Terms of reference and conduct of the inquiry

Terms of reference

1. On 28 May 2009 the OFT sent the following reference to the CC:

   1. In exercise of its duty under section 22(1) of the Enterprise Act 2002 (“the Act”) to make a reference to the Competition Commission (“the CC”) in relation to a completed merger the Office of Fair Trading (“the OFT”) believes that it is or may be the case that—

      (a) A relevant merger situation has been created in that:

         (i) enterprises carried on by or under the control of **Stagecoach Group Plc** have ceased to be distinct from enterprises carried on by or under the control of **Preston Bus Limited and**;

         (ii) as a result, the condition specified in section 23(4) of the Act will prevail, or will prevail to a greater extent, with respect to the supply of commercial local bus services in Preston, Lancashire; and

      (b) the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the UK for goods or services, including the supply of commercial local bus services in Preston, Lancashire.

   2. Therefore, in exercise of its duty under section 22(1) of the Act, the OFT hereby refers to the CC, for investigation and report within a period ending on 12 November 2009, on the following questions in accordance with section 35(1) of the Act—

      (a) whether a relevant merger situation has been created; and

      (b) if so, whether the creation of that situation has resulted or may be expected to result in a substantial lessening of competition within any market or markets in the UK for goods or services.

   3. In relation to the question whether a relevant merger situation will be created, the CC shall exclude from consideration one of the subsections (1) and (2) of section 23 of the Act if they find that the other is satisfied.

   (signed) **Amelia Fletcher**
   Senior Director, Mergers, Office of Fair Trading
   28 May 2009

Conduct of the inquiry

2. Notices inviting interested parties to submit evidence to the CC were placed in the following publications: *Lancashire Evening Post, Lancashire Telegraph* and *Bus and*

Coach Professional. We also posted an invitation to express views to us on the CC website[1] together with an administrative timetable for the inquiry.

3. We sought evidence from competitors, customers, regulators and possible bidders for PBL. We held staff hearings with a number of parties, some by telephone. Evidence submitted, and non-confidential versions of summaries of hearings, were published on the CC website. Following the publication of the provisional findings and the notice of possible remedies, we sought views from third parties and held staff telephone conversations with a number of them.

4. Members of the group, accompanied by staff, visited the operations of Stagecoach and PBL in Preston.

5. We received written evidence from Stagecoach and held two hearings with it. Non-confidential versions of its submissions were placed on the CC website.

6. In the course of this inquiry, we sent to Stagecoach: a statement of issues; a number of working papers; the provisional findings; a notice of possible remedies; and a working paper on remedies.

7. On 2 June 2009, we adopted the initial undertakings agreed by the OFT with Stagecoach for the purpose of preventing pre-emptive action. The CC had ongoing concerns regarding the integration of the merged businesses which led to directions being issued to Stagecoach on 15 June pursuant to the undertakings to appoint a Monitoring Trustee. On 6 July directions were issued to Stagecoach pursuant to the undertakings to make changes to the management arrangements for PBL and Stagecoach. On 14 October directions were issued to Stagecoach to appoint a Hold Separate Manager for PBL. Copies of these directions have been placed on the CC website.

8. A copy of this final report has been placed on the CC website.

[1]www.competition-commission.org.uk.

Financial performance of Stagecoach Preston

Financial performance to April 2007

1. We asked Stagecoach whether it had benchmarked the results of its Preston operations against those of other units within Stagecoach Northwest and those of Stagecoach in other regions of the UK, and to provide the results of any such benchmarking exercise undertaken since May 2006. In response Stagecoach gave us two reports for each of the three financial years to 30 April 2007, 2008 and 2009.

2. The first of these reports was the Northwest Summary which set out the results for each of the seven depots in the region. Part of this report is summarized in Table 1.

TABLE 1 **Stagecoach: performance of Stagecoach Northwest depots, year to April 2007**

Depot	*Revenues £'000*	*Op profit £'000*	*Op margin %*	*Pax* '000*	*Miles '000*	*Hours '000*	*PVR**	*Staff*	*Rev/ mile £*	*Rev/ hour £*	*Rev/ PVR £'000*	*Op pft/ PVR £'000*
Barrow	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Chorley	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Kendal	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Lancaster	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Carlisle	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Preston	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
West Cumbria	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total SCNW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Stagecoach.

*Pax = passenger numbers. PVR = peak vehicle requirement.

3. The table shows that Preston was the largest of the seven in terms of revenues, and in terms of staff and bus numbers (PVR) was similar in size to the profitable depot in Lancaster. Preston generated revenue per mile below that of Lancaster. Revenue per pax was above the average for the region (Preston £[✂], Lancaster £[✂], average £[✂]), but pax per mile was the lowest of all seven depots. Miles per PVR were [✂] for Preston, [✂] for Lancaster and [✂] for the north-west region. At £[✂], operating profit per PVR (the best proxy for return on capital employed) was only [✂] per cent of the regional average of £[✂]. Operating margin was by far the worst of the seven depots at [✂] per cent of revenues, indicating that operating costs were above those of the other depots. Commenting on our analysis, Stagecoach said that the higher revenue per pax and lower revenue per mile reflected the nature of predominantly inter-urban services operated from its Preston depot. Any implication that there was a cost control problem was misplaced.

4. The second report, the Profit Centre Summary, set out summary results for Stagecoach depots ranked in order of total operating profit. For the year to April 2007, it showed that on this measure Preston was 70th out of 113 depots. For profit per PVR,[1] it ranked 84th out of the 102 depots for which there was a PVR measurement. Although its operating profit at £[✂] was well above budget (£[✂]) and the previous year (£[✂]), it is clear that Preston was under-performing compared with most Stagecoach depots. The lower profit figure for the year to April 2006 suggests that Preston's performance was not a recent problem for Stagecoach Northwest and for UK Bus.

[1]Peak vehicle requirement, ie the maximum number of buses used. Total buses include spare buses and those not in use.

5. Stagecoach told us that, although its other Northwest depots had similar revenues, the Preston depot mostly operated inter-urban routes. These were less profitable than intra-urban routes. Stagecoach said that this had been described as the dough-nut problem: the services were around the edges but the most profitable services tended to be intra-urban services because of the higher density of population.

Financial performance of Stagecoach Preston since June 2007

6. The overall effect of the new intra-urban services on Stagecoach can be seen from the Profit Centre Summary, ranking the performance of all its depots. For the year to April 2007, the Preston depot had been ranked 70th out of 113 depots in terms of total operating profit (see paragraph 4). In the year to April 2008, Stagecoach Preston ran the same services as in the preceding year and, for ten months, its new intra-urban services. Although its old services would have made a positive contribution, the Profit Centre Summary showed Preston in last place out of 113 depots with an operating loss of almost £[✄] million.

7. The Profit Centre Summary for the year to April 2009 covered a period after Stagecoach had increased fares and the three months after the merger when some profitable services had been transferred from PBL.[2] Even so, in terms of total operating profit Preston was ranked 116th out of 120 depots, with an operating loss of £[✄]. The budgeted loss was £[✄], showing that Stagecoach management had expected the period of abnormal competition with PBL to result in even greater losses.

8. We also looked at the profitability of individual routes (see Appendix G).

Bus fleet

9. We received from Stagecoach details of changes in the number of buses at its Preston depot, including the Fleetwood outstation, over the last five years.

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[2] In those months Stagecoach moved some of PBL's more profitable services to its own depot.

TABLE 2 **Stagecoach Preston: changes in bus fleet, five years to April 2009**

	Years ended April				
	2005	*2006*	*2007*	*2008*	*2009*
Opening fleet	[✂]	[✂]	[✂]	[✂]	[✂]
Additions:					
External	[✂]	[✂]	[✂]	[✂]	[✂]
Inter-group transfers	[✂]	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]
Disposals:					
External	[✂]	[✂]	[✂]	[✂]	[✂]
Inter-group transfers	[✂]	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]
Closing fleet	[✂]	[✂]	[✂]	[✂]	[✂]
Composed of:					
Double deck	[✂]	[✂]	[✂]	[✂]	[✂]
Single deck	[✂]	[✂]	[✂]	[✂]	[✂]
Midibuses	[✂]	[✂]	[✂]	[✂]	[✂]
Minibuses	[✂]	[✂]	[✂]	[✂]	[✂]
Coaches	[✂]	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]
					£'000
Closing fleet value					
Cost	[✂]	[✂]	[✂]	[✂]	[✂]
Depreciation reserve	[✂]	[✂]	[✂]	[✂]	[✂]
Net book value	[✂]	[✂]	[✂]	[✂]	[✂]
Charges					
Depreciation	[✂]	[✂]	[✂]	[✂]	[✂]
Operating lease charges	[✂]	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Stagecoach.

10. Table 2 shows that at the end of April 2007, there were [✂] buses based at the Preston depot, on average about 60 per cent depreciated. Stagecoach told us that the average age of its Preston fleet in May 2007, before the arrival of the buses for the Preston Citi network, was [✂] years. By the end of the following year, there had been a net increase of [✂] buses. Stagecoach said that for the Preston Citi operation, it had purchased 25 new minibuses. It had also transferred to its Preston depot 15 nearly new double-deck buses from within the group, which were branded Preston Citi but were replacement vehicles for Stagecoach's existing 2/2A services. In the year to April 2009, growth on the network had seen a switch from minibuses to larger capacity double-deck vehicles. The average bus was less than 40 per cent depreciated, reflecting the modernization of the fleet.

Financial performance of PBL

Financial performance to March 2007

1. We reviewed the financial performance of PBL as reported in its statutory accounts. Table 1 shows PBL's financial performance for five years to March 2008. The table is based on the profit and loss account and the statement of total realized gains and losses.

TABLE 1 **PBL: summary of results for five years to March 2008**

£'000

	52 weeks to				
	*28/3/2004**	*27/3/2005*	*2/4/2006†*	*1/4/2007*	*30/3/2008*
Turnover	9,986.1	10,154.9	10,970.5	11,191.9	11,242.3
Cost of sales	–8,370.3	–8,467.2	–9,053.9	–9,297.8	–10,078.5
Gross profit	1,615.8	1,687.7	1,916.6	1,894.1	1,163.8
Admin expenses	–1,337.0	–1,467.4	–1,945.9	–1,735.1	–1,454.1
Operating profit	278.8	220.3	–29.3	159.0	–290.3
Exceptional items	-	–100.0	952.0	244.0	-
Provision on loan to EBT	40.4	–90.6	155.9	-	-
Sale of fixed assets	3.8	16.5	15.2	47.1	31.7
Profit before interest and tax	323.0	46.2	1,093.8	450.1	–258.6
Interest (net)	0.4	36.3	43.2	117.0	61.5
Pre-tax profit	323.4	82.5	1,137.0	567.1	–197.1
Tax	–73.5	–46.5	–184.9	16.3	32.1
Retained profit	249.9	36.0	952.1	583.4	–165.0
Actuarial gain on pension scheme*	-	–247.0	566.0	–19.0	–696.0
Prior period adjustment	-	-	–2,736.3	-	-
Total gains/losses	249.9	–211.0	–1,218.2	564.4	–861.0
Operating expenses:					
Payroll	6,228.2	6,269.3	6,836.8	6,924.6	7,583.3
Depreciation	667.1	551.6	508.2	537.4	660.4
Other expenses	2,812.0	3,113.7	3,654.8	3,570.9	3,288.9
	9,707.3	9,934.6	10,999.8	11,032.9	11,532.6
Average employee numbers	294	280	276	281	295
Per employee (£'000)					
Revenues	34.0	36.3	39.7	39.8	38.1
Payroll	21.2	22.4	24.8	24.6	25.7
Annual change per employee (%)†					
Revenues		6.8	7.3	0.3	–4.3
Payroll		5.7	8.6	–0.8	4.5

Source: PBL.

*The accounts for the 52 weeks to 28 March 2004 do not reflect the pension scheme deficit (pre-FRS 17), so there is no actuarial gain or loss.
†53 weeks to 2 April 2006. Annual change in revenues and pay per employee adjusted to reflect this.

2. Table 1 shows that the operating profit before exceptional items averaged £157,000 in the four years to March 2007. Exceptional items were all related to the WMPTA pension scheme; the actuarial gains and losses and the prior period adjustment were recorded in the statement of total recognized gains and losses, and so did not affect the profit for the year. In the year to March 2006, PBL had to pay pension contributions to the WMPTA scheme of £438,000, compared with £157,000 in the previous

year.[1] This increase, which had led to a small operating loss, had brought about the closing of the scheme for future service (see Appendix D, paragraph 7).

3. The cash flow statements from PBL's statutory accounts are set out in Table 2.

TABLE 2 **PBL: cash flow statements, five years to March 2008**

					£'000
			52 weeks to		
	28/3/2004	*27/3/2005*	*2/4/2006**	*1/04/2007*	*30/03/2008*
Operating profit/loss	278.8	120.4	922.7	403.0	–290.3
Pension scheme credit	40.4	100.0	–952.0	–244.0	–244.0
Share based payments	-	-	-	5.0	-
EBT loan provision	-	–90.6	155.9	-	-
Depreciation	667.1	551.6	508.2	537.4	660.4
Change in working capital	–70.4	33.6	–72.9	–86.3	–552.1
Cash flow from operating activities	915.9	715.0	561.9	615.1	–426.0
Interest received/paid	0.4	40.3	63.2	36.0	–10.5
Taxation	–50.4	–99.7	–83.5	127.9	8.4
Cash from operating activities after tax	865.9	655.6	541.6	779.0	–428.1
Net capital expenditure					
Purchases of fixed assets	–120.8	–220.9	–308.5	–2,759.0	–1,712.9
Less: Hire purchase arranged	-	-	-	1,796.7	1,564.7
Sales of fixed assets	20.5	46.0	54.8	1,205.2	78.7
	–100.3	–174.9	–253.7	242.9	–69.5
Cash inflow/outflow before financing	765.6	480.7	287.9	1,021.9	–497.6
Financing					
Repayment of debenture loan	–14.9	–14.9	–14.9	–14.9	–14.9
Repayment of hire purchase creditors	-	-	-	–570.5	–597.0
Repayment of bank loans	–320.6	-	-	-	-
	–335.5	–14.9	–14.9	–585.4	–611.9
Increase/decrease in cash	430.1	465.8	273.0	436.5	–1,109.5
Turnover	9,986.1	10,154.9	10,970.5	11,191.9	11,242.3
Cash from operating activities after tax	865.9	655.6	541.6	779.0	–428.1
Cash flow after tax: turnover (%)	*8.7*	*6.5*	*4.9*	*7.0*	*–3.8*

Source: CC from PBL data.

*53 weeks to 2 April 2006.

4. Table 2 shows that PBL had a positive cash flow from operations in each of the four years to March 2007. It was also increasing its cash balances. In the first three years asset purchases were lower than the amount provided for depreciation as a result of delays in the introduction of the new Orbit bus service and in deliveries of new buses. This had the effect of conserving cash. But in the year to March 2007, there was more than £2.7 million of capital expenditure, nearly all of it on buses, financed by selling old buses and using a new hire purchase facility. There was further expenditure on buses in the year to March 2008.

5. Table 3 summarizes PBL's balance sheets for the same five years.

[1]Annual accounts, note 19.

TABLE 3 **PBL: summary year-end balance sheets, five years to March 2008**

£'000

	28/3/2004	*27/3/2005*	*2/4/2006*	*1/4/2007*	*30/3/2008*
Fixed assets	3,227.5	2,867.4	2,628.0	3,691.6	4,714.2
Other operating assets/liabilities	–1,068.8	–644.5	–635.5	–590.9	–199.6
Net operating assets	2,158.7	2,222.9	1,992.5	3,100.7	4,514.6
Financed by					
External debt	126.6	111.7	96.8	1,307.9	2,278.1
Cash balances	–578.9	–1,044.6	–1,317.6	–1,754.0	–644.6
Net external debt/cash	–452.3	–932.9	–1,220.8	–446.1	1,633.5
Intercompany balances (net)	–273.6	800.8	800.8	800.8	800.8
Pension scheme deficit*	N/A	2,114.0	793.0	555.0	998.0
Net debt/cash	–725.9	1,981.9	373.0	909.7	3,432.3
Equity	2,884.6	241.0	1,619.5	2,191.0	1,082.3
Capital employed	2,158.7	2,222.9	1,992.5	3,100.7	4,514.6
Average capital employed	2,158.7	2,190.8	2,107.7	2,546.6	3,807.7
Operating profit before exceptional items	278.8	220.3	–29.3	159.0	–290.3
Turnover	9,986.1	10,154.9	10,970.5	11,191.9	11,242.3
Operating margin (%)	2.8	2.2	–0.3	1.4	–2.6
Asset turnover (times)	4.6	4.6	5.2	4.4	3.0
Return on capital employed (%)	12.9	10.1	–1.4	6.2	–7.6

Source: CC from PBL data.

*FRS 17 was not implemented until 2005, so the balance sheet at 28 March 2004 does not include a pension scheme deficit.
Note: N/A = not applicable.

6. Table 3 shows that fixed assets, mostly buses, were the largest component of net operating assets, increasing in the last two years with the large-scale purchases already described. During the first four years PBL was building up its cash balances, which reached £1.75 million by March 2007, providing a cushion against any future increase of costs that could not be immediately recovered by increased fares. It also meant that PBL had net interest income—Table 1 shows that this had increased to £117,000 in the year to March 2007, supplementing the operating profit.

7. The external debt at March 2007 consisted of £1.23 million of obligations under hire purchase contracts, and a debenture from PCC of £74,400 which was being repaid in annual instalments over the following five years. The debenture was secured by a floating charge over all of the company's assets. The intercompany balances comprised a net amount (loan account less current account) of about £800,000 due to PTHL. The loan to the EBT to fund its purchases of the shares of employees leaving the company, which the EBT could not repay since it had no funds of its own, has been treated as a deduction from equity in Table 3.

8. A new Financial Reporting Standard (FRS17) had a significant impact on PBL's balance sheet. Although the underlying position was not considerably different from the previous year, the existence of a material pension scheme deficit was recognized for the first time in the March 2005 balance sheet and reported equity was greatly reduced.

9. Return on capital employed (ROCE) can be expressed as the product of two components, operating margin and the rate of asset turnover. Table 3 shows that the latter was fairly stable, so changes in ROCE were mostly driven by changes in operating margin.

Financial performance of PBL since June 2007

10. Before June 2007, PBL had been profitable in most years (see Table 1). Using management accounts, we calculated 12-month rolling sales revenues, costs and profits, to eliminate any seasonal effects, for the period March 2007 to September 2008. In May 2007, the last month before Stagecoach launched its new intra-urban services in Preston, PBL had an annualized trading profit of £234,000 on revenues of £11.36 million. By October 2007 it moved into trading losses on an annualized basis, and by December 2007 the loss for the calendar year 2007 was £379,000 on revenues of £11.40 million. By June 2008 the annual trading loss was over £1 million.

11. Figure 1 shows the 12-month rolling revenues, costs and profits of PBL.

FIGURE 1

PBL: 12-month rolling sales revenues, costs and profits

[✄]

Source: CC from PBL data.

12. Figure 1 shows that, in spite of increasing competition from Stagecoach, PBL managed to preserve its revenues.[2] Semi-variable and fixed costs were little changed, but variable costs increased from just under £[✄] million to more than £[✄] million, driven by an increase in total drivers' wages and bus depreciation. There was also a large increase in the cost of fuel during 2008.

13. [Former PBL Director Z] told us that she had been Finance Director at the time and had originally calculated that PBL would run out of money, by exceeding its £700,000 overdraft facility, in October 2008. When this forecast was made in the spring of 2008, PBL's financial position had been exacerbated in recent months by the increased cost of fuel. [Former PBL Director Z] told us that every penny on a litre of fuel cost PBL £20,000 a year, and the fuel price had gone from 79p to £1.09 very quickly, although it did drop back again. It had had a huge effect on profits. Changes in concessionary fare reimbursements and the loss of some tenders added to PBL's problems.

14. [Former PBL Director Z] said that the expected date for running out of money had lengthened as the fuel price eased off. The company had won some additional tenders and made some savings on employee terms and conditions. [Former PBL Director X] told us that even so, PBL would still have run out of money by April 2009. It had been making losses every month and the directors saw no prospect of a return to profitability, and no prospect of the overdraft facility being increased.

Bus fleet

15. We received details of the changes in PBL's bus fleet, as set out in Table 4.

[2] Management accounts show that in the year to March 2008 a fall in on-bus revenues of more than £[✄] was largely offset by increased receipts from LCC for concessionary fares and tendered services. In the following six months the decline in on-bus revenues continued, but there was little growth in receipts from LCC.

TABLE 4 **PBL: changes in bus fleet, five years to March 2009**

	52 weeks ended				
	27/3/2005	*2/4/2006**	*1/4/2007*	*30/3/2008*	*22/1/2009†*
Opening fleet	[✂]	[✂]	[✂]	[✂]	[✂]
Additions	[✂]	[✂]	[✂]	[✂]	[✂]
Disposals	[✂]	[✂]	[✂]	[✂]	[✂]
Closing fleet	[✂]	[✂]	[✂]	[✂]	[✂]
Composed of:					
Double deck	[✂]	[✂]	[✂]	[✂]	[✂]
Single deck	[✂]	[✂]	[✂]	[✂]	[✂]
Midibuses	[✂]	[✂]	[✂]	[✂]	[✂]
Minibuses	[✂]	[✂]	[✂]	[✂]	[✂]
Coaches	[✂]	[✂]	[✂]	[✂]	[✂]
Training buses	[✂]	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]
					£'000
Closing fleet value					
Cost	[✂]	[✂]	[✂]	[✂]	[✂]
Depreciation reserve	[✂]	[✂]	[✂]	[✂]	[✂]
Net book value	[✂]	[✂]	[✂]	[✂]	[✂]
Depreciation charge	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Stagecoach.

*53 weeks to 2 April 2006.
†Period 31 March 2008 to 22 January 2009, the date of the merger.

