

Part II

Background and evidence

3 The companies and the merger situation

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Introduction

3.1. This chapter provides information about the history, current operations and financial performance of the companies involved in the merger situation. It goes on to describe the merger itself and relevant aspects of the franchise agreement concerning ScotRail, and finishes with the competition issues which were addressed at the time the franchise was awarded.

National Express Group PLC

History and origins

3.2. The origins of NEG lie in the creation in 1968 of the state-owned NBC which effected the integration of a large number of both state- and privately-owned bus and coach operators which had previously operated independently of one another. This was the result of a Government initiative to create a more integrated national public passenger transport system. In 1974 the National Express brand was introduced to cover scheduled long-distance coach services operated by the constituent members of the NBC.

3.3. The Transport Act 1980 removed the need for road service licences for coach services on which no passenger travelled less than 48 km measured in a straight line, thus beginning deregulation of bus and coach services. In the face of the ensuing new competition, the frequency and general competitiveness of National Express services were significantly enhanced. A premium brand, Rapide, was introduced on selected routes, involving higher-specification coaches with more on-board facilities, and more direct routes.

3.4. Following deregulation of local bus services outside London under the Transport Act 1985, the Government decided to privatize the NBC on a piecemeal basis. A large number of management buyouts followed including that of the long-distance coach activity of the NBC, operated by NEL, in 1988.

3.5. NEL's core business, the provision of scheduled long-distance coach services, continued to be operated by contract coaches and crews. The new management began to diversify through acquisitions, notably of the local bus operator Crosville Wales, the coach operator Amberline and the coach operation that later became Express Travel.

3.6. The financing costs of these acquisitions, the poor trading performance of all except Express Travel and the impact of the recession on the core businesses resulted in a deterioration of the group's financial position from early 1990. On 23 July 1991 a new management team, backed by a number of development and venture capital investors, effected a management buy-in. A new group holding company, National Express Group Limited (later to become PLC), was formed and effected a share exchange to acquire the existing holding company which subsequently transferred its group shareholdings to the new company and became dormant.

3.7. The new management team, led by Mr Ray McEnhill until his retirement in August 1996, began to refocus the group on its core activities, selling Crosville Wales and Amberline and divesting interests in a number of joint ventures. The new corporate strategy was to:

- (a) refocus the business of the group;
- (b) improve the efficiency, quality and level of service within the group's existing operations;
- (c) develop new products within the existing operations; and
- (d) develop organically and by the acquisition of new businesses related to passenger transport and handling services.

3.8. In October 1991 the group acquired Speedlink Airport Services Limited (Speedlink), an operator of coach services primarily between Heathrow and Gatwick.

3.9. In December 1992 NEG arranged an offer and placing of some 27.8 million ordinary shares of 5p each at £1.65 per share and the shares were admitted to the Official List of the London Stock Exchange. The offer and placing comprised the issue of 15.5 million new ordinary shares to raise some £23.9 million after expenses and the sale of 12.3 million ordinary shares by existing shareholders. NEG used £9 million of the proceeds to redeem its 10 per cent cumulative preference share capital and the remainder to expand the group, modernize the coach network and introduce new facilities to meet additional requirements highlighted by market research.

Activities and development since flotation

3.10. Since flotation NEG has continued its expansion and development by acquiring, *inter alia*:

- (a) Citylink¹ for £5.6 million in May 1993;
- (b) Eurolines (Nederland) BV for £2.2 million in July 1993-this was NEG's first continental European acquisition;
- (c) East Midlands International Airport (EMIA) from the then four local authority shareholders for £28.3 million in August 1993;
- (d) Bournemouth International Airport for £7.4 million in April 1995;
- (e) West Midlands Travel Limited (WMT), the largest provider of bus services in the West Midlands and previously the municipal bus operation of Centro, for £248.3 million in April 1995;
- (f) a one-third interest in Altram (LRT) Limited (Altram), together with a contract from Altram for WMT to operate Line 1 of the Midland Metro light rail line, in October 1996. Altram has a 23-year concession to design, finance, build, maintain and operate the Midland Metro, services on which are expected to begin in August 1998;
- (g) the franchises to operate the Gatwick Express and MML passenger rail services, together with the relevant operating companies, in April 1996;
- (h) TayBus, the major provider of urban bus services in Dundee, for £12.2 million in February 1997; and
- (i) the franchises to operate the Central Trains, NLR and ScotRail passenger rail services, together with the relevant operating companies, in February 1997.

In February 1996 L&CR, a consortium in which NEG had acquired a 17 per cent share for an investment of £5.8 million in March 1995, was awarded the contract to build and operate the Channel Tunnel Rail Link and to operate Eurostar services.

Current activities

3.11. NEG now comprises four main businesses: scheduled coach services, airports, urban buses and railways.

Scheduled coach services

3.12. NEG's scheduled coach business is divided into four separate operations: NEL, Citylink, Eurolines and Speedlink.

3.13. NEL organizes, controls and markets a network of long-distance scheduled coach services in England and Wales, with extensions to parts of Scotland. NEL is discussed further in paragraphs 3.35 to 3.40.

3.14. Citylink operates scheduled coach and inter-urban bus services in Scotland and has 25 per cent holdings in two coach operators, Skyeways Travel Limited and Craig of Campbeltown Limited (which trades as West Coast Motors). Citylink is discussed further in paragraphs 3.41 to 3.49.

3.15. NEL and Citylink together comprise NEG's non-airport UK scheduled coach operations.

¹Reported on in the MMC's Saltire report: see footnote to paragraph 2.21.

