

7 Views of National Express Group

Contents

	<i>Page</i>
Introduction	112
Jurisdiction	112
Differentiated nature of MML's and NEL's products	112
Nature of the services	112
Categories of passenger	112
Fare levels	113
Competition faced by NEL and MML from other forms of travel	113
The car	113
Air	113
Other TOCs	113
Coach	114
The discretionary nature of leisure travel	114
Impact of regulatory and commercial constraints on MML	114
Scope for anti-competitive behaviour arising from common ownership of NEL and MML	115
Implications for MML	115
Implications for NEL	116
Involvement of NEG in rail franchising	117
NEG's views on undertakings	117
Undertakings sought by the OFT and the Secretary of State	117
Further aspects of undertakings	118
Additional points relating to the undertakings previously offered to the OFT	118
Coach frequency: duplicates	119
'Special fares' from Sheffield and Chesterfield	119
Changes in terms and conditions	119
Availability of lower-cost tickets	120
Rail APEX tickets	120
Possible additional undertakings	120
Extension of fare undertakings to rail leisure fares	120
Single tickets for rail travel	121
Fare increases below the rate of inflation for rail and coach travel	121
Withdrawal of coach services without behavioural undertakings	121
Reversal of existing contractual arrangement with coach operators on the reference services	122
Disposal of the MML franchise	123
NEG's continuing financial liability	123
Limiting NEG's strategic diversification	124
Loss of NEG from the bidding process for future TOC franchise awards	124
Loss of NEG from the privatized rail industry	125
Loss of NEG's expertise in transferring passenger transport businesses successfully into the private sector	125
Lack of proportionality	125
Summary	125

Introduction

7.1. In this chapter we summarize the evidence put to us by NEG in its written submission and at an oral hearing. To begin we give its views on jurisdiction, on why MML's and NEL's services compete in largely different markets, on the competition each faces and on the regulatory environment in which MML operates. We then summarize why NEG feels that common ownership of NEL and MML does not provide scope for anti-competitive behaviour by NEG. The chapter concludes with NEG's views on its involvement in rail franchising and its reactions to the undertakings sought by the OFT and the Secretary of State prior to the reference of the merger to the MMC.

Jurisdiction

7.2. We asked NEG to comment on the implication in our terms of reference that we should consider the effects of the merger on the share of supply of the reference services in the UK as a whole rather than in a substantial part of the UK. NEG argued that it would not be appropriate for the MMC to judge the merger in the context of the UK as a whole and then to conclude that the share of supply test was met by the simple expedient of defining the services narrowly in terms of public transport services between London and the five specified places. To pursue this approach and use the whole of the UK as the reference area whilst incorporating some form of geographical limit in the definition of the services could, in NEG's view, result in mergers that were obviously *de minimis* and not meriting a reference being regarded as qualifying mergers. For this reason NEG said that it considered this would be an incorrect application of the legislation.

7.3. We also asked NEG to comment on whether the merger could be regarded as resulting in a qualifying merger in a substantial part of the UK, taking for this purpose the supply of long-distance public transport services within an area bounded by Greater London to the south, the five places specified in the reference in the north, and the area bounded by the M1 and the MML route in between. NEG argued that it could not see on what basis the routes taken by the respective vehicles could be regarded as relevant to determine the part of the UK served by the services in question since this appeared to NEG to be an arbitrary definition of an area; if, on the other hand, the relevant part of the UK was to be defined by reference to the routes of the two services, it believed it inconsistent then to include the whole of the Greater London area within the same geographic area because this would be mixing physical routes with a concept closer to catchment areas.

Differentiated nature of MML's and NEL's products

Nature of the services

7.4. Although NEG accepted that there was competition between coach and rail, it believed the effect of this was relatively small compared with competition from the car or from the public deciding not to travel at all. NEG told us that the context in which the merger should be considered was important. MML's and NEL's services were highly differentiated. NEL operated a nation-wide network of coach services providing low-cost leisure travel combined with secure and convenient transfers between services at coach station hubs. MML offered a significantly more expensive but more frequent, rapid and comfortable service to business and leisure passengers.

Categories of passenger

7.5. As a result NEL and MML principally served different categories of passengers. NEL's passengers were typically lower-income individuals attracted by the fare levels offered. A significant number were students. A high proportion of others were women and the elderly travelling alone. On the other hand almost half of MML's passengers were travelling for business reasons with a further 14 per cent commuting. They were predominantly in the age range 24 to 64 and in the upper socio-economic range.

Fare levels

7.6. NEG told us that direct price competition occurred only at the level of the APEX rail fare. APEX fares accounted for only 3.63 per cent of MML's total passenger journeys and only 3 per cent of total revenue. The APEX fare was subject to seven-day advance booking and quota restrictions. In national terms 80 per cent of NEL's passengers travelled on tickets cheaper than the cheapest available rail fare. NEG also told us that as a general rule coach fares needed to be at least 30 per cent lower than rail fares on comparable routes to recognize the faster journey times and better facilities offered by rail travel.