16. PBL's Orbit service started on 22 October 2006 with a new fleet of 18 buses. The Department for Transport (DfT) had paid for seven of them, LCC had paid for [✂], and [✂] had been bought by PBL at a cost of about £[✂]. One bus was jointly funded by PBL and LCC, with PBL contributing £[✂] to its cost. These buses have been included in the fleet numbers in Table 4, even though the ones purchased by the DfT and by LCC were not included in the fleet value. Three of the DfT buses were delivered in January 2006 and used on other services until the delayed start of the Orbit service. Provided that the Orbit service continues for five years (to October 2011), [✂].

17. Table 4 shows that in addition to the Orbit service buses, there was a small increase in the size of the fleet in 2006/07 and a move away from double deckers and minibuses to midibuses.

18. In June 2007, PBL's fleet included about 27 buses which were mostly used as school buses, but which also ran on commercial services during the afternoon peak to maintain reliable schedules. These had an average age of 18.7 years, but the remaining fleet had an average age of 6.7 years, less than that of Stagecoach's Preston fleet (see Appendix B, paragraph 10).[3]

19. Overall, there does not seem to have been much difference in the average age of the two fleets. We received no complaints from third parties about the age of the bus fleets or standards of maintenance.

[3]The exclusion of about 27 PBL buses that were mostly used for school services has a material impact on the average age of its fleet, while the same adjustment for Stagecoach Preston, with far fewer buses for schools, has little impact. We were told that in June 2007 about five of PBL's minibuses were awaiting sale or being used for spare parts; their exclusion would further reduce the average age of its fleet at that time.

Performance of the bus operations

20. Stagecoach suggested that we had not devoted sufficient effort and resource to establishing on a reliable basis the profitability of PBL routes and its bus operations, and this had affected in particular our assessment of the sustainability of the PBL business. Stagecoach also suggested that the CVRM contract that PBL had secured with PCC ensured PBL's profitability, implying that the bus operations were not profitable on a stand-alone basis.

21. We were provided with limited data regarding the profitability of PBL prior to Stagecoach's operation of the intra-urban routes. However, we received some route costing data for June 2006,[4] which is before Stagecoach launched its new intra-urban services. This showed that the bus operations were contributing £[✂] million before the fixed costs of the head office were allocated. These fixed costs were around £[✂] million in both 2006/07 and 2007/08; assuming a similar figure in 2005/06 would mean that the business would have been making around £[✂] million loss without the CVRM contract;[5] this also assumes that there were no head office costs associated with this contract.

22. We do not believe that PBL would necessarily have become an unsustainable operation if the CVRM contract had been terminated, as the commercial bus operations were covering their direct costs and depot overheads and so were commercially viable. They were also making a significant contribution to general overheads, although the scale of PBL's fixed costs was driving down overall profitability and these would have needed to be managed. We note that PBL had a strategy of not maximizing profits in order to forestall higher wage demands from the employee shareholders and to discourage entry by competitors (see Appendix H, paragraph 10). If it had lost the contribution from the CVRM contract, it should have been able to increase the margin of its bus operations by [✂] per cent (on revenues of £[✂] million) to make up the shortfall.

[4]There is some uncertainty as to whether the route costing data is annualized data as at June 2006 or whether it is the 2005/06 annual figures; either way, it relates to the period before Stagecoach's entry on the new intra-urban routes and is therefore appropriate for this analysis.
[5]The CVRM contract generated a pre-fixed cost contribution of £[✂] in 2006/07 and £[✂] in 2007/08, which contributed to PBL's overall profitability.

PBL's defined benefit pension scheme

Introduction

1. This appendix sets out relevant background to the PBL's pension arrangements, in particular the defined benefit pension scheme that was closed in 2006.

PBL's pension arrangements

2. PBL participates in two schemes:

- a group stakeholder scheme; and
- a defined benefit scheme, closed to new members and new accrual of benefits.

Group stakeholder scheme

3. The group stakeholder scheme is a money-purchase arrangement under which PBL makes employer contributions of 4 per cent of pensionable pay. Staff who had been in the local government pension scheme (LGPS) had the option of a 5 per cent contribution, but with less death in service cover—the standard death in service cover was five times pay. Under this defined contribution scheme, PBL does not face a risk of a pension deficit, as the risk of matching fund assets with pension liabilities is borne by the employees. PBL incurred £385,474 of employer contributions for this scheme in the year ended March 2008, representing 3.4 per cent of turnover (2007: £374,396). In Stagecoach's opinion, the level of employer contributions was 'not a major issue'. The stakeholder scheme is therefore not considered further in this appendix.

The closed pension scheme

4. Before the company was sold to its employees in 1993, they were members of an LGPS, the Lancashire County Council Superannuation Fund. This was a defined benefit scheme with pensions linked to final salaries. The sale meant that the employees were no longer eligible to continue as members of the LGPS, so PBL sought a new pension arrangement for which the Council was requested to be the guarantor.

5. The administering authority of the pension scheme that was selected in 1993 is the West Midlands Passenger Transport Authority (WMPTA).[1] PBL was admitted to the WMPTA fund, with membership limited to those employees who were in the LGPS at that time.

6. [Former PBL Director X] told us that only part of the LGPS assets relating to PBL's employees and pensioners moved to the WMPTA in 1993, with the remainder moving across over a period of about 11 years. These staged payments were a requirement of PCC, and at the time it was thought that they would not be a problem. In practice, the staging of the transfers resulted in a loss of the growth that would

[1] The WMPTA had 3,045 members at 31 March 2007. The balance is employees of West Midlands Travel Ltd, which has no connection to PBL.

have taken place had the assets moved in a single amount to the WMPTA in 1993. The amounts transferred from the LGPS paid part of the PBL annual employer's contributions, and in later years they more than covered the amount that was required by the WMPTA fund. Even so, the monthly payments received from PCC were paid in full to the WMPTA. PCC had not funded the scheme, but for a while there had been no expense for PBL from the defined benefit pension scheme.

7. The actuarial valuation carried out in 2005 showed that PBL's portion of the WMPTA scheme was in deficit. It was agreed that PBL should make 20 annual payments, initially set at £244,000, to cover the deficit for past service. There was to be a further annual payment for current service of £220,000. After PBL had sought advice from KPMG (see Appendix H, paragraphs 8 and 9), the scheme was closed to existing members in February 2006, who transferred to the group stakeholder scheme (see paragraph 3) for future service. From this date on, benefits accruing to members related only to their service up to February 2006. There is no new accrual for service since February 2006.

8. At the date of the 2008 actuarial valuation, 94 of the 150 members had retired and 56 were yet to retire.[2] One member of the defined benefit scheme was a serving director of PBL.

9. PBL's financial statements for the year ended March 2008 recorded a total market value of assets of £13.9 million and a present value of scheme liabilities of £15.1 million, resulting in a net pension liability of £1.0 million.

10. Table 1 sets out the cash expense for defined benefit scheme for each of the six years to March 2008, and the deficit at the end of those years.

TABLE 1 **PBL: annual pension costs**

Year to March	*Defined benefit pension expense (cash basis)* £	*Open to existing members*	*Defined benefit pension (deficit) (FRS17 basis)* £
2003	0	Yes	(2,479,000)
2004	0	Yes	(1,783,000)
2005	157,093	Yes	(2,114,000)
2006	193,524	No	(793,000)
2007	248,000	No	(555,000)
2008	244,000	No	(998,000)

Source: PBL audited accounts (Note 19).

The 'pension guarantee' provided by Preston City Council

11. When PBL was sold to its employees in 1993, PCC supplied a guarantee for future employer contributions to the defined benefit scheme. The pension guarantee was required by the WMPTA to protect West Midlands council tax payers should PBL fail to make the required payments. It was not done to give security to the members of the scheme. The guarantee requires PCC to fund any payments that the WMPTA requires into the pension fund, but which PBL is unable to meet. Although there is no specific test of solvency, it is likely that if PBL were to become insolvent the WMPTA could call the guarantee and PCC would pick up the cost of the pension contributions.

[2]Includes a deferred tax asset of £0.2 million. Calculation based on FRS17 assumptions.

12. We understand that the pension guarantee has the following provisions:

- no financial tests of solvency are specified that would trigger the guarantee;
- the guarantee requires that the WMPTA is notified if any new shareholder is admitted to PBL (except an employee of PBL), eg an acquirer of the business;
- the pension guarantee cannot be withdrawn if there is a change of control of PBL; and
- there is no requirement to gain consent from either the WMPTA or PCC for a change of control of PBL.

Triennial actuarial valuations

13. An actuarial valuation is performed every three years by Mercer, the appointed actuaries. The most recent triennial valuation was prepared in 2008, based on a valuation date of 31 March 2007. Following this valuation, PBL was required to continue to make annual payments of £244,000 a year (2.2 per cent of PBL's turnover in 2008). The payment schedule therefore remains fixed at £244,000 for 2010 and 2011, and is projected to remain at this level for a period of 17 years (ie 2008 to 2025). The 2008 review had suggested that PBL could reduce the payments to £140,000, as the scheme was now closed for future service. However, the WMPTA decided to continue with annual payments of £244,000. The amount of the annual payments continues to be subject to reviews at least every three years.

14. Depending on the results of the next actuarial valuation in 2011, the annual payments could be higher or lower or the same. This will depend on a number of variables, which are unknown today.

Key variables affecting the pension scheme deficit

15. Given that the pension fund only has two employing bodies and is closed to new members, the major variables affecting the pension deficit relate to the performance of the investment portfolio, inflation and mortality, as well as the effect of the deficit recovery payments (for PBL the annual £244,000 payments) into the scheme.

16. Generally speaking, and before taking account of the effect of inflation on investment returns, a higher rate of inflation will result in a larger pension liability as the pension benefits of members will be increased in line with inflation. It is evident from PBL's financial statements that the assumptions for inflation and 'rate of increase for pensions in payment and deferred pensions' are the same. The FRS17 assumptions for the three years ending March 2006 to 2008 were 2.5 per cent, 2.9 per cent and 3.3 per cent respectively. The inflation assumptions employed by Mercer were 3.1 per cent (Mercer 2008 triennial valuation) and 3.8 per cent (Mercer August 2008 valuation).

17. Investment performance of the portfolio will determine the value of the scheme's assets. Given the variations in performance of individual classes, the fund's total assets can change significantly between valuation dates. In determining the FRS17 valuation and performing the actuarial valuation an estimate is required for future performance. We note that the mix of assets in the WMPTA scheme was 56 per cent equities in 2008. We have not considered further whether this weighting towards equities was best suited to the demographic profile of the 150 members, but note that this is largely a matter for the pension fund trustee to determine.

18. Portfolio performance and future inflation expectations are particularly important. This was neatly summed up by Stagecoach in an internal email:

> [✂] has discussed with [✂], who is willing to take a long term view on pensions, and as such is willing to stick by an offer price of £[✂] million less balance sheet debt, subject of course to entering into suitable arrangements with the WMPTA… assuming nothing changes on acquisition … then for the next two years we would pay £244,000 pa. After this there would be a new valuation, and on today's LGPS assumptions, we would pay about £600,000 pa for the next 17 years. If the inflation assumption was lowered to 2.9 per cent, then we would pay £250,000 pa rather than the £600,000. This involves taking a bet on inflation and/or market recovery.

and

> Stock markets have fallen in excess of 20 per cent between 31 August and 14 October … Of course, and to balance the discussion I must say this, stock markets can recover and it is always possible that the deficit can be recovered over the long term from investment returns.

Demographic effects are also important—ie actual mortality (plus any benefits accruing to dependents) of the existing 150 members, and the effect of retirement (56 members yet to retire). We have not reviewed the approach taken by the actuary in relation to the specific members.

Actuarial valuation at 31 August 2008

19. The pension fund actuary, Mercer, performed a valuation as at 31 August 2008. This was a special exercise that was commissioned by PBL at the request of PCC. The results were:

- Ongoing: £[✂] million.
- Buyout/in: £[✂] million.

20. The valuations were never applied for any purpose, as the deficit recovery payments were fixed in 2008 at £244,000 a year and were not due to be changed until after the next valuation in 2011. The 2011 valuation will be based on the assumptions relevant at that time, rather than on those as at 31 August 2008. It is impossible to predict what the 2011 assumptions will be.

Effect of the deficit on the sale process

21. The information memorandum (3 June 2008) disclosed a pension deficit of £1.5 million at 31 March 2007[3] to bidders and stated: 'The Company is negotiating with Preston Council, in their capacity as guarantor, to take on the ongoing liabilities of the scheme and the deficit as part of the sale of the business and is confident that a buyer will not have to adopt the scheme or the deficit.'

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[3]Deficit attributed to Mercer Limited valuation dated 31 March 2007.

22. Both Go-Ahead and Arriva based their offers on the assumption that the pension deficit would not transfer with the company, in accordance with the wording in the sales documentation.

23. PBL failed to persuade PCC to take on the liabilities of the pension scheme before the decision to invite Stagecoach to bid for PBL, and the sale to Stagecoach proceeded without the liabilities being transferred to PCC.

The positions taken by various parties

Preston City Council

24. PBL approached PCC setting out its current difficulties, and discussions and negotiations took place over several months about PBL's proposals. PCC recruited specialist advisers to assist them in this process. [✂]

25. We were told by KPMG [✂].

26. [✂]

Pension Trustee (WMPTA)

27. The Director of Pensions, Wolverhampton City Council, the administering body for the WMPTA, indicated the position that the WMPTA would take:

- the guarantee protects the interests of the fund and no variation to the guarantee should be allowed as this may weaken the fund's position;
- the fund should seek to avoid any additional third-party arrangements that may add to the complexity of the arrangements. The simplest solution is to maintain the direct interests with PBL, regardless of who owns the shares;
- deficit recovery would continue on the existing basis; and
- it may be that if PBL ceases to exist as a legal entity, the WMPTA may have no alternative but to call the guarantee. The matter requires expert advice if such a proposal arises.[4]

PBL

28. In each of the four years to March 2007 PBL generated a positive operating cash flow after paying pension contributions (see Appendix C, Table 2). In the year to March 2008 the company suffered a cash outflow after pension expenses.

29. [✂]

30. Subsequently PBL was sold for cash to Stagecoach at a valuation that delivered a positive value to its shareholders.

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[4]On the basis that a new Admission Agreement would be required.

Stagecoach

31. Stagecoach agreed that PBL would, as required, continue to make the annual deficit recovery contributions in accordance with the current Schedule of Contributions arising under the 2008 triennial valuation, but in return sought confirmation from the WMPTA that there would be no acceleration in the recovery of the deficit or any change to the pension guarantee. Stagecoach concluded that the pension guarantee would survive a change of control, and that no approvals were required, nor rights of veto, over its offer for PBL. Stagecoach did not provide a formal guarantee, but confirmed its support to PBL to make the payments of £244,000 a year.

32. Stagecoach recognized the downside of being seen to be unsupportive to PCC, as set out in an internal email: there would no doubt be significant local political ramifications if we 'let the Company go bust'.

The regulation of local buses

Introduction

1. This appendix summarizes the requirements for a bus operating licence, the role of Traffic Commissioners and of local authorities in relation to bus services, and outlines the normal system of regulating local bus services. It also sets out the reimbursement system for concessionary fares.

2. Over 80 per cent of local bus services in Great Britain are provided on a commercial basis.[1] Bus operators should have little difficulty operating whatever bus services they wish to operate,[2] provided that they satisfy a number of legal requirements (details of which are set out below). Operators are generally free to decide what frequency of service to offer and fares. However, bus operators have to register 'local services' with their local Traffic Commissioner and operate such services in a way which is consistent with what was registered.[3]

The requirements for a bus operating licence

3. Each bus operator needs to apply for a public service vehicle (PSV) operator's licence from a Traffic Commissioner and must meet a number of statutory criteria for eligibility. To be eligible for an operator's licence the applicant must be of good repute, have appropriate financial standing and be professionally competent.

4. Good repute can be established by satisfying the Traffic Commissioner that the operator, its servants or agents do not have relevant convictions recorded against them and that there are no other relevant matters as set out in the schedule to the Public Passenger Vehicles Act 1981 (as amended).

5. The test of appropriate financial standing is fixed by EU regulation and the figures are established by the Secretary of State for Transport. The Traffic Commissioner needs to be satisfied that an operator has sufficient finance to run a business properly. Traffic Commissioners have issued a practice direction which took effect from 1 January 2005. The practice direction states that for a standard national licence the financial requirements will be met though demonstrating funds of £6,200 for the first vehicle and £3,400 for each additional vehicle.

6. The test for professional competence is satisfied by an operator holding a certificate of professional competence to act as a transport manager (or the operator employing someone who holds the certificate).

7. In addition to satisfying the three statutory tests set out above, an operator must also establish that there will be adequate facilities or arrangements to ensure that its buses are maintained properly in the interests of road safety and that it is capable of securing compliance with the law relating to the driving or operating of registered bus services.

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[1] Source: DfT.
[2] London and areas with quality partnerships or quality contract schemes are subject to greater scrutiny.
[3] 'Local service' is defined in the Transport Act 1985. Broadly, it is a bus service operated at separate fares where the distance between stopping places or overall journey length is less than 15 miles (as the crow flies).

8. Operators' licences do not have an expiry date but are subject to the payment of annual or five-yearly fees and a five-year licence review. The Traffic Commissioner is required to impose a condition limiting the number of vehicles that can be operated simultaneously under the licence. The operator is then issued with the number of operator's discs it requires (up to the maximum number allowed in the licence) and one of these must be displayed in the windscreen on each vehicle when a bus is being used under the licence. A variation application must be made if the operator wants to increase the maximum number of buses it may operate at the same time. On the grant of a licence, the Traffic Commissioner is required to attach certain conditions and (to a limited extent) can attach others under sections 16 and 16A of the Public Passenger Vehicles Act 1981.

Traffic Commissioners

9. A Traffic Commissioner is appointed by the Secretary of State for Transport as an independent regulator for each of eight traffic areas. The Traffic Commissioner's principal role is to ensure compliance with the principles of road safety and fair competition. Preston is in the North Western Traffic Area. Traffic Commissioners act as licensing authorities for the heavy goods (HGV) and PSV industries, ie buses carrying nine or more passengers for hire or reward.[4] The Traffic Commissioner has no control over bus and coach fares.

10. A Traffic Commissioner, when discharging regulatory functions, acts in a judicial capacity as a single person tribunal. Regulatory action may be taken against non-compliant operators. Where an operator's breach is not serious, the matter may be dealt with by correspondence, through the issue of a warning letter, or in exceptional circumstances, an operator may be dealt with by an interview (in chambers). In many cases of non-compliance, the Traffic Commissioner will require the operator to attend a public inquiry. Where the Traffic Commissioner finds that the operator has been at fault, regulatory action may be taken. A Traffic Commissioner may revoke or suspend an operator's licence or vary conditions attached to the licence under section 16 of the Public Passenger Vehicles Act 1981, in accordance with section 17 of that Act. The conditions which may be varied under section 16 may include a condition which restricts the number of vehicles which an operator may use under the licence. The Traffic Commissioner may take action against an operator who has failed to comply with a condition or undertaking which has been attached to the licence where there has been a material change of circumstances since the licence was granted. Many cases of non-compliance relate to poor maintenance of an operator's vehicles.

11. In some cases, the Traffic Commissioner may attach a condition which prevents an operator from operating local services on certain routes or from providing local bus services of any description.[5] This includes cases where the operator has failed to run its services as registered, has failed to comply with the requirements of a quality partnership scheme, has interfered with another operator's services or has operated dangerously. If an operator fails to run a local registered service in accordance with the statutory provisions, the Traffic Commissioner may impose a financial penalty, the amount of which is set out by statute.[6]

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[4] Or eight or fewer passengers when small vehicles are used to carry passengers at separate fares in the course of the business of carrying passengers.
[5] Section 26 of the Transport Act 1995 (as amended by the Local Transport Act 2008).
[6] The maximum financial penalty which a Traffic Commissioner may impose is £550 multiplied by the number of vehicles which are authorized on an operator's licence. Each case is assessed on its merits by the Traffic Commissioner using the guidance set out in the Traffic Commissioners' Practice Direction number 4, issued in November 2004. In reaching a decision, the Traffic Commissioner will apply their judicial discretion.

12. Operators are required to comply with the timetables they have submitted. The Traffic Commissioners have published a practice direction on bus standards. It states that they expect bus operators to achieve a target of 95 per cent of their timetabled services leaving the timing points for the route within the accepted tolerance of 'up to 1 minute early or up to 5 minutes late'. For frequent services, the Traffic Commissioners expect that (on 95 per cent of the occasions that the service is sampled) six or more buses will depart within any period of 60 minutes and that the interval between buses will not exceed 15 minutes. These targets apply everywhere outside London. An operator will always have the opportunity to submit to a Traffic Commissioner that there was a 'reasonable excuse' for a bus failing to run to its registered timetable, but the Traffic Commissioner will be particularly interested in patterns of timekeeping and whether the operator has taken all reasonable steps to ensure that buses run to their published times.

13. The Vehicle and Operator Services Agency (VOSA) monitors services on behalf of the Traffic Commissioners. Such a request to monitor may follow complaints to a Traffic Commissioner. The Traffic Commissioner can take action against an operator if one of its local services has not been operated according to the registered particulars.

Registration of local bus services

14. Under the Transport Act 1985 (1985 Act), an operator can provide a new local bus service after giving 56 days' notice to the Traffic Commissioner (in special circumstances the Traffic Commissioner can use discretion to accept a shorter period of notice). There is no need for any 'approval', but the operator has to provide the statutory particulars and other information that the Traffic Commissioner reasonably requires. If an operator wishes to vary or cancel a service, the operator must again give 56 days' notice. Traffic Commissioners publish details of bus service registrations fortnightly.[7]

15. Operators have to provide their Traffic Commissioner and the relevant local authorities with information about each proposed route, including its starting and finishing points, a map, the timetable (or a statement that the service interval will be 10 minutes or less) and stopping arrangements.[8] The timetable has to show timing points at principal points on the route. The operator is free to vary the service in two ways without further reference to the Traffic Commissioner:

- if demand is unusually high, additional 'duplicate' buses may be run as closely as possible to the registered times; and

- as the registration of a 'frequent service' (one with a frequency of at least one bus every 10 minutes) does not oblige the operator to specify a timetable, it can alter timings on these services provided that it operates within the frequency requirement.