3.16. Eurolines (UK) Limited and Eurolines (Nederland) BV are major partners in the Eurolines International long-distance coach organization which provides services to 470 towns and cities throughout Western and Central Europe.

3.17. Speedlink has a range of airport-related services with dedicated ticket offices and lounges within the terminals at Heathrow, Gatwick and Stansted airports. It is also responsible for services under the Jetlink, Gatwick Direct and Flightline names. Speedlink provides scheduled coach services between Heathrow and Gatwick and from centres of population in the South-East and certain railway stations to the three main London airports.

Airports

3.18. EMIA is the fourth-largest regional airport (ie excluding the three London airports) in England in terms of passengers handled. EMIA is situated on an 850-acre site at the junction of the M1 and the M42 extension and close to the M6. The airport primarily serves the cities of Derby, Nottingham, Leicester and Sheffield, but residents of Birmingham, Stoke-on-Trent, Northampton, Lincoln and Peterborough are also within the airport's catchment area. In total some 12 million people live within 90 minutes' travel of the airport.

3.19. Bournemouth International Airport is small in terms of passenger numbers but the site and catchment area are large. In order to develop traffic at the airport NEG has invested £2 million in a runway extension which now enables the airport to handle fully-loaded long-haul aircraft.

Urban buses

3.20. WMT operates the largest single-area bus fleet in Great Britain with about 5,000 employees and 1,700 public service vehicles covering 114 million scheduled vehicle km a year. WMT is the major provider of local bus services in the West Midlands conurbation, carrying 320 million passengers a year in this densely populated urban area of some 2.6 million people.

3.21. TayBus provides high-frequency urban bus services in Dundee.

3.22. Highland Country Buses operates local buses in Skye, Lochalsh, Caithness, Fort William and Aviemore.

Railways

3.23. NEG has acquired five franchises to operate railway services under the previous Government's privatization process. Under this process, all the track, station and other infrastructure was transferred to Railtrack and the rolling stock was transferred to three ROSCOs. Passenger train operations were transferred to 25 TOCs. The right to operate the services of each TOC for a period of years, usually seven, was subjected to a commercial tendering process as a result of which successful bidders were granted a franchise and acquired the relevant TOC at net asset value. Each TOC is obliged, *inter alia*, to provide a minimum level of service (known as the PSR), to pay rail access charges to Railtrack and to pay train leasing charges to the ROSCOs.

3.24. NEG's rail interests currently comprise:

(a) *MML*: In April 1996 NEG was awarded a ten-year franchise (subject to investment in new rolling stock) to operate passenger rail services on the Midland Main Line. These are mainly services between South Yorkshire and the East Midlands and London St Pancras.

(b) *Gatwick Express*: Also in April 1996 NEG was awarded a 15-year franchise (subject to investment in new rolling stock) to operate the Gatwick Express services between London Victoria and Gatwick.

- (c) *NLR*: On 6 February 1997 NEG was awarded a seven-year franchise to operate the services of NLR, for which it assumed responsibility on 2 March 1997. NLR operates passenger services on the Northampton, North London and West London lines.
- (d) *Central Trains*: On 14 February 1997 NEG was awarded a franchise for seven years and one month to operate the services of Central Trains, for which it assumed responsibility on 2 March 1997. Central Trains provides urban services in the West Midlands and inter-urban and urban/rural services across a wide area of central England and into Wales.
- (e) *ScotRail*: On 21 February 1997 NEG was awarded a seven-year franchise to operate the services of ScotRail, for which it assumed responsibility on 31 March 1997. ScotRail is discussed further in paragraphs 3.50 to 3.64.
- (f) *L&CR*: NEG holds a 17 per cent share in L&CR (see paragraph 3.10).

With five of the 25 rail passenger transport franchises awarded to it, NEG has more than any other company.

Strategy

3.25. NEG said in its annual report for 1996 that it intended to build on its position as one of the major forces in the UK mass passenger transport services market. Its financial strength allowed it to pursue profitable opportunities, both within the UK and increasingly internationally, as other countries followed the UK's example of privatizing their passenger transport industries. The group's range of activities gave it an additional intermodal perspective when assessing potential opportunities. It would look for opportunities, not only within the areas of its four major divisions, but also in related areas.

Structure

3.26. NEG acts as a holding company, with each subsidiary having a board comprising directors of NEG and its own executive directors. Boards of the subsidiary companies are able to approve capital expenditure projects up to a specified limit as long as they are within budget: outside those parameters group approval is required. NEG told us that it operated on a highly decentralized basis and that only some two dozen people were employed at head office. The corporate structure of the group is set out in Appendix 3.1.

3.27. Having acquired five TOCs, NEG has created a trains division between head office and the subsidiary train companies. Its purpose is to achieve economies by, for example, pooling the purchasing power of the TOCs; to spread best practice techniques; and to oversee compliance with regulatory requirements.

Financial performance

3.28. An analysis of NEG's turnover and operating profit during the five years ended 31 December 1996 is shown in Table 3.1.

3.29. The table clearly shows the impact of diversification away from coaches and into buses, airports and trains. The contribution of trains in 1996 represents the eight months following the acquisition of MML and Gatwick Express.

3.30. The increase in scheduled coach travel turnover in 1994 reflected the first full year's contribution from Citylink, at that time turning over £11.5 million a year. The increase in turnover of 10 per cent in 1996 derived from increased volumes on core UK services of 6 per cent, with the balance from price movements. European coach service margins came under continued pressure from Eurostar services and the low margins on coach services to airports reflected the use of a high proportion of discounted airline tickets.

