index. Figure 4 illustrates how First's revenue might rise if it spread the catch-up over three years (the green line, followed by the red line after the point of intersect) and if it spread the catch-up over seven years (the blue line showing a smooth spread and the brown line showing different rates of catch-up across the period).

37. First proposed a formula that would allow it to recover the catch-up adjustment over an indefinite period. Essentially, this formula involved:

(a) the calculation of the amount of the catch-up adjustment as it would be if applied entirely in 2008 (as an absolute money amount);

(b) allowing First in 2008 to increase revenues by the amount of the catch-up adjustment; and

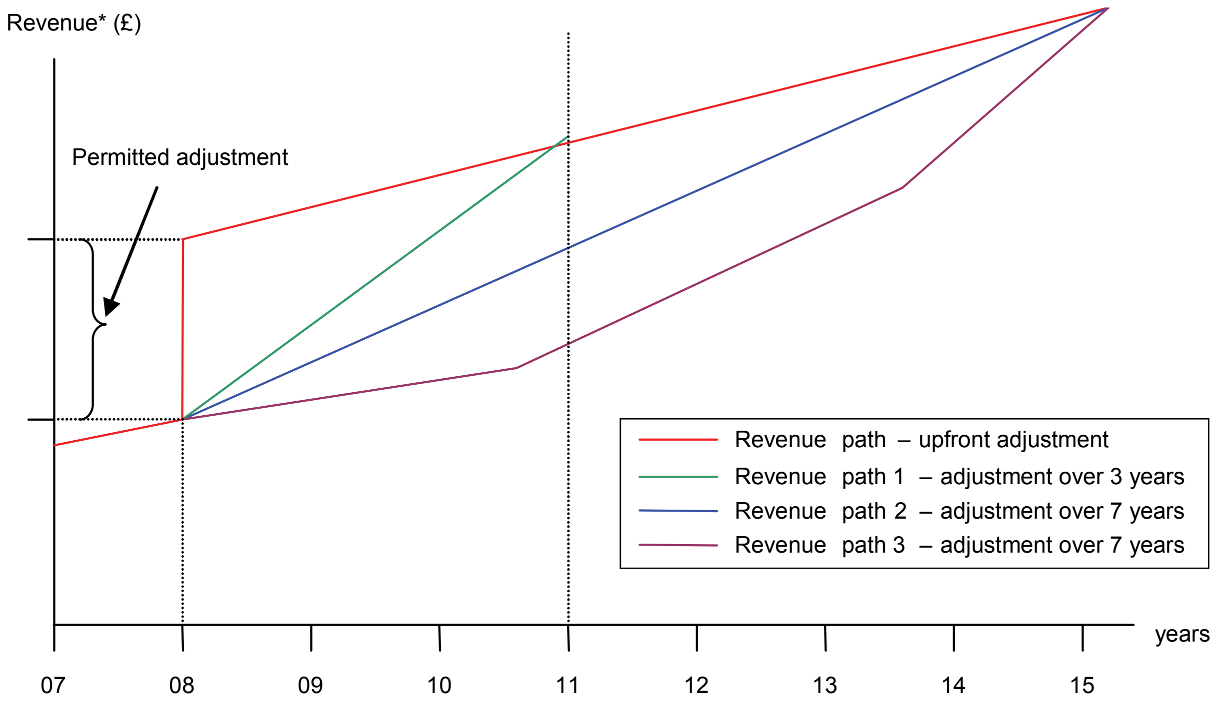
(c) allowing First in 2009 to increase revenues by the specified index (in accordance with the CC's provisional decision, whichever was the lower of the CPT (Scotland) and the CPT (GB)) plus whatever remained of the catch-up adjustment. And so on in subsequent years until First had exhausted the catch-up adjustment.

38. This formula would allow First an additional revenue increase on top of the specified index. However, since the catch-up adjustment is expressed as an additional increase in absolute terms (rather than as a percentage) First would not gain by deferring the catch-up. If the catch-up had been expressed as a percentage increase then First may have gained by deferring the catch-up as in each successive year the catch-up would have applied to increased revenues. No adjustment would be made to the catch-up adjustment amount over time (eg indexing by inflation or cost of

capital) so that the later First made any adjustment the less that adjustment would be worth.

FIGURE 4

Implication of flexibility in catch-up adjustment for fares



Source: CC analysis.

39. The CC accepts that there are strong arguments in favour of allowing First to spread the catch-up adjustment over time, rather than obliging it to make the adjustment either in the first year of the revised control or over a set period. Even though the CC does not accept that First faces sufficiently greater competition to release the undertakings, the fact that First would generally face incentives to adjust fares as quickly as possible means that it seems reasonable to the CC to accept that only commercial pressures would prevent it from doing so.

40. In addition, if First were to choose to increase revenues by less than it would have been allowed using a one-off upfront catch-up adjustment in the first year of the revised cap followed by increases in line with a specified index (ie if the actual path of fares is below the red line in Figure 4 above), First will benefit passengers. The CC notes that, from the passenger's perspective, there would be no benefit in requiring First to make the catch-up adjustment over a specified number of years rather than indefinitely. The CC has therefore provisionally decided that First should be allowed an indefinite period over which to make the catch-up adjustment. The CC also considers that the formula proposed by First would be an effective way of achieving this, and this formula is contained in the varying undertakings provided at Appendix 1 and a complete set of Undertakings that would be in force if the varying undertakings were accepted is provided an Appendix 2.