16. Apart from any restriction in its operator's licence conditions, there is only one circumstance where an operator which meets the normal minimum standards may be prevented from providing a service.[9] That is where the Traffic Commissioner has determined 'traffic regulation conditions' at the request of a local authority. The conditions have to apply to all local services in the area specified in the conditions (or all

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[7]In *Notices and Proceedings* available from the VOSA at www.vosa.gov.uk.
[8]If there are potential road safety or congestion problems, the local authorities may put restrictions on the roads being used.
[9]Other than in London and areas with quality partnerships or quality contracts.

those of a specified class). They have to be attached to the licence of every operator with a registered service affected by the conditions. Such conditions may be used only when required to prevent dangerous traffic conditions, reduce severe traffic congestion or reduce noise and air pollution. The few traffic regulation conditions that have been made normally regulate the amount of time that buses can wait at designated bus stops in areas where local authorities are concerned about road safety or congestion and there is substantial competition between operators.

17. A traffic regulation condition can be made only for the purpose specified in the legislation. This includes limiting the number of vehicles which may be used, or the frequency at which vehicles may be operated, in the provision of a service along all or part of its route whether generally or during particular periods or at particular times.[10]

Local authority powers and responsibilities

18. The 1985 Act obliged local authorities to transfer their bus operations into companies operating at arm's length. Since that requirement nearly all bus companies have been privatized and only a few councils still own bus companies.

19. Under the Transport Act 2000 (the 2000 Act), local authorities have a statutory duty to produce a bus strategy document setting out their policies for the promotion of safe, integrated, efficient and economic transport facilities in their areas. This strategy document provides a policy template for making the best use of an authority's powers and duties. There is a requirement on authorities to consult bus operators or their representatives with regard to the bus strategy. Local authorities have powers under other legislation to secure provision of socially necessary services that are not provided commercially and school bus services. District councils are statutorily required to provide concessionary fare permits for the old and the disabled.[11] Local authorities have powers under the 1985 Act to make travel concessions schemes for children as well as the old and the disabled.[12]

20. The Local Transport Act 2008 (the 2008 Act) amended some parts of the 2000 Act to give local authorities powers to improve the quality of local bus services, including the ability to review and propose local arrangements for planning and delivery of local transport and to create a bus passenger champion to represent the interests of bus passengers. The 2008 Act also updated local authorities' legal powers to develop local road pricing schemes to best meet local needs.

21. Local authorities also have powers, as roads and traffic authorities, to manage traffic. As well as direct measures, such as bus lanes, that give priority to buses, other traffic management policies, including parking policy and congestion control measures, may improve significantly the relative competitiveness of bus services compared with trains and cars, although much clearly depends on the specifics of policy-making and particularities of the area in question.

22. The 2000 Act (as amended by the 2008 Act) also gave local authorities new powers. In particular, a local authority may:

- make quality partnership (QP) schemes;

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[10] Public Service Vehicles (Traffic Regulation Conditions) Regulations 1986 (SI 1986/1030).
[11] Section 145 of the Transport Act 2000.
[12] Section 93 of the 1985 Local Transport Act.

- make quality contract (QC) schemes with local transport operators (under certain circumstances); and

- make statutory ticketing schemes.

Quality partnerships

23. There are two possible types of QP; statutory and voluntary. Each is explained below:

Statutory quality partnerships

24. A QPS is a statutory scheme introduced by the 2000 Act, as amended by the 2008 Act. QPSs are made by the local transport authority (LTA) (or jointly with district councils) following consultation with operators and are open for any operator in the relevant area to join, providing that they meet the required quality standards and provide undertakings to the Traffic Commissioner as to the standards of service they will provide. These undertakings may relate to a broad range of quality standards, including: emissions and noise; driver training and punctuality; and reliability. The 2008 Act, which came into effect on 6 April 2009, expands the terms of the QPS model to allow an LTA to specify the requirements as to frequencies, timings or maximum fares as part of the service standard to be provided under the scheme, in addition to the quality standards.[13] The undertakings are provided in exchange for access to the facilities invested in and provided by the LTA under the QPS, for example bus lanes, bus shelters, improved lighting/seating, printed displays at passenger facilities and parking, loading and waiting restrictions. Operators who do not join the QPS are not permitted to use the QPS facilities.

25. Establishing a QPS requires commitment from all parties and the 2008 Act prescribes a statutory consultation procedure which would have been required between the LTA and the stakeholders, ie local bus operators, groups representing bus users, any other relevant local authority (eg district councils), the Traffic Commissioner for the area and the chief police officer for the relevant area. Although it is for the LTA to formally propose a QPS, guidance issued by the DfT acknowledges that, in practice, the proposals are developed in close collaboration with the bus operators and the initial suggestion for a QPS would normally come from external sources, such as a bus operator.

26. Before making a QPS, the LTA must be satisfied that it will contribute to the implementation of their local transport policies.[14] LTAs and operators will need to consider the competition issues that arise. Annex 1 to this appendix summarizes the competition tests that apply to LTAs and to bus operators with respect to QPSs.

27. There is currently no statutory QP scheme in the Preston area (although we understand that Stagecoach and PBL have discussed the possibility of such a scheme) and we understand that there is only one operating out of all the England areas.

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[13] *DfT: The Local Transport Act 2008, Quality partnerships: statutory guidance to English local transport authorities and metropolitan district councils,* March 2009, paragraph 4.
[14] Ibid, paragraph 14.

Voluntary quality partnerships

28. Voluntary QPs have existed since the mid-1990s. Under a voluntary QP scheme, a local authority typically provides improved facilities such as bus shelters, bus stations and bus lanes. Operators who wish to use the facilities undertake to provide bus services of a particular standard, for example by introducing modern low-floor buses. There are several informal quality bus partnerships between the local transport authorities and Preston bus operators in relation to the provision of specific routes within Preston. The principal agreement is that the bus operator provides new low-floor vehicles, driver training, marketing and statistics and the LCC provides new bus top infrastructure, real-time information (on some routes), some highway improvements, improved timetable information and shelter maintenance in partnership with PCC.

Quality contracts

29. QCs differ significantly from QPs. Under the 2000 Act a local authority may make a QC scheme, with the approval of the Secretary of State, for an area if it is satisfied that it is the only practicable way for it to implement its transport strategy. As there is no QC in the Preston area or anywhere else in England, this is not discussed further.

Ticketing schemes

30. The 2000 Act gives local authorities powers to set up statutory bus ticketing schemes. If voluntary arrangements cannot be made, these schemes can require all operators of local bus services in the area to provide integrated ticketing. In making a statutory scheme, the local authority must be satisfied that it is in the public interest and helps to implement its relevant general policies. The types of tickets that may be covered by a ticketing scheme are:

- tickets that entitle the holder to make more than one journey, or cover more than one service;
- through tickets entitling the holder to make a particular journey using two or more local services (whether or not they are run by the same operator);
- 'multi-operator individual tickets' that entitle the holder to make a journey on any service (where a particular journey could be made on several services provided by a number of operators); and
- tickets entitling the holder to make a journey, or more than one journey, involving both travel on one or more local services and travel by one or more connecting rail or tram services.

31. A ticketing scheme has to satisfy the 'competition test' if it results from the exercise of local authority powers. Any aspect of an agreement between operators that does not result from the exercise of local authority powers remains subject to the Competition Act 1998. There is no statutory ticketing scheme in the Preston area.

Subsidized bus services

32. Local authorities are no longer able to provide general financial support for bus services in their areas. However, under the 1985 Act county councils have a duty, and district councils have power, to secure the provision of public transport services that they consider appropriate to meet social needs and that would not otherwise be

available, for example in rural areas. Under the 1996 Education Act local authorities can secure the provision of school buses. Local authorities that wish to subsidize local bus services must generally invite tenders and, when deciding which (if any) tender to accept, must have regard to a combination of economy, efficiency and effectiveness; the implementation of the policies set out in the bus strategy; and the reduction or limitation of traffic congestion, noise or air pollution.[15] Furthermore, where tenders are in excess of EC financial limits, the local authority must comply with the EC procurement rules.

33. There are two main types of contract for tendered services:

- cost based: the local authority receives the revenue and the contractor tenders for the whole cost of operating the contract (ie revenue risk is taken by the authority); and

- subsidy based: the operator retains the revenue and tenders for the cost of operating the service less the estimated revenue (ie revenue risk is taken by the operator).

34. The contract usually specifies the details of the service, including the type of buses (including age), route and timetable, and may specify the fares (or a range of fares). Most contracts include clauses allowing them to be suspended if another operator decides to register the service commercially. There are four quality bus routes in Preston that are tendered on a subsidy basis; the park-and-ride service is one example.

Concessionary fares

35. The Concessionary Bus Travel Act 2007 provides that everyone aged 60 and over or disabled in England can obtain free off-peak travel on all local buses anywhere in England from April 2008. This is an extension of earlier entitlements which only allowed these persons to travel for free on buses within their local area.

36. For many years local authorities have provided concessionary fares for elderly and disabled people. The 1985 Act gave local authorities power to make concessionary schemes and, when making schemes, requires them to have as an objective the provision of compensation to operators such that they are no worse off as a result of the scheme. Concessionary fare schemes must be open to all operators of local bus services and local authorities may compel operators to join a scheme. Preston has had a concessionary fare scheme since the 1970s for people over 70 and we were told that the recent introduction of the national scheme was not a substantive change compared with other parts of the country (but see paragraphs 38 and 41 below). We understand that concessionary fares are around [✂] to [✂] per cent of all PBL journeys.

37. Prior to April 2006, the Preston concessionary fare scheme allowed half-fares for pass-holders over 60 and a 50p flat rate fare (or half-fare if cheaper) for holders of a

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[15]Tenders are not required under the 1985 Act where action is urgently required for the purpose of: maintaining an existing service; securing a service which has ceased to exist; or securing a service to meet a public transport requirement which has arisen unexpectedly and ought to be met without delay. The agreement must not remain in force for more than three months and the local authority must invite tenders as soon as possible. There is also an exemption based on the authority’s forecast expenditure on service subsidies. An agreement is exempt from the tender requirements if the subsidies under the agreement and the amount payable under other non-tendered service subsidy agreements for the financial year in which the agreement is made do not exceed one-quarter of the authority’s forecast for that year. If the agreement remains in force after the end of the year, subsidies payable under it in any subsequent year must not exceed one-quarter of the forecast expenditure on service subsidies for that year. Furthermore, the exemption does not apply to an agreement for more than five years.

disabled pass. Pass-holders over 70 were permitted free travel within Preston. After April 2006 mandatory free concessions were introduced. This resulted in free trips for all pass-holders within their area. Cross-boundary trips to or from the area of residence were a 50p flat-rate fare and trips wholly outside the pass-holder's home area were half-fare (50p flat rate for disabled pass-holders).

38. The Concessionary Bus Travel Act 2007 statutorily extended concessions to travel throughout England, which has resulted in significantly greater concessionary fare patronage in Preston.

39. The provisions in the Act apply from 1 April 2008 and provide for:

(a) free bus travel for those eligible from 9.30am until 11pm weekdays and all day weekends and bank holidays, across England;

(b) local authorities to offer additional benefits over and above the statutory entitlement;[16] and

(c) adjustment of a number of features through regulations:

(i) future mutual recognition of concessionary bus passes across the UK;

(ii) the mechanism that bus operators are reimbursed by; and

(iii) scope of the concession.

40. The national scheme was revised to change the way that concessionary fare journeys are recorded with application since 1 April 2008. Prior to 2008, relevant journeys were recorded on the basis of whether the concessionary pass-holder was a resident in the transport district. This system was amended so that relevant journeys are recorded on the basis of where the journey originates (this change was essential as the national scheme allows travel by concessionary pass-holders from anywhere in England).

41. We were told by LCC that there has been an increase in the overall cost of concessionary travel, and the status of Preston as a transport interchange for popular tourist destinations such as Blackpool and Lancaster has contributed to higher costs falling on Preston. LCC told us that Stagecoach (across a number of its depots in Lancashire) has almost doubled the reimbursement it received between 2007/08 to 2008/09 from £[✂] million to £[✂] million. This increase reflects the increase in the average length of concessionary journeys (ie pass-holders are taking longer and more expensive journeys) in addition to fare increases. The number of concessionary journeys reimbursed to PBL and the value of the reimbursements against all bus operators in Preston and the entire Lancashire district, are presented in Table 1.

[16]LCC had previously allowed unlimited use of concession passes but on the introduction of the 2008 scheme restricted travel to after 9.30am, and from October 2008 restricted it further to the statutory minimum of 9.30am until 11pm. However, disabled pass-holders were again entitled to 50p flat fares for journeys at any time, funded by LCC (ie restoring the entitlement available before 1 April 2008).

TABLE 1 **Number of concessionary fare journeys and value reimbursed in Lancashire, 2008/09**

	PBL	*Preston (all operators)*	*Lancashire*
Journeys (m)	[✂]	4.690	25.597
Value (£m)	[✂]	4.814	26.913

Source: LCC.

42. In the Preston area, bus operators are reimbursed for concessionary travel pursuant to the Lancashire Joint Concessionary Travel Scheme. This scheme sets out how operators are reimbursed for concessionary fares.

43. In summary, the reimbursement rate for free concessions was 71.4 per cent until 28 June 2008. From 29 June 2008 the rate was reduced to 63 per cent. From April 2009 it has further reduced to 50 per cent, although this is subject to appeal[17] by a number of operators including Stagecoach and PBL.

44. The value of the 'average adult fare' used for reimbursement is calculated by dividing adult revenue of an operator by the number of adult single journeys multiplied by a generation factor to account for the fact that additional journeys are generated by providing free travel to pass-holders. For operators using electronic ticket machines (ETMs), the fare used for reimbursement is the full fare equivalent for the concessionary journey made, less a discount on a proportion of these for the discounts on 'rover'-type tickets where available. In 2007, LCC increased the generation factor[18] which effectively reduced the reimbursement to operators. PBL was negatively affected by these changes and savings of £[✂] had to be made as a consequence.[19]

45. LCC told us that a supplement in respect of additional costs has also been paid to bus operators since 1 April 2006. This is set at 2.5 per cent of free concessions to take account of the additional marginal costs of concessionary travel. It was considered that the increase in trips could largely be accommodated within the existing timetable, but any additional operating costs were to be covered by the 2.5 per cent.[20]

46. In some regions we are aware that there may also be exceptional circumstances where existing load factors and the local level of generated travel are very high and extra capacity has to be provided, which may be reimbursed by an authority as 'additional capacity costs'. We were told that there were a number of outstanding appeals on the value of reimbursement by some operators, which included claims for additional capacity costs. We were also told that LCC had never paid an amount to operators for this and intended to contest these claims and any claims for a higher value than 2.5 per cent to represent additional costs. The DfT told us that claims for this reimbursement were becoming more prevalent and, together with the standard additional costs, were the source of most of the controversy from bus operators in respect of the concessionary fares scheme.

[17]The appeal relates to the right to claim additional capacity costs rather than to the reimbursement rate.
[18]The generation factor is used to assess the proportion of concessions generated as a result of the national concessionary travel scheme existing and is part of the mechanism used to reimburse bus operators.
[19]Source: PBL.
[20]The DfT has set out in its guidance that, where appropriate, standard additional costs might range from £0.05 to £0.14 which is intended to approximate the marginal cost of additional concessionary fare passengers. The lower end of the scale represents the additional cost of each passenger. A higher reimbursement would reflect those costs expected from increasing services as a result of increasing numbers of concessionary fare passengers (a 0.5 per cent increase in services might be expected to increase cost by around £0.08 per concessionary passenger).

47. The recent changes to the concessionary fare scheme, in particular since 2008, have resulted in diverging viewpoints of bus operators, local authorities and the DfT.

Bus service operators' grant

48. Immediately after deregulation, the only form of subsidy available to commercially-operated local bus services was fuel duty rebate. Operators of registered local bus services received a grant which offset a substantial part of the duty paid on the fuel used in running local bus services. The 2000 Act replaced this grant with the 'bus service operators' grant' (BSOG),[21] which again reimburses most of the fuel duty (all for new cleaner fuels) paid by the operators.

[21]Areas with a QC will not have a BSOG, as the parallel sum will be transferred to the local authority.

The competition test under the Transport Act 2000

1. Under the Transport Act,[22] competition tests applicable to LTAs, a QP, ticketing scheme or tendering exercise for subsidized services has to be 'justified' if it has a significantly adverse effect on competition. A bus scheme is 'justified' if it:

   (a) improves the quality of vehicles or facilities by, for example, providing bus stops that give electronic real-time information about waiting times;

   (b) has other substantial benefits to users by providing, for example:

   (i) more reliable and possibly more frequent services; or

   (ii) greater integration of services between different types of transport; or

   (iii) journey time savings; and

   (c) reduces or limits traffic congestion, noise or air pollution by, for example:

   (i) requiring the introduction of buses with better emissions standards; or

   (ii) increasing the use of public transport, leading to less pollution from private vehicles.

2. Where a scheme has a significantly adverse effect on competition, it may be justified if it produces benefits and is 'proportionate'.

3. The competition test is applied by the OFT, which has issued detailed guidance.[23] Where a scheme meets the first or second justification in paragraph 1, the OFT has said that it will adopt a two-stage approach. It will consider a significant adverse effect on competition proportionate when passengers are better off overall because the benefits to them outweigh the detriments to competition. Second, it will consider whether the parts of the scheme that adversely affect competition are reasonably necessary to achieve the justification. The OFT has said that it is unlikely to consider that the elimination of all competition would be proportionate.

4. Where a scheme is justified on environmental grounds, the OFT has said that it will take a view on whether the benefits of the scheme to passengers and the public outweigh the detriment to competition. The local authority must demonstrate that the restriction is needed to achieve the purposes specified.

5. If the OFT decides that the competition test is not met, it may give the local authority appropriate directions. These may include:

   - varying or revoking a QP or ticketing scheme;
   - varying or withdrawing an invitation to tender for subsidized services;
   - varying or terminating an agreement resulting from such a tender; and

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[22]The 2000 Act, as amended by the 2008 Act.
[23]OFT452: *Guidance on the application of competition law to certain aspects of the bus market following the Local Transport Act 2008*.

- prohibiting the scheme in the form proposed.

6. Where the OFT decides that the competition test is satisfied, it may subsequently take action in the instance that it has:

- reasonable grounds to believe that there has been a material change of circumstances since it made its decision; or

- a reasonable suspicion that the information upon which it based its decision was incomplete, false or misleading in a material way.

7. Agreements between bus operators are usually subject to the Competition Act 1998. Where an LTA has implemented a statutory quality partnership scheme in accordance with the 2000 Act, the 2000 Act sets out the mechanism whereby a related agreement between the bus operators must be certified and endorsed by the LTA in order that the Competition Act 1998 does not apply to the agreement between the bus operators.

Key events leading up to the merger

Introduction

1. The purpose of this appendix is to describe the interactions between Stagecoach and PBL in the months leading up to the launch by Stagecoach of the Preston Citi network of services in 2007, and in the following months until the time of the merger.[1]

Stagecoach's strategy for Preston

Background

2. At the beginning of our inquiry, we asked Stagecoach to provide us with any strategic plans, business plans and other documents relevant to Stagecoach's bus service operations produced in the last three years. In response, Stagecoach told us that its operating units do not produce a business plan as such, but that a performance-based budget is produced for each and does not extend beyond the coming year. Stagecoach only produced these annual budgets in response to our further request.

3. At a subsequent meeting, we reiterated our request for documents relating to Stagecoach's strategy and plans in Preston and asked for any contemporaneous documents (including notes of meetings and emails produced since the beginning of 2006) that might shed light on Stagecoach's intentions and plans for local bus services in Preston. We had by then become aware that Stagecoach had used a code name 'Project Biscuit' for its Preston expansion strategy and asked specifically for documents linked to this project. In its written response to the request, Stagecoach stated:

> [Stagecoach Director A] uncovered some documents which, although they do not relate directly to Stagecoach's decision to enter Preston in 2007, may nevertheless be of some interest. An internal meeting took place at Stagecoach's headquarters in autumn 2006 regarding the possible launch of bus services in Preston. [Stagecoach Director A] advises that the meeting was not minuted.

It was further stated that during that meeting two maps were spread out on a boardroom table (which were provided), [Stagecoach Director A] made an informal presentation (no document was provided to us) and some (unrecorded) discussion took place thereafter. Draft timetables and costing documents were also discussed (and provided to us). It was finally stated that all documents provided to us were retained in hard copy only.

4. On 23 June 2009 we issued a Notice to Stagecoach under section 109 of the Enterprise Act 2002 requesting:

> (i) all emails, either received or sent during the period 1 January 2006 to 23 January 2009 by the individuals listed in (i)*(a)–(e)* in their capacity as employees or officers of Stagecoach Group plc

[1]The review of the events described in this paper is based on a number of items of evidence received during the course of the inquiry including: the Traffic Commissioner's file of evidence gathered for the purposes of the Public Inquiry planned to be held on 10 June 2008; evidence from [former PBL Director X] and [former PBL Director Z]; internal Stagecoach documents, including emails; oral evidence from Stagecoach, and minutes of PBL board meetings.

(including any of its subsidiaries), which contain any of the following words: 'strategy', 'biscuit', 'Preston', 'Citi', 'PB', 'PBL'

(a) [Stagecoach Director B];

(b) [Stagecoach Director D];

(c) [Stagecoach Director M];

(d) [Stagecoach Director C];

(e) [Stagecoach Director A].

(ii) All correspondence, including emails (if not already provided in response to paragraph (i) above) minutes, records of meetings and phone conversations, presentations, reports and hand written notes, which were produced by or for Stagecoach Group plc, (including any of its subsidiaries) in the period 1 January 2006 to 23 January 2009, which are relevant to the business strategy of Stagecoach bus operations in Preston and/or the acquisition of Preston Bus Limited.