Competition faced by NEL and MML from other forms of travel

The car

7.7. NEG said that the merger should be judged in the context of the wider competitive constraints affecting leisure travel, in particular that leisure travel had for many years been dominated by the private car and would continue to be so for the foreseeable future. The car accounted for 90 per cent of leisure journeys over 50 miles, compared with rail's 7.8 per cent and coaches' 1.9 per cent. Private car users remained the principal target for increased leisure passenger revenue for MML and the car was the major competitive price constraint on all forms of public transport. In NEG's view most consumers considered only the marginal costs of a car journey (that is, the petrol costs) and not the total costs.

7.8. In relation to the area served by MML, NEG observed that car ownership was high and continuing to increase and there were good road links to London. The distances between the five places and London were 150 miles or less, a range where, according to research, the dominance of the private car was greatest in relation to rail. So far as coach was concerned, 49 per cent of NEL's customers belonged to a car-owning household and could switch if fares rose or quality fell. NEL was already experiencing switching by students due to higher car ownership and car sharing.

Air

7.9. NEG said that leisure travel was subject to new competitive forces as a result of low-cost air transport operators, like EasyJet and Ryanair, which were specifically targeting leisure travellers. There was no current significant direct air competition to MML, but NEG noted that Sheffield Development Corporation was developing a short take-off and landing airport at Sheffield, due to open in mid-1997, intending to introduce direct flights to Heathrow and London City Airports. In its financial projections for MML £[*] million a year of lost revenue had been assumed on the Sheffield-London service because of this. NEG also said that air was challenging other TOCs, which were responding on price, and this could indirectly constrain fares on some MML services.

Other TOCs

7.10. NEG noted that on-rail, off-route, competition was not subject to regulation. The newly privatized TOCs were now competing actively with each other for increased revenue. MML faced competition from other TOCs, including both the ICEC and ICWC services. It was therefore reasonable to expect that these TOCs, faced with high costs and mandatory minimum service requirements, would seek to fill their off-peak capacity by trying to attract more leisure travellers by offering restricted-availability low-price leisure fares in the same way as MML was proposing to do, and there was evidence that this was already happening.

7.11. MML's neighbouring TOCs were able to attract passengers from areas where their catchment areas overlapped, either via connecting rail services or by passengers driving to the relevant main station on ICEC or ICWC and taking advantage of faster journey times. In particular, the MML Sheffield-London service was subject to competition from ICEC at Doncaster where the journey time to London was 36 minutes faster. Under the railway revenue allocation arrangements it was recognized that this route accounted for a significant

*Figure omitted. See note on page iv.

slice of the London-Sheffield business. NEG quoted other examples involving Chesterfield, Derby and Nottingham.

7.12. We asked NEG about the significance of the fact that a higher fare level was charged for a London-Sheffield journey by any alternative reasonable route (for example, via ICEC and Doncaster) than via Chesterfield on MML. It told us that this did not mean there was no competition-it was quite active-and MML had to have a lower fare because it could not compete on journey time.

Coach

7.13. NEG said that on the reference services NEL currently faced no competing coach services. However, new entry could occur at any time, particularly if NEL were to increase its prices beyond prevailing levels. Although for a new entrant the barriers to establishing a nation-wide network of coach services such as that operated by NEL were significant, the barriers to operating a limited single or multiple corridor service were low. In particular, no regulatory approval (beyond possession of an operator's licence) was necessary and an operator could use its existing fleet, particularly if currently a contractor, or alternatively could acquire additional coaches at reasonable second-hand prices or on a leased or subcontracted basis. Access to stops/coach stations was generally available; depot facilities could be rented or bought; only limited expenditure on advertising would be necessary; and services could be limited to the busiest times of the day rather than offering a comprehensive timetable.

7.14. Maximum start-up costs, in NEG's estimation, would amount to no more than £0.3 million, which was low in relation to potential sales revenue on the reference services. Most of these costs would be recoverable if an operator subsequently exited the market. When we asked NEG why no coach competition existed on the reference services, it referred to three companies which had operated Sheffield-London services in recent years but no longer did so (detailed in Chapter 4). More generally NEG told us that NEL currently faced competition on 44 per cent of its services to London.

7.15. We asked NEG whether NEL had adopted a practice of offering competitors work as contractors. It told us that this was not NEG's practice or policy. NEL provided details of five occurrences since 1992 including one on the reference services. In at least two cases the operator approached NEL with a request to become a contractor; in two other cases the contractor had been a contractor prior to being a competitor and only became a competitor because their operator contract was terminated. As soon as NEL agreed, they became contractors again. The circumstances of the fifth case were not known to NEG's present management.

The discretionary nature of leisure travel

7.16. NEG argued that the fact that leisure travel was discretionary was a major constraint on the business strategy of any travel operator. Increased leisure travel was heavily dependent on the cost. If fares were too high passengers would simply reduce the number of leisure journeys they made or not travel at all. This affected both MML and, particularly, NEL, which catered predominantly to lower-income passengers who were making non-essential journeys (over 60 per cent for the purpose of seeing friends and relatives). NEG said that in the leisure market the consumer was less concerned with whether to travel by rail or coach than whether to spend disposable income on travel or on some different form of consumption.

Impact of regulatory and commercial constraints on MML

7.17. NEG pointed to the new regulatory and commercial constraints governing MML's behaviour. MML was operating in a new business environment in which, in addition to the increasing competitive constraints, its commercial strategy was conditioned by: regulatory restrictions on its ability to increase season ticket and key leisure fares; obligations to maintain minimum service frequencies and standards; high fixed payment commitments to Railtrack and the ROSCOs; and above all the need to increase its profitability in the face of rapidly reducing revenue support from OPRAF and subsequently to meet the very significant fixed payments due to OPRAF. Such payments were contractual obligations through the franchise agreement and were not related to MML's passenger numbers, revenues or profitability.