Variation of the mileage floor

41. In addition to considering possible variations to the fare cap, the CC has also considered whether and how the mileage floor, which relates only to the First

Edinburgh area, should be varied. The Undertakings currently require First to operate at least 95 per cent of the mileage it ran in the area in 2002. The purpose of any variation of the mileage floor would be to ensure that First was not obliged to continue operating mileage that had been persistently unprofitable and which was unlikely to become profitable in the near future.

42. First said that the mileage floor (which applies only in the First Edinburgh area) currently requires it to operate a number of services,[9] which it argues have been persistently unprofitable, and which it wishes to discontinue. Taking this into account, the CC considered whether to make a one-off adjustment to the percentage mileage floor, which would allow First to discontinue whichever of the [✂] services the CC considered appropriate, perhaps with an additional reduction to allow for a degree of flexibility in the future. Alternatively, the CC considered whether it would be appropriate to deal with such a situation by varying the Undertakings to include a test designed to allow First to discontinue mileage in certain specified circumstances and, if so, how such a test should be specified.

43. These two broad approaches are not mutually exclusive. If a test were introduced allowing First to discontinue services, and if First were permitted to discontinue services as a result of that test, it would be necessary to reset the percentage mileage floor. If, for example, First were permitted to discontinue a route that comprised 5 per cent of its 2002 mileage the mileage floor would need to be reduced by 5 percentage points to reflect this.

44. These two approaches—the one-off reduction and the introduction of a test into the Undertakings—are discussed in turn below. Having considered the two approaches, the CC has provisionally decided to vary the Undertakings by means of a one-off reduction in the mileage floor to the level of 75 per cent.

One-off reduction in mileage floor

45. A one-off reduction in the mileage floor could be arrived at by two different methods. Following one method, the CC could take a view on a lower percentage floor that would allow First a greater degree of flexibility in its mileage and which it considered would provide a more reasonable basis for controlling mileage in the future. First had asked, on this basis, for a reduction to 80 per cent. Following another method, the CC could choose a new percentage for the mileage floor based on its assessment of First's request to discontinue the unprofitable services. If, after assessing the detail of First's request, the CC were to allow First to discontinue the unprofitable services, this would see First operating [75 to 85] per cent of 2002 mileage. As discussed above, this would mean that the percentage mileage floor would need to be reset.

46. If the CC were to agree that First should be permitted to discontinue the unprofitable services, requiring First to operate [75 to 85] per cent of 2002 mileage going forward would not allow First any further flexibility at the margin, which suggests that it would be preferable to reset the mileage floor to a slightly lower level. If First were obliged to run 95 per cent of [75 to 85] per cent of 2002 mileage—effectively maintaining the same relationship between the new mileage floor and 2008 mileage as between the original mileage floor and 2002 mileage—it would be obliged to run [around 70 to 80] per cent of 2002 mileage.

47. A one-off reduction in the percentage mileage floor would have the advantage of simplicity. Such a variation would also represent a minimal change to the

[9]These services are: [✂].

Undertakings, which would continue to operate in the future in the same way as they have to date. However, a one-off adjustment alone would arguably not address the underlying problem with the mileage floor, namely its potential to require First to operate services that are persistently unprofitable. Even if it were to deal with First's existing request to discontinue the operation of the [✄] services, a one-off adjustment alone would not establish a mechanism for dealing with the same problem should it arise in the future.

Introduction of a test

48. A test-based approach would see the introduction of a test in the Undertakings that would allow First to discontinue a service provided the relevant criteria had been fulfilled.

49. First suggested that the undertakings be varied to include two tests and that it should be allowed to discontinue a service provided that either test were fulfilled. The first test would involve an assessment of service revenues against cost. If First could demonstrate that service revenues had persistently failed to cover the avoidable costs of operating the service, the service could be discontinued.

50. However, it should also be recognized that not all bus industry costs are scalable at the level of individual services; some costs are scalable at the level of groups of routes, most commonly at the level of a depot. It may therefore be appropriate to allow First to discontinue a group of routes, provided it could demonstrate that the revenue from that group of routes persistently failed to cover the avoidable costs of that group of routes. It would aid the application of such a test if it could include a list of cost categories that would be considered 'avoidable' for this purpose.

51. First argued that [✄].

52. The CC has given considerable thought to how a cost-based test could be designed in order to minimize complexity, in particular in relation to the allocation of costs and revenues. First noted that a mechanism for the allocation of revenues to particular services exists and was used in the *Scotrail* undertakings. This involved the use of ticket machine data to calculate revenues from tickets sold on the relevant services, and an algorithm for the allocation of revenues from multiple-service or multiple-journey tickets (eg through-tickets or season tickets) between services. First also provided information showing the cost categories it routinely uses to assess the profitability of its services. It said that certain of these cost categories could be designated 'direct' (ie avoidable at the service level), 'semi-direct' (ie avoidable across a group of services) and 'overhead'.