5. In response to this request, we received a large number of emails, minutes of various meetings, letters, presentations, some marketing survey reports and several spreadsheets. The vast majority of the documents were of no relevance to our inquiry. There was no plan, strategy or formal document on which we could rely to establish Stagecoach's strategic intentions in Preston. We were told that Stagecoach proceeded with an investment of £4 million[2] in new vehicles and the recruitment of 70 staff, including 55 drivers, without any documented plan. Further details of the Stagecoach internal process to acquire buses (commonly known internally as 'bus bids') are set out at paragraph 23.

6. We also asked Stagecoach whether it had projected the costs and revenues from the new Preston intra-urban services in its 2007/08 Stagecoach Northwest budget. When questioned during the inquiry, both the Finance Director of UK Bus ([✂]) and [Stagecoach Director C] told us that the 2007/08 budget was for the ongoing business only and excluded the new services. Nevertheless, as explained at paragraph 27 Stagecoach subsequently provided a spreadsheet called the 2007/08 budget which included costs and revenues for the new Preston intra-urban services. Stagecoach told us that the cost and revenue information in question was a minor entry on an inner tab of a multiple tab budget and had simply been forgotten by the above individuals. We noted that [Stagecoach Director A], despite his direct responsibility for the performance of the Preston depot, also appeared unaware of these cost and revenue projections when questioned during the inquiry. This suggested to us that the future performance of the new intra-urban Preston services was of little concern to any of Stagecoach's directors when the decision was made to launch them.

7. We examined Stagecoach's strategy for the Preston area, based on Stagecoach's submissions to us, evidence from other parties, notably [former PBL Director X] and the array of contemporaneous evidence mentioned in paragraphs 2 to 6 above.

[2]The reference to an investment of £4 million was included in the letter from Stagecoach Director C to the *Lancashire Evening Post* dated 2 November 2007 and also in the draft letter from Stagecoach Director C to Mark Hendrick MP dated 12 December 2007. Stagecoach subsequently stated that this comprised a cash investment of £[✂] million in new buses (25 vehicles at £[✂] each) for the Preston route expansion plus the transfer of new low floor buses valued at £[✂] million from elsewhere in Stagecoach for use on existing Service 2.

The formation of Stagecoach's Preston strategy

8. In its initial submission, Stagecoach told us that as part of its process of drawing up the annual budget for 2006, internal discussions had taken place within Stagecoach which had identified that the development of Stagecoach's business in Preston was affected by uncertainty surrounding the position of PBL. Stagecoach considered that PBL was not particularly well managed and that its model of employee ownership was likely to prove unsustainable in the long term. Stagecoach considered that a sale by PBL to another buyer was possible at some point and that it was likely that a future purchaser of PBL would take a more proactive approach to network development and perhaps threaten Stagecoach's operations around Preston. In the light of these considerations, Stagecoach had decided that the best approach to adopt was to expand its own business thereby consolidating its position and attempt to take a greater share of the Preston intra-urban market than had previously been the case.[3]

9. [Stagecoach Director C] told us that in 2006 Stagecoach 'had identified an opportunity to increase its share of the urban market in Preston against an operator which it considered to be extremely inefficient, unimaginative, rather dull and lacklustre'. Stagecoach further explained that it expected that PBL would sell out sooner rather than later to another, more efficient, better organized operator, which would make it more difficult for Stagecoach to gain market share.

10. Stagecoach told us that each year in the six-year period between 2000 and 2006, during the budget development process (which takes place in January/February) the management of the north-west division discussed the possibility of competing in Preston or buying PBL. Every year managers agreed that buying PBL was the preferred option if it came up for sale. This had been followed with meetings with [former PBL Director X] in 2001 and 2006. Stagecoach told us that when it approached PBL in 2006, it did not expect a positive response, based on its previous experience.

11. The minutes of Board of Directors meetings of Stagecoach Northwest show that from January 2006 until May 2007, there was a 'Preston Bus' project[4] being discussed at each meeting. Of particular notice are the following records:

    (a) The January 2006 minutes indicate that [Stagecoach Director G] was to ask for guidance from [Stagecoach Director C] and discuss next steps.

    (b) The March 2006 minutes state that [Stagecoach Director C] was showing an interest in taking the issue forward; [Stagecoach Director A] was to update the P&L and revalue the business, a Stagecoach employee ([✂]) was to estimate the value of the fleet and [Stagecoach Director G] was to write to PCC regarding the servicing of refuse lorries.[5]

    (c) The May 2006 minutes recorded that the fleet value was still to be estimated and that the option was to be discussed with [Stagecoach Director B] following the update of the financial statement.

    (d) The June 2006 minutes record the project is ongoing and that a further meeting has been arranged.

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[3] This explanation is consistent with Stagecoach's statement to the Traffic Commissioner.
[4] We note that [✂].
[5] PBL has a contract to maintain PCC's refuse lorries (the CVRM contract). As far as we are aware, Stagecoach has never competed with PBL for this contract.

(e) From then on, project ‘Preston Bus’ is ongoing until May 2007, at which point, the registration of Stagecoach’s new intra-urban services in Preston is recorded in the minutes of the meeting.

12. Stagecoach told us that the references to ‘Preston Bus—Project Ongoing’ remained in a number of minutes, because many of the headings were simply rolled over, and that the minutes should have been updated after the meeting with PBL in July 2006 came to nothing.

13. Commenting on the March 2006 minutes, [Stagecoach Director C] told us that before deciding to launch the new services in Preston, Stagecoach carefully evaluated PBL’s position. He told us that Stagecoach would expect to want to know everything it could about its competitor, including the value of PBL’s fleet and more information on PBL’s contract with PCC for the servicing of refuse vehicles. [Stagecoach Director A] confirmed that this type of research was entirely consistent with wanting to expand in the Preston bus services market. [Stagecoach Director A] added that he had no brief at that time to pursue the acquisition of PBL. [Stagecoach Director B] told us that the PBL fleet had been valued in order to make an offer for the company. He also told us that in the period between May 2006 and the meeting with PBL on 21 July 2006 Stagecoach was ‘working in the office to see what we thought the company was valued at and obviously we did get a set of the Preston Bus accounts just to look at their turnover, etc’. We note that in March 2007, [Stagecoach Director D] obtained the accounts of both Preston Transport Holdings and PBL.

Stagecoach’s interest in acquiring PBL: the 2006 approach

14. [Stagecoach Director A] and [Stagecoach Director B], participated in a meeting with [former PBL Director X], at which an approach was made to acquire PBL.[6] This meeting took place on 21 July 2006. [Stagecoach Director C] told us that he had requested his colleagues [Stagecoach Director B] and [Stagecoach Director A] to attend the meeting and to ‘enquire as to whether PBL may be for sale’. Stagecoach also told us that during this meeting, [Stagecoach Director B] and [Stagecoach Director A] insisted that [former PBL Director X] should take the approach to the PBL board of directors. [Stagecoach Director B] told us that ‘the agenda was to buy this company’ and that ‘it did take me about ten minutes to persuade him [former PBL Director X], again, repeating that he would have a job at the end of it, and he eventually agreed to take it to his Board of Directors’. According to [former PBL Director X], during the meeting, [Stagecoach Director B] indicated that Stagecoach wanted to purchase PBL and to initiate due diligence. [Former PBL Director X] later made a statement to the Traffic Commissioner that he was then told by [Stagecoach Director B] ‘…there is an easy way and a hard way… [of acquiring the business]’. [Former PBL Director X] was clear that this meant that Stagecoach would attempt to force the sale of the PBL business through competitive means. In a hearing with the CC, [Stagecoach Director B] denied making any threat during the meeting on 21 July 2006 and told us that he had commented: ‘there are other things I could do in my business’, by which he said he meant looking for cost reductions. In another submission to us, Stagecoach stated: ‘it would have been commercial madness to disclose Stagecoach’s intention to enter the Preston market almost a year before that was feasible. This would simply have given Preston Bus an opportunity to prepare for any such entry.’

[6] We are also aware that there had been an earlier meeting, on 6 June 2006, requested by Stagecoach to introduce [Stagecoach Director B].

15. We noted that PBL's minutes of 30 August 2006 Board meeting (the first board meeting after the 21 July 2006 meeting), stated: 'there was a discussion regarding the likelihood of service changes by Stagecoach and our response to such changes' and that [former PBL Director X] confirmed that following his meeting with Stagecoach, PBL had actively prepared for the entry of Stagecoach on its routes.

16. In its evidence to the Traffic Commissioner, Stagecoach stated that the approach made to [former PBL Director X] of PBL was to establish whether the uncertainty surrounding the future of the Preston market, from the perspective of Stagecoach, might be resolved through acquisition. Stagecoach further stated that 'it must be stressed that no threats, competitive or otherwise, were made by Stagecoach in this process, but the possibility of competition was mentioned'.[7]

17. [Stagecoach Director A] told us that he did not remember the exact words used in the meeting and that [Stagecoach Director B] had said that there were other options open to Stagecoach to improve the performance of Stagecoach's Preston depot. [Stagecoach Director C] told us that, having spoken to [former PBL Director X], [Stagecoach Director A] and [Stagecoach Director B], he had come to believe that [Stagecoach Director B] had probably said more than he should have, but that this was not a threat in the way it was taken. [Stagecoach Director C] added that, in his view, [former PBL Director X] had no reason to lie about this issue.

18. On 2 November 2007 [Stagecoach Director C] sent a letter to the Lancashire Evening Post, in which he stated emphatically that Stagecoach had not expressed an interest in PBL for many years. [Stagecoach Director C] acknowledged in the hearing with us that this was not consistent with the facts and that he knew this to be the case. In a subsequent submission, [Stagecoach Director C] told us that the letter to the LEP was 'strictly accurate in narrow terms as [he] had not personally discussed that or any other matter with [former PBL Director X] for some years although [he] had sent [Stagecoach Director B] and [Stagecoach Director A] to ask the question'. We note, for completeness, the relevant text of this letter: '[Former PBL Director X] accuses us of trying to buy Preston Bus. I have known him personally for many years. It is correct that I said to him some years ago that Stagecoach would be happy to make an offer if the Company were for sale. However he made it very plain that he would not consider an offer from us … and I have not pursued the matter since … For the record, we seek neither to buy Preston Bus, nor to put it out of business.'

19. In a draft of a letter to Mark Hendrick MP, [Stagecoach Director C] stated:

> In the debate on bus services in Preston on 27 November you made a number of inaccurate statements. I presume these were the result of false information provided to you by Preston Bus […] Taking the points you made in the debate: […] My [✂] Director [✂] expressly denies that he has ever told [former PBL Director X] that he would secure the business by hostile action if they did not sell to us, and is supported in this by our [✂] Director, [✂], who was present at the meeting.

20. [Stagecoach Director C] told us that the statements made in this draft letter were consistent with what [Stagecoach Director B] had told him at the time. As noted in paragraph 17, he did, however, acknowledge that he subsequently came to doubt [Stagecoach Director B]'s words. We note that the statements were removed from the otherwise identical final text of the letter that was sent to Mr Hendrick, dated 12

[7]This explanation is set out in the Stagecoach statement to the Traffic Commissioner upon the calling of the Public Inquiry, June 2008.

December 2007, and we also note that the final letter was sent under the signature of [Stagecoach Director A].

21. The 2006 approach was declined by PBL two weeks after the meeting, the delay being due to a PBL director being on holiday at that time.

The plan for expansion

22. Following the meeting with [former PBL Director X], Stagecoach produced ‘some rough and ready figures of what it would take to establish a credible level of competition in Preston’. By 4 August 2006, Stagecoach had prepared a high level plan for the launch of new services and revision of current services in Preston. These plans set out a frequency increase on service 2/2A to 10 minutes, and the launch of services 11, 16 and 35. Cost estimates were made at this time but there was no analysis of revenue. The plan also indicated that existing services might need to be reinforced. It was set out that the frequency of service 132[8] could be increased to every eight minutes, and an additional low-floor vehicle and increased frequency on service 125 (an inter-urban service to Bolton) might be required.

23. Stagecoach explained to us that there was an annual process when all Stagecoach depots submitted bids for new buses (‘bus bids’). The number of buses in these bids was usually greater than the number that Stagecoach could afford to purchase, and the management of UK Bus had to scale back the bids and assign buses to the services which had the highest profit margins and the highest potential for generating more growth. In making their bids, the regional managing directors were required to provide an explanation of what they wanted the buses for and the route performance of the services for which new buses were wanted. The expected operating margin of the service would normally be part of the consideration. We asked Stagecoach to provide us with Stagecoach Northwest’s bid for 2007/08. In its response, Stagecoach provided a list of ‘bus bid’ documents. Stagecoach told us that on 28 July 2006 [Stagecoach Director A] submitted bids for new buses for the north-west region to [Stagecoach Director C] and these did not request new buses for expansion in Preston as there were no firm plans to expand at that time. Subsequent bus-bid documents dating from August to September 2006 also make no mention of 25 buses for Preston. Discussion of draft timetables for new services in Preston took place in October 2006 and at this time the proposal was to use buses from the Stagecoach reserve fleet. About a month later [Stagecoach Director C] indicated to [Stagecoach Director A] that if Stagecoach were going to expand in Preston it would be with new vehicles. The first mention of 25 new minibuses was recorded in an email from [Stagecoach Director C] to a Stagecoach employee [✂] dated 19 November 2006.

24. By mid-November 2006, [Stagecoach Director C] had provisionally allocated 25 new buses for potential intra-urban services in Preston, as part of his annual order of 500 buses for the entire UK Bus group. [Stagecoach Director C] told us that no projection of revenues or operating margin had been made in support of this order and that the only document in support of this decision was the 4 August business plan prepared by [Stagecoach Director A’s] team. He also told us that because of the uncertainty surrounding their launch he would not typically attempt to project revenues for services launched on competitors’ established routes. The bus bid documents provided to us by Stagecoach confirmed that no such projections had been made.

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[8] Subsequently renumbered 3.

25. [Stagecoach Director C] explained that there was a long lead time for the delivery of the new buses and, this was the only reason why it had not been possible to launch the new Preston Citi services until the summer of 2007.

26. As explained in paragraph 3, there was a meeting at Stagecoach headquarters in autumn 2006, during which maps and timetables for the new intra-urban services were discussed. Stagecoach told us that 'the proposal was not taken forward at that time but was revised in January 2007'. Stagecoach also stated that the plans were not taken forward whilst the new bus allocation was underway.

27. The detailed operational plans for the new intra-urban services were ready by February 2007. It was expected that an additional 55 drivers would be recruited and it was confirmed that 25 new buses would be allocated to Preston. The plans were intended to be carried out in three phases, between 25 June and 28 August 2007 and involved the launch of five new services across Preston. A high-level projection of revenue and cost was included in Stagecoach Northwest's 2007/08 budget. The budget did not contain an estimate for market share and we have seen no commentary on the budget figures.

28. The plans are listed in Table 1.

TABLE 1 **Stagecoach: Preston new services plan (February 2007)**

	*PVR**	*Drivers*	*Frequency (minutes)*
Phase 1 (25 June 2007)			
Service 11—Ribbleton–Gamull Lane	4	20†	10
Service 16—New Hall Lane–Farringdon Park	4		7–8
Phase 2 (30 July 2007)			
Services 1 & 1A—Preston Hospital‡	10	25	9
Phase 3 (28 August 2007)			
Service 33—Tanterton	5	10	10
Total	23	55	

Source: Stagecoach.

*PVR is Peak Vehicle Requirement.
†Combined driver requirement for Service 11 and 16.
‡Subsequently introduced as 19/22.

29. We questioned the rationale for launching a network of routes across the entire city over such a short period of time, given that there seemed to be little strategic urgency and given Stagecoach's argument that customers in Preston do not value networks of services. Stagecoach accepted that there was no strategic urgency, but argued that launching several services together under a common brand had benefits in terms of promotional cost and impact.

30. Stagecoach planned to set fares below those of PBL, with significant discounts offered on daily and weekly tickets. These fares are listed in Table 2.

TABLE 2 **Stagecoach: planned fares compared to PBL fares (February 2007)**

	Stagecoach	*PBL*
Adult (short distance)	£0.50	£0.60
Adult (medium distance)	£0.75	£0.80
Adult (long distance)	£0.95	£1.00 and £1.10
Day ticket	£2.50 (introductory—£1.50)	£3.00 (children free after 9.15am)
Weekly ticket	£7.50 (introductory—£5.00)	£9.00 (children free after 9.15am)

Source: Stagecoach.

31. In April 2007, the new intra-urban services were registered with the Traffic Commissioner and final sign-off for the vehicles was given. The recruitment of drivers and other new staff was initiated following registration of the new services.

Expansion of Stagecoach services

32. Stagecoach made some minor changes to its existing services before launching its intra-urban services to directly contest routes serviced by PBL. In the period between July 2006 and March 2007 there were changes made to the Stagecoach fare structure and frequency of those services overlapping with the routes of PBL. It also increased the frequency of its intra-urban service 132 to Penwortham (later re-numbered to 3). Then, in the period from March 2007 to May 2008, Stagecoach launched a number of new routes to compete directly across the entire PBL network. We review these two phases next.

Frequency and fare changes on existing overlaps

33. In the eight months following the meeting on 21 July 2006 between PBL and Stagecoach a number of changes to Stagecoach and PBL services were implemented.[9]

(a) *October 2006.* Most Stagecoach fares were increased but the maximum adult single fare on two routes overlapping with PBL was held to 90p (Gamull Lane and Lea). The frequency on Stagecoach service 2 was increased to every 10 minutes during the day and 20 minutes on Sunday, between Preston and Longridge only. PBL withdrew services 6 and 43; adjusted services 7, 8, 11, 14, 19, 21, 23, 24, 25, 34, 44 and 36; and introduced new services 88A, 88C and 89 (these new services were tendered by Lancashire County Council). PBL implemented a postponed fare increase (originally budgeted for June 2006);

(b) *December 2006.* Stagecoach increased frequency on service 68 to 10 minutes within Preston, and the single fare was set at 90p (£1.35 return). Stagecoach advertised on service 2/2A highlighting a Route Rider ticket at £10 and the availability of a weekly ticket from the driver, implemented later last departures, improved Sunday timetables, and ran a Boxing Day service; and

(c) *February 2007.* Stagecoach implemented minor changes to the timetable of service 68, adding three additional journeys during school holidays and the change to a timing point.

[9]These observations were recorded in PBL management minutes and can be seen from timetable information provided by Stagecoach.

Introduction of the new intra-urban routes

34. From June 2007 new services were launched by both Stagecoach and PBL in direct competition with services provided by the other. We saw from an internal Stagecoach communication that it was closely monitoring any service changes being implemented by PBL. In May 2007 copies of PBL registrations for services 2 and 3[10] were obtained from the Vehicle and Operator Services Agency (VOSA). In June 2007 Stagecoach observed that PBL was withdrawing services 21 and 36, introducing a new service 87 and varying the timetables and frequencies for other services. Between June 2007 and March 2008 Stagecoach launched new services and varied others, as set out in Table 3.

TABLE 3 **Stagecoach: new services launched and variations of services**

Date	*Service*	*Frequency*
24 June 2007	New service: 11—Preston–Ribbleton	Every 10 min
	New service: 16—Preston–Farringdon Park	Every 7–8 min
	Service 2: Sunday timetable frequency reduced to coordinate with service 11	Every 30 min
30 July 2007	New Services: 19 and 22—Preston to Hospital clockwise and anti-clockwise circulars	Every 10 min
28 August 2007	New Service: 33—Preston–Tanterton	Every 9–10 min
8 October 2007	Service 11 revised to comply with Traffic Regulation Condition at Lancaster Road and Grange Estate.	
	Service 16 changed to service 9 and revised route.	
	Services 19/22 revised to comply with Traffic Regulation Condition at Sharoe Green Lane	
28 October 2007	New service: 32—Preston–Larches	Every 15 min
30 March 2008	Service 1 introduced to replace part of service 2/2A	
	Service 3: revised peak frequency	
	Service 9: increased Monday to Saturday frequency	Every 5–6 min
	Service 9: increased Sunday frequency	Every 15 min
	Service 11: revised timetable to co-ordinate with service 1	
	Service 19/22: revised timetable	
	Service 32 withdrawn	
	Service 33: new evening and Sunday timetables	

Source: Stagecoach.

35. In August 2007 Stagecoach calculated its share of journeys and passengers from observations of services and noted:

(a) *Gamull Lane (services 2/11):* 25 per cent of journeys and 51 per cent of passengers, compared with 38 per cent of journeys and 45 per cent of passengers before the new services;

(b) *New Hall Lane (service 16):* 45 per cent of journeys; 40 per cent of inbound passengers and 27 per cent of outbound passengers; and

(c) *Penwortham (service 3):* 67 per cent of journeys in total, 81 per cent inbound and 89 per cent outbound. Previously Stagecoach had between 85 per cent and 93 per cent against Blue Bus.

36. The background to the service changes after summer 2007 is as follows: Stagecoach explained to us that around August 2007, it decided to launch an additional route to Larches, due to a very favourable public response to the first three phases of new service introduction in June, July and August. Based on some observations on other routes in the Preston area, Stagecoach thought the Larches services would 'go quite

[10]The former being a service four times a day to Southport, served by Stagecoach's route 2, and the latter to compete with Stagecoach's route 3 to Penwortham.

well with the previous phasing of services that we had introduced'. We note that there is no contemporaneous document in support of these assertions and that no projection of cost or revenue was supplied to us. We also note that PBL had registered a new service to Larches in June 07. [Stagecoach Manager K] had commented in an email at the time: 'probably having a go at our 68 short trips and also ensuring that Larches is sewn up, as [former PBL Director X] is probably convinced that Larches is a future likely target in the bus war.' By March 2008, the service was withdrawn by Stagecoach, due to poor customer demand and competition from PBL.

37. As well as launching new services and varying others, Stagecoach reviewed and changed fares, usually increasing them. Table 4 sets out details of Stagecoach's fare changes between January 2007 and February 2009.

