

## Enterprise Act: request for a variation of undertakings given by FirstGroup plc

The OFT's advice to the CC under section 92 (2) given on 12 December 2005. Full text of advice published 3 February 2006.

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**Please note that square brackets indicate figures or text which have been deleted or replaced with a range at the request of the parties for reasons of commercial confidentiality.**

In this submission I advise under section 92(2) of the Enterprise Act 2002 on a request from FirstGroup plc (First) for the variation of certain aspects and further clarification of the undertakings it signed in October 2004.

### **TIMING**

**Routine.** The second six-monthly review by the monitor was due to start on 15 November, covering the period 16 April 2005 to 15 October 2005. An invitation to comment was issued on Monday, 26 September. No comments have been received. Although there are no statutory or administrative timetables in force for reviews of undertakings, it has been suggested that the usual 40-day administrative timetable should apply, which would give the deadline for advice as 17 November 2005, which it has not been possible to meet.

### **BACKGROUND**

FirstGroup's proposed acquisition of the ScotRail franchise was referred to the Competition Commission (CC) on 13 January 2004, under section 33 (1) of the Enterprise Act 2002 (the Act).

The effect of the merger has been to combine the operations of the largest operator of rail services in Scotland with those of the leading operator of bus services in Scotland and in Glasgow in particular. The CC found a number of routes where either it would be in First's interests to alter the routes to take advantage of the overlaps or where there would be no effective competition. The CC concluded that existing undertakings in

relation to First's bus operations would not be sufficient to prevent adverse effects which may be expected to result from the merger, and consequently found that the proposed acquisition may, therefore, be expected to result in a substantial lessening of competition on overlap flows on the identified bus routes.

In order to remedy the identified adverse effects of the merger the CC requested a number of behavioural undertakings which cover, among other things, fares and levels of service on the identified routes, multimodal tickets and the display of other bus operator's services at rail stations. The CC negotiated these undertakings with FirstGroup and accepted them on 15 October 2004.

### **FIRSTGROUP'S REQUEST FOR VARIATION**

Following the implementation of the undertakings and in advance of the Monitor's first review, First discussed several issues of clarification with the CC. First had identified certain routes in Glasgow, which were subject to the fare limit in the undertakings for which there were few or no comparators and raised this as an issue with the CC. After discussions between First and the CC, CC officials reached the view that any correction to the undertakings would need to be considered as a variation rather than as a clarification, and it was left to First to submit a request in due course. First also queried with the CC at that time the application of the effective competition test as set out in the undertakings.

Subsequent to the first review First has identified additional issues which require either variation or clarification. The matters that First are now requesting a variation include:

- the Fare Limit and Base Fare Groups (where there are insufficient comparators)
- the definitions of the Glasgow and Edinburgh Regions that are used in the undertakings to ensure consistency with similar definitions used in pre-existing undertakings given in the FirstGroup / SB Holdings merger and
- a change to the capacity benchmark for Edinburgh routes X24 and X26, to enable First to use single-deck buses rather than the double-deck buses currently stipulated.

The two areas that First are seeking the CC's clarification are:

- the effective competition test and
- the time periods during each day when the undertakings apply to First's bus services identified as Controlled Routes.

## REQUESTS FOR VARIATION

### The Fare Limit and Base Fare Groups

Paragraph 6.2 of the undertakings states: 'The Bus Subsidiary shall ensure that, throughout the lifetime of the undertakings, each Restricted Fare<sup>1</sup> is no higher than the relevant Fare Limit<sup>2</sup>'. Each 'restricted' fare value will have a Fare Limit. In order to be able to calculate the Fare Limit, First is obliged to identify, for each fare value that is 'restricted', a basket of 'comparator fares', consisting of all fares of the same value as the 'restricted' fare value<sup>3</sup> on non-tendered non-controlled routes (or Comparator Routes) as at May 2004. These 'comparator fare baskets' are termed Base Fare Groups in the undertakings.

The request for variation applies in respect of two 'restricted' fare values in the Glasgow Region<sup>4</sup> for which there are an insufficient number of comparator fares. These are the £1.85 adult fare (for which there are no comparator fares at all) and the £1.65 adult fare (for which there are only five comparator fares).

The definition of 'Fare Limit' currently in the undertakings states:

'The level of fare which is equal to or exceeded by the fare charged on at least 75 per cent of the fares in number in the applicable **Base Fare Group**'

First has suggested an extended definition, which is reproduced below with the OFT's suggested amendment in bold:

'.....except where the number of fares in a Base Fare Group is 15 or less when the Fare Limit will be the lesser of:

- a) the maximum fare value for a fare in that Base Fare Group; or
- b) the sum of the weighted average fare increase for each Base Fare Group in that region **since 2 May 2004 or the date of the last fare increase (which ever is the later)**.