53. The CC discussed with First the proposition that the seasonality of many Scottish bus services meant that if a service had failed to recover its costs over a 12-month period this would probably be sufficient to constitute 'persistent' failure to recover its costs. However, First argued that it should be allowed to discontinue a service that had been failing to recover its costs over a shorter period if it could demonstrate that this service was unlikely to recover its costs in the future. First suggested that it would be able to do this if, for example, the service was failing to recover its costs in what had historically been the most profitable time of the year. First also suggested that it would be able to support such a case using historic revenue data.

54. If First were to be allowed to discontinue a service, it would seem appropriate that it should also demonstrate that there were no steps it could reasonably take in order to ensure that the service covered its avoidable costs in the future. A test-based approach would therefore also need to include a requirement on First to consider

options design to improve revenues and/or cut costs on the service, and to show that none of those steps were likely to result in the service covering its avoidable costs.

55. In addition to this cost-based test, First argued for the introduction of a second test which would see it allowed to discontinue a route should it be able to demonstrate that it faced 'effective competition' on that route. It suggested that effective competition should be defined in the same way as under the *Scotrail* undertakings,[10] involving an assessment of whether First faces a competitor with services no less than half as frequent as First's services across flows on the route such that faces it effective competition for at least 90 per cent of route revenues.

56. First noted that if it were to face a competitor on the service this would demonstrate that the service could be operated commercially. The local authority would therefore not put that service out to tender and so First would not face an incentive to discontinue that mileage in the hope of precipitating a tender that it could win and operate more profitably. It argued that the presence of a competitor on the service should therefore be sufficient in itself to allow First to discontinue the service.

57. In proposing this test-based approach, First stressed the importance for it of timely decisions on requests to discontinue services. First proposed that it would submit applications to the OFT no later than one month before it wanted to deregister[11] the services in question. First then proposed that the OFT would then have two weeks in which to tell First that it was not content with First's application and/or the information provided in support of it. If the OFT is content with First's application, it would then provide it with a decision no later than two months after it received the application. First proposed that if it had not received a decision from the OFT within that time, it would be deemed to have given consent.

58. Overall, the CC considers that a test-based approach would have the advantage of addressing the problem with the current mileage floor at source, by allowing First to withdraw mileage that persistently failed to recover its cost (and was unlikely to do so in the future). However, the CC considers that the practical difficulties associated with such a test are likely to be considerable. In particular, the CC notes that the validity of the test would depend on the allocation of costs and revenues and that such allocations can be complex, time-consuming, and open to question. If the CC were to consider an effective competition test in relation to mileage appropriate this would add considerable additional complexity. The CC considers that these practical difficulties outweigh the advantages that the test-based approach offers in principle. The CC has therefore provisionally decided to vary the mileage floor by making a one-off adjustment to the percentage floor.

59. The CC has considered whether First should be permitted to discontinue the services it has said it would like to discontinue. First has provided the CC with data showing the revenue and costs it associated with these services. First has also explained to the CC why, in these cases, there are no reasonable options available to it to increase revenues on these services. This data is discussed in more detail in Appendix 3. Overall, the CC is satisfied that these services, either individually or when considered as a group, have persistently failed to recover their avoidable costs and are unlikely to do so in the future. The CC therefore considers that First should be permitted to discontinue these services. It has taken this into account in deciding the appropriate level at which the mileage floor should be set for the future.

[10]The *Scotrail* undertakings are available at: www.competition-commission.org.uk/inquiries/completed/2004/first/varied_undertakings_annex_b.pdf.
[11]Bus operators In Scotland must give the Traffic Commissioner 70 days' notice in advance of discontinuing a service.

60. Discontinuing the services that First has asked to discontinue would see First operate 75 to 85 per cent of 2002 mileage. The CC does not consider that it would be appropriate to revise the mileage cap so that First was required to operate 75 to 85 per cent of 2002 mileage in the future. The CC notes that if the revised mileage floor were set on the basis of the same relationship with 2008 mileage as existed between the original floor and 2002 mileage, the mileage floor would be revised to between 70 and 80 per cent of 2002. However, the CC considers that the 95 per cent mileage floor included in the current undertakings has not proved to be robust over time, as it has resulted in First being required to operate services that did not recover their avoidable costs. Given that the CC does not intend to vary the Undertakings to provide for First to discontinue services in the future on the basis of a test, the CC considers it appropriate to allow a degree of additional flexibility in the floor. The CC has therefore provisionally decided to vary the mileage floor on a one-off basis to 75 per cent of 2002 mileage. This will be sufficient to allow First to discontinue the services that have persistently failed to recover their avoidable costs and no additional measures are necessary to provide for this.

Summary of provisional decision on variation

61. In summary, the CC has provisionally decided that the Undertakings should be varied to:

(a) allow fares to increase so that revenue rises by no more than whichever is the lower of the CPT (Scotland) index and the CPT (GB-wide) index;

(b) allow a catch-up adjustment in revenue for each of First Glasgow and First Edinburgh that reflects the difference between revenue and cost (including weighted average cost of capital);

(c) allow First to spread the catch-up adjustment across an indefinite period; and

(d) rebase the mileage floor (which applies only to First Edinburgh) to 75 per cent of 2002 mileage.

Next steps

62. The CC is issuing this notice to provide an opportunity for representations to be made in relation to its provisional decision to retain the Undertakings. This notice also provides an opportunity for representations to be made in relation to the CC's willingness to consider an application by First to vary the undertakings.