TABLE 4 **Stagecoach fare changes January 2007 to February 2009**

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Date of change	*Single*	*Return*	*Citi Day*	*Citirider*	*Dayrider*	*Megarider*
As at January 2007*	0.50	0.90	N/A	N/A	3.15	12.00
	0.55	N/A				
	0.65	N/A				
	0.70	1.25				
	0.80	1.45				
	0.85	1.50				
	0.90	1.65				
	1.00	1.80				
	1.05	1.90				
	1.15	2.05				
	1.45	2.60				
	1.50	2.60				
4 March 2007	No changes	No changes	N/A	N/A	3.30	12.00
24 June 2007	0.60	N/A	1.50	5.00	3.30	12.50
	0.80	N/A				
	1.00	N/A				
30 September 2007†	0.60	N/A	2.00	6.00	3.30	12.50
	0.80	N/A				
	1.00	N/A				
3 February 2008	0.60	N/A	2.00	7.00	3.50	13.00
	0.80	N/A				
	1.00	N/A				
30 March 2008‡	0.70	N/A	2.00	7.00	3.50	13.00
	0.90	N/A				
	1.00	N/A				
14 September 2008§	0.75	N/A	2.20	7.30	3.50	13.00
	0.95	N/A				
	1.10	N/A				
1 February 2009¶	0.80	N/A	2.60	8.00	3.50	13.50
(Fares merged with PBL)	1.00	N/A				
	1.20	N/A				

Source: Stagecoach.

*Penwortham Routerider (£7.50) withdrawn.
†Penwortham special return introduced at £1.75. Penwortham Routerider re-introduced £5 per week.
‡Penwortham Routerider increased to £6 per week.
§Penwortham special return increased to £1.90. Penwortham Routerider increased to £6.50 per week.
¶Penwortham special return increased to £2.00. Penwortham Routerider increased to £7.00 per week.

38. By December 2007, Stagecoach management began to express some concern over the losses incurred on all of the new intra-urban routes. Measures taken to address this issue, included: relocating a bus from service 19/22 (without affecting frequency)

to bolster service 3; some off-peak resource was transferred away from service 19/22 to service 9; and service 32 was withdrawn. These actions were expected to reduce costs by £25,000 and reduce revenue by £7,000 in each period, which would reduce the deficit each period from £[✂] to £[✂].

39. Concerns over the performance of Stagecoach Preston services started to be recorded in the minutes of Directors' meetings for Stagecoach Northwest in February 2008. By June 2008, underlying performance was causing concern and all services were subject to scrutiny. 'Bus savings in the autumn and other options' were to be considered.

40. [Stagecoach Director C] confirmed to us that he had been concerned that progress with the new routes was slower than he would have liked, but he added that he was satisfied that progress was being made. [Stagecoach Director C] also told us that 'the level of competition in Preston [in late 2007] could not continue indefinitely'.

41. Throughout the period, PBL was maintaining a close review of Stagecoach's services. At the August 2007 board meeting, it was noted 'so far Stagecoach are not having much impact on the 19/23 route [hospital service]. They are putting in massive resources to little effect'. The PBL board also noted its own 'service change which was implemented on 30 July. The aim of the change had been to try to pre-empt what Stagecoach might do next and to protect our network'.

42. At the September 2007 PBL board meeting, the plans to increase the frequency on the Ingol service and the registration by Stagecoach of its service 32 to operate from 29 October were noted. It was agreed that a further two vehicles were needed to defend PBL's own service and this purchase was agreed. In addition, the PBL board agreed to purchase eight new Solo buses at its meeting of 31 October 2007. The new PBL services and changes to route frequency or timetable are set out in Table 5.

TABLE 5 **PBL: new services launched and variations of services**

Date	*Service*
19 July 2007	New service: 3—Preston–Penwortham New service: 2—Preston–Southport
30 July 2007	Services 7, 8, 11, 14, 16, 19, 21, 22, 23, 24, 25, 31, 33, 34, 35, 44, 88A/88C, 89 increased frequencies or timetable changed. New service: 87—Preston to Larches and Lea
31 October 2007	Service 24/25 registration submitted to operate this with 25s
1 December 2007	PBL wins the Preston Park & Ride for next five years
10 December 2007	Service 44 amended to correct errors in the registration
19 May 2008	Services 7, 8, 11, 16, 19, 22, 23, 35, 44 timetables changed or reduced frequencies at shoulder peak times Service 87 withdrawn

Source: PBL.

43. There was a series of meetings between Stagecoach and PBL between December 2007 and July 2008. Early on in our inquiry,[11] Stagecoach stated unambiguously that in the first of these meetings (4 December 2007), 'informal enquiries were made by [Stagecoach Director A] and [Stagecoach Director C] about the possibility of acquiring PBL and a suggestion was also made about the possibility of a statutory quality partnership (SQP)', (see Appendix E for description). According to Stagecoach, both issues represented no more than a brief exchange and no substantive discussion took place. Stagecoach added that both of these suggestions were rejected by [former PBL Director X]. Later on during our inquiry, Stagecoach

[11]In response to one of our questionnaires.

asserted that it had not enquired about the possibility of acquiring PBL during the December 2007 meeting, putting forward written notes of the meeting taken by [Stagecoach Director A] at the time as evidence of this assertion. We noted that the content of [Stagecoach Director A]'s notes were inconclusive on this matter. However, [former PBL Director X]'s recollection of the meeting was that Stagecoach had not enquired formally about the possibility of buying PBL, but that an offhand comment might have been made.

44. [Stagecoach Director C] told us that '[former PBL Director X] made [an] offer to buy Stagecoach's operation in Preston'. [Stagecoach Director C] added that he thought 'it was rather laughable'. Stagecoach clarified that this referred to the difficulty that PBL would have in completing such a transaction given the scale of Stagecoach's entire Preston operations relative to the size of PBL.

45. Stagecoach stated that in December 2007, it had made an offer to sell its Preston intra-urban operations to PBL. Stagecoach told us that Stagecoach's proposal outlined to PBL 'was for a sale of 25 minibuses for £[✂] each[12] plus the transfer of staff under TUPE. The option of a hire charge instead of the purchase of the vehicles was also floated. We note that the proposed sale price for the buses would have represented a premium to the original cost of the new vehicles when they were purchased approximately 12 months earlier, that Stagecoach's operation was loss-making and that PBL would have had to make at least some the drivers redundant as a result of this acquisition. [Former PBL Director X] told us that the proposal also included a £[✂] contribution towards the drivers' training costs, but Stagecoach denied this. Although the former management of PBL said it considered the offer to be very good, it turned it down on legal advice.

46. Stagecoach also said it had proposed a Quality Partnership to PBL. It explained to us that the rationale for this suggestion was to allow both PBL and Stagecoach to retrench and said this was evidence that Stagecoach was not seeking to force PBL to sell. We note [Stagecoach Director E]'s comments, which we understand to have been provided in the context of general policy advice that Stagecoach had an aversion to ('[✂]') registration restrictions. 'Not only do they restrict new entrants—they prevent you expanding your services too. [✂]'. [Stagecoach Director A] also commented in correspondence with [Stagecoach Director E] that the Quality Partnership process was complex and bureaucratic. We contacted LCC to understand how far the discussions between LCC and Stagecoach had progressed. In its response, LCC indicated that whilst preliminary discussions had taken place, no outcome was ever determined.

47. Stagecoach told us that following the rejection of its offer to purchase PBL in July 2006 and until it was invited to make an offer in September 2008, a merger with PBL had not been anywhere in Stagecoach's thinking.

Involvement of the North West Traffic Commissioner

48. [Former PBL Director X], in a letter to the North West Traffic Commissioner dated 22 May 2007, expressed his concerns that Stagecoach appeared to have registered new services in a way that would block bus stops and create traffic congestion problems. In particular, on services 11 and 16 the timetable allocated 4 minutes for a journey that took 1 minute. He suggested that this meant the bus would be parked at the first stop from the bus station for about 3 minutes, which would cause obstruction

[12] Total: £[✂] million. This compares with an acquisition cost for each vehicle of £[✂] when the vehicles were acquired by Stagecoach some 12 months earlier.

and delays to services. He also stated that Stagecoach had reduced fares to 50p to reach the terminus of PBL's service 16, but were charging the normal fare of £2.35 to the next stop where Stagecoach had no competition. At this time PBL was charging £1.10 to its terminus.

49. Stagecoach received a letter from the North West Traffic Commissioner dated 18 May, expressing concern over the potential operation of bus services in Preston around the Gamull Lane and Farringdon Park area. She reminded Stagecoach that it 'must not indulge in any anti-competitive behaviour or intentionally interfere with other operators of registered local bus services'. In an interview in the Lancashire Evening Post the North West Traffic Commissioner was quoted:[13]

> if operators are intentionally interfering with one another I have the power to stop them, such as stopping them running services. It is a fine line between intentional interference and fair and open competition, but what I won't tolerate is bus companies deliberately trying to obstruct each other. I am monitoring the situation very carefully. Intentional interference could include blocking bus stops, shepherding passengers onto a particular bus or flooding an area with bus services.

50. Third parties submitted complaints to the North West Traffic Commissioner, which began to arrive at the end of June 2007. These complaints were mostly about issues resulting from Stagecoach's operations launched in direct competition with PBL. There was one complaint against PBL. In July 2007 the North West Traffic Commissioner began to request details of journeys, registrations and numbers of Stagecoach passengers.

Traffic Regulation Conditions

51. LCC wrote to Stagecoach and PBL on 1 July 2007 to express concern about the disruption to highways, congestion and the loading of passengers on the carriageway. In response, Stagecoach stated that it was to deploy supervision to ensure that traffic movement was not impeded and pavement safety was protected. Stagecoach also considered other options to address the issues raised, such as adjustment of the journey and layover times on service 16, and an alternative route for service 16.

52. LCC continued to receive complaints, and on 24 July 2007 made a request to the North West Traffic Commissioner that Traffic Regulation Conditions should be imposed. Traffic Regulation Conditions were put into effect from 30 July 2007 on the following roads:

(a) Lancaster Road—in its entirety.

(b) Farringdon Park Area: Tudor Avenue and Cairnsmore Avenue.

(c) Gamull Lane Area: B6243 Longridge Road, between Fir Trees Avenue and Grange Avenue; Grange Avenue; Fir Trees Avenue and Sharoe Green Lane (between Tower Lane and the A6 Garstang Road).

53. After the imposition of the Traffic Regulation Conditions, Stagecoach wrote to LCC to point out that they were not consulted on the Traffic Regulation Conditions which were excessively wide. Some consultation with PBL and Stagecoach followed this

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[13] 21 June 2007.

letter and some aspects of the Traffic Regulation Conditions were relaxed, reducing the times they were in force. Monitoring of the Traffic Regulation Conditions occurred on 6 and 9 August 2007, and it was observed that the conditions were being largely complied with. The conditions were further modified in November 2007 and in January 2008. The latter amendment was for Stagecoach services 11 and 16 to allow for standing time at the Farringdon Park terminus and layover time at Grange Avenue, but only one bus was allowed on the stand at any given time.

Events leading to the public inquiry

54. In August 2007 two Stagecoach bus drivers threw eggs at PBL buses in Ribbleton and New Hall Lane. Stagecoach told us that this conduct resulted in disciplinary action being taken against the drivers involved. PBL wrote to the North West Traffic Commissioner on this 'dangerous behaviour', giving details of the incident. PBL wrote again to the North West Traffic Commissioner in September, alleging that the tactics employed by Stagecoach were anti-competitive practices. The North West Traffic Commissioner held an in-chambers hearing with Stagecoach about these allegations on 18 September 2007.[14] However, at that time the North West Traffic Commissioner did not provide Stagecoach with details of the alleged complaints which were referred to and Stagecoach therefore did not have a chance to respond.[15] On the next day PBL again wrote to the North West Traffic Commissioner about further incidents that had occurred on 18 September, involving the removal of customer information and aggressive behaviour. On 20 September PBL sent allegations that Stagecoach was intentionally interfering with PBL services and that this had followed from an unwillingness of PBL to enter sale negotiations with Stagecoach. Stagecoach wrote to the North West Traffic Commissioner on 1 October attaching a DVD to suggest misconduct by PBL.

55. Third-party complaints continued to be received by the Traffic Commissioner until October 2007, the majority making complaints against Stagecoach. Councillors Terry and Joyce Cartwright wrote to the Traffic Commissioner on 30 September 2007, criticizing the 'tactics' used by Stagecoach and passing on concerns of fellow passengers regarding safety. Councillor Alan Hackett also wrote on 1 October 2007, relaying concerns of the public and of members of the Council's Environment Review Panel, which had met on 25 September. A letter dated 25 October 2007 was also received from Aidan Turner-Bishop of the Lancashire Campaign for Better Transport, in which he referred to 'irregular practice being used by Stagecoach on Preston Citi route 19'. In its evidence to the Traffic Commissioner, Stagecoach alleged that complaints had been orchestrated by PBL.

56. The Traffic Commissioner wrote to Stagecoach on 30 November 2007 stating that she had decided to hold a Public Inquiry into the behaviour of Stagecoach. The Public Inquiry was arranged for 28 February 2008, and PBL was to be called as a witness. On 11 December 2007 Stagecoach complained to the Traffic Commissioner that she was not being even-handed, and on 14 February the Traffic Commissioner decided that the 28 February hearing would be replaced by a further directions hearing and that the Public Inquiry would be adjourned to a later date. PBL was called to the Public Inquiry on 23 May 2008.

57. In his evidence to the Traffic Commissioner, [former PBL Director X] provided detailed statements from PBL staff of Stagecoach's conduct and identified the

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[14]On 21 September 2007 Stagecoach disclosed to the Traffic Commissioner that the two employees involved in the egg-throwing incident had been disciplined and a police investigation had resulted in each receiving a fixed penalty fine of £80 for disorderly conduct.

[15]The detail of the allegations was provided to Stagecoach in April 2008.

following tactics used by Stagecoach as evidence of interference with PBL's operations:

(a) the use of a large number of on-street controllers to manage Stagecoach services;

(b) blocking bus stops and manipulating departure times, so that Stagecoach vehicles ran in front of those operated by PBL;

(c) large marketing campaigns to highlight cheap weekly tickets;

(d) free travel to customers who had indicated an intention to board a PBL bus rather than a Stagecoach one and badgering customers to board Stagecoach vehicles;

(e) touting for customers while and making disparaging remarks about PBL including deliberately giving false information to undermine PBL customer loyalty; and

(f) aggressive behaviour towards PBL staff.

58. One of the PBL employees, who was employed to observe bus operations at Lancaster Road to ensure the safe operation of PBL buses during the 2007 summer, supplied a statement of one particular conversation with two Stagecoach executives: [Stagecoach Director J] and [Stagecoach Director B]. [Stagecoach Director J] was said to have commented that '[former PBL Director X] should have accepted the offer made to him by Stagecoach'. [Stagecoach Director B] had been said to state very aggressively that 'by the time that they had finished with us, my shares [in PBL] would be worthless, and nobody would want to buy us'. [Stagecoach Director B] told us that this statement was untrue and Stagecoach commented that this statement was part of PBL's concerted campaign against Stagecoach.

59. Stagecoach told us that it provided detailed evidence to the Traffic Commissioner in response to these allegations. In particular Stagecoach asserted that [former PBL Director X] had omitted to state to the Traffic Commissioner that he had planned to react to Stagecoach in a way that ensured the Traffic Commissioner would become involved and had instructed his drivers to block Stagecoach buses. According to Stagecoach, he also failed to declare that many of the complainants were linked to PBL and its orchestrated campaign.

Public inquiry

60. We understand that in May 2008 the Traffic Commissioner heard representations from both PBL and Stagecoach about the ongoing issues in Preston. It was the preference of the Traffic Commissioner that the operators should resolve their problems among themselves rather than through the public forum of an official inquiry, which was to begin on 10 June 2008. There was correspondence between the parties leading up to the 10 June date and at that time an agreement was finalized. It was ultimately agreed that that both operators would allow 20 per cent of their services to be monitored, in addition to the already existing Traffic Regulation Conditions, which had proved effective at resolving the disputes that had been arising.

The effects of Stagecoach's operation of the new intra-urban routes

1. This appendix provides analysis and information to support our findings regarding the effects of the operation of the new intra-urban routes which Stagecoach entered in summer 2007.

2. First, we analyse the changes to services, frequencies, fares and passenger numbers in the period of operation of the new intra-urban routes by Stagecoach compared with the situation that existed before Stagecoach launched its new intra-urban services in Preston and with the situation after the merger. Second, we set out our views on when new routes might be expected to become profitable, based on evidence from third parties and Stagecoach. We then examine the profitability of these routes in 2007–09 using two cost allocation methods. Finally we look at the profitability of PBL during this period.

Competition between the parties after June 2007

Stagecoach's new services

3. Between June and October 2007, Stagecoach introduced six new routes within Preston; these were services 11, 9 (16), 19/22,[1] 33 and 32 (the 'new intra-urban routes'). Services 11 and 19/22 overlapped on all flows with PBL's services of the same name. Services 9 (16), 33 and 32 overlapped with a combination of PBL services 8, 16, 31, 35 and 44.

4. Service 32 to Larches was the first to be withdrawn in March 2008. Services 11 and 33 were withdrawn following the merger. Services 9 and 19/22 continue to run. (See Annex 1 for more details.)

Frequencies

5. We found that following the launch of Stagecoach's new intra-urban services, the frequency on overlap route segments[2] increased considerably in comparison with the period before Stagecoach entered these routes, in some cases tripling. We also found that following the merger, Stagecoach reduced the frequencies of services to the levels that existed before it entered on PBL routes on five out of ten overlap route segments.[3] As for the other five overlap route segments, in two cases, the entirety of routes 19 and 22, the service levels have increased by 20 per cent from 10 buses per hour to 12 buses an hour compared with the levels before Stagecoach entered these routes. In the case of the overlap between PBL's services 31 and 44 and Stagecoach's service 33, the number of buses has increased by 17 per cent from 6 buses an hour to 7 buses an hour. In the case of the overlap of PBL's route 16 and Stagecoach's route 9, the service level increased by 50 per cent from 8 buses an

[1] Note these are two separate Stagecoach routes which both run to the hospital operating in different directions, although with most services then continuing back to the bus station via the other direction and with the other number, allowing through journeys on through tickets.
[2] As we explain in paragraph 3 while PBL's and Stagecoach's services overlap heavily, they do not overlap exactly with some consecutive flows being served by both companies with both using differently routed services. For ease of comparison, it might be more appropriate to consider different segments of routes on which the two operators overlapped. An overlap segment is therefore obtained by adding together as many consecutive overlap flows as possible served by a particular service by each company.
[3] We note that nine of the ten overlap segments were created by Stagecoach's expansion on PBL's routes, while one overlap segment was created by PBL's retaliation on Stagecoach's route 3.

hour to 12 buses an hour. Finally, in the case, of routes 8 and 9 to Moor Nook, it would appear that services have increased by 100 per cent from 6 buses an hour to 12 buses an hour. However, routes 8 and 9 only overlap on a small part of the route from Preston Bus Station to the terminus by Moor Nook, as both services take a different route to reach this destination (see Annex 2 for more details).

Fares

6. Stagecoach responded to PBL's pricing by offering the 'Citirider' ticket which was equivalent to PBL's weekly network ticket, 'Easi Week'. The price of the Citirider increased considerably during the period of operation of the new intra-urban routes and before the acquisition of PBL. It started at £5 in June 2007, increased to £6 by September 2007, further increased to £7 in February 2007 and to £7.30 by September 2008. PBL did not respond to Stagecoach's entry by lowering its fares; the price of the Easi Week ticket remained at £9 (the level charged before Stagecoach's launch of the new intra-urban routes) before and during the period of Stagecoach's operation of the new intra-urban routes. Following the merger, in February 2009, Stagecoach set the price of the Citirider ticket at £8. At the same time, it lowered the price of the PBL's Easi Week ticket from £9 to £8, thus aligning the pricing of the two companies. Stagecoach charged considerably less for its network ticket, for a significant part of the period of operation before acquisition of PBL, compared with its longer-term pricing requirements. (See Appendix F for more details.)

7. We noted that during our inquiry Stagecoach increased fares.[4] This increase led to Stagecoach's single ticket prices being above the levels charged by PBL before Stagecoach's entry on PBL's routes while Stagecoach's network tickets remained below the levels previously charged by PBL. Given that Stagecoach derives more revenues from single tickets than from network tickets,[5] it is possible that the consumer benefit from lower fares has now been reversed. Indeed, before Stagecoach's expansion on PBL's routes, the average fare for intra-urban journeys in the Preston area was £[✄] but following the merger it was £[✄].[6]

Passenger numbers—market growth

8. Stagecoach submitted that before it launched its new intra-urban services in Preston, it 'saw a clear possibility of growing the overall market for bus travel in Preston (as proved to be the case)'. It further submitted that '[i]t is evident from the limited information available that the changes to the network in 2007 expanded the overall market for bus travel in Preston, and it is evident that a proportion of the additional trips were from existing bus travellers and a proportion from new or previously irregular users'. Stagecoach further submitted that it grew custom in the Preston area by 9 per cent in 2008. [Stagecoach Director A] told us that following the integration of PBL's and Stagecoach's networks a fall in passenger numbers was to be expected, although not by as much as 9 per cent. Stagecoach also told us that since 2008, passenger numbers in the Preston area had fallen by some 2 per cent, but Stagecoach attributed this fall to the recession.

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[4]Single fares increased as follows: £0.80 fare increased to £0.90, £1.00 to £1.10, and £1.20 to 1.30.
Network tickets increased as follows: City Day increased from £2.60 to £2.65 and Citirider from £8 to £8.50.
[5]Based on data provided by Stagecoach in response to one of our written questionnaires, in 2008 Stagecoach derived around [✄] per cent of revenues from single tickets and [✄] per cent from network tickets.
[6]Based on data provided by Stagecoach in response to one of our written questionnaires.

9. We analysed the overall growth in passenger numbers in the Preston area generated by both parties. We focused on three periods, May 2007, May 2008 and May 2009. We chose the same month in each year to avoid problems with seasonality. The three periods also correspond to a period before and after Stagecoach rolled out the new intra-urban services in Preston and the post-merger period. We used parties' data on passenger numbers generated on each route and the list of services operating at each analysed period of time.