TABLE 3.1 NEG: analysis of turnover and operating profit, 1992 to 1996

| <i>Years ended 31 December</i> | | | | | | | | | | |
|--------------------------------|----------------|-----------------|----------------|-----------------|----------------|-----------------|----------------|-----------------|----------------|-----------------|
| | <i>1992</i> | | <i>1993</i> | | <i>1994</i> | | <i>1995</i> | | <i>1996</i> | |
| | <i>£'000</i> | <i>%</i> | <i>£'000</i> | <i>%</i> | <i>£'000</i> | <i>%</i> | <i>£'000</i> | <i>%</i> | <i>£'000</i> | <i>%</i> |
| Turnover | | | | | | | | | | |
| Coaching activities: | | | | | | | | | | |
| Scheduled coach travel | 95,175 | 78.9 | 99,784 | 71.8 | 108,985 | 64.1 | 108,280 | 34.1 | 119,522 | 24.8 |
| European coaches | 15,153 | 12.6 | 23,018 | 16.6 | 32,552 | 19.1 | 36,878 | 11.6 | 36,295 | 7.5 |
| Airport coach services | <u>6,811</u> | 5.6 | <u>8,203</u> | 5.9 | <u>8,956</u> | 5.3 | <u>12,761</u> | 4.0 | <u>14,048</u> | 2.9 |
| Total coaching activities | 117,139 | 97.1 | 131,005 | 94.2 | 150,493 | 88.5 | 157,919 | 49.7 | 169,865 | 35.2 |
| Airports | 0 | 7,722 | 5.6 | 19,516 | 11.5 | 26,071 | 8.2 | 28,615 | 5.9 | |
| Buses | 0 | 0 | 0 | 133,754 | 42.1 | 175,587 | 36.4 | | | |
| Trains | 0 | 0 | 0 | 0 | 108,481 | 22.5 | | | | |
| Discontinued activities | <u>3,489</u> | <u>2.9</u> | <u>320</u> | <u>0.2</u> | <u>0</u> | | <u>0</u> | | <u>0</u> | |
| Total turnover | <u>120,628</u> | <u>100.0</u> | <u>139,047</u> | <u>100.0</u> | <u>170,009</u> | <u>100.0</u> | <u>317,744</u> | <u>100.0</u> | <u>482,548</u> | <u>100.0</u> |
| | <i>As % of</i> | <i>As % of</i> | <i>As % of</i> | <i>As % of</i> | <i>As % of</i> | | | | | |
| | <i>£'000</i> | <i>turnover</i> | <i>£'000</i> | <i>turnover</i> | <i>£'000</i> | <i>turnover</i> | <i>£'000</i> | <i>turnover</i> | <i>£'000</i> | <i>turnover</i> |
| Operating profit | | | | | | | | | | |
| Coaching activities: | | | | | | | | | | |
| Scheduled coach travel | 4,502 | 4.7 | 4,852 | 4.9 | 7,631 | 7.0 | 6,891 | 6.4 | 9,195 | 7.7 |
| European coaches | 1,100 | 7.3 | 1,485 | 6.5 | 1,537 | 4.7 | 1,729 | 4.7 | 272 | 0.7 |
| Airport coach services | <u>643</u> | 9.4 | <u>723</u> | 8.8 | <u>689</u> | 7.7 | <u>1,065</u> | 8.3 | <u>1,020</u> | 7.3 |
| Total coaching activities | 6,245 | 5.3 | 7,060 | 5.4 | 9,857 | 6.5 | 9,685 | 6.1 | 10,487 | 6.2 |
| Airports | 0 | 2,152 | 27.9 | 6,421 | 32.9 | 9,614 | 36.9 | 10,303 | 36.0 | |
| Buses | 0 | 0 | 0 | 24,745 | 18.5 | 39,418 | 22.4 | | | |
| Trains | 0 | 0 | 0 | 0 | 2,097 | 1.9 | | | | |
| Discontinued activities | <u>69</u> | <u>2.0</u> | <u>40</u> | <u>12.5</u> | <u>0</u> | | <u>0</u> | | <u>0</u> | |
| Total operating profit | <u>6,314</u> | <u>5.2</u> | <u>9,252</u> | <u>6.7</u> | <u>16,278</u> | <u>9.6</u> | <u>44,044</u> | <u>13.9</u> | <u>62,305</u> | <u>12.9</u> |

Source: NEG.

3.31. The operating profit margin on turnover in scheduled coach travel has remained flat in the 6.4 to 7.7 per cent range over the last three years. These margins are substantially lower than those of the bus operations, but part of the margin effectively passes to the contracting coach operator whereas the bus operations use NEG's own vehicles.