63. Comments are therefore invited and should be received by the CC no later than 5pm on 7 March 2007 and should be addressed to:

Cathryn Ross
Director of Remedies and Business Analysis
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Or emailed to: cathryn.ross@cc.gsi.gov.uk.

64. Before issuing its final decision in relation to the Undertakings, the CC will have regard to any representations made in accordance with this notice and may modify its decision as a result of such representations.

(signed) PETER FREEMAN
Chairman
20 February 2007

Draft undertakings varying the original undertakings

Further Undertakings given to the Competition Commission by FirstGroup plc which vary the undertakings given by FirstGroup plc to the Secretary of State for Trade and Industry following the Monopolies and Mergers Commission Report on the merger between FirstBus plc and S B Holdings Ltd

1. In January 2002 the Secretary of State for Trade and Industry accepted final undertakings ("the Undertakings") from FirstGroup plc ("FirstGroup") in respect of the merger between FirstBus plc and S B Holdings Ltd.

2. On 16 December 2005 FirstGroup submitted an application to the Office of Fair Trading ("OFT") for the release of the Undertakings.

3. On 2006 responsibility for the Undertakings was transferred from the Secretary of State for Trade and Industry to the Competition Commission ("CC") by The Enterprise Act 2002 (Enforcement Undertakings and Orders) Order 2006 (SI 355/2006).

4. On 13 December 2006 the OFT recommended the release of the Undertakings to the CC.

5. On 15 November 2007 the CC provisionally decided not to release the Undertakings, but indicated that it would be sympathetic to an application to vary the Undertakings given their negative effects on the markets in question.

6. On ● February 2008 the CC published a Notice of a Proposal to accept Further Undertakings varying the Undertakings.

7. FirstGroup now undertakes and agrees with the CC that the Undertakings shall be varied as follows:

Average increase in fares

8. In the heading between clauses 1 and 2 delete the words "not to exceed the rate of retail price inflation".

9. In clause 2(1), after the words "Subject to" insert the words "clause 2(3) below and".

10. Insert the following wording after the end of clause 2(2):

    "2(3) FirstGroup shall be entitled to set the average fare increase at a level which exceeds the permitted fare increase where it is entitled to an exceptional fare increase.".

Commercial mileage

11. In the heading between clauses 8 and 9 delete the words "not to be reduced below 95%".

12. In clause 9 delete the figure of “95 per cent” and substitute the figure of “75 per cent”.

Interpretation

13. In clause 14, between the definitions of “discounted fare” and “excluded fare” insert

““exceptional fare increase” means the entitlement to increase fares by more than the permitted fare increase, which in respect of the fare year commencing 26 August 2007 is by:

[3–6] per cent for journeys within the First Glasgow operating area; and

[7–10] per cent for journeys within the Midland Bluebird and Lowland operating area;”.

14. In clause 14, at the definition of “fare year”

insert after the word “means” the following: “the period from 26 August 2007 to 30 March 2008 and thereafter”;

delete “1 September” and substitute”1 April”; and

delete “that date” and substitute “any of these dates”.

15. In clause 14, at the definition of “the index”, delete the words “the general index of retail prices (for all items) published by the Office for National Statistics”, and substitute the words “the CPT cost index for the 12 months to 31 December published by the Confederation of Passenger Transport UK”.

16. In clause 14, at the definition of “the permitted fare increase”, delete the entirety of the current wording in sub-paragraph (a) (including, for the avoidance of doubt, the wording in sub-paragraphs (a)(i) and (a)(ii)) and substitute:

“the overall percentage change in operating costs figure for Scotland in the index relating to the 12 months to 31 December immediately preceding the fare year in which the increase is made;”.

17. In clause 14, at the definition of “the permitted fare increase”, at the end of (b)(ii) delete the “,” and substitute:

“; and

(c) any part of any exceptional fare increase

applicable in any year or fare years preceding the fare year in which the increase is to be made, but

not applied by FirstGroup in that or any subsequent year,

such fare increases shall be applied in accordance with Schedule 1 and Schedule 6”.

Schedule 6

18. After the end of Schedule 5 insert the following:

“**Schedule 6**

1. This Schedule sets out the methodology to be used for applying fare increases, in particular, where the whole or any part of any fare increases need to be carried forward between fare years where they are not applied in full in the fare year in which they become available.

This will be the case in any fare year where:

$$(\sum_{i=1}^{n} P_i^y Q_i^{y-1}) < (\sum_{i=1}^{n} P_i^{y-1} Q_i^{y-1})(1+f^y)$$

Where:

i and n are used in the same way as in Schedule 1;

P_i^y = the price in the relevant fare year of fare category or fare value i;

‘ P_i^{y-1} = the price in the previous fare year of fare category or fare value i;

Q_i^{y-1} = the number of passengers purchasing tickets of fare category or fare value i in the previous fare year;

f^y = the percentage potential fare increase in the relevant fare year - being the sum of:

(i) the applicable change in operating costs in the index (see definition of “permitted fare increase”, sub-paragraph (a)); and

(ii) any exceptional fare increase.