10. Our analysis shows that total numbers of passengers in Preston generated on both intra-urban PBL and Stagecoach routes and the parts of inter-urban Stagecoach routes that can be attributed to the Preston area grew by 12 per cent from the launch of the new intra-urban routes by Stagecoach until the acquisition of PBL. We also found that following the merger, passenger numbers fell to 4 per cent above the level that existed before Stagecoach's operation of the new intra-urban routes.[7]

11. Stagecoach told us that this fall could at least in part be explained by the current economic climate suggesting that passenger numbers have fallen across the UK over the last year by around 1.5 per cent. We note that the impact of recession on bus usage is not clear cut. DfT statistics suggest that passenger numbers have been resilient in the recession with a 1 per cent increase in bus and light rail journeys in England in Winter 2008/09 and a 0.7 decline in spring 2009 compared with the same periods last year.[8] Even if we were to accept that passenger numbers fell across the UK and that Preston were affected in the same way as the UK average, we would still observe a considerable drop in passenger numbers since 2008.

12. When we focus on the parties' intra-urban services only, we find that total patronage grew by 10 per cent after Stagecoach introduced its new intra-urban services, but fell to 1 per cent below the level that existed before Stagecoach's operation of the new intra-urban services following the merger. (See Table 1.)

13. We note that the difference between the two sets of figures is caused by a sharp increase in passenger numbers on Stagecoach's inter-urban routes that occurred in 2008 and a further sharp increase in 2009. (See Table 1.) According to LCC, changes to the concessionary fare scheme with passengers over 60 taking one-day trips to towns such as Blackpool and Southport and Preston's position as a hub for such services have resulted in significant growth in patronage on Stagecoach's inter-urban services. Stagecoach notes that there are too many variables at play to attribute the rise in inter-urban passenger numbers to a single cause, even though the introduction of the national concessionary fare scheme has played a significant role.

[7]We engaged in a detailed discussion with Stagecoach about the methodology to be used to analyse the market growth. We used the latest information provided by Stagecoach regarding the percentages of passengers on its inter-urban routes who used these services to make intra-Preston journeys. We also excluded service 4 from our analysis as there was some controversy as to whether this route should be considered as commercial or tendered. We also included passengers travelling on service 89, although did not include passengers on service 87. This is because we had no data about the passenger numbers on this service. However, we understand that the numbers of passengers on this service are small and would have had only a minimal impact on our calculations. We applied similar methodology to PBL's data. In particular, we excluded from our analysis services 21 and 36 which were run on a commercial basis in May 2007 but discontinued shortly after Stagecoach's expansion on to PBL's routes. We understand that route 21 was later tendered to Blue Bus and that patronage on route 36 was picked up by Stagecoach's service 4 which followed a very similar path.
[8]www.dft.gov.uk/adobepdf/162469/221412/221535/224295/477931/q22009.pdf.

TABLE 1 **Estimated growth in passenger numbers in Preston**

	May 07	*May 08*	*May 09*
Market growth on inter- and intra-urban services serving the Preston intra-urban area including Stagecoach's service 1 in 2008 and excluding those Stagecoach inter-urban services that were too infrequent to constrain PBL			
Total pax in the Preston area			
PBL	793,833	727,554	[✂]
Stagecoach	93,657	269,040	[✂]
PBL & Stagecoach	887,490	996,594	918,928
Market growth since 2007 (%)	*100*	*112*	*104*
Market growth on intra-urban Preston area services			
Total pax in the Preston area			
PBL	793,833	727,554	[✂]
Stagecoach	60,613	211,219	[✂]
PBL & Stagecoach	854,446	938,773	845,087
Market growth since 2007 (%)	*100*	*110*	*99*
Market growth on those Stagecoach's inter-urban services that also serve the Preston intra-urban area			
Total pax on the inter-urban routes	284,951	366,049	416,298
Market growth since 2007 (%)	*100*	*128*	*146*

Source: Stagecoach.

Profitability analysis of Stagecoach's new intra-urban routes

14. We reviewed the profitability of Stagecoach's six new intra-urban routes during the 20 four-week accounting periods[9] (P3 of 2007/08 to P9 of 2008/09) between the launch of the services and the acquisition of PBL.[10]

15. We considered how long a route might be expected to take to become profitable and which costs might be expected to be covered. Average variable costs (AVC) are often used as a measure of short-run profitability. AVC should isolate those costs that are linked to the increase in output. In the bus market, we would therefore look at the costs directly linked to operating individual bus routes (such as fuel, wages, insurance, depreciation of buses (where additional buses are needed to supply the additional services[11]), leasing of additional stands at bus stations etc) leaving out any allocation of the costs of the depot and head office unless they have directly increased as a result of the new operations.

Profitability—benchmarks

16. Stagecoach provided a number of statements regarding the budgeting process for the new routes and how long it expected to take for these routes to reach profitability; these did not provide a clear position. Other bus operators said that they expected direct costs on new routes to be covered within three to six months of entry, with the routes becoming fully profitable (ie making a profit after allocation of overheads) after one to two years. This evidence is set out in more detail in Annex 3 to this appendix.

17. We asked Stagecoach and other bus companies what is the usual period for which they are in general prepared to bear losses following their launch of a new route. As we explain in detail in Annex 3, Stagecoach as well as other large operators

[9] Stagecoach manages its business based on 13 (four-week) periods in a year, rather than calendar months. Week 1 starts 1 May.
[10] Not all six routes were operating for the full 20 four-week periods—see Annex 1 for details. The acquisition occurred in P10 2008/09. We have excluded P10 from the analysis.
[11] We note that Stagecoach acquired 25 new buses to operate on the intra-urban routes.

indicated that they would expect to cover their direct costs within one year, many within an even shorter period.

18. Stagecoach told us that there were ‘a number of other recent/current examples in the UK where Stagecoach had engaged in competition for a number of years without services achieving profitability’. Stagecoach provided five examples of services launched with the help of the DfT’s Kickstart scheme and the following two examples of a situation where it competed against another large national operator: [✂].

19. We note that Kickstart scheme examples are not a good benchmark for our analysis. This is because the scheme is targeted at supporting routes which operators would not find commercially viable to start on their own and are by definition likely to take much longer to reach profitability than other commercial services.[12] For this reason these services benefit from support within the Kickstart framework of the DfT. The two examples of competition against two large national operators may also not be a good benchmark. This is because these were cases of turnaround situations following an acquisition of a pre-existing market operator, rather than new entry on a competitor’s established route. Similarly in both cases, Stagecoach was competing against a large national operator with a similar access to financial resources as itself and therefore the effect on competition would be different from a case where the competitor’s access to financial resources was more limited, such as PBL.

20. Based on the evidence reviewed, we would expect to see some measure of AVC on the six new intra-urban routes being covered reasonably quickly, with a sufficient contribution being made to cover a proportion of depot overhead costs in the medium term and of head office overhead costs in the longer term (although these last phases would perhaps not be essential if these costs could be covered by other parts of the Stagecoach network and the routes had another strategic purpose). We note that businesses do not in general enter into activities just to cover AVC and that contributing to overhead costs and delivering a return to shareholders is usually required. The exact time frame for this will vary, but after 80 weeks (the period between the launch of the new services and the acquisition of PBL), we would have expected to see these new services covering their AVC and making some contribution to overheads, unless there is a particular strategic rationale for prolonging the loss-making period associated with operating new routes.

Stagecoach’s two methods of cost allocation

21. Stagecoach submitted profitability analyses using two methods of cost allocation. One used incremental costs—the extra costs needed above existing levels to operate the new routes. The other allocated all costs to each route, in accordance with Stagecoach’s usual cost allocation method which is used across UK Bus. Neither of these analyses took account of the cost of capital associated with operating the new routes.[13]

22. For the purposes of monitoring the new intra-urban routes, Stagecoach created a set of management accounts (known as the ‘Biscuit accounts’) based on the incremental costs of the services. Costs in the Biscuit accounts were split into four categories:

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[12] According the DfT, ‘Kickstart is targeted at schemes which have the potential to become successful but which initially might be more marginal in commercial terms and require some financial help to start them off, or which are currently marginal schemes that with some extra support could be made more successful.’ See www.dft.gov.uk/press/speechesstatements/statements/kickstartbusfunding.

[13] We estimated this to be approximately £[✂] across the 20 four-week periods, based on a bus acquisition cost of £[✂] and an annual cost of capital (as reported in the Stagecoach group 2008/09 annual report) of 8.5 per cent.

(a) Drivers' costs—wages and training costs specific to those drivers operating on these intra-urban routes.

(b) Direct costs—fuel, tyres, insurance, bus licences and bus depreciation.[14]

(c) Engineering costs—the actual costs for maintaining the specific fleet operated on the intra-urban routes.

(d) Operations costs—an allocation of operations management and administration costs, and specific marketing costs.

Stagecoach told us that these accounts did not include an allocation of depot or head office costs, as these costs were not increased as a result of the new intra-urban routes. We refer to the Biscuit accounts as the 'incremental cost' data.

23. Stagecoach usually analyses its depots' performances on a route-by-route basis using route costing data, which 'allocate all costs to all services on a pro rata basis to hours, miles and PVR'. The data is split into three categories: direct costs, depot costs and head office costs. This route costing data is used across the Stagecoach group and is reviewed in further detail in Annex 4. We refer to this data as the 'allocated total cost' data. The cost of capital is not included in Stagecoach's operational costing or management account reporting formats (as they reflect the operating performance only); however, we consider the cost of capital to be relevant when assessing overall profitability.

24. This method of assessment seems to be a more appropriate reflection of the longer-term profitability of the routes than the incremental cost data as the Biscuit accounts reflect the short-term rather than long-term incremental costs (see paragraph 25). Stagecoach's stated aim in launching the routes was to improve depot profitability and hence run the routes on an ongoing basis. It seems likely that in the longer term these routes would have been analysed on the same basis as the rest of the Stagecoach group (ie on a total allocated costs basis) rather than on a specific project basis. We accept Stagecoach's argument that depot profitability could be improved without making a profit on a total allocated costs basis, as long as some contribution over and above the AVC costs was being made.

25. The key difference between the two analyses is that the incremental cost data reports the exact costs of the new routes whereas the allocated total cost data reports an allocation of costs to the new routes. For example, Stagecoach told us that with respect to drivers' costs the incremental cost data reports the salaries paid to specific drivers whereas the allocated total cost data allocates a proportion of total Preston drivers' costs based on the number of drivers operating on the new routes. The total allocated cost data will therefore include Stagecoach Preston's average pension entitlement which Stagecoach will not need to cover on these new routes immediately after their launch as drivers are in a qualification period and are not immediately eligible for pension contributions. Stagecoach also told us that 'For example, engineering costs are allocated on a pro rata basis [in the allocated total cost data] whereas the services were actually operated by minibuses under warranty'. The incremental cost data therefore reflects only the costs incurred in excess of the costs covered by warranty.

26. As noted in paragraph 23, the allocated total cost data also includes apportionments of depot and head office overheads. However, allocated direct cost data can be

[14]The contemporaneous Biscuit accounts included bus depreciation as a direct cost, in subsequent Biscuit account analysis Stagecoach has included depreciation as a separate item. See paragraph 28 for detail.

extracted from allocated total cost data. We examined the contribution of the new intra-urban routes using both the incremental cost and allocated direct cost data; considering both to be proxies for AVC as both methods reflect the costs on a per route basis and are therefore linked to variation in output.[15]

Profitability analysis

Incremental costs

27. As noted in paragraph 22, Stagecoach produced the Biscuit accounts which covered the six new intra-urban routes. These assessed the incremental cost of the new services rather than the direct costs as allocated across the rest of the business. The Biscuit accounts also allocated slightly less revenue to the routes than in the total cost allocation data, around £6,000[16] in each year.

28. Table 2 sets out the contribution of the new routes on this incremental cost basis. The depreciation charge has been shown separately. The Biscuit accounts include the depreciation of the buses used on the new routes. However, in subsequent analysis prepared for us, Stagecoach stripped out the depreciation charges for the buses and focused on the incremental contribution of the new routes without a charge for the bus depreciation. Stagecoach told us that the buses would have value elsewhere in the Stagecoach business—'Stagecoach orders in excess of 500 vehicles a year and nearly new vehicles would simply have been redeployed elsewhere'. We noted this, but consider depreciation to be a relevant cost which reflects the cost to a company of an asset's decline over time (and with usage). Although it would of course remain open to Stagecoach to redeploy the buses elsewhere, this does not justify excluding from a consideration of the long-term sustainability of the services, the cost of the buses needed to operate them. The total depreciation charge in the Biscuit accounts was £[✂] over the 20 four-week periods to P9 2008/09. We include the depreciation charge in our assessment of the incremental contribution[17] unless otherwise stated.

TABLE 2 **Incremental contribution**

£ 000

	2007/08 (periods 3–13)*	*2008/09 (to P9)*
Incremental revenue	[✂]	[✂]
Incremental drivers costs	[✂]	[✂]
Incremental direct costs	[✂]	[✂]
Incremental engineering costs	[✂]	[✂]
Incremental operational costs	[✂]	[✂]
Incremental depreciation (buses)	[✂]	[✂]
Incremental start-up costs†	[✂]	[✂]
Incremental contribution	[✂]	[✂]

Source: Stagecoach.

*A small element of the start-up costs was incurred in the last two four-week periods of 2006/07.

[15]We consider the allocated total cost data to give an indication of the scale of the losses incurred in operating the new routes if all allocated costs are considered, as would be the case if the new intra-urban route project was continued and reported in the same manner as all other Preston routes, see Table 4.
[16]£6,000 less in 2007/08 and £5,700 less in 2008/09. Some general income, for example advertising income, was not included in the Biscuit accounts.
[17]We consider that the incremental cost would also include the cost of capital associated with the operation of these new intra-urban routes—this has not been estimated in the analysis and as such the incremental contribution loss is understated.

†In a separate piece of analysis Stagecoach noted that there were an additional £[✂] of costs which related to the new routes covering both start-up costs and additional costs incurred in Periods 3 to 6 of 2007/08.

29. The incremental contribution analysis shows that the six new routes made an incremental loss (including start-up costs) of £[✂] in the 2007/08 financial year, compared with incremental turnover of £[✂]. In 2008/09 (to period 9) the five remaining routes produced an incremental contribution loss of £[✂], compared with turnover of £[✂]. Review of the Biscuit accounts shows the incremental contribution of the routes on a four-week period by four-week period basis was negative[18] right up to the acquisition of PBL. The negative result was reducing over time and Stagecoach told us that profitability would have been achievable in due course.

30. Stagecoach's own analysis[19] of the effect of the new intra-urban services also showed that the operation of the new intra-urban routes had resulted in lost revenues on route 3 of £[✂] in 2007/08 as a result of PBL's retaliation. PBL launched a service 3 to Penwortham as a direct consequence of Stagecoach's launch of the new intra-urban services having not previously operated this route, Stagecoach counted this as a loss related to the operation of its intra-urban routes when analysing the performance, and we note that including this as an additional cost takes the loss as calculated above in 2007/08 from £[✂] to £[✂]. Stagecoach has not calculated an estimate of the effect of PBL's retaliation in 2008/09. If we assume a similar loss on route 3 in 2008/09, since the conditions of competition on this route remained broadly similar in 2008/09 until the merger, then the 2008/09 loss to period 9 could be increased from £[✂] to £[✂].[20]

31. We consider that the cost of PBL's retaliation should be treated as a part of the overall cost of Stagecoach's expansion in Preston and this effect would be incurred at some level regardless of the accounting method used. We did not include this loss in our analysis in Figure 1 as it depended on PBL's response rather then being an inherent part of Stagecoach's expansion; this approach does not take account of all the losses the company needed to bear within the Preston area as a whole as a result of launching the intra-urban routes.

32. Stagecoach submitted to us that by this point (September 2008) its Citi network[21] had broken even and it was expecting further growth and consistent profitability. Stagecoach argued that a price rise was planned and that it could afford to do this as its prices were below those of PBL and that a small increase in customer numbers would make the network consistently profitable on an ongoing basis. A small positive incremental contribution (without including a charge for depreciation) was made in P1 of 2008/09 and then from P6 of 2008/09 through to the acquisition of PBL; this resulted in an incremental contribution (without taking account of the depreciation charge when calculating the cost of the services) across the nine four-week periods of £[✂].

33. Figure 1 shows that from P6 of 2008/09 the incremental contribution increased to a level just below the break even point. This is a result of a price increase in P6 and a

[18]There was a £[✂] positive contribution in P8 of 2008/09.

[19]Stagecoach noted that this analysis was not part of the Biscuit accounts rather 'a document prepared to discuss Preston depot performance … specifically in relation to the extent to which the depot performance was affected by the launch of the Citi services in order to negotiate with [Stagecoach Director C] with regard to staff bonus payments'.

[20]Based on 2007/08 loss (incurred between P3 and P13, ie 11 four-week periods) on route 3 of £[✂] apportioned over 9 four-week periods.

[21]We received conflicting information from Stagecoach with regard to the routes included in the Citi network; for these purposes we have considered only the routes included in the Biscuit accounts. Certain routes (the 1, 2/2A, 3/3A) were also branded as Citi, but were definitively not included in the Biscuit accounts. The confusion appears to have arisen from the fact that Citi has been used as a shorthand way to refer to the new intra-urban routes.

stabilization of incremental costs that can be seen stemming from the beginning of 2008/09.

FIGURE 1

Incremental costs, revenues and contribution on the new intra-urban routes between P3 of 2007/08 and P9 of 2008/09

[✂]

Source: CC from Stagecoach data.
Notes:
1. P9 is Christmas so drop in revenue and costs is expected.
2. This data excludes the relevant portion of the £[✂] of additional set up costs referred to in Table 2.

34. As we noted above the new routes were approaching break even on an incremental cost basis at the time of the PBL acquisition. We note that in the long run these incremental costs will increase as warranties on the buses expire and drivers become eligible for pension contributions. In order to cover the cost of capital associated with these routes further contribution would have been required from them. Additionally, Stagecoach's aim was to improve the profitability of the Preston depot which would have required a contribution in excess of the incremental costs.

Allocated direct costs

35. We also reviewed the contribution of each of the six routes, based on Stagecoach's allocated direct costs which Stagecoach produces as part of its allocated total cost data. Allocated direct costs include drivers' costs, fuel, insurance, bus depreciation, maintenance etc—see Annex 4 for further details. For the most part, we considered that the allocations of costs were reasonable for our purpose.

36. Table 3 sets out the revenue and allocated direct costs for 2007/08 and 2008/09 for the six routes together.

TABLE 3 **Allocated direct contribution**

£ 000

	2007/08 (periods 3–13)	*2008/09 (to P9)*
Allocated revenue	[✂]	[✂]
Allocated direct costs	[✂]	[✂]
Allocated direct contribution	[✂]	[✂]

Source: Stagecoach.

37. Figure 2 shows that all six routes were loss-making in each four-week period at the allocated direct contribution level until the acquisition of PBL. Route 32 was closed after six months; the five other routes remained in operation beyond the acquisition of PBL. The total allocated direct loss incurred across these six routes in the 20 four-week periods between their launch and the acquisition of PBL was £[✂].[22]

[22]Of this £[✂] related to route 32 which closed after six months.

FIGURE 2

Stagecoach allocated direct contribution by period for the new intra-urban routes between P3 of 2007/08 and P9 of 2008/09

[✂]

Source: CC from data supplied by Stagecoach.

38. If we assess the percentage increase in average fares required to cover allocated direct costs then based on approximately [✂] passengers and allocated direct costs of around £[✂] per four-week period, with average revenue of £[✂] per customer (following the P6 of 2008/09 price increase[23]), then a price increase of £[✂] per passenger or [20 to 30] per cent would be necessary to break even on this basis.

39. In order to estimate when profitability was likely to occur, we looked at revenue and cost trends on the intra-urban routes. The results are set out in Figure 3.

FIGURE 3

Allocated direct costs, allocated revenues, allocated direct contribution and their trends, on Stagecoach's new intra-urban routes between P7 of 2007/08 and P9 of 2008/09

[✂]

Source: CC from Stagecoach data.

40. We note that after Stagecoach launched all its services by P7 of 2007/08, its passenger numbers continued to grow at a much slower pace (see Figure 4). We also note that throughout this period, Stagecoach gradually increased its fares. Given that immediately before the merger, Stagecoach's fares were close to PBL's, further fare increases by Stagecoach were going to be increasingly difficult (see Appendix F for more details on fare changes) unless PBL also increased fares.

41. Assuming that Stagecoach could continue to increase the fares at the same rate without losing passengers and hence continue to grow its revenue at the same pace as it did during the period between P7 of 2007/08 and P9 of 2008/09 (we note potential difficulties with this in paragraph 40 above), the revenue generated on Stagecoach's Preston city routes would only start covering the allocated direct costs of these routes in 15 more four-week periods.[24] This means that in total, it would take 33 four-week periods from the launch of all six routes for Stagecoach to cover just its allocated direct costs on the new intra-urban routes. This is considerably longer than even the longest estimate of time that other bus operators told us they would require to achieve an overall profitability, let alone cover their direct costs.

42. Stagecoach argued that this calculation does not take account of the fact that *(a)* PBL would not have been able to maintain its fares in the face of rising industry costs, and *(b)* PBL would have had to cut service frequencies resulting in further passenger and revenue growth for Stagecoach. On the first point, Stagecoach provided the CPT Cost Index data for the 12 months to 30 June 2009 and the annual data for 2007 and 2008 which shows that operating costs increased in Northern

[23]Using P6–P8 data, we exclude P9 as Christmas and therefore seasonally affected.
[24]These figures are based on the trends identified in the graph in Figure 3 and assume that both the cost and revenue trends would continue unchanged for the foreseeable future.