3.32. Table 3.2 contains a summary of the financial performance of NEG.

TABLE 3.2 NEG: financial performance

| | £'000 | | | | |
|---|-------------------------|---------|---------|---------|---------|
| | Years ended 31 December | | | | |
| | 1992 | 1993 | 1994 | 1995 | 1996 |
| Turnover | 120,628 | 139,047 | 170,009 | 317,744 | 482,548 |
| Operating profit | 6,314 | 9,252 | 16,278 | 44,044 | 62,305 |
| PBIT* | 6,909 | 9,488 | 16,278 | 44,044 | 62,305 |
| Profit before tax | 6,818 | 9,305 | 15,236 | 41,538 | 60,092 |
| Profit after tax | 4,392 | 6,347 | 10,212 | 27,533 | 41,424 |
| Average net operating assets#~ | (3,911) | 24,770 | 52,023 | 101,640 | 160,113 |
| Average shareholders' funds# | 7,556D | 22,760 | 40,715 | 74,738 | 126,019 |
| Operating profit as a percentage of turnover | 5.2 | 6.7 | 9.6 | 13.9 | 12.9 |
| PBIT as a percentage of turnover | 5.7 | 6.8 | 9.6 | 13.9 | 12.9 |
| PBIT as a percentage of average net operating assets | N/A | 38 | 31 | 43 | 39 |
| Profit after tax as a percentage of average shareholders' funds | 58 | 28 | 25 | 37 | 33 |
| Earnings per share fully diluted (p) | 16.7 | 16.4 | 25.2 | 27.9 | 32.8 |
| Closing share price on 24 September 1997 (p) | | | 532 | | |
| Historic price:earnings ratio | | | 16.2 | | |

Source: NEG/MMC analysis. Share price information: *Financial Times*.

*Profit before interest and tax.

#Arithmetic means of the year-end figures.

~ Net operating assets comprise fixed assets, current assets and current liabilities excluding cash, borrowings, proposed dividends and unrelated investments.

DYear-end figure because the previous year-end figure was negative.

3.33. Whilst the growth in turnover and profits has been substantial, the performance indicators lie in the margin on turnover, return on net operating assets and earnings per share. The last of these has shown consistent growth over the three most recent years, whilst the margin on turnover and the return on assets both fell slightly in 1996. NEG's interim statement for the six months ended 30 June 1997 showed turnover from continuing operations up by 29 per cent; operating profit up 30 per cent; and basic earnings per share up 17 per cent. Passenger volumes on MML and Gatwick Express had increased by 6.5 and 7.7 per cent respectively while volumes on the newly-acquired train operations were up by between 2 and 5.3 per cent since acquisition. All divisions were reported to be trading well in the second half of the year.

3.34. Further financial information is set out in Appendix 3.2.

National Express Limited

3.35. Until 1993 NEL was the core business of NEG and its history is covered in the history of NEG in paragraphs 3.2 to 3.9.

Operations

3.36. NEL has the only national network of scheduled coach services covering England and Wales, providing scheduled services linking 1,100 locations over 200 routes. NEL services all of these routes by contracting-in coaches complete with crews for periods ranging from six months to several years. The number of contractors used is around 40 to 45.

3.37. Services operate under the National Express, Flightlink and Express Shuttle brands. NEL is the promoter of all its services, thereby carrying the commercial risk. It designs the routes and timetables, organizes the coaches, operates and monitors a reservation system, sets and monitors quality standards and sets fare levels. All revenues, except for selling commissions, accrue to NEL and the coach operators are paid an amount per mile, negotiated individually with each operator.

3.38. NEL perceives its network to be important: during the first half of 1996, 28 per cent of passengers transferred between coaches during their journey. Arrivals and departures are therefore synchronized whenever practicable so as to minimize waiting times and bus stations are used wherever they are available.

Financial performance

3.39. Table 3.3 contains a summary of the financial performance of NEL.

TABLE 3.3 NEL: financial performance

| | <i>£'000</i> | | | | |
|---|--------------------------------|-------------|-------------|-------------|-------------|
| | <i>Years ended 31 December</i> | | | | |
| | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> |
| Turnover | 94,288 | 92,342 | 97,883 | 97,773 | 105,976 |
| Operating profit/PBIT | 3,269 | 4,043 | 5,795 | 5,200 | 7,166 |
| Profit before tax | 3,213 | 3,888 | 5,885 | 5,356 | 7,137 |
| Profit after tax | 2,370 | 2,785 | 3,936 | 3,621 | 4,774 |
| Average net operating assets*# | 9,940 | 8,826 | 5,052 | 6,119 | 7,107 |
| Average shareholders' funds* | 5,233 | 6,405 | 7,434 | 9,213 | 8,993 |
| Operating profit/PBIT as a percentage of turnover | 3.5 | 4.4 | 5.9 | 5.3 | 6.8 |
| PBIT as a percentage of average net operating assets | 33 | 46 | 115 | 85 | 101 |
| Profit after tax as a percentage of average shareholders' funds | 45 | 43 | 53 | 39 | 53 |

Source: NEG/MMC analysis.

*Average figures for net operating assets and shareholders' funds are arithmetic means of the year-end figures.

#Net operating assets comprise fixed assets, current assets and current liabilities excluding cash, borrowings, proposed dividends and unrelated investments.

The table shows that NEL's turnover remained essentially flat, and therefore declined in real terms, between 1992 and 1995 but improved in 1996. Margins on turnover have improved steadily, except for a temporary setback in 1995, so that the return after tax on shareholders' funds has held up relatively strongly.

3.40. Summaries of NEL's balance sheets and profit and loss accounts since 1992 are shown in Appendix 3.3.

Scottish Citylink Coaches Limited

History

3.41. Citylink, formerly part of the SBG, was privatized by sale to Saltire, a management and employee buyout vehicle, in 1990. Saltire was itself acquired by NEG in May 1993. That acquisition was the subject of a reference to the MMC,¹ which reported that the merger was not against the public interest.

¹Op cit (see paragraph 2.21).