7.18. Against this background, NEG's acquisition of MML did not create any commercially viable opportunity for NEG to attempt to maximize group profits through altering the competitive behaviour of either MML or NEL. Fare and service levels on MML and NEL's services on the routes between London and Sheffield, Chesterfield, Derby, Nottingham and Leicester were currently designed to maximize long-run profitability for each business, viewed independently of each other. Before modifying either MML's or NEL's behaviour in pursuit of a potential improvement in group profitability, NEG would need to be satisfied that the benefits of such strategic behaviour would outweigh the costs; on the available evidence they would not.

Scope for anti-competitive behaviour arising from common ownership of NEL and MML

Implications for MML

7.19. NEG told us that the various constraints on MML meant that common ownership of MML and NEL created no new opportunity for MML to increase its fares as a result of the direct and indirect regulatory controls on fare increases, the competitive threat from the private car and other TOCs and the risk of losing revenue from discretionary travellers. There was no new opportunity for MML to reduce costs through MML service quality or frequency reductions, due to the minimum service level commitments under the franchise plan, the high proportion (some 46 per cent) of MML's total operating costs that were fixed and the need for MML to maintain and enhance its service quality to attract increased passenger revenue.

7.20. We asked what scope existed within the requirements of the franchise plan for service reductions. NEG told us that this was limited to one train a day on the key routes, but that through the leasing arrangements with Porterbrook it was contractually committed to the use of the existing number of train sets. So the incentive was to use the rolling stock as intensively as possible. In addition under the franchise agreement they were required to have 400 seats available on a train during peak hours. This meant that at most one standard coach could be taken out of each train set.

7.21. We also asked NEG about its plans to reduce MML's employment costs. NEG told us that it planned a [*] in employment, [*Details omitted. See note on page iv.*].

7.22. NEG said that there was no commercially viable incentive for MML to modify its behaviour in order to protect NEL's coach revenues, since the scale of MML's revenue was so much greater than NEL's on the reference services, and it was impossible to target coach passengers with fare initiatives which would not impact on MML's other income.

7.23. MML's commercial strategy was to increase its profitability by raising its passenger revenue through attracting greater numbers of passengers to its services and encouraging them to use the services more frequently. NEG told us that average loading (that is, passenger miles divided by seat miles) was currently [*] per cent. The franchise bid was based on increasing this to [*] per cent. Asked how feasible such an increase was, NEG replied that, based on early indications including recently introduced fare initiatives, it was a feasible target. In order to achieve this increase without abstracting from existing passenger revenues, MML was seeking to fill its substantial surplus off-peak capacity by offering restricted-availability, deep-discount off-peak fares. Service enhancements including rolling stock refurbishment, station improvements, rail coach links and additional services were aimed at attracting extra passengers. With its costs largely fixed, any additional revenue went straight to MML's bottom line. The greatest potential sources of new business and leisure revenue for MML were existing car users and those who were not existing travellers.

7.24. This strategy of limited-availability, discounted fares was not unique to MML under NEG's ownership. MML's own management had independently formulated a virtually identical plan in preparing their own management buy-out bid. It was also becoming increasingly apparent that other TOCs were pursuing similar policies.

*Details omitted. See note on page iv.

7.25. We asked NEG to account for the significant difference in value of its bid for MML compared with that of the management team. NEG replied that it had been able to take a far more positive view of likely revenue growth. A further factor was that an established company with a strong balance sheet was in a better position to bid compared with a management buy-out team with the cost of capital being provided by a venture capital fund. NEG also told us that compared with the successful bids for similar franchises to MML, the profitability turnaround envisaged in NEG's bid for MML was somewhat less ambitious. NEG said that its bid made no assumption about any benefit to MML's revenue based on its ownership of NEL because NEG's ownership of both MML and NEL did not create any additional opportunities for MML which would not exist under independent ownership.

7.26. NEG recognized that MML's proposed business strategy might have the incidental effect of attracting a small amount of new business to MML from NEL's coach services. However, the company could not risk interfering with MML's pricing policy because of the much greater risks for NEG if MML was unable to increase its profitability sufficiently (through increased passenger revenue) in order to meet its obligations to OPRAF. The potential for MML to contribute to (or alternatively to damage) NEG's group profitability far outweighed that of the NEL coach services in the MML area. MML's capacity on the five reference services was over 12 times that of NEL and MML's passenger revenue on these services was over £[*] million compared with just over £[*] million for NEL.

Implications for NEL

7.27. NEG acknowledged that it might be thought that NEG's acquisition of MML would create an opportunity for it to constrain NEL's competitive response to MML in order to maximize profits for the group as a whole. However, any such strategic behaviour would entail significant potential disadvantages. A failure by NEL to continue to offer a competitively-priced coach service increased the risk of new entry by competing coach operators for whom the barriers to entry with a 'corridor' service were low; and risked adversely affecting NEL's revenue from outside the MML area as a result of potential damage to NEL's reputation for providing a low-cost, high-quality network of coach services. NEG would also face revenue loss from passengers who switched from NEL services not merely for the section of their journey in the MML area but also for the remainder of the journey; 28 per cent of NEL passengers were known to 'interline' (that is, to change coach within their journey).