England and across the UK as whole in both years. We understood from our discussions with PBL that in 2007 and 2008 fuel prices increased considerably[25] which put pressure on its business, with PBL fearing running out of cash in October 2008. However, this situation changed in the summer 2008 when fuel prices decreased and PBL gained some additional schools contracts and made changes to the conditions of employment for staff which improved the financial situation. We also note that such fuel cost rises would affect both PBL and Stagecoach, although Stagecoach as a large national company might have been able to mitigate the impact of these cost increases (for instance by hedging of fuel costs) more effectively, at least in the short-term, than a smaller, stand-alone local company such as PBL.

43. On the second point, we note that in most cases, Stagecoach and PBL ran services of similarly high frequency. Stagecoach told us that 'it is evident that more buses than were necessary or sustainable had operated on certain corridors in Preston in the period between summer 2007 and the acquisition. The pre-merger level of service provision was unusually high. Stagecoach is not aware of bus services being offered at this level of frequency outside major UK cities such as London, Manchester and Edinburgh'. We also note that both companies were incurring heavy losses throughout the period of Stagecoach's operation of the new intra-urban routes. It does not follow that it was only PBL that had to reduce its services.

44. In response to our provisional findings, Stagecoach submitted that 'whilst Stagecoach may have chosen to reduce its services, it was unlikely that it would have been forced to do so by financial constraints in the way that PBL would have been'. In this statement Stagecoach seems to acknowledge that if it were minded to, it would have had the ability to compete until PBL was forced to scale back its operations due to its capacity to incur heavy losses for a longer period than PBL

45. Stagecoach also submitted that 'increasing prices on several occasions is inconsistent with entry which is solely designed to drive PBL from the market, because price increases, particularly a succession of them, risk the new market price level rising above the costs of the target firm, making predation ineffective.' First, we note that prices are only one aspect of competition in the bus market and must be considered together with frequencies and other aspects of competition. As we have discussed in Section 5 of our report, Stagecoach ran unusually high frequencies of service. When Stagecoach's frequencies are taken together with PBL's frequencies, most routes on which Stagecoach expanded were oversupplied.[26] Second, regardless of its intentions, we note that Stagecoach was not covering its AVC for a significantly longer period than is usual in the bus industry.

Total allocated costs

46. Table 4 shows that, on the basis of all overheads being allocated, total allocated losses on the new routes over the 20 four-week periods between Stagecoach's launch of the new intra-urban routes and acquisition of PBL were £[✄]. This compares with total allocated revenues of £[✄]. As expected, these losses are higher than losses incurred on the basis of incremental cost and allocated direct costs. If we assess the percentage increase in average fares required to cover total allocated costs, then based on the same average passenger and average fare assumptions as in paragraph 38, an increase of £[✄] or [50 to 60] per cent would be required to

[25]This is supported by the CPT Cost Index provided by Stagecoach which shows fuel costs increasing for bus and coach operators in Northern England by 8.4 per cent in the year to 31 December 2007 and increasing by 13.9 per cent in the year to 31 December 2008.
[26]Although we note that in some cases taking just Stagecoach's frequencies in isolation may lead to the same conclusion because they were higher than already high PBL frequencies from before July 2007.

cover the total allocated costs of around £[✂] per four-week period. Assuming a cost of capital of £[✂][27] per four-week period in addition to the total allocated costs requires an average fare increase of £[✂] or [60 to 70] per cent to break even.

TABLE 4 **Total allocated contribution**

		£ 000
	2007/08 (periods 3–13)	*2008/09 (to P9)*
Allocated revenue	[✂]	[✂]
Allocated direct costs	[✂]	[✂]
Allocated depot costs	[✂]	[✂]
Allocated head office costs	[✂]	[✂]
Total allocated contribution	[✂]	[✂]

Source: Stagecoach.

Impact of new routes on Stagecoach's Preston depot

47. We looked at the effects of the new routes on the performance of Stagecoach's Preston depot as a whole, to determine whether the losses were being offset by additional network benefits. Table 5 sets out the operating profit/loss of the Stagecoach Preston depot and Stagecoach Northwest business over the past three financial years, and shows that the losses incurred on the new intra-urban routes *(a)* after incremental costs, *(b)* after allocated direct costs and *(c)* after total allocated costs represent a significant investment by Stagecoach in Preston, ie these were not being compensated for elsewhere in Preston. We note that losses have been made in other areas of the Preston business too.

TABLE 5 **Operating profit compared with losses sustained on new intra-urban routes**

			£ million
	2006/07	*2007/08*	*2008/09 (to P9)*
Operating profit/loss—Stagecoach Preston depot*	[✂]	[✂]	[✂]
Operating profit—Stagecoach Northwest	[✂]	[✂]	[✂]
Loss on new intra-urban routes—incremental cost	[✂]	[✂]	[✂]
Loss on new intra-urban routes—allocated direct costs	[✂]	[✂]	[✂]
Loss on new intra-urban routes—total allocated costs	[✂]	[✂]	[✂]

Source: Stagecoach.

*The figures presented here include property charges and statutory accounts adjustments. These charges have been excluded in Stagecoach's Depot Profit Summaries (used in Appendix B) as these summaries are a management tool which uses adjusted figures for comparability purposes.
Notes:
1. N/A = not available.
2. n/a = not applicable.

48. Passenger numbers for Stagecoach Preston depot as a whole and for the new routes are set out in Figures 4 and 5.

[27]As calculated in paragraph 21.

FIGURE 4

Stagecoach passenger numbers on the new intra-urban routes between P3 of 2007/08 and P9 of 2008/09

[✂]

Source: CC from data supplied by Stagecoach.

FIGURE 5

Stagecoach total passenger on the Preston depot routes between P3 of 2007/08 and P9 of 2008/09

[✂]

Source: CC from data supplied by Stagecoach.

49. The two figures show that whilst passenger numbers initially increased with the expansion of the new intra-urban routes, in the year before the acquisition of PBL the passenger numbers on the new intra-urban routes had stabilized at around [✂]. As we show in Table 1, in the period reviewed the passenger growth had two main sources, the new routes (in particular in 2008) and inter-urban services (in particular in 2009). This can be seen in the increasing number of passengers shown in Figure 5 in the year before the acquisition of PBL. Stagecoach suggested that the concessionary fare scheme had contributed to this passenger growth. Unless these new intra-urban routes were making passengers more willing to pay higher prices for tickets on other routes in the network (which seems unlikely), then it is unclear how they were bringing net benefits.

50. Assessing the overall Preston depot network showed that contribution after total allocated costs varied on a four-week period by four-week period basis but overall showed an increasing trend. At an allocated total cost contribution level, the Preston depot network made a positive contribution in P1 and P8 of 2008/09. Stagecoach has confirmed that the increases in direct contribution in the year before the acquisition of PBL were driven by an increase in passenger numbers due to the strong uptake of the concessionary fares scheme and also by price changes and cost management across the network. Stagecoach did not provide evidence to suggest that increased contribution across the Preston area was linked in any way to the new routes (which were directly reducing this overall contribution).

51. It may be commercially viable to run loss-making marginal routes in some circumstances, for example where overall contribution to the network is enhanced. In this case, however, the new intra-urban routes are main corridors in Preston and for PBL they had been the most profitable routes, so they cannot be considered marginal routes. In addition, we have not seen evidence to suggest that running these loss-making routes was bringing overall network benefits to Stagecoach.

Profitability of PBL during the period between Stagecoach launching the new intra-urban routes and the acquisition of PBL

52. In assessing the effect of Stagecoach's new intra-urban routes, we also look at the effect this had on PBL. Table 6[28] sets out the change in contribution on the key PBL routes which were affected by Stagecoach's introduction of new services. This shows that contribution had fallen heavily between June 2006[29] (before Stagecoach's launch of new intra-urban routes) and September 2008. Other PBL routes also suffered from the launch of Stagecoach's new intra-urban routes, although to a lesser extent.

TABLE 6 **Direct* contribution (pre-capital costs) for key PBL routes contested by Stagecoach**

Annual figures *£'000*

Route	*June 2006*	*September 2008*
8—Moor Nook	[✂]	[✂]
11—Gamull Lane	[✂]	[✂]
16—Farringdon	[✂]	[✂]
19/119/99—Hospital	[✂]	[✂]
33/35—Tanterton	[✂]	[✂]
24/25—Lea	[✂]	[✂]
27/127—Larches	[✂]	[✂]†
22/23/122—Asda‡	[✂]	[✂]
Direct contribution from key contested routes	[✂]	[✂]
Total direct contribution from commercial routes ('000)	[✂]	[✂]
Direct contribution from key contested routes as a percentage of total Direct contribution from commercial routes (%)	[✂]	[✂]

Source: CC from data supplied by Stagecoach.

*Direct costs calculated as revenue less apportioned driver and depot wages, insurance, bus materials, fuel and tyres.
†The Larches services (27/127) were superseded by services 88A/88C Orbit which were introduced as part of a government funded Kickstart bid on 26 October 2006. However, the Orbit service is not a true comparison to service 27/127 as it is a 17 mile circular route integrating various previous service areas in Preston.
‡Stagecoach did compete with this route (with its route 22) although not quite as far as Asda.
Note: N/A = not applicable.

53. The overall profitability of PBL suffered significantly from Stagecoach's entry on to its key routes. These had contributed a significant part of PBL's profits ([✂] per cent of direct contribution from commercial routes in June 2006) and suffered a direct contribution decline of over £[✂] million a year between June 2006 and September 2008. This is as a result of revenue lost to Stagecoach over this period (£[✂] million a year). There were overall direct cost savings on these routes of around £[✂] a year. This includes the net effect of closing route 27/127, combined with increased costs incurred in increasing service frequency, which was implemented as a defence against Stagecoach's entry.

[28] We note that the information in Table 6 does not include a charge for depreciation (this data is not available); it is therefore not directly comparable to the information in Table 5 for Stagecoach. Despite this we consider that the information in Table 6 still provides relevant information about the scale of the decline suffered in PBL's profitability following Stagecoach's entry on to PBL's key routes.
[29] June 2006 was selected as this was the only point at which we were provided with route level data prior to Stagecoach's launch of the new inter-urban services (ie prior to June 2007). There is some uncertainty as to whether the route costing data is annualized data as at June 2006 or whether it is the 2005/06 annual figures; either way, it relates to the period before Stagecoach's entry on the new intra-urban routes and is therefore appropriate for this analysis.

54. Table 6 also shows that over this period, an additional £[✄] direct contribution a year has been lost on other commercial routes. It is not clear from the data available exactly what drove this loss as there are a number of different factors to incorporate. The orbit services (88A/88C) were introduced in October 2006, these were contributing £[✄] a year by September 2008. These services will have cannibalized contribution from some of the routes existing at June 2006. The net effect of withdrawing routes[30] and introducing the Orbit services appears to be broadly contribution positive.[31] The key contribution loss (£[✄] a year) is coming from the continuing routes 7, 14, 31 and 44/45. PBL did increase service frequency on its other routes in July 2007; this will have had cost implications but as well as increased costs on these routes, three of them suffered revenue decline which may be due to competition either from Orbit or Stagecoach's intra-urban routes[32] or both or indeed be due to other factors. We note that Stagecoach's new intra-urban routes affected almost the entire PBL network to some extent (see paragraph 5.50 of the main report).

55. In addition to defending its routes, PBL responded to Stagecoach's new routes by launching its own route 3 'Preston-Penwortham' in direct competition with Stagecoach's existing operation. By September 2008 this had made a direct loss of £[✄]. PBL also opened a route 2 'Preston–Southport' in competition with an existing Stagecoach route; the new route had a low frequency of service. Route 2 is not included in the analysis in Table 6 as it was opened and closed within the period considered.

56. PBL was not able to withstand the decline in its revenues. Whilst PBL's managers did incur additional costs in entering new routes as retaliation, and incurred contribution loss on other commercial routes as set out in paragraph 54 which cannot all be attributed to Stagecoach's actions, the annual revenue decline incurred on the key contested routes of £[✄] million (see paragraph 53) was enough seriously to damage PBL's operations. PBL had hoped that if it took a determined approach, Stagecoach would retreat after six months or a year. PBL's former management said that it did not try to scale down operations because it did not want to show any signs of weakness, which might have resulted in a scaling up of operations by Stagecoach. Stagecoach stated that PBL's response was 'based on hope, largely emotional; not rational'.[33]

57. We consider PBL's actions in paragraph 5.61 of the main report. We note that PBL's management held differing views on the options available. [Former PBL Director Y] suggested that by February 2008 there were no obvious solutions to the many conflicting problems and interests:

> The worry of [former PBL Director X] was that to change the network -- to reduce the network to what was suggested was inappropriate because it would have meant that Stagecoach would have got an increase in their patronage and their revenue per journey. Because there would have been bigger gaps created. But the -- but what was the alternative? We could not sustain -- carry on as we were doing, it was unpalatable whichever way that you went.

[30]Routes 5/105, 6, 21,36 and 43 were withdrawn between June 2006 and September 2008.
[31]Around £[✄].
[32]Routes 31 and 44/45 will have been affected by Stagecoach's new intra-urban routes to some extent and Route 7 may have suffered from competition with the Orbit routes.
[33]Stagecoach's response to our provisional findings.

58. Stagecoach considered that this statement from [former PBL Director Y] proved that a 'partial retrenchment by PBL was a valid (if unpalatable) alternative'. [Former PBL Director X]'s view differed from that of [former PBL Director Y]; he told us that [former PBL Director Y] had not considered all the revenue implications of making changes to the services and that other factors needed to be considered.

59. Taking into account all considerations PBL's former management team did not think that a 'partial retrenchment' from the intra-urban routes was a valid option. [Former PBL Director X] expressed some of the difficulties facing PBL to us as follows:

> It could be asked why we did not reduce the conditions of employment for staff more than the changes we made in 2008. [Former PBL Director Y] reported back to [former PBL Director Z] and myself with a list of possible changes to the business. He had ideas that saved £800,000 a year (which in practise was an overestimated figure). The savings would have come from service reductions and from cuts in conditions of employment for staff.
>
> Regarding the service cuts these would have involved deciding to live with Stagecoach by giving them parts of our business and by withdrawing from the Penwortham and the Southport services. The Southport withdrawal was a sensible idea. Giving up the Penwortham service would have lost all the revenue we took on the route and given up a valuable negotiating position we had with Stagecoach. The other changes would have involved cuts to our established network enabling Stagecoach to become established on the routes. Had they become established [it] would have been very difficult to compete with them. Given this and the loss of revenue we decided not to follow the main points [former PBL Director Y] put forward.
>
> Regarding the conditions of employment we followed some of the recommendations [former PBL Director Y] made and introduced others. We wanted to make changes that involved all staff rather than just saying to the drivers it's only you who are involved. We could have made greater savings. Negotiating these would have been very difficult especially since we could not tell the staff how much the competition with Stagecoach was damaging the business. We also had a very difficult balance to make. As an employee owned company if it came to being a below average employer you need to question why is the business employee owned. Also given that we were actively following a line of selling the business it would have been very dishonest to make dramatic cuts in conditions of employment knowing that the staff will have given up conditions that they could have retained under a sale or a TUPE situation.

60. In acquiring PBL, Stagecoach has now gained the PBL business in total. In June 2006, before Stagecoach started competing on PBL's key routes, PBL's commercial business was contributing £[✄] million (pre-capital costs) a year (see Table 6). The losses[34] made by Stagecoach in operating the new intra-urban routes before its acquisition of PBL (£[✄] million on an incremental cost basis or £[✄] million after total allocated costs) will be recouped reasonably quickly if Stagecoach is able to operate the PBL network at least as efficiently as PBL did before June 2006.

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[34]Note not intended as a direct comparison as Stagecoach's losses include depreciation charges.

Conclusion

61. We found that:

(a) Following the launch of Stagecoach's new intra-urban services, service levels in Preston were unusually high. Stagecoach considered this level of service to be unsustainable. The service levels were lowered considerably following the merger.

(b) Passenger numbers in the Preston area increased by 12 per cent during the period of operation of Stagecoach's new intra-urban routes up until the acquisition of PBL. However, following the merger passenger numbers decreased to 4 per cent above the level that existed before Stagecoach launched its new intra-urban routes.

(c) Regardless of the cost method used, before acquiring PBL Stagecoach incurred heavy losses during the period of operation of the new intra-urban routes and it is doubtful that it would have been able to achieve a level of profitability, under the pre-merger conditions, that would have covered more than the incremental costs.

(d) In the 20 four-week periods of Stagecoach's operation of the new intra-urban routes until the acquisition of PBL, Stagecoach covered the incremental costs of the routes in only one four-week period; the incremental costs were just covered in P8 of 2008/09 by £[✂].

(e) The new intra-urban routes continued to make significant losses for longer than is usual among other large bus companies.

(f) Stagecoach's operation of the new intra-urban routes resulted in a contribution reduction (driven by revenue decline) for PBL of £[✂] million on its key routes; this seriously damaged PBL's operating performance.

Stagecoach's new routes

Stagecoach's route	*Launched*	*Withdrawn*	*PBL competing service*	*Nature of overlap*	*PBL service post-merger*
11 Gamull Lane	24/06/2007	Withdrawn post-merger 22/03/2009	**11** Gamull Lane	**11** identical	**11** continuing
9 (ex 16) Moor Nook	24/06/2007	Continuing	**8** Moor Nook **16** Farringdon Park	**8** end to end journeys only **16** up to the turn off to Blackpool Road only	**8** operates as an SC service **16** operates as an SC service
19 Royal Preston Hospital via Deepdale Road **22** Royal Preston Hospital via Plunginton Road	29/07/2007	Continuing	**19** Royal Preston Hospital via Deepdale Road **22** Royal Preston Hospital via Plunginton Road **23** Sherwood (Asda)	**19** identical **22** identical **23** only until Royal Preston Hospital	19 modified into **19a**, serves slightly different route **22** withdrawn **23** continuing
33 Tanterton	26/08/2007	Withdrawn post-merger 22/03/2009	**35** Tanterton **44** Ingol	**35** from Woodplumpton Road onwards **44** from Woodplupton Road to Tag Lane	**35** continuing **44** continuing
32 Larches	29/10/2007	Withdrawn pre-merger 30/03/2008	**24/25** Lea **31** Savick **35** Tanterton	**31** up to Ashton on Rible **35** up to Woodplumpton Road	**24/25** withdrawn **31** continuing **35** continuing

Source: Stagecoach.

Note: In addition to the overlap with Stagecoach's new intra-urban services, PBL's service 11 overlapped with Stagecoach's inter-urban service 2/2a (later 1) and PBL's services 24/25 and 31 overlapped with Stagecoach's inter-urban service 68. The frequencies on Stagecoach's services 2 and 68 increased in autumn 2006.

Changes in frequencies in the Preston area since 2007

Overlap route	*Services*	*Companies*	*May-07**	*Jan-08**	*Apr-09**
Preston City centre to the turn off to Blackpool Road on New Hall Lane	16	PBL frequencies	7.5 min	6 min	10 min
	9	SC frequencies	N/A	6 min	10 min
		No of buses per hour	**8 buses**	**20 buses**	**12 buses**
Preston City centre to Moor Nook (end-to-end passengers only—different routes)	8	PBL frequencies	10 min	7.5 min	10 min
	9	SC frequencies	N/A	6 min	10 min
		No of buses per hour	**6 buses**	**18 buses**	**12 buses**
Preston City centre to the turn off to Cromwell Road on Ribbleton Avenue	8/11 (PBL)	PBL frequencies	3.33 min (combined)	3 min (combined)	5 min (combined)
	1/11 (SC)	SC frequencies	10 min	4.3 min (combined)	5 min (combined)
		No of buses per hour	**24 buses**	**34 buses**	**24 buses**
Cromwell Road on Ribbleton Avenue to Gamull Lane	11 (PBL)	PBL frequencies	5 min	5 min	10 min
	1/11 (SC)	SC frequencies	10 min	4.3 min (combined)	5 min
		No of buses per hour	**18 buses**	**26 buses**	**18 buses**
Preston City centre to the Royal Preston Hospital via Deepdale Road	19 (PBL)	PBL frequencies	6 min	6 min	10 min
	19 (SC)	SC frequencies	N/A	10 min	10 min
		No of buses per hour	**10 buses**	**16 buses**	**12 buses**
Preston City centre to the Royal Preston Hospital via Plunginton Road	22/23 (PBL)	PBL frequencies	6 min (combined)	5 min (combined)	10 min
	22 (SC)	SC frequencies	N/A	10 min	10 min
		No of buses per hour	**10 buses**	**18 buses**	**12 buses**
Preston City centre to Ashton Lane Ends	31/44	PBL frequencies	10 min (combined)	7 buses/hour	7 buses/hour
	33	SC frequencies	N/A	7.5 min	N/A
		No of buses per hour	**6 buses**	**16 buses**	**7 buses**
Ashton Lane Ends to Tanterton	35	PBL frequencies	7.5 min	7.5 min	7.5 min
	33	SC frequencies	N/A	7.5 min	N/A
		No of buses per hour	**8 buses**	**16 buses**	**8 buses**
Preston City centre to Savick	31	PBL frequencies	15 min	12 min	15 min
	32	SC frequencies	N/A	15 min	N/A
		No of buses per hour	**4 buses**	**9 buses**	**4 buses**
Preston City centre to Penwortham	3	PBL frequencies	N/A	9 min	N/A
	3	SC frequencies	7.5 min	6 min	7.5 min
		No of buses per hour	**8 buses**	**17 buses**	**8 buses**

Source: Stagecoach.

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*These periods were chosen to represent the competitive situation that existed before Stagecoach launched the new intra-urban routes (May 2007), the competitive situation at the height of the period of direct competition on these routes (January 2008) and the situation that existed after the post-merger adjustment of services (March 2009).

Relevant time frame and costs

1. Paragraphs 15 to 20 of Appendix G set out our views on relevant time frame and type of costs to be considered in our analysis; further detail is provided below.

2. Stagecoach considered the new intra-urban routes to be part of the Preston Citi network which encompasses routes 1, 2/2A, 3/3A, 9 (previously 16), 11, 19/22, 32 and 33. Stagecoach noted in its submission to the Traffic Commissioner that 'this network was not designed to lose money, although as a new-start business it was not expected to be profitable in the short-term'. We note that we have not received detailed business plans for the new routes to give an indication of Stagecoach's view of the short term. Indeed, the business plan that we have seen focuses on costs and not revenues; this plan covers new route 11 and changes to other Citi network routes. Indeed, Stagecoach subsequently commented that 'rather than being a business plan (despite its title) this document was little more than an initial consideration of costs involved in operating certain services'.