2. Where paragraph 1 applies, the following formulae should be used to determine the fare increase available in the next fare year:

(a) Let:

$$PI^y = \sum_{i=1}^{n} P_i^{y-1} Q_i^{y-1})(1+f^y)$$

$$AI^y = (\sum_{i=1}^{n} P_i^y Q_i^{y-1})$$

Where:

PI^y = the potential fare increase value in any fare year; and

AI^y = the actual fare increase value utilised in any fare year.

(b) Such that:

$$PI^y - AI^y = RV^y$$

Where:

RV^{y} = the residual value of allowable fare increase not used.

(c) Then:

$$TUI^{y+1} = PI^{y+1} + (RV^{y} * (1 + f^{y+1}))$$

Where:

TUI^{y+1} = the total useable fare increase in the year following the year in which First did not use the entirety of the fare increase that it could have used.

(d) Should:

$$TUI^{y+1} - RI^{y+1} > 0$$

Then:

$$TUI^{y+1} - RI^{y+1} = RV^{y+1}$$

Such that the unused residual value from the useable fare increase (RV^{y+1}) can be carried forward into the following fare year in the same way as described above in paragraph (c)."

Complete set of undertakings that would be in force following acceptance of varying undertakings

MONOPOLIES AND MERGERS COMMISSION REPORT ON THE MERGER BETWEEN FIRSTBUS PLC AND S B HOLDINGS LTD

UNDERTAKINGS GIVEN BY FIRSTGROUP PLC TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY

FirstGroup plc (former FirstBus plc) hereby gives to the Secretary of State for Trade and Industry pursuant to section 88(2) of the Fair Trading Act 1973 the following undertakings for the purpose of remedying or preventing adverse effects specified in the report of the Monopolies and Mergers Commission entitled *FirstBus plc and S B Holdings Ltd – a report on the merger situation* (Cm 3531, January 1977);

Fares not to increase for a fixed period

1. Subject to clause 5 below, except with the prior written consent of the Director General, FirstGroup shall not:

(a) until 1 September 1999 charge a fare for a journey within the First Glasgow operating area which exceeds the fare which it charged for that journey on 1 September 1997; or

(b) until 1 February 2000 charge a fare for a journey within the Midland Bluebird and Lowland operating area which exceeds the fare which it charged for that journey on 1 February 1998.

Average increase in fares

2. (1) Subject to clause 2(3) below and clause 5 below, except with the prior written consent of the Director General, FirstGroup shall not in any fare year;

(a) from 1 September 1999 set the average fare increase for journeys within the First Glasgow operating area; or

(b) subject to paragraph 2(2) below, from 1 February 2000 set the average fare increase for journeys within the Midland Bluebird and Lowland operating area

at a level which exceeds the permitted fare increase for that fare year in that operating area.

(2) Subject to clause 5 below, except with the prior written consent of the Director General, FirstGroup shall not during the periods:

(a) from 1 February 2000 until 27 August 2000; and

(b) from 27 August 2000 until 26 August 2001,

set the average fare increase for journeys within the Midland Bluebird and Lowland operating area at a lever which exceeds the interim permitted increase for that period.

(3) FirstGroup shall be entitled to set the average fare increase at a level which exceeds the permitted fare increase where it is entitled to an exceptional fare increase.

Terms and conditions of bus services and fares not to be altered

3. Subject to clause 5 below, except with the prior written consent of the Direct General FirstGroup shall not:

(a) change the location of any fare stage within the relevant area from its location on the date of these undertakings and, in relation to any bus services introduced in the relevant area after the date of these undertakings, any new fare stage shall reflect existing fare stages as closely as reasonable practicable, and, in the case of any dispute, shall be determined by the Director General;

(b) change the boundary of the fare stage area;

(c) change the boundary of any fare zone;

(d) extend or introduce a peak fare period for the "rush hour" or otherwise for a fare in the standard fare scheme;

(e) for journeys in the First Glasgow operating area:

(i) other than on the first day of any fare year (but only for those fares which are not set by reference to the number of fare stages travelled through), directly or indirectly withdraw any fare value (e.g. "£1.10 adult single");

(ii) directly or indirectly withdraw any fare category (e.g. "3 stages adult single" where fares are set by reference to the number of fare stages travelled through or "adult single" were fares are not so set) in the standard fare scheme; or

(iii) vary the terms and conditions which apply on the date of these undertakings to any fare in the standard fare scheme, all such terms and conditions being set out in Schedule 4; or

(f) for journeys in the Midland Bluebird and Lowland operating area;

(i) other than on the first day of any fare year, directly or indirectly withdraw any fare value (e.g. "£1.10 adult single");

(ii) directly or indirectly withdraw any fare category (e.g. "adult single") in the standard fare scheme; or

(iii) vary the terms and conditions which apply on the date of these undertakings to any fare in the standard scheme, all such terms and conditions being set out in the Schedule 4.

Revised fares in force to be delivered to the Director General

4. Within the period of one month after the beginning of any fare year, FirstGroup shall deliver to the Director General:

(a) a revised standard fare table effective during that fare year; and

(b) a spreadsheet showing that FirstGroup has complied with the undertaking in clause 2 above

and any variations to that revised standard fare table during that fare year shall be delivered to the Director General within 30 days of such variation together with a spreadsheet showing that FirstGroup continues to comply with the undertaking in clause 2 above.