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<sup>1</sup> Restricted Fare is defined as, 'A fare which is available for use on a Problem Overlap during a Problem Time of Day'.

<sup>2</sup> Fare Limit is defined as, 'The level of fare which is equal to or exceeded by the fare charged on at least 75 per cent of the fares in number in the applicable Base Fare Group'.

<sup>3</sup> For example, for a 70p 'restricted' fare, the set of comparator fares will consist of all fares on non-tendered non-controlled routes which were 70p in May 2004.

<sup>4</sup> 'The Glasgow region' means the unitary authority areas of the City of Glasgow, North Lanarkshire, South Lanarkshire, East Dunbartonshire, West Dunbartonshire, Argyll and Bute, Renfrewshire and East Renfrewshire.

The weighted average fare increase for a Base Fare Group is the average fare increase for that Base Fare Group multiplied by the number of fares in the Base Fare Group and divided by the total number of fares in all the Base Fare Groups in that region'.

First has proposed a figure of 15 comparator fares for the cut off point to which the revised definition would apply. It is First's opinion that this is a reasonable cut off point, [ ]. Since the OFT does not have a list of all the base fare Groups and the number of fares within them it is difficult to judge whether 15 is a reasonable number for the intended purpose, but notes that of those base fare groups that the OFT is aware of the number of fares in a group range between 26 and 5,000 plus. The CC may therefore wish to consider whether 15 is a reasonable cut off point to apply the fare limit as set out above.

The either / or method of calculating the Fare Limit is as discussed by the CC and First earlier this year. In effect the £1.85 adult fare, which has no comparator fares would be subject to the method at (b) above while the £1.65 adult fare, would be subject to a fare limit that is the lesser of the two methods. It should be noted that this change to the definition of Fare Limits is not affected by any changes that may be adopted as a result of First's second matter for variation.

Should the CC approve the proposed variation set out above the OFT considers that a variation will also be required to the definition of 'Base Fare Group' since this cross refers to the definition of Fare Limit. The OFT suggests that the variation to the wordings of the definition of a 'Base Fare Group' should take account of any revised method adopted by the CC of calculating the Fare Limit for those routes with either zero or only five comparator fares.

### **Definition of the Glasgow and Edinburgh Regions**

As well as the fare limits imposed by the ScotRail undertakings, First is also subject to undertakings which concern the level of fare increases it can implement in parts of Scotland (including Glasgow and the wider Edinburgh area) as a result of the behavioural undertakings it gave (the SBH undertakings) following the MMC's report into First's acquisition of SB Holdings.<sup>5</sup>

The CC noted in the ScotRail report<sup>6</sup> that that the pre-existing SBH undertakings would coexist with the new undertakings. It is First's belief that as the CC noted that the two sets of undertakings need to coexist, it would not want the two sets of undertakings together to be more restrictive than they would be individually.

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<sup>5</sup> A report into the acquisition by FirstGroup (formally FirstBus) plc of SB Holdings - January 1997

<sup>6</sup> Paragraph 6.19

In the preparation for the first review First noted that in some cases this had occurred, due to the fact that in some cases the basket of fares used to constrain fare increases on certain routes were different under the two sets of undertakings. This is due to the regions in the undertakings (Edinburgh 1 Region and Edinburgh 2 Region) being made up of different unitary authorities from the corresponding regions under the SBH undertakings (the Midland Bluebird and Lowland operating area, which for the purpose of the fare undertaking is split into Midland Bluebird and Lowland), resulting in a mismatch between the two sets of undertakings. See below:

<b>The undertakings</b>	<b>SBH undertakings</b>
Edinburgh 1 Region: City of Edinburgh <b>West Lothian</b> Midlothian East Lothian	Lowland area:      Midlothian East Lothian Scottish Borders
Edinburgh 2 Region: Stirling Clackmannanshire Falkirk	Midland Bluebird area: Stirling Clackmannanshire Falkirk <b>West Lothian</b>
For both Regions, it is only the fares on that part of the route that operates within the area that are included within the basket not (if relevant) that part of the route that operates outside the area.	For both areas, it is the fares on any route operated from a depot in the area that are included within the basket, even if the route operates outside the area.

Under the ScotRail undertakings, the Fare Limit is the level of fare which is equal to or exceeded by the fare charged on at least 75 per cent of the fares in the applicable fare basket. For example, [ ] First is unable to increase its fares on 'controlled' routes in the City of Edinburgh, East Lothian or Midlothian under the terms of the undertakings although it would be permitted to do so under the SBH undertakings.