7.28. The benefits to be gained from such behaviour were uncertain because of the difficulty of predicting what proportion of passengers would switch from NEL and, of those, how many would transfer to MML, given also the risk of them moving to other TOCs. In NEG's view such gains were likely to be relatively small. Also, to achieve any benefits whilst trying to minimize the risks would require a level of management involvement in both subsidiaries and at the group level that would be disproportionate to the potential benefits.

7.29. NEG added that it had no certainty of retaining the MML franchise beyond the initial ten- (or possibly only seven-) year term. It would therefore be reckless to embark on a policy of constraining NEL's competitive response to MML. The significant risks for the wider NEL business entailed in such a policy would be undesirable when NEL was having to adjust and respond to the effect of the privatization of the rail industry across the entire NEL network. In these circumstances the most sensible commercial strategy for NEG was to continue to allow MML and NEL to operate and compete as entirely independent businesses. That was the approach that NEG had historically adopted to the operation of all its subsidiaries.

*Figures omitted. See note on page iv.

Involvement of NEG in rail franchising

7.30. NEG argued that its acquisition of MML was unlikely to operate against the public interest in other respects. It believed that its continuing active involvement in the privatized rail industry was in the public interest because it was one of a relatively small number of businesses with the financial strength and transport management skills to deliver the benefits the Government was seeking from the rail privatization process. NEG had a long-term commitment to the UK passenger transport industry and believed that the application of its existing expertise in providing passenger transport facilities would operate in the public interest. It had extensive experience of enabling passenger transport businesses to make a successful transition from the public to the private sector involving financial, personnel motivation and development skills. It described these skills as a 'core competency'.

7.31. There were also significant benefits to the Government of NEG remaining, as NEG wished to be, an active participant in the future franchise-awarding process. The fact that other bidders were aware of NEG's serious interest in participating would tend to sharpen the competitive bids. NEG wished to obtain a balanced portfolio of regional, commuter and some InterCity routes. The type of franchise which MML represented was attractive to NEG because of its flat year-round revenue profile compared with other businesses in the group which were highly seasonal. If it was forced to withdraw from the franchising process other than for regional TOCs due to competition concerns there would be an adverse impact on the competition for the remaining franchises. It was also in the public interest for NEG to remain a significant force in the restructured railway industry, so preventing concentration of the rail industry into the hands of a small number of powerful transport businesses.

NEG's views on undertakings

Undertakings sought by the OFT and the Secretary of State

7.32. At our request NEG described its discussions with the OFT about possible remedies to the concerns which the OFT had identified. (These discussions are summarized in Chapter 3.)

7.33. NEG told us it believed that if the merger was considered to give rise to any public interest concerns, the type of behavioural undertakings it had offered in discussion with the OFT would adequately remedy such concerns in a manner that was simple, effective, transparent (and so readily monitorable), and would avoid the potential damage to the public interest inherent in any undertakings involving either divestment or withdrawal of services. Should there be concerns about NEG's market power at some stage in the future, the possibility remained of using the competition authorities' monopoly control powers to address any future problems that might emerge (an approach which, NEG pointed out, the Government had recently adopted in relation to an acquisition in the bus industry).

7.34. In relation to the structural and behavioural undertakings sought by the Secretary of State for Trade and Industry, NEG told us that it was concerned at the prospect of giving an unconditional commitment to provide facilities to third parties who wished to operate on the reference services irrespective of matters such as:

- (a) the frequency of the third parties' services;
- (b) the age and condition of their coaches;
- (c) the quality of customer care provided both on board and at coach stations;
- (d) whether or not the operators intended to use coach stations or merely proposed setting down passengers at the roadside even in major towns;
- (e) the reliability and safety record of the operators; and
- (f) the potential number of such third parties on particular routes.

7.35. If NEG were to withdraw from the reference services NEG believed there could, in the period immediately following such withdrawal, be a number of new operators offering competing services, operating in a variety of different ways. NEG was concerned about the practical difficulties of incorporating details of an uncertain and potentially fluctuating number of operators' services in its existing timetables, information, sales and reservations systems. In view of the experience immediately after deregulation in the bus industry, it was also possible that there would be fairly frequent changes in the timetables of the operators and the quality of their services as they competed to establish themselves on these routes. Whilst these developments reflected active competition, the prospect of providing the specified assistance to all such operators, particularly during this initial period of instability, presented significant difficulties for NEG.

7.36. NEG was concerned that, particularly in this initial period, compliance with the sort of undertakings sought by the Secretary of State would impose a very significant operational burden and consequent expense on NEG and would create confusion for both NEG sales agents and potential passengers.

7.37. It was also concerned that if other operators' services were advertised in NEG's own timetables and other NEG publicity material, and NEG sales agents and NEG's own sales staff had a duty to refer passengers to the other operators' services and to sell tickets for them, there would inevitably be a strong perception in the minds of passengers and the public that NEG was in some way endorsing all of these operators. This perception would arise irrespective of any warning notices issued by NEG. Consequently any problems would be seen as in some way the responsibility of NEG. Passengers might seek to hold NEG legally responsible for the shortcomings of these third party operators or NEG's reputation might be tarnished by association. In view of the very heavy emphasis that NEG placed on the quality of its own services, NEG felt unable to expose itself to the level of legal risk and potential damage to its reputation that would have been entailed in acceptance of the proposed undertakings.