Excluded fares

5. Nothing in clauses 1 to 4 above shall prevent FirstGroup:

(a) from charging:

(i) a tendered fare;

(ii) a concessionary fare; or

(iii) a multi-operator fare

which exceeds a fare which FirstGroup would otherwise be required to charge in accordance with those clauses, or

(b) where FirstGroup has satisfied the Director General that it is not reasonably practicable for FirstGroup to charge for a journey within the relevant area a fare differing from a tendered fare for that journey, from charging the same for that journey as the tendered fare.

Fares and frequency to be maintained on routes where competitor ceases to operate bus service

6. (1) If:

(a) during the prescribed period FirstGroup operates a bus service within the Midland Bluebird and Lowland operating area wholly or mainly on a route on which a competitor operates a registered bus service;

(b) after the competition:

(i) sets a fare for a journey on that route, FirstGroup sets a fare for a journey on that route lower than the lowest equivalent fare set by the competitor for the equivalent journey; or

(ii) sets the frequency of the bus services in any hour on that route, FirstGroup increases the frequency of the bus service in any hour which it provides on that route at a level higher than the frequency set by the competitor;

(c) the competitor ceases to operate its bus service within 3 years of the date of these undertakings; and

(d) the condition set out in paragraph 6(2) below is not satisfied —

FirstGroup shall comply with the fare and frequency obligation.

(2) The condition referred to in sub-paragraph (d) above is that FirstGroup has satisfied the Director General:

(a) that FirstGroup took the action under sub-paragraph (b) above as a result of a specific and clearly identified cause unrelated to the registration or operation of the bus service by the competitor;

(b) that the competitor ceased to operate the bus service as a result of a specific and clearly identified cause unrelated to the action taken by FirstGroup under sub-paragraph (b) above; or

(c) that in respect of a tendered service, FirstGroup was required to take the action taken under sub-paragraph (b) above by the other party.

Bus services to be evenly spaced between competitors' bus services

7. (1) Except with the prior written consent of the Director General, FirstGroup shall not provide a bus service within the Midland Bluebird and Lowland operating area at any point on a route which immediately precedes a bus service provide by a competitor at that point on that route by an interval shorter than the interval between the immediately preceding bus service provided by the competitor at that point and the bus service provided by FirstGroup at that point.

(2) Nothing in sub-paragraph 7 above shall prevent FirstGroup from providing:

(a) a bus service in respect of a tendered service where the supply of that bus service is required by the other party;

(b) a bus service which immediately precedes a bus service provided by the competitor by more than 30 minutes at every point along that route;

(c) the first journey on any day; or

(d) a bus service which it provided on a route on the date when the competitor first registered a bus service on that route.

No competition with tendered services

8. If:

(a) FirstGroup makes a formal application to operate a tendered service within the Midland Bluebird and Lowland operating area; and

(b) a competitor enters into a tendered service agreement in relation to that tendered service –

except with the prior written consent of the Director General and the other party, FirstGroup shall not during the period of the tendered service agreement:

(c) provide or operate wholly or mainly on the route of that tendered service during the prescribed period a commercial service other than an existing commercial service; or

(d) increase the frequency of an existing commercial service provided or operated wholly or mainly on the route of that tendered service from the frequency provided or operated on the date when it applied to operate the tendered service.

Commercial mileage

9. Except with the prior written consent of the Director General FirstGroup shall not reduce its commercial mileage in the Midland Bluebird and Lowland operating area below 75 per cent of its commercial mileage in that area on the date of these undertakings.

Compliance

10. FirstGroup shall procure that each of its subsidiaries shall comply with these undertakings as if it had been given them.

11. FirstGroup shall comply with such reasonable written directions as the Director General may from time to time give:

(a) to take such steps within its power as may be specified or described in the directions for the purpose of carrying out or securing compliance with these undertakings, and

(b) to do or refrain from doing anything so specified or described which it might be required by these undertakings to do or refrain from doing.

12. FirstGroup shall promptly deliver to the Director General:

(a) such reports on the business or any part of the business of FirstGroup prepared by its accountants or other independent advisers, and

(b) such other documents and information

as he may from time to time reasonably require for the purpose of performing any of his functions under section 88 of the 1973 Act in relation to these undertakings.

13. Compliance with these undertakings does not affect the duty on FirstGroup to comply with or restrict the application of the Competition Act 1998.

Interpretation

14. For the purpose of these undertakings:

"the 1973 Act" means the Fair Trading Act 1973;

"the average fare increase" is to be calculated in accordance with Schedule 1;

"business" has the meaning given by section 137(2) of the 1973 Act;

"bus service" has the meaning given by section 159(1) of the Transport Act 1968 as amended by paragraph 1 of Schedule 1 to the Transport Act 1985 but excludes services on which the fare charged includes payment for a live or recorded commentary about the locality being services primarily for the benefit of tourists;

"commercial mileage" (in relation to FirstGroup) means the total of its registered bus miles in respect of its commercial services;

"commercial service" means a bus service other than a tendered service;

"competitor" means a bus operator other than FirstGroup or any subsidiary of FirstGroup;

“concessionary fare” means a fare charged in accordance with a travel concession scheme made under section 93 of the Transport Act 1985 or such other similar schemes as the Director General may determine from time to tine;

“the Director General” means the Director General of Fair Trading;