To resolve this issue First has suggested that West Lothian should be moved from the Edinburgh 1 Region to the Edinburgh 2 Region and the definitions changed to reflect the definitions used in the SBH undertakings. This would bring the fare baskets used in the ScotRail undertakings into alignment with the fare baskets used in the pre-existing SBH undertakings. An alternative option might be to move West Lothian from the Midland Region to the Lowland Regions for the SBH undertakings; however the SBH undertakings are not the subject of the current request for variation.

Since this proposal affects the Edinburgh Regions rather than the Glasgow Region the variation concerning Base Fare Groups outlined above does not apply. However, First has provided tables that show that should this change be accepted the number of comparator fares in the revised Base Fare Groups will exceed [ ] in every case. The revised fare baskets, therefore, would still have sufficient comparator fares to achieve the objective of the ScotRail undertakings, i.e. to prevent First from customising fares on bus routes which overlapped with rail so as to encourage bus passengers on these routes to switch to the rail service.

First's proposed changes to the definition of the Edinburgh regions are given below. First has also proposed changes for the Glasgow Region to ensure that this is consistent and dovetails with the definitions for the Edinburgh regions:

*'Proposed wording varying the definition of Edinburgh 1 Region and Edinburgh 2 Region*

**Edinburgh 1 Region:**

The region comprising the unitary authority areas of the City of Edinburgh, Midlothian and East Lothian and a journey or any bus service within the Edinburgh 1 Region means any journey or bus service that operates out of a depot in the Edinburgh 1 Region regardless of whether the journey or bus service continues out of the Edinburgh 1 Region.

**Edinburgh 2 Region:**

The region comprising the unitary authority areas of the City of Stirling, Clackmannanshire, Falkirk and West Lothian and a journey or any bus service within the Edinburgh 2 Region means any journey or bus service that operates out of a depot in the Edinburgh 2 Region regardless of whether the journey or bus service continues out of the Edinburgh 2 Region.

**Glasgow Region:**

The region comprising the unitary authority areas of the City of Glasgow, North Lanarkshire, South Lanarkshire, East Dunbartonshire, West Dunbartonshire, Argyll and Bute, Renfrewshire, and East Renfrewshire and a journey or any bus service within the Glasgow Region means any journey or bus service that operates out of a depot in the Glasgow Region regardless of whether the journey or bus service continues out of the Glasgow Region.'

**Capacity benchmark for Edinburgh routes X24 and X26.**

Yet another undertaking restricted First's ability to reduce capacity on 'controlled routes'. This requirement does not apply if the OFT is satisfied that for safety or for technical reasons beyond First's control the capacity is reduced, and it is also open to First to supply the OFT with a reasoned request for the OFT to review the benchmark

percentages calculated as per Annex C of the undertakings. While the undertakings allow the OFT to review and revise the benchmark, it seems appropriate, given First's request for variation of the other matters, to advise the CC on this request for a variation of the benchmark figure.

[ ]

First has stated that the background [ ] was a need to reschedule service 43 from the Livingston depot (from which services X24 and X26 operate) to the Linlithgow depot due to driver shortages at Livingston. Passenger demand on service 43 requires double-deck buses and Linlithgow had insufficient double-deck vehicles to operate the additional service as well as the existing services. Double-deck vehicles were consequently transferred from Livingston to Linlithgow to meet service 43's requirements. This resulted in there being insufficient double-deck vehicles to cover services X24 and X26, as well as the other services out of Livingston depot.

In support for its request to revise the capacity bench mark for services X24 and X26, First supplied passenger loadings for the two services for May 2004 and July 2005. This data shows that at the benchmark date – in May 2004 - when double-deck vehicles were being used, the average loading was [ ] for X24 and [ ] for X26. The maximum number of passengers on the services was [ ] and [ ] respectively. In July 2005, [ ]. The capacity of First's double-deck vehicles is 79. First have proposed that a weighted average bus capacity of [ ] would be a more realistic capacity benchmark to apply to these two services. This appears acceptable given the passenger loading data supplied.

Services X24 and X26 are both express services to Edinburgh with limited stops; operating one return journey a day. The average and maximum loading data for the two months provided [ ]. The data provided by First suggests, therefore, that none of the journeys in either May 2004 or July 2005 actually required the use of double-deck vehicles [ ].

### **Requests for clarification**

As mentioned above, there are two areas where First are seeking clarification from the CC. These two matters are the application of the 'effective competition test' and the application of the undertakings in particular time periods. Since the OFT was not involved in the negotiation of the undertakings with First it is not possible to advise on First's requests for clarification. The OFT has therefore simply set out First's requests for clarification below:

## **Effective Competition Test**

As early as May 2005, First had expressed concern to the CC about the application of the effective competition test as set out in the undertakings. The basis of their concern was that the outcome of the effective competition test in the undertakings was different from the list of possible and controlled routes contained in the undertakings and the final report. The CC commented that it had acknowledged the possibility that the mechanistic approach of the undertakings may well produce some slightly different results to the more specific analysis carried out for the report. The CC had suggested that a check could be done to make sure that they were not anomalous for reasons other than the shift from specific to mechanistic.