7.38. As a separate matter NEG said that it was unable to identify what would actually be divested since no assets were involved and its contracts with the operators were not assignable. There were also difficulties in separating out the reference services from the relevant NEL services which in several instances originated or terminated at a different location from any of the five places named in the reference.

7.39. NEG expressed the view to us that divestment would be against the public interest because the 28 per cent of passengers who 'interlined' would be denied the network benefits offered by NEL and would probably not be able to make connections to other local services as easily as at present. Although some new operators might seek to offer a regular service, others might simply operate a 'no-frills', low-cost service operating only at peak times and reducing costs by dropping passengers at the roadside to avoid coach station charges. Whilst such a service would meet the requirements of certain passengers, it would not provide the same level of security for passengers that use of a coach station provided.

7.40. We also asked NEG whether it had received any offers to take over the reference services. NEG told us that it had received one letter suggesting this but felt that this had not been a serious offer and neither party had pursued the matter.

Further aspects of undertakings

7.41. As our discussions progressed, various parties put points to us about possible undertakings which might be sought from NEG should we conclude that the merger could be expected to operate against the public interest. We sought NEG's comments on these points. The following paragraphs summarize the comments we received from NEG on aspects of undertakings not considered earlier.

Additional points relating to the undertakings previously offered to the OFT

7.42. We put to NEG some points of clarification about the undertakings it had offered to the OFT.

Coach frequency: duplicates

7.43. First, we asked NEG whether the undertakings as to coach frequency would also apply to running duplicates to serve the provision of adequate capacity.

7.44. NEG told us that it would have no objection to giving such an undertaking and its original proposal was intended to cover the provision of duplicates. It would not, however, be possible to express this obligation in terms of the provision of a particular number of duplicates in respect of specific services on specific days each year because the requirement for duplicates was by its nature variable. NEG, however, believed it should be possible to develop a formula in terms of occupancy rates on the reference services not exceeding particular percentages over a given period of time in order to provide a means of monitoring compliance with such an undertaking. It suggested two indices to measure seat availability with commitments that those indices would not fall outside a given margin of the historic figure for the index in any period. First it suggested a seat occupancy index, which would measure the proportion of seats occupied (and hence also the number available for sale) at the start of each business day, which it regarded as a true measure of any constraint on supply side capacity. NEL would undertake to ensure that this index did not fall outwith a percentage of previous historic averages. NEL believed it could operate on the basis of a [*Details omitted. See note on page iv.*] around the historic average: the ceiling (that is, [*]) would be the principal control since NEL would commit itself to providing duplicates or additional frequency to keep the ratio under the ceiling, but the floor (that is, [*]) could be used to permit NEL to be released from the undertakings since it would indicate falling demand, requiring a reduction in service levels. Secondly, it suggested a journey availability index, by which NEL would commit that the proportion of full journeys (that is, coaches that were fully booked at the start of the business day) measured at the start of the business day would not rise above a certain percentage of the moving monthly average. Application of this second index (although probably unnecessary) would prevent NEL from manipulating the seat occupancy index to stay below the ceiling whilst restricting demand at the preferred time of travel.

'Special fares' from Sheffield and Chesterfield

7.45. We next asked whether the undertakings as to coach fares would apply equally to the 'special fares' from Sheffield and Chesterfield.

7.46. NEG said that because the fares on these routes were so much lower than the average for the NEL network NEL could keep the fares at this level only if it continued to achieve the much higher level of seat occupancy ([*] per cent in 1995) on these routes than was achieved by NEL's network on average ([*] per cent in 1995). Consequently NEG would be concerned at the prospect of being both committed to maintaining existing frequency levels and capping fare increases on these routes at the rate of increase in the RPI for the full duration of the MML franchise. As an alternative NEG said that it would be willing to cap fare increases on these routes at the RPI level for a shorter period, say until the end of 1997, but for there to be some greater flexibility, say three times the increase in the RPI, thereafter, subject to a ceiling which could be fixed by reference to fares on comparable routes elsewhere in the country.

Changes in terms and conditions

7.47. We asked NEG whether the undertakings would incorporate the effect of any changes in terms and conditions, for example in the period for which return tickets could be used.

7.48. NEG said that it would be willing to undertake not to make any changes to the terms and conditions applicable to coach tickets on the reference services which would reduce the availability of particular tickets or would otherwise be detrimental to passengers. However, this would have to be subject to a proviso that NEG would be free to implement changes where this was part of a general revision of its terms and conditions applicable across NEL's entire network.

*Details omitted. See note on page iv.

Availability of lower-cost tickets

7.49. We then asked whether undertakings could be given to ensure that availability of lower-cost tickets was not unreasonably restricted.

7.50. NEG told us that NEL did not place any restrictions on the number of coach tickets in any particular price category that it was willing to sell. NEG said that it would be happy to undertake not to introduce a quota system on coach tickets on the reference services. If necessary it would also be willing to agree to maintain the availability of the different categories of tickets on the reference services, subject only to a proviso to cover the possibility that NEL may wish to restructure its categories of fares across its entire network at some time in the future.