“discounted fare” means a fare whose value is reduced below that which would otherwise ordinarily be charged for that fare and such a fare shall be a discounted fare only for the period of the reduction;

“exceptional fare increase” means the entitlement to increase fares by more than the permitted fare increase, which in respect of the fare year commencing 26 August 2007 is by:

(a) [3–6] per cent for journeys within the First Glasgow operating area; and

(b) [7–10] per cent for journeys within the Midland Bluebird and Lowland operating area;

“excluded fare” means a concessionary fare, a multi-operator fare or a tendered fare;

“existing commercial service” means a commercial service which FirstGroup provided on the date when it made a formal application to operate a tendered service;

“the fare and frequency obligation” means an obligation not, in relation to bus services wholly or mainly on a route on which a competitor has previously registered it bus service, for a period of 3 years from the date on which the competitor gives or (or if earlier) is required to give notice of deregistration of a bus service:

> *(a)* to charge any fare for a journey on a bus service exceeding the sum of:
>
> > (i) the lowest level at which FirstGroup set it after the competitor registered its bus service, and
> >
> > (ii) the amount which corresponds to any increase in the index since:
> >
> > > (A) the last date on which the fare was charged at that level on that bus service; or
> > >
> > > (B) (if earlier) the date on which the competitor ceases to operate its bus service, or
>
> *(b)* to reduce the frequency of the bus service below the highest frequency which FirstGroup operated after the competitor registered and before it ceased to operate its bus service, provided that FirstGroup may operate such seasonal variations to the frequency of bus service as it operated during the same periods in the year preceding the date on which the competitor ceased to operate its bus service;

“fare stage area” means the area delineated on the map in Schedule 2;

“fare year” means the period from 26 August 2007 to 30 March 2008 and thereafter a period of 12 months commencing on 1 April in any year or, where any of these dates does not fall on a Sunday, the Sunday immediately preceding that date;

“fare Zone” means the areas identified in Schedule 3 or any one of those areas;

“the First Glasgow operating area” means the areas identified in the report as the unitary authorities of the City of Glasgow, North Lanarkshire, South Lanarkshire, East Dumbartonshire, West Dumbartonshire and East Renfrewshire and a journey or any bus service within the First Glasgow operating area means that part of any journey or any bus service that is within the First Glasgow operating area regardless of whether the journey or bus service continues to or from a place outside the First Glasgow operating area;

“FirstGroup” means FirstGroup plc;

“the index” means the CPT cost index for the 12 months to 31 December published by the Confederation of Passenger Transport UK;

“interim permitted increase” means:

(a) for the period from 1 February 2000 until 27 August 2000, the figure of 1.2%; and

(b) for the period from 27 August 2000 until 26 August 2001, the figure of 2.1%;

“journey” means an individual passenger journey on a bus service;

“the Midland Bluebird and Lowland operating area” means the areas identified in the report as the unitary authorities of Stirling, Clackmannanshire, Falkirk, West Lothian, Midlothian, East Lothian and the Scottish Borders and a journey or bus service within the Midland Bluebird and Lowland operating areas means that party of any journey or any bus service that is within the Midland Bluebird and Lowland operating area regardless of whether the journey or bus service continues to or from a place outside the Midland Bluebird and Lowland operating area;

“multi-operator fare” means a fare the payment of which as a matter of practice enables the passenger to use transport services operated by:

(a) FirstGroup or any of its subsidiaries; and

(b) persons other than FirstGroup or any of its subsidiaries;

“the other party” (in relation to a tendered service) means the other party to the tendered service agreement under which the tendered service is supplied;

“passenger” includes an animal where a fare is charged for carriage of an animal;

“the permitted fare increase” means the total of:

(a) “the overall percentage change in operating costs figure for Scotland in the index relating to the 12 months to 31 December immediately preceding the fare year in which the increase is made; and

(b) any part of the permitted fare increase:

(i) applicable in any year or fare years preceding the fare year in which the increase is to be made, but

(ii) not applied by FirstGroup in that or any subsequent year; and *(c)* any part of any exceptional fare increase

(i) applicable in any year or fare years preceding the fare year in which the increase is to be made, but

(ii) not applied by FirstGroup in that or any subsequent year,

such fare increases shall be applied in accordance with Schedule 1 and Schedule 6 and for the avoidance of doubt where there is deflation, the permitted fare increase will be negative and clause 2 will require a reduction in fares;

"the prescribed period" (in relation to a bus service operated by FirstGroup or any of its subsidiaries on a route on which a competitor operates a bus service) means a period in any day commencing 30 minutes before and ending 30 minutes after the period during which that competitor operates a bus service on that route;

"provide" (in relation to bus services) means register or show on a timetable;

"registration" means the registration of a local service in accordance with section 6 of the Transport Act 1985, and references to registering a bus service and to deregistration of a bus service are to be construed accordingly;

"relevant area" means the First Glasgow operating area and the Midland Bluebird and Lowland operating area and a journey or bus service within the relevant area means that part of any journey or any bus service that is within the relevant area regardless of whether the journey or bus service continues to or from a place outside the relevant area;

"relevant date" means, in relation to the fares being charged by FirstGroup or any of its subsidiaries:

(a) in the First Glasgow operating area, 1 September 1997; and

(b) in the Midland Bluebird and Lowland operating area, 1 February 1998;