The same point arose following the first review where, as a result of the Monitor applying the effective competition test contained in the undertakings, a small number of routes moved from being 'possible' to 'controlled' as set out in the table below, which has been based on tables in the Monitor's final report:

<b>Service No.</b>	<b>In Hours reclassification</b>	<b>Out of Hours reclassification</b>
<b>Part 1 of Annex F</b>		
[ ]	[ ]	[ ]
[ ]	[ ]	[ ]
[ ]	[ ]	[ ]
[ ]	[ ]	[ ]
[ ]	[ ]	[ ]
[ ]	[ ]	[ ]
<b>Part II of Annex F</b>		
[ ]	[ ]	[ ]
[ ]	[ ]	[ ]

First argues that since there has been no material change to First's frequency or the frequency of its competitors on the routes identified by the Monitor as requiring reclassification it has doubts whether the effective competition test set out in the undertakings, and applied by the Monitor, is the same test applied by the CC during the inquiry, and if not then the Undertaking test would be inconsistent with the final report, which First considered a breach of section 41(3) of the Enterprise Act, which stipulates that when deciding on remedies the CC has a duty to be 'consistent with its decision included in its report'. It is First's belief that the undertakings can only restrict its behaviour on routes where there is an SLC following the application of the same effective competition test carried out by the CC during the inquiry, which resulted in the table of routes at Annex G of the report and repeated at Annex F of the undertakings.

#### **Clarification of the application of the undertakings**

The CC concluded that the adverse effects of the transaction would be on certain overlap routes where First both operated buses and trains. Where it would be profitable for First to switch bus passengers to rail by increasing fares and/or reducing frequency, or rerouting services, and /or by reconfiguring routes.

For those time periods when First does not operate an overlapping train service, there is no possibility of an SLC since First does not have the incentive to switch bus passengers to rail. It follows that the undertakings should not apply to those time periods. However, the undertakings do not expressly say so and First is asking for clarification that the undertakings do not apply to 'controlled' bus services for the

portion of the 'in hours' or 'out of hours' period when an overlapping rail service does not operate.

First's point seems logical, the only comment we would want to make is to what extent, if First's point is correct, this clarification would impact on the application of the 'effective competition test'.

### **THIRD PARTY VIEWS**

An invitation to comment was issued on Monday, 26 September. No comments have been received. The OFT did not contact any third parties direct in view of the nature of the variations being requested.

### **CONCLUSION AND RECOMMENDATION**

The OFT accepts that in this case its advice is relatively limited. This is because these undertakings were negotiated only comparatively recently without any significant input by the OFT. Accordingly the CC's understanding of the underlying intent and planned effect of the undertakings is likely to be substantially greater than the OFT's. Since the proposed variations largely aim to address oversights at the time of the negotiations and do not result from a change in the competitive circumstances that the CC investigated the CC is, perhaps, in a position to be able to assess the appropriateness of the proposed variations without the need, in this case, of significant input from the OFT.

It would appear that the absence of comparator fares for the two fares identified by First is not as a result of a change in circumstances. Indeed it is probable that this was the position at the time that the undertakings were agreed in October 2004. However, as First's request for a variation of the fare limit and base groups merely corrects an oversight which is insignificant relative to the scope of the undertakings as a whole it seems appropriate to recommend acceptance of the proposed variation.

The second matter for variation again does not appear to have been triggered by a change of circumstances. Instead it appears to have been a point that was missed by FirstGroup, at least, during the original negotiations. However, since the CC in its final report commented at paragraph 6.19 that the two sets of undertakings were intended to address problems of a 'different scope and a different nature', it is not clear whether the outcome, as described by FirstGroup above and in its request for a variation, was unintentional on the part of the CC and therefore requiring the remedy as proposed by FirstGroup. Whilst it would seem logical to have the same areas in the definitions for the Glasgow and Edinburgh Regions for both sets of undertakings, only the CC can say whether the mismatch in definitions was intentional or not.

On the third matter, the capacity bench mark, while open to the OFT to give consent, it seems most practical, in view of the other matters being considered, to include a request for consent within this submission for variation. The average and maximum loading data for July 2005 supplied by First is similar to that used to set the bench mark in May 2004, and suggests that the bench mark may have been set too high in the first instance. The data provided by First in support of its request suggests that none of the journeys in either May 2004 or July 2005 actually required the use of a double-deck vehicle.

All three requests for variation appear to be based on logical reasoning and, subject to the caveat in regard to the second matter for variation, the OFT recommends that the CC should vary the undertakings as requested by First.