Rail APEX tickets

7.51. We also asked whether it would be appropriate to require similar undertakings on the availability of rail APEX tickets.

7.52. NEG told us that it would be willing to give this undertaking. However, because of the means by which the quotas were set such an undertaking would have to be expressed in general terms because the actual quotas for any given service varied from day to day. NEG said that the objective of having quotas on APEX fares was to enable MML to respond to emerging demand and to attempt to encourage higher occupancy levels on trains that would otherwise be likely to have significant capacity, whilst avoiding overcrowding on more popular services. The quota for each train was set daily by proprietary software run overnight, based on a combination of input data including historical patterns of passenger numbers for a particular service and reservation levels. If it appeared that a service was likely to be filled with full or higher rate fare-paying passengers, the APEX quota was reduced. For this reason the quota was automatically set at zero for some peak demand trains. However, in certain circumstances the computer system required a decision on quota levels to be taken manually; in addition, modifications to the quotas were made to address anticipated but irregular increases in demand such as major sporting events or half-term holidays.

7.53. Consequently NEG said that it would not be possible to commit itself to maintain quotas for each service at precisely the levels applicable in the last year but it would be possible to give the undertaking in the general terms. There would also be no difficulty in NEG undertaking not to make the availability of the APEX fare more restricted in other ways, for example by requiring a longer period of advance booking.

Possible additional undertakings

7.54. We raised with NEG various suggestions made to us about further possible undertakings.

Extension of fare undertakings to rail leisure fares

7.55. The first possible further undertaking was the extension of fare undertakings to SuperSavers and other leisure-related tickets.

7.56. NEG told us that increases in the leisure fares cheaper than the Saver fare, that is the SuperSaver, SuperAdvance and APEX fares, were indirectly restricted by virtue of the existing regulatory controls on increases in the Saver fare. If MML increased these lower-priced leisure fares at a higher rate than the increases it was permitted to make to the Saver fare, it would run the risk that the differential between the Saver and the other lower-price fares would be regarded by passengers as insufficient to justify the more limited availability or advance booking requirement attaching to them. As a result MML would risk passengers upgrading to the less restrictive tickets and creating a risk of overcrowding on the popular trains which, in turn, would reduce the attraction of the train over the car for higher fare-paying passengers. NEG said that this would be wholly contrary to MML's overall business strategy which was to enhance the rail service in a way that increased the attractiveness of rail to both business and leisure car users.

7.57. However, should the MMC conclude that further restrictions on rail fares would be justified, NEG suggested that this should be limited to the SuperAdvance fare. [

Details omitted. See note on page iv.

Details omitted. See note on page iv.

]

Single tickets for rail travel

7.58. We also asked NEG to comment on the possible extension of undertakings to single tickets on the basis that some were purchased for leisure travel.

7.59. NEG said that whilst some single tickets were purchased for leisure travel, it believed it would be excessive for it to give undertakings in relation to single fares. MML regarded singles principally as a business and not a leisure fare. Although MML did not have any plans to increase its single fares above the rate of inflation, NEG felt that the imposition of controls on single fares would be excessive.

Fare increases below the rate of inflation for rail and coach travel

7.60. We put to NEG the view expressed to us that it would be challenging but not unreasonable to limit increases in APEX and other leisure fares to RPI-2.

7.61. In NEG's view the imposition of an RPI-2 cap on rail leisure fares would be a wholly inappropriate and arbitrary response to any possible competition concern. In the absence of evidence that the privatized TOCs were introducing price reductions across all their leisure fares at that sort of level, NEG said that there could be no competition justification for imposing such a constraint on MML. In other words, unless there was evidence that under other ownership MML would achieve additional efficiency gains of 2 per cent a year and that these gains could then be appropriately attributed to particular leisure fares, NEG would regard such a remedy as inappropriate.

7.62. NEG said that the use of the RPI-2 formula for coach fares was even less appropriate than for rail fares. Even on the reference services NEG would again regard such a price cap as arbitrary in the absence of evidence that if NEL and MML were under separate ownership NEL could reasonably be expected to achieve efficiency gains of 2 per cent a year in respect of those services. However, NEG would agree that NEL could maintain the existing differentials between the [

Details omitted. See note on page iv.

] on the reference services, subject to this undertaking being of more limited duration on the Sheffield and Chesterfield routes for the reasons outlined in paragraph 7.46.

Withdrawal of coach services without behavioural undertakings

7.63. NEG provided us with further views on a possible undertaking requiring NEG to withdraw coach services on the reference services but without being asked to provide any assistance to new operators who establish themselves on those routes. In NEG's view such a proposal would not have the operational, liability and reputational problems associated with the undertakings sought by the Secretary of State. Although NEG did not wish to rule out this possibility entirely, it believed this remedy would not be in the public interest because of its adverse effect on coach passengers.

7.64. At present, coach passengers had the benefit of a nation-wide network of coach services provided by NEL operated to high safety and service standards which were strictly enforced by NEL. This meant that a passenger could buy a single ticket and make a single reservation in order to travel on interconnecting services and be confident of the quality of service they would find on all the sections of the journey.