"the report" means the report of the Monopolies and Mergers Commission entitled *FirstBus plc and S B Holdings Ltd: a report on the merger situation* (Cm 3531, January 1997);

"return journey" means a journey involving outward and return travel by a passenger between two single points, whether made on the same day or different days;

"season fare" means a fare entitling a passenger to make an unlimited number of journeys of a certain description on any day during a specified period of at least 7 consecutive days on bus services within the relevant area;

"service subsidies has the meaning given by section 63(10)(b) of the Transport Act 1985 or such other similar meaning as the Director General may determine from time to time;

a "single journey" is made by a passenger and excludes a journey which can be made only by changing from one bus service to another;

"the standard fare scheme" means all regulated fares [listed in Schedule 5] being:

(a) the categories of standard fares charged by FirstGroup or any of its subsidiaries as at the relevant date for single journeys and return journeys

within the relevant area which can be made on bus services operated by FirstGroup or any of its subsidiaries; and

(b) all season fares charged by FirstGroup or any of its subsidiaries as at the relevant date for all journeys within the relevant area;

but excluded fares and discounted fares;

“standard fare table” means a table or tables showing all the individual dare values for all journeys in the relevant area;

“subsidiary” has the meaning given by section 736(1) of the Companies Act 1985 as substituted by section 144(1) of the Companies Act 1989;

“tendered fare” (in relation to a tendered service operated by FirstGroup or any of its subsidiaries) means a fare which FirstGroup or its subsidiary is required to charge by the other party;

“tendered service” means a bus service supplied under an agreement providing for service subsidies and tendered service within that area regardless of whether the tendered service continues to or from a place outside that area;

“tendered service agreement” means an agreement under which a tendered service is supplied; and

where the consent of the Director General is required, he shall not unreasonably withhold or delay it.

For and on behalf of FirstGroup plc:

Signed: .... (director)

Name: ....

Signed: .... (director)

Name: ....

Date: ....

Schedule 6

1. This Schedule sets out the methodology to be used for applying fare increases, in particular, where the whole or any part of any fare increases need to be carried forward between fare years where they are not applied in full in the fare year in which they become available.

This will be the case in any fare year where:

$$(\sum_{i=1}^{n} P_i^{y} Q_i^{y-1}) < (\sum_{i=1}^{n} P_i^{y-1} Q_i^{y-1})(1+f^{y})$$

Where:

i and n are used in the same way as in Schedule 1;

P_i^{y} = the price in the relevant fare year of fare category or fare value i;

‘ P_i^{y-1} = the price in the previous fare year of fare category or fare value i;

Q_i^{y-1} = the number of passengers purchasing tickets of fare category or fare value i in the previous fare year;

f^{y} = the percentage fare increase in the relevant fare year - being the sum of:

(i) the applicable change in operating costs in the index (see definition of “permitted fare increase”, sub-paragraph (a)); and

(ii) any exceptional fare increase.

2. Where paragraph 1 applies, the following formulae should be used to determine the fare increase available in the next fare year:

(a) Let:

$$AI^{y} = \sum_{i=1}^{n} P_i^{y-1} Q_i^{y-1})(1+f^{y})$$

$$RI^{y} = (\sum_{i=1}^{n} P_i^{y} Q_i^{y-1})$$

Where:

AI^{y} = the available fare increase value in any fare year; and

RI^{y} = the real fare increase value in any fare year.

(b) Such that:

$$AI^{y} - RI^{y} = RV^{y}$$

Where:

RV^{y} = the residual value of allowable fare increase not used.

(c) Then:

$$TUI^{y+1} = AI^{y+1} + (RV^{y} * (1 + f^{y+1}))$$

Where:

TUI^{y+1} = the total useable fare increase in the year following the year in which First did not use the entirety of the fare increase that it could have used.

(d) Should:

$$TUI^{y+1} - RI^{y+1} > 0$$

Then:

$$TUI^{y+1} - RI^{y+1} = RV^{y+1}$$

Such that the unused residual value from the useable fare increase (RV^{y+1}) can be carried forward into the following fare year in the same way as described above in paragraph (c)."

Assessment of First's request to discontinue services

This table sets out the CC's assessment of whether those services that First has requested permission to discontinue would pass or fail the tests that have been suggested for inclusion in a varied mileage floor. A service has been marked as likely to pass a cost-based test if First has provided information that supports the view that the service is not covering avoidable costs, either at the service level or aggregated across a number of services.

Although the CC has provisionally decided not to include vary the mileage floor to introduce either of these tests on a forward-looking basis, the CC does believe that the principles underlying the test-based approach, and in particular the assessment of whether service revenues are covering avoidable costs, are the correct ones to apply in considering whether First should be permitted to discontinue a service. The CC's view that First should be permitted to discontinue the services it has asked to discontinue rests on the fact that all these services fail to recover their avoidable costs, either at the service level or when aggregated across a group of services.

TABLE 1 **Assessment of First's request to discontinue services**

Service or service group	*Passes competition test?*	*Passes cost-based test on stand-alone or aggregate level?*	*Comments*
[✂]	Yes—[✂]	Yes	[✂]
		Yes	
		Yes	
		Yes	
		Yes	
		Yes	

Source: CC.