Operations

3.42. Citylink is based in Glasgow and operates in a substantially similar way to NEL: it does not own coaches but contracts them in from local operators of which there are currently 16, all based in Scotland. However, its contracts with the operators are relatively informal and mostly renewed year by year, unlike those used by NEL. It operates 340 services a day, and over 72 per cent of the mileage operated is on services with stops at less than 24-km intervals, thereby qualifying them as bus services. On some longer routes, such as Glasgow-Inverness (which has 14 weekday services employing 32 vehicles), there may be several operators.

3.43. Citylink services pick up passengers at a combination of coach and bus stations and roadside pick-up points. Citylink has no control over these facilities with the exception of that at Perth which is leased by Strathtay (part of the Yorkshire Traction group) and managed by Citylink. Further details of Citylink's services are set out in Chapter 4.

3.44. During 1996 Citylink carried 2.2 million passengers and had a turnover of £11.3 million. It employs some 90 staff, of whom 65 are at its head office and 25 at retail outlets or working as customer care staff at coach stations.

Financial performance

3.45. Table 3.4 summarizes the financial performance of Citylink.

TABLE 3.4 Citylink: financial performance

| | <i>£'000</i> | | | | |
|---|--------------------------------|---------------------------|-------------|-------------|-------------|
| | <i>Years ended 31 December</i> | | | | |
| | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> |
| Turnover | 15,530 | 12,438 | 11,519 | 11,013 | 11,326 |
| Operating profit | 927 | 407 | 1,808 | 1,709 | 1,677 |
| PBIT | 927 | 454 | 1,808 | 1,709 | 1,677 |
| Profit before tax | 989 | 514 | 1,909 | 1,896 | 1,835 |
| Profit after tax | 951 | 523 | 1,395 | 1,272 | 1,228 |
| Average net operating assets/(liabilities)* | 286 | (365) | (1,181) | (1,501) | (1,541) |
| Average shareholders' funds | 854 | 1,239 | 1,422 | 1,980 | 2,480 |
| Operating profit as a percentage of turnover | 6.0 | 3.3 | 15.7 | 15.5 | 14.8 |
| PBIT as a percentage of turnover | 6.0 | 3.7 | 15.7 | 15.5 | 14.8 |
| PBIT as a percentage of average net operating assets | 325 | Negative operating assets | | | |
| Profit after tax as a percentage of average shareholders' funds | 111 | 42 | 98 | 64 | 50 |

Source: NEG/MMC analysis.

*Net operating assets comprise fixed assets, current assets and current liabilities excluding cash, borrowings, proposed dividends and unrelated investments.

3.46. The most noticeable feature is that Citylink's turnover has declined from £15.5 million in 1992 to £11.3 million in 1996, a reduction of 27 per cent over four years which would be even greater in real terms. NEG told us that the main reason for the decline was the transfer of cross-border services to NEL following NEG's acquisition of Citylink. Operating profit peaked in 1994 and has since fallen. These results suggest that the business is under pressure in terms of both volume and margins, although the average margin on turnover remains over twice that of NEL.

3.47. Summaries of Citylink's balance sheets and profit and loss accounts since 1992 are at Appendix 3.4.

Route profitability

3.48. Table 3.5 shows Citylink's profitability on its major long-distance routes which overlap with those of ScotRail.

TABLE 3.5 **Citylink: route profitability**

| | <i>Route</i> | | | | | | | | |
|---|--|------------------------------|-------------------------------|--------------------------------|---------------------------------|--------------------------|--------------------------------|------------------------------|----------------------------|
| | <i>Glasgow- Edinburgh</i> | <i>Glasgow- Aberdeen</i> | <i>Glasgow- Inverness</i> | <i>Edinburgh- Aberdeen</i> | <i>Edinburgh- Inverness</i> | <i>Glasgow- Oban</i> | <i>Glasgow- Ft William</i> | <i>Inverness- Thurso</i> | <i>Inverness- Kyle</i> |
| <i>1994</i> | | | | | | | | | |
| Total revenue £'000 | [| | | | | | | | |
| Net profit before interest and tax (£'000) | | | | | | | | | |
| Margin on revenue (%) | | | | | | | | | |
| <i>1995</i> | | | | | | | | | |
| Total revenue (£'000) | | | | | | | | | |
| Net profit before interest and tax (£'000) | <i>Figures omitted. See note on page iv.</i> | | | | | | | | |
| Margin on revenue (%) | | | | | | | | | |
| <i>1996</i> | | | | | | | | | |
| Total revenue (£'000) | | | | | | | | | |
| Net profit before interest and tax (£'000) | | | | | | | | | |
| Margin on revenue (%) |] | | | | | | | | |

Source: NEG.

Note: Revenue figures include off-bus revenue (fuel duty rebate, season ticket sales etc) which has been apportioned across the routes. The route profitability figures are arrived at after taking into account direct costs and all company overheads, both of which have been apportioned across these and Citylink's remaining services.

3.49. The table shows a wide range of margins in the latest year, from a loss of [*] per cent of turnover on the Glasgow-Inverness route to a profit of [*] per cent on the Inverness-Kyle and Glasgow-Fort William routes. NEG told us that it was not possible to draw any conclusions about the profitability of the routes between Edinburgh/Glasgow and Aberdeen/Inverness because of the extent of interchanging, particularly at Perth, and the resulting difficulty of allocating revenue accurately between those services. By way of comparison, Citylink's 1996 overall net margin was 14.8 per cent and NEL's was 6.8 per cent.

ScotRail Railways Limited

History

3.50. ScotRail is the principal operator of passenger train services in Scotland and provides through services to Newcastle via Dumfries and Carlisle. It also operates Anglo-Scottish sleeper services.