7.65. If NEG withdrew from the reference coach services, this would mean that passengers who would otherwise have travelled on the NEL coaches on those routes would be faced with the possibility that, initially at least, there would be a reduction in the availability of coach services on those routes. When other operators replaced NEL the passengers would have no certainty that the new operator or operators would operate to similar frequencies or have quality standards as high as NEL's; there was a significant risk that new operators might, as many operators already did, set down passengers by the roadside in towns in order to save on coach station fees, thus depriving passengers of the security of interchange at a coach station. Passengers making interconnecting journeys might also face longer delays and less convenient transfers between other NEL services and the new operators' coach services on the reference services. Passengers would also be faced with buying two separate tickets and making two reservations and it would be more difficult for passengers who lived outside the region to obtain information about the new operator's services.

7.66. NEG therefore believed it would not be in the public interest for NEG to be required to withdraw from the reference coach services. These disadvantages for passengers would increase if a similar requirement were imposed in respect of other routes as a condition of NEG acquiring other rail franchises.

7.67. NEG also said that withdrawal from the reference coach services would mean that NEL would have to terminate prematurely its contracts with the operators of the 440, 450 and 560 services. The contractual implications were very unclear at this stage but three alternative possible outcomes had been identified:

- (a) premature termination by application of the contractual clause relating to individual diagram termination to all diagrams simultaneously, that is using this clause effectively to end the contract;
- (b) giving notice to end the contract with compensation payable as 'due revenue less variable costs' except that no provision is allowed for vehicle costs after one year (that is, mitigation of loss); and
- (c) as for (b) but without any deduction of vehicle costs.

The total prospective liability varied from £[*] million for (a) to £[*] million for (c).

7.68. The withdrawal of these services would also affect NEG's revenue from other parts of its network due to the significant proportion of NEL's passengers using more than one NEL service in the course of their journey. [

Details omitted. See note on page iv.

]

Reversal of existing contractual arrangement with coach operators on the reference services

7.69. We also raised different forms of undertaking, namely that NEG should terminate its existing contracts with coach operators on the reference services and enter into new contracts, which would replicate the original operating contracts, save that fares and frequency would be set by the new operator. They would also be entitled to all revenue from the routes and bear all revenue risks.

7.70. NEG said that in effect this would be a form of franchise operation whereby it provided the coach operator with the benefit of the National Express name and the NEL central network facilities whilst leaving the operator free to determine independently its fare levels and frequencies and to take the revenue benefits and risks. Such an approach had the significant public interest benefit of keeping the NEL network intact and so avoiding the disadvantages to passengers of some of the other possible outcomes. NEG said that such an arrangement would, in principle, be workable subject to agreement on certain important operational issues such as:

*Figures omitted. See note on page iv.

- (a) The operator would have to provide NEL with details of its schedules and fares in sufficient time for NEL to include them in its printed timetable.
- (b) Changes to schedules and fares could only be made when NEL was reprinting timetables (which it did twice a year).
- (c) The fare structure (that is, the categories of ticket available as distinct from the fare levels) would have to be compatible with NEL's fare structure so that details of the independent operators' fares could be carried on NEL's existing computer information, sales and reservations systems.
- (d) The terms and conditions applicable to journeys on the routes operated by the independent operator should be the same as those of NEL in order to avoid the risk of passengers being confused by different conditions covering different sections of a multi-leg journey, which at least as far as the passenger was concerned was all being provided by NEL.
- (e) If the independent operator were to benefit from the National Express name and goodwill and from the NEL central network facilities (for example, computer systems, telesales, network of sales agents, etc), NEL would expect to receive some payment for these benefits from the operator.
- (f) Consideration should be given to whether the operator should also be required to adhere to a minimum frequency in order to protect NEL's network integrity and avoid excessive interconnection times.

7.71. NEG said that this proposal would still entail early termination of the existing operators' contracts and the consequent potential damages claims against NEL. However, this would be mitigated if NEL was able to award the new contracts to its existing operators.

Disposal of the MML franchise

7.72. Finally NEG commented on its view of an undertaking to divest the MML franchise.

7.73. NEG said that it regarded this possibility as wholly unacceptable, both from its own commercial perspective and in terms of the public interest. The consequence of such a remedy would be very significant and, in NEG's view, totally disproportionate to any possible competition concerns. [

Details omitted. See note on page iv.

] NEG made the following points in support of this view.

NEG's continuing financial liability

7.74. The possibility of NEG undertaking (or being required) to give up the MML franchise as a result of an adverse MMC report was not expressly contemplated in the Franchise Agreement and it was not entirely clear to NEG how OPRAF would proceed in these circumstances. However, the Franchise Agreement did contain provisions which could come into effect in the event of such a remedy being imposed. An order requiring NEG to cease to own or operate MML would itself amount to an Event of Default under Clause 21.4 of the Franchise Agreement, which provided that it was an Event of Default if it was unlawful for MML to provide all or a material part of the passenger services. Equally if NEG voluntarily undertook to cease to operate the franchise there would be an Event of Default as soon as NEG ceased to operate the MML franchise.