3.51. Under public ownership, management of the Scottish operations lay with the Scottish Region of BRB which had responsibility for operations, railway infrastructure and rolling stock. The ScotRail name was adopted in 1983. Since then, mostly in conjunction with SPTE and local authorities, many stations have been improved, 49 stations opened or reopened and six lines reopened. All trains except sleepers have been upgraded to multiple units and electrification has been extended in Ayrshire and between North Berwick and Edinburgh.

3.52. On 1 April 1994, in preparation for privatization, ScotRail was created as a division of BRB and responsibility for most of the infrastructure and rolling stock was passed to Railtrack and the ROSCOs respectively. In March 1995 the operation and management of Anglo-Scottish sleeper services and certain services in north-eastern England were transferred to ScotRail. In December 1995 the ScotRail business and most of its assets and liabilities were vested in ScotRail Railways Limited, a wholly-owned subsidiary of BRB. The company was acquired by NEG on 21 February 1997 (see paragraph 3.65).

Operations

3.53. ScotRail services cover 3,030 route km and call at 352 stations, of which 327 are leased to and operated by ScotRail. The balance consists of three, Edinburgh Waverley, Glasgow Central and London Euston, which are owned and operated by Railtrack; 21 which are leased to and operated by other TOCs in England; and the independently-operated Prestwick International. ScotRail also leases Lockerbie station at which its own services do not call but those of other TOCs do. A map of ScotRail's routes is at Figure 4.1. Some 1,220 route km are single track, covering much of the more remote routes to the north and west of Glasgow, Perth and Aberdeen. Routes in England cover some 600 km. The number of passenger journeys in 1996/97 was around 53 million.

3.54. ScotRail's leased rolling stock consists primarily of 109 electric multiple unit (EMU) and 126 diesel multiple unit (DMU) train sets, in each case about 20 more than it needs for its current daily operation of some 1,900 weekday services. Each set is of typically two or three vehicles which can be coupled to form longer trains. ScotRail also has 79 sleeper vehicles which are hauled by locomotives hired from other TOCs.

3.55. Many of ScotRail's local services in the Glasgow area are operated under contract for SPTE which sets the fares, retains all revenues and carries the commercial risk. Almost all the EMUs and about one-fifth of the DMUs are in SPTE livery. SPTE services account for some two-fifths of ScotRail's passenger km and three-quarters of its passenger journeys.

3.56. ScotRail leases seven train depots from Railtrack, four of which are equipped to carry out both running and heavy maintenance. Under the terms of its rolling stock leases, ScotRail is responsible for

* Figures omitted. See note on page iv.

running maintenance but the heavy maintenance is the responsibility of the ROSCOs. Some work is done under contract to ROSCOs and other TOCs.

3.57. As at 31 March 1997 ScotRail employed 3,768 staff including 851 drivers, 392 conductors and 647 who were involved in train maintenance and cleaning. Half of the total were attributable to the provision of SPTE services.

Financial performance

3.58. Table 3.6 summarizes ScotRail's financial performance historically in so far as information is available.

TABLE 3.6 ScotRail: financial performance summary

| | <i>£ million</i> | | | | |
|---|-----------------------------|-------------|----------------|----------------|--------------|
| | <i>Years ended 31 March</i> | | | | |
| | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997*</i> |
| Revenue: | | | | | |
| Inter-urban, urban and rural services | 53.1 | 53.8 | 50.3 | 53.7 | [|
| Sleeper services | # | # | # | 13.2 | |
| OPRAF incentive scheme | N/A | N/A | N/A | N/A | |
| SPTE incentive scheme | N/A | N/A | N/A | N/A | |
| Other~ | # | # | 21.6 | 22.3 | |
| Total | <u>53.1</u> | <u>53.8</u> | <u>71.9</u> | <u>89.2</u> | |
| Costs: | | | | | |
| Operating costs | # | # | (125.3) | (140.7) | |
| Railtrack charges (including performance regime) | # | # | £ (150.6) | (173.5) | |
| Rolling stock lease charges | # | # | (48.0) | (52.3) | |
| Total | <u>#</u> | <u>#</u> | <u>(323.9)</u> | <u>(366.5)</u> | |
| Operating loss | # | # | (252.0) | (277.3) | |
| Bonds, interest receivable and exceptional items | # | # | 0.0 | 0.0 | |
| Loss before financial support | # | # | (252.0) | (277.3) |] |
| Financial support [£] | # | # | # | # | 285.1 |
| Profit/(loss) before tax | # | # | (252.0) | (277.3) | [|
| Tax | # | # | 0.0 | 0.0 | |
| Profit/(loss) after tax | # | # | <u>(252.0)</u> | <u>(277.3)</u> | |
| | | | £ | | |
| Profit before tax as percentage of turnover (including financial support) | | | | | |
| Fares collected on behalf of SPTE | # | # | 35.9 | 38.0 |] |

Source: OPRAF Indicative Bid Invitation and NEG.

*Draft.

#Not available.

~ Includes income from train maintenance, car parking and retailing.

£ Represents the total of receipts from OPRAF and SPTE.

£ The amount of financial support shown above differs from the figure of £292.3 million referred to in para-graph 3.62 as having been claimed by BRB. This is a consequence of negotiations over the completion accounts which were still continuing as we reported.

Note: Revenue from SPTE services has been excluded from ScotRail's income in the above table because it is for SPTE's account.

3.59. Historical information is incomplete, primarily because until 31 March 1994 ScotRail was a vertically integrated profit centre of BRB's Regional Railways division, operating both rolling stock and infrastructure as well as trains, and there was no statutory audit requirement applicable to individual operating divisions.

3.60. Sleeper service revenue fell in 1996/97 because Motorail and seated accommodation services were withdrawn.

3.61. Total revenue figures exclude revenue collected on behalf of SPTE because that revenue is not part of ScotRail's commercial operations.

3.62. NEG told us that the annual average amount of financial support which it would receive under the franchise agreement was £237.5 million in constant 1997 prices, about £55 million less than the subsidy claimed by BRB for the year ended 31 March 1997 of £292.3 million (since revised by NEG to £285.1 million). The amount declines year by year over the life of the franchise: in its first year of ownership by NEG ScotRail is contracted to receive £280.1 million and in the last year £202.5 million—a reduction of about 31 per cent from the final BRB claim. The SPTE element of subsidy remains constant at 54.5 per cent. throughout the term of the franchise. These figures are at February 1997 values and are to be adjusted for inflation in accordance with movements in the RPI. The financial support claim by BRB for 1996/97 included £11.3 million of administered profit and an SPTE element of £155.8 million (which was partly offset by SPTE fares collected of £41.3 million).

3.63. ScotRail's balance sheets as at 31 March 1996 and as estimated at 31 March 1997 are set out in Appendix 3.5. The estimated 1997 balance sheet was the starting point for finalizing the completion accounts following the acquisition by NEG.

Route profitability

3.64. NEG told us that route profitability reports were not routinely prepared, mainly because the largest component of costs was the Railtrack charge which was not disaggregated by route. Furthermore, routes were interrelated so that a cost-allocation exercise would be complex and of doubtful value. Assessment of the impact of new routes was undertaken using identifiable income and costs in specific exercises.

The merger situation

Award of the franchise

3.65. On 25 April 1996 the Franchising Director issued an invitation to potential bidders to apply for pre-qualification for the right to provide the passenger rail services of ScotRail. On 18 September 1996 pre-qualifiers were provided with an information memorandum giving details of the business and invited to submit non-binding indicative bids to provide the services for seven years under a franchise agreement. On 25 October 1996 NEG submitted an indicative bid. It was shortlisted [*Details omitted. See note on page iv*] and on 21 January 1997 submitted its final bid. On 10 February 1997 NEG was informed that it was the preferred bidder. Final due diligence then took place, the franchise agreement was entered into on 21 February 1997 and on the same date NEG acquired the entire issued share capital of ScotRail for its net asset value of £1. NEG assumed responsibility for the operation of ScotRail services on 31 March 1997.

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

TABLE 3.7 ScotRail: net present cost of financial support in bids received for the franchise

*£m,
1997 prices*

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

Source: OPRAF.

3.67. OPRAF told us that in evaluating the bids it had regard, first, to the level of subsidy required and, secondly, to the level of services promised by the bidder. NEG's bid required the lowest subsidy [*] while guaranteeing a high level of services.

Rights and obligations arising from the franchise

3.68. An overview of the rail industry and the privatization process is set out at Appendix 3.6. Taking on a franchise involves four significant financial commitments and an operational commitment:

- to pay to, or receive from, the Franchising Director annual sums in exchange for the right to operate the services as specified;
- to lease the majority of rolling stock requirements from one or more of three ROSCOs;
- to pay track access charges to Railtrack, some 90 per cent of which are fixed whilst the balance varies with train mileage;
- to lease certain stations and depots from Railtrack; and
- to comply with the PSR which establishes a minimum service framework specifying service characteristics including frequency of trains, stations to be served, maximum journey times, first and last trains, weekend services, through services, and load factors and/or peak train capacity.

3.69. There are several other requirements of a franchise. A TOC's ability to increase certain ticket prices, primarily Saver and weekly season tickets, is restricted. Such restrictions are not universally applied to all TOCs but are tailored to suit each TOC's business environment. NEG told us that some 33 per cent of ScotRail's revenue, excluding SPTE services, was currently subject to fares regulation. Each franchisee is required to produce its own Passenger's Charter which must be at least as good as that previously provided by BRB: NEG told us that in most cases franchisees had improved on the BRB version by committing themselves to higher standards of punctuality, reliability or passenger compensation for poor service.

3.70. In addition, ScotRail's franchise agreement commits it, *inter alia*, to:

- (a) operate at least current levels of annual train mileage throughout the franchise term;
- (b) run an additional 80,000 train miles (129,000 train km) a year to be operated during off-peak periods on SPTE services, to SPTE's specification;
- (c) supply a 15-minute frequency from Monday to Saturday on the Edinburgh-Falkirk-Glasgow service from May 2000, and to invest in nine new three-car DMUs to provide this increase in frequency (current frequency is 30 minutes);
- (d) invest £1 million in stations in order to improve security, accessibility and station standards;
- (e) achieve enhanced standards on Anglo-Scottish sleeper services including refurbishment of rolling stock, provision of single-berth standard-class accommodation and introduction of high-quality airline-style reclining seat accommodation;
- (f) double the off-peak frequency of service to half-hourly on the Fife Circle route for at least two years from 1998;
- (g) invest in 38 new EMUs to replace old Class 303 and 305 units on SPTE services by 2000;
- (h) refurbish ScotRail's Class 150 and 156 diesel unit trains;

*Details omitted. See note on page iv.