7.75. Following an Event of Default, OPRAF would, in effect, have an option to terminate the Franchise Agreement. In order to avoid a breakdown in the rail network NEG anticipated that OPRAF would exercise this option. OPRAF could then retender the franchise. However, it appeared that this would involve seeking a new franchisee who was willing to undertake NEG's obligations under the Franchise Plan. These included the various commitments that NEL had given in relation to refurbishing existing rolling stock, acquiring new rolling stock, improving surveillance equipment at the stations and station car parks, procuring a coach service from Corby to Kettering, improving the timetable and spending at least £[*] million during the first three

*Figure omitted. See note on page iv.

years of the franchise term to improve facilities at stations. This, in itself, might prove difficult for OPRAF to achieve. There was also clearly a significant risk that any new franchisee would only be willing to take on the franchise obligations on terms that involved a higher level of revenue support from OPRAF and/or lower payments to OPRAF than NEG was willing to offer.

7.76. NEG said that under Clause 23 of the Franchise Agreement OPRAF was entitled to bring an action against NEG or MML for losses arising out the early termination of the Franchise Agreement. Consequently, if OPRAF had to accept less advantageous revenue support arrangements from a new franchisee in order to get them to take on the franchise, OPRAF might seek to recover the difference between the new terms and the more favourable terms NEG had offered, from NEG. OPRAF might also seek to recover from NEG the costs of the retendering process. Under Clause 35.5 of the Franchise Agreement OPRAF would be entitled to take its losses from the performance bond and season ticket bond provided by NEG (which together totalled approximately £[*] million). This would invoke the various counter-indemnity clauses between NEG and its bankers, in respect of these bids. This meant that NEG would still be funding the payments claimed by OPRAF.

7.77. An alternative, although in NEG's view less likely, scenario was that OPRAF would consent to NEG assigning the MML Franchise Agreement (with all its obligations including the revenue support arrangements) to a third party. However, NEG believed it would face very significant difficulties in finding a new franchisee to take a straight assignment and that it was only likely to succeed in doing so if NEG was prepared to make significant payments to the assignee.

7.78. Consequently if it was required to give up the MML franchise, either through the termination or assignment of the Franchise Agreement, NEG would face the prospect of significant financial penalties either in the form of damages due to OPRAF or payments to subsidize a new franchisee.

Limiting NEG's strategic diversification

7.79. NEG said that passenger rail services now formed a significant part of the UK passenger transport industry. As a diversified passenger transport business NEG also wished to be involved in the provision of passenger rail services through the acquisition of a portfolio of commuter, InterCity and rural routes. If NEG was forced to give up the MML franchise this was likely in practice to mean that NEG would also be precluded from acquiring other InterCity and possibly other TOCs. [

Details omitted. See note on page iv.

]

Loss of NEG from the bidding process for future TOC franchise awards

7.80. If NEG was effectively excluded from the acquisition of other InterCity and probably also most other TOCs, this would mean that NEG would be excluded from participating in bidding for many of the remaining TOCs that were still to be privatized and from acquiring these franchises in future award rounds. Whether or not a particular franchise was ultimately awarded to NEG, the fact that other bidders were aware of NEG's serious interest in participating in the privatized railway industry and its intention to bid for future franchises inevitably tended to sharpen their competitive bids. [

Details omitted. See note on page iv.

]

*Figure omitted. See note on page iv.

Loss of NEG from the privatized rail industry

7.81. NEG said that whilst it was premature to predict the likely shape of the privatized rail industry, initial indications were that after early expressions of interest from a relatively wide range of third parties, as well as existing management teams, experience of the initial rounds of bidding had led to a number of potential bidders withdrawing from the process. This was increasingly leading to the prospect of franchises going either to existing management backed by venture capital finance or to one of a relatively small number of transport operators including in particular other bus and coach operators such as Stagecoach and FirstBus. There was also the prospect that those franchises which had been awarded to management teams backed by venture capital finance would, in the short to medium term, be transferred to other operators as the venture capital investors sought to realize their investment. NEG believed the rapid concentration of the rail industry into the hands of a very small number of powerful transport businesses would not necessarily be in the public interest and it would therefore be desirable for the number of businesses participating in the rail industry to be as great as possible and therefore for NEG itself to be included.

Loss of NEG's expertise in transferring passenger transport businesses successfully into the private sector

7.82. NEG had extensive experience of taking over passenger transport businesses that were previously in public ownership and enabling such businesses to adapt rapidly to (and succeed in) the privatized environment. This involved not merely financial but also personnel motivation and development skills. NEG believed it would be in the public interest for its skills to continue to be available to MML and to other TOCs.

Lack of proportionality

7.83. MML's turnover in the year to March 1996 was £99.2 million based on 436 million passenger miles. In contrast NEG's revenue from the entire routes (including the sections not covered by MML) of services 440, 450 and 560 was under £3.5 million from 54 million passenger miles. Given the very different scales of the two businesses, NEG believed it would be wholly disproportionate to any potential competition concerns for it to be required to give up the MML franchise. [

Details omitted. See note on page iv.

]

Summary

7.84. In summary NEG said that if the MMC concluded that its ownership of both the MML franchise and the NEL coach business on the reference services was likely to operate contrary to the public interest to such an extent that remedies were necessary, NEG believed the public interest would be best served by a combination of behavioural undertakings affecting both NEL's coach services on the reference services and MML's rail services.

P H DEAN (*Chairman*)

J BEATSON

A FORSTER

R HALSTEAD

J S METCALFE

P A BOYS (*Secretary*)

22 November 1996