- (i) use all reasonable endeavours to replace one-half of the existing Class 101 and 117 vehicles as soon as reasonably practical;
- (j) contribute to feasibility studies totalling £135,000 jointly with Railtrack or SPTE into new or improved routes and facilities (for example, a Glasgow Airport link, park-and-ride facilities, Edinburgh-Glasgow electrification);
- (k) make commitments to a number of integrated transport schemes and trials, including:
 - a coach feeder service between Ullapool and Inverness (for a minimum of two years);
 - a bus feeder service as agreed with SPTE, or other equivalent benefit, within a predetermined prescribed cost (also for a minimum of two years);
 - promote SPTE park-and-ride facilities; and
 - provide through-ticketing between coach and rail services, particularly in the Highlands; and
- (l) improve Passenger's Charter standards and apply the new Charter to SPTE services. ScotRail is committed by its Passenger's Charter to raise the punctuality standard from 90 to 92 per cent on Express, Highland and South West services by September 1997 and to increase the reliability standard (proportion of scheduled services run) from 99 to 99.5 per cent on Express, Highland and ScotRail Central services, also by September 1997. The new Charter will apply to SPTE services with a punctuality standard of 94 per cent and a reliability standard of 99 per cent with effect from September 1997.

3.71. NEG is required to maintain ScotRail as a discrete business so that it can readily be transferred to another franchisee if necessary.

Subsidies and incentives

3.72. Under the franchise agreement NEG will receive the annual subsidy payments referred to in paragraph 3.62. There are also performance incentive arrangements between TOCs and other parties. That with OPRAF is based on punctuality measured against benchmarks, performance above or below which results in payments to or by the TOC, and on timetable changes which result in payment by the TOC. In ScotRail's case, a similar arrangement exists with SPTE. The arrangement with Railtrack is also based on benchmarks, except that responsibility for late trains is determined whenever practicable between Railtrack and a TOC. If Railtrack's benchmark exceeds the average train lateness for which it is responsible, it collects an incentive payment from the TOC; if the reverse occurs, the TOC collects from Railtrack.

3.73. Where PTE services are operated, a Service Quality Incentive Regime (SQUIRE) applies whereby payments are made to or by the franchisee depending on performance in delivering a wide range of quality measures such as hours of station staffing, station cleanliness, passenger information provision and security against benchmark levels. In addition, penalties can be levied where identified faults are not rectified within a certain time period.

3.74. Where revenue is passed to a PTE, as in the case of SPTE, a Ticket Inspection Incentive Regime (TIRE) also applies which is designed to encourage franchisees to be diligent in reducing ticketless travel on PTE-sponsored services where the revenue is passed directly to the PTE.

3.75. Such incentive schemes are applied by OPRAF where the Franchising Director believes the market is too weak to motivate the relevant franchise operator to respond adequately to customer demands for a punctual and reliable train service and/or where there is little or no incentive to collect fares on behalf of a PTE. All the above schemes apply to ScotRail.

Competition issues

3.76. The invitation to tender advised interested parties to give consideration to the possible application of UK and EC competition law to their tender. NEG said it had satisfied itself that the transaction did not constitute a concentration with an EC or EFTA dimension under the EC Merger Regulation (Council Regulation 4064/89) because each of NEG and ScotRail achieved more than two-thirds of its EFTA/EC turnover in the UK.

3.77. Under section 66(3) of the Railways Act, the acquisition of a passenger rail franchise is treated as the acquisition of control of an enterprise for the purposes of the Fair Trading Act. The estimated gross assets transferred to NEG at completion were £[*] million and NEG told us that the final figure would not exceed £[*] million. The transaction was not therefore a merger situation qualifying for investigation under section 64(1)(b) of the Act. The application of the share of supply test under section 64(1)(a) of the Act is discussed in Chapter 2.

3.78. On 17 January 1997, following earlier discussions, the Franchising Director wrote to NEG confirming that he would require to be satisfied that any competition issues arising from NEG's ownership of other transport operations had been resolved and would not delay either signing or completion of the franchise agreement. NEG's bid should therefore set out how this had been achieved. [

Details omitted. See note on page iv.

]

3.79. NEG intimated to OPRAF its willingness to give [*] undertakings, in the expectation that they would be broadly in line with those recommended by the MMC in their MML report which had been published in December 1996. These were:

- (a) not to increase coach fares above the increase in the RPI;
- (b) to make no restrictive changes to the terms and conditions applicable to coach tickets; not to introduce any quota system for coach tickets; and to maintain the current availability of different categories of tickets;
- (c) to provide adequate capacity on the coach services to meet current demand and any increase in demand; in particular to provide no less than the current frequencies on the services unless there was a significant reduction in passenger numbers and to provide sufficient duplicate services to meet demand; and for this purpose to agree with the DGFT appropriate formulae for seat occupancy and journey availability;
- (d) to provide a quality of service at least equal to the standards on other parts of the NEL network; and
- (e) to agree with the DGFT arrangements for the monitoring of performance against the foregoing undertakings.

3.80. [*Details omitted. See note on page iv.*

] NEG's views are more fully described in Chapter

7.

3.81. The DGFT, however, subsequently recommended to the Secretary of State that she refer the acquisition to the MMC if NEG did not give undertakings, in lieu of a reference, to divest Citylink. The Secretary of State announced on 22 May 1997 that, after carefully considering the DGFT's advice, she had concluded that the merger should be referred immediately to the MMC for a thorough investigation because it raised competition concerns in the market for the supply of public transport passenger services in Scotland.

*Details omitted. See note on page iv.