3. We discussed with Stagecoach the budgeting for these new routes and expectations of management with regard to likely timescales for profitability. Stagecoach stated that there was 'not a profit or loss forecast; simply a cost projection' with regard to introducing the new services in Preston during 2007/08. This is different to normal practice as Stagecoach stated that profit margin is a consideration when assessing the business case for new buses, where [✂]. However, in this case Stagecoach commented that 'we did not project any revenue because it would simply be a projection. It could be almost any number'. In terms of time to expected profitability Stagecoach noted that they would expect 'some sort of return at that level of time period [three to six months] for an individual route'. It also said that it did not have a fixed timeframe in mind for positive contribution at an operating profit[35] level, but thought that it would take 'an extended number of months, possibly to a year or beyond'.

4. Stagecoach noted that in the case of new routes in Preston:

> when we started planning the routes, we did not have a specific timeline in mind because we were treading new territory. There was a series of phased introductions of routes adding up to more than 20 vehicles at the final phase. There was an existing established operator on most of those routes. There were other operators in the area. We were establishing a marketing and promotional campaign which would obviously have an impact. So there were a number, if you like, of new variable factors that needed to be taken into account. It would be longer, possibly significantly longer, than start up time for an individual route. We estimated it would take longer than the six to nine[36] months that you mentioned … I think we were looking at an extended number of months, possibly to a year or beyond. But it was, in a sense, a learning curve for us.

5. Stagecoach submitted further statements regarding the period required to develop services 'to assess the commercial viability or otherwise of services in a competitive

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[35]The margin referred to was described as 'the operating profit over the turnover in the management accounts'.
[36]Stagecoach was responding to a CC question which indicated that three to six months might be a reasonable timeframe for a new route to cover its direct costs.

situation can require a timeframe of several years and that in other instances outside Preston, Stagecoach has been prepared to persist with operating competitive services for a far longer period than the CC may have used'.

6. We note that the examples cited by Stagecoach relate to competition against major operators, rather than small local businesses, against whom there is likely to be a national as well as regional competition strategy. These have been considered in detail in paragraphs 18 and 19 of the main appendix.

7. Veolia noted in its response to the CC's questionnaire that: [✂].

8. In subsequent correspondence Veolia confirmed that it would [✂].

9. Go-Ahead told us that it did not expect new routes to be profitable straight away but looked to cover direct costs 'quite soon'. At the hearing with the CC it confirmed that it would expect direct costs to be covered within three to six months.

10. Review of the Transdev response showed that it 'would seek any new route to be profitable within [✂] of operation, depending on the quantum of the initial losses' but TransDev did not indicate how it would measure profitability.

11. Arriva told us that as regards route profitability, it hoped that direct costs would be covered right from the start. It reviewed costs every three months. It would look for a contribution to overheads as well; its general rule of thumb was that investments made had to cover its weighted average cost of capital (WACC).

12. Finally, we note that small operators told us that they would expect to cover their costs immediately after their entry on a new route.

Stagecoach route costing—revenue and cost allocation methods

1. Paragraphs 35 to 46 in Appendix G assess Stagecoach contribution by route at an allocated cost level. The detail below looks at the allocation of revenue and costs by route.

Revenue allocation

2. Table 1 sets out the revenue streams relevant to the six routes considered and the allocation method used.

TABLE 1 **Revenue allocation methods**

Revenue stream	*Allocation method*
On bus	Direct
Off bus	Pro-rata to on bus (Except where high usage of off-bus tickets dictates otherwise, eg tourist area services, high-volume commuter services etc)
Concession	Direct Based on Electronic Ticket Machine data by service (shadow fares recorded by machines even though nil value tickets issued)
Miscellaneous (primarily advertising revenue)	Peak Vehicle Requirement (PVR)
Scholars	Direct

Source: Stagecoach.

Note: Stagecoach confirmed that the six routes considered did not receive revenues from tenders, contracts, National Express or hire/excursion.

Cost allocation

3. Stagecoach allocates costs within the management accounts into three core categories: Direct, Depot and Head Office. In assessing the profitability of the new intra-urban routes, it is useful to consider whether we agree with the allocation methods and to assess our own position as to which costs were directly attributable to the routes.

Allocated direct costs

4. Table 2 sets out Stagecoach's method of allocating direct costs to routes.

TABLE 2 **Direct cost allocation methods**

Cost type	*Allocation method*
Driver pay	Scheduled hours
Driver training pay	Scheduled hours
Driver other costs	Scheduled hours
Fuel	Scheduled miles
Fuel duty rebate	Scheduled miles
Departure charges	Scheduled miles
Passenger Carrying Vehicle (PCV) insurance	Scheduled miles
PCV licences	PVR
PCV depreciation	PVR
PCV lease/hire	PVR
Servicing labour pay	PVR
Maintenance labour pay	PVR
Maintenance materials	Scheduled miles
Maintenance external	Scheduled miles
Insurance recoveries	Scheduled miles

Source: Stagecoach.

5. Stagecoach confirmed that up to 57 (later reduced to 47) additional drivers were employed for the purposes of staffing these six routes. These were a mix of new drivers and drivers allocated from other Stagecoach routes. Drivers work on a mixture of routes but wages are allocated to routes by scheduled hours and not by number of drivers. New drivers were allocated on permanent contracts, and whilst this restricts to some degree Stagecoach's ability to manage costs in the short term, we do not consider these to be particularly restrictive over the period of time between Stagecoach launching the routes and the acquisition of PBL.

6. Stagecoach acquired or leased (on hire purchase over ten years) 25 additional buses to cover the six routes. Given the scale of Stagecoach's overall UK bus business, we do not consider the length of the hire purchase contracts to restrict Stagecoach's ability to manage costs in the short term. Stagecoach confirmed that all its HP agreements for new buses are capable of being settled before the date of expiry of the full term by requesting, and settling, a settlement quotation form the finance provider.

Depot costs

7. Depot costs are considered by Stagecoach to be overheads which are apportioned by route. The method for allocating depot costs is shown in Table 3, and PVR appears to be a reasonable measure of allocation. We also consider whether the nature of these costs suggests that they are better classified as overheads or direct costs—see paragraphs 8 to 11 below.

TABLE 3 **Depot costs allocation methods**

Cost type	*Allocation method*
Engineering management	PVR
Plant depreciation	PVR
Other engineering	PVR
Operations costs	PVR
Premises costs	PVR

Source: Stagecoach.

8. Engineering management charges have gradually increased over the period of operation of the new intra-urban routes. Allocation of charges by PVR appears reasonable; however, as the number of engineers has increased over the period, this could be considered to have some direct cost implications for routes.

9. Other engineering covers tools and equipment, cleaning materials, training, health and safety provision, new bus delivery charges, fuel management contract etc. This cost peaks in 2007/08. Stagecoach attributed this to costs associated with new buses and additional apprentice training. It could be argued that certain elements of these costs are direct costs associated with the six routes, eg costs for new bus deliveries.

10. Operations costs includes operations management and admin pay, travel shop and enquiry pay, publicity and marketing, equipment depreciation and other operations costs. It seems reasonable to assume that a proportion of these costs are genuine overheads that were not affected by the new routes, although some costs may have increased directly as a result. These are considered below:

    (a) *New staff*. The number of Operations staff has increased across the period under review from an average of 20 in 2006/07, to 21 in 2007/08, to 23 in 2008/09. Stagecoach did not attribute this increase directly to the operation of the six routes. It noted that 'costs of supervision and monitoring were increased because of the increased network and for regulatory reasons'. Stagecoach considered 75 per cent of the additional cost to be due to increases in supervision and monitoring costs.

    (b) *Publicity and marketing.* This cost does increase in 2007/08, the year when the six new routes were implemented. Stagecoach confirmed that two-thirds of the increase in this spend was in relation to the new services. In general, it would appear reasonable to allocate marketing costs by PVR unless specific costs have been incurred for marketing specific routes as has been suggested here, in which case they could be allocated directly by affected route instead of spread across the bus network.

    (c) *Equipment depreciation and other ops.* There is an increase in 2007/08 which Stagecoach attributed to additional ticket machines, on-bus equipment (including CCTV), ticket stocks and staff lockers. It could be considered that some of these costs are direct costs for routes eg ticket machines on buses operating on specific routes.

11. Plant depreciation and premises costs have not increased for Stagecoach overall despite the opening of the new intra-urban routes. We therefore agree with Stagecoach that these should be considered as overheads.

12. An argument can be made to allocate some of these costs directly but overall it seems broadly reasonable that depot costs are allocated as an overhead.

Head office

13. Head office costs include wages, rent and rates, IT, professional fees, depreciation etc. These appear largely to be fixed costs by nature. The number of staff allocated to head office averages five in 2006/07 and 2007/08 and drops to an average of four in 2008/09. There is no obvious step change in head office costs, but we note that general insurance and SSC (Shared Service Centre) costs have increased notably. Professional fees have increased from of £[✂] a year in 2006/07 to £[✂] a year in 2007/08 and pro-rata £[✂] a year in 2008/09. Professional fees stand out as a possible area where the six new routes may have caused directly increased costs.

Stagecoach confirmed that professional fees had increased due to ‘employment tribunal, Public Inquiry and Concessionary Fares Appeals in these periods’. The Public Inquiry (called by the Traffic Commissioner) was in relation to the Citi network which included the new intra-urban routes. Stagecoach noted that the fees incurred for the Public Inquiry and the Concessionary Fares Appeals were one-off costs. Stagecoach confirmed to us that there were no additional one-off fees for setting up the six new routes.

The 2008 counterfactual

Stagecoach's submission

1. In a submission to us Stagecoach said the following:

   (a) PBL was a failing firm. Absent the merger, it would have been unable to meet its financial obligations in the near future and would have been unable to restructure itself successfully;

   (b) a third party would not have been able to restructure PBL successfully to make it profitable in the face of competition from Stagecoach; and

   (c) the most likely outcome for PBL under the counterfactual was that it would have entered administration and would have been liquidated. Its assets would have been unlikely, in those circumstances, to have been acquired to provide local bus services in Preston.[1]

Assessment of PBL as a failing firm

2. If one of the parties to a merger is failing, the pre-merger competitive conditions are unlikely to continue and cannot form the basis of a plausible counterfactual. This is covered by our guidance:[2]

> In some cases, whether or not one of the firms merging would fail may be an issue. Where the CC considers that one of the firms would fail then the situation in the market without the merger may be similar to that which would result from the merger, and thus the merger itself may not lead to any significant changes in the extent of competition in the market.
>
> For a firm to be considered a failing firm, the CC will need to be satisfied that:
>
> - the firm is unable to meet its financial obligations in the near future; and that
>
> - the firm is unable to restructure itself successfully.

3. Whether and to what extent the CC will take the failing firm issue into account will depend on various circumstances. First it will need to consider whether any other persons might have acquired the firm, its businesses or any of its assets or wish to do so. A further consideration is how the sales of the failing firm, should it exit the market, will be redistributed among the firms remaining in the market. If without the merger they are likely to be dispersed across a number of other firms, then the merger, by transferring most or all sales of the failing firm to the acquirer, may well have a significant impact on competition in the market. In other cases the great majority of sales may be expected to switch to the acquiring firm anyway, in which case the merger may have little effect on competition. In some instances, similar sorts of considerations to those outlined above may apply to situations where it is

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[1]Disregarding for the purposes of the counterfactual that Stagecoach would have acquired the assets.
[2]*CC2*, *Merger References: Competition Commission Guidelines,* paragraphs 3.61–3.63.

argued that a division or subsidiary of one of the parties to the reference does not have a viable future.

4. By September 2008, PBL had received bids from Arriva and Go-Ahead. Arriva had requested further information on liabilities including the pension scheme. PBL was also negotiating with PCC over the pension scheme deficit and the Council's guarantee.

5. At this point it was decided to approach Stagecoach, and in mid-September KPMG invited Stagecoach to submit a bid for PBL. Stagecoach responded positively, submitting a preliminary offer on 10 October, commencing the process that led to the merger. We have to consider whether, in the absence of this bid or any later bid from Stagecoach, PBL would have met the criteria for a failing firm set out above.

Ability to meet financial obligations

6. Stagecoach said that PBL would have been unable to meet its financial obligations in the near future:

- PBL's auditors, KPMG, had been clear that PBL would not be able to continue as a going concern. Stagecoach cited an Emphasis of Matter statement (which did not amount to a qualification) in the auditors' report on the financial statements for the year to March 2008 in which PBL reported a loss of almost £165,000. In the report, dated 16 January 2009, one week before the merger completed, the auditors pointed out that the financial statements did not include the adjustments that would result if the company were unable to continue as a going concern.

- KPMG in its options review report of May 2008 had been clear that the business was not viable in its current form.

- The OFT had noted in its decision that a substantial amount of evidence had been received that PBL was in severe financial difficulties.

- In a letter dated 6 August 2008 to the Treasurer of PCC, PBL's Finance Director [✂], had said that the trading position had continued to deteriorate and in the absence of a share sale in the following three months, it was likely that PBL would become insolvent, leading to either closure or a sale of the business and assets through an insolvency procedure.

- If PBL had somehow survived to April 2009, it faced a 19 per cent cut in concessionary revenue from LCC. Based on the revenue paid to PBL in 2008, the loss of revenue would have been about £[✂] a year.

- Finally, the BSOG was no longer linked automatically with fuel duty, and the duty increase of 2p per litre on 1 April 2009 would not be reflected in an increase in BSOG (we note that this applied to Stagecoach and all other bus operators in Preston too).

7. Stagecoach also said that the financial troubles of PBL were long-standing. Operating profits of £923,000 in 2005/06 and of £403,000 in 2006/07 were enhanced by exceptional income from the defined benefit pension scheme (see Table 1 in Appendix C). Without this exceptional income, the position for those years would have been worse.

8. Stagecoach drew attention to a letter from KPMG to PBL dated December 2005. It was addressed to the Finance Director, who had asked for KPMG's view on the affordability of the final salary scheme. It set out the underlying net profit before tax of PBL (£'000):

2001	*2002*	*2003*	*2004*	*2005*
321	309	286	283	277

9. KPMG said that, as could be seen, profitability had been around £[✂], albeit reflecting a downward trend. Apart from 2005, when there was a £100,000 charge for the scheme, no charges had been made, largely because for the first ten years, contributions had effectively been funded by PCC. ([Former PBL Director X] told us this was not correct. Over a period of about 11 years from 1993, assets were transferred from the LGPS to the WMPTA scheme, and these had in later years covered all scheme costs—see Appendix D, paragraph 6.) Were the scheme to be continued annual contributions of £464,000 would be required, £244,000 for past service and £220,000 for current service. Had these contributions been required in the past, the company would have been substantially loss-making in each of the above years, with the company only just being able to cover the contribution level for past service. Stagecoach said that this demonstrated that PBL had serious financial problems of a chronic nature.

CC assessment

10. We do not accept that the financial troubles of PBL were long-standing. [Former PBL Director Y] told us that in his view as long as profits had been around £[✂], everybody was happy. PBL had deliberately kept fares low, because if there had been high fares and high returns it would have suggested to potential competitors, bigger groups or even smaller independents, that there was money to be made in Preston. Equally, as an employee-owned company, the employees would have viewed high returns as theirs, and there would have been a push for higher wages. Some employee terms and conditions were expensive, but there was a reluctance to make changes that were not good for the employees in a company that was employee-owned. This had not prevented PBL from responding to KPMG's letter by closing the defined benefit pension scheme for future service in 2006, reducing its annual payments to £244,000 for past service. We think it likely that the main purpose of the KPMG letter was to persuade the employee directors of the need to change pension arrangements rather than to demonstrate inadequate profits.

11. From June 2007, following the launch of Stagecoach's new intra-urban services, PBL's financial position deteriorated. In May 2008, the KPMG report had forecast that PBL would exceed its overdraft limit in October, with average monthly cash outflows of £200,000 if Stagecoach continued to compete at the level then prevailing. PBL management also prepared an updated cash flow forecast for the 2008/09 financial year which estimated that PBL would reach its overdraft limit at the end of 2008.

12. At the end of September 2008, PBL's management accounts recorded an overdraft of £[✂], a better performance than the cash flow forecast (£[✂]) and the KPMG estimate (approximately £[✂]). This suggests that PBL would have been able to continue for a further few months. However, given the continuing competition with Stagecoach it was unlikely that PBL's losses and cash outflows would have lessened significantly during the later months of 2008. We would therefore think that it was likely that PBL would eventually have been unable to meet its financial obligations.

Ability to restructure itself

13. Despite [Former Director Y] suggesting a number of cost cutting strategies, the scale of the losses meant that it was unlikely that PBL would have been able to restore itself to profit and cash generation without further financial investment. Stagecoach told us that PBL was not prepared to embark on any restructuring that involved job losses. As an employee-owned company it had shown no inclination to restructure by minimizing costs, cutting services and streamlining the organization, but any such restructuring would have involved one-off costs such as redundancy payments which it could not afford.

14. After discussions among PBL's directors, [former PBL Director Y], was invited to submit his suggestions for improving the efficiency of the company and making savings. In a memorandum dated 8 March 2008, he put forward several proposals. These included a fare increase, a revised sick pay scheme, changes to services on routes that were underperforming and steps to address a shortage of drivers. Commenting on his memorandum, he told us that changing terms and conditions in an employee-owned company had been difficult, but changes had been made in May 2008. [Former PBL Director X] told us that some proposals for service changes had not been made because of the loss of revenues that would ensue.

15. Although steps were taken to reduce costs, PBL's financial position, its ongoing losses and the turbulent economic conditions in the autumn of 2008, all made it unlikely that further external finance would have been raised. It is also unlikely that sufficient new equity could have been raised from employee-shareholders. We therefore consider that it was unlikely, in the continuing presence of abnormal competition from Stagecoach, that PBL would have been able to restructure itself.

Transferring the pension scheme deficit to the council

16. An obstacle to a sale of PBL was the WMPTA pension scheme deficit. KPMG [✂] in June had invited bids for PBL excluding the scheme. On 6 August PBL had written to PCC stating that its trading position had deteriorated (see paragraph 6). It said that it had received two preliminary offers, indicative and subject to due diligence, which were conditional on the defined benefit pension liability not transferring to the purchaser. To facilitate the sale rather than insolvency, PBL formally requested PCC, [✂].

17. By September [✂] the value of the deficit had been made more uncertain by the unsettled condition of the financial markets. Using the deficit value at August 2008 (£[✂] million) the Council would have received a dividend of approximately £[✂].[3] This figure represents a baseline, against which any deal with PBL would have been compared.

[3]Other unsecured creditors, such as employees and trade creditors, would have received less as a result of the higher deficit.

Alternative buyers for PBL

18. In the absence of a bid from Stagecoach, PBL would have continued negotiations with Arriva and Go-Ahead and, possibly, sought further interest from the other recipients of the information memorandum who had not submitted bids, [✂].

19. Stagecoach stated in its submission that the options for restructuring PBL's operations could be realized by one party only—Stagecoach. No other operator could restructure PBL effectively to make it profitable in the face of competition from Stagecoach. Stagecoach had estimated several classes of savings. The annual amounts were:

- Network consolidation savings—£[✂].
- Fuel price savings—£[✂].
- Reduction in overheads—£[✂].

20. Stagecoach accepted that fuel price savings were available to any large purchaser; the reduction in overheads was realizable by any purchaser with operations in Lancashire, such as Arriva, but was only partially realizable by others such as Go-Ahead. We note that the savings from rationalizing the network resulted from a reduction of competition rather than a redesign of the network. Some of this would have been available to another buyer, although it would have taken more time and not have necessarily been as extensive (but less extensive rationalization of services would have been to the benefit of bus users).

21. Stagecoach also told us in its submission that there was no realistic alternative purchaser of PBL as a going concern. It said that this was unsurprising given that a sale process had already been conducted to identify potential parties. It dealt specifically with Arriva and Go-Ahead.

22. Stagecoach said that Arriva had pulled out of the process on 5 September due to concerns about the current run rate of losses during the period April to September 2008 (on average £[✂] a month). Attempts had clearly been made to re-engage Arriva but they had been unsuccessful. Arriva had stated to the OFT that it had been interested in acquiring PBL only if it was also able to acquire Stagecoach's Preston operations. All available evidence, Stagecoach said, pointed to the fact that, absent Stagecoach's offer, discussions with Arriva would not have continued.

23. Stagecoach told us that there was similarly no evidence to support the view that it would have been possible for PBL to reach an agreement with Go-Ahead. As a best case scenario, its revised offer of 7 October would have permitted PBL to offer £[✂] (the sum offered for the share capital) to PCC to assume the pension liability, the same offer which PCC had already rejected (see paragraph 16). Stagecoach considered that there were likely to be insurmountable barriers to any discussion with Go-Ahead leading to an agreement for the purchase of PBL. The suggestion that a deal would have taken place was, it said, based more on supposition than evidence.

24. Arriva told us that it had not pulled out of the process. It had been due to make a second round offer by 5 September, but had not found all the information that it needed in the data room, and had not submitted an offer. [Former PBL Director X] told us that Arriva had not withdrawn from the process but had become inactive.

25. Arriva told us that it had been serious in its pursuit of PBL, and its regional managing director had met KPMG and PBL management three or four times to see if there was

any way in which PBL could be restored to profitability. In the absence of a bid from Stagecoach, it would have continued to pursue an acquisition. However, the monthly management accounts had shown that the financial position was worse than that shown in the information memorandum and its indicative offer was unsustainable.

26. Arriva said that it would have been prepared to take on the pension scheme deficit, but given a reduced value for PBL's business from its July offer, this could have given a negative value for PBL, implying that Arriva should seek a payment for taking PBL off its shareholders' hands—clearly not feasible. By October the financial climate had deteriorated since it was first approached by KPMG in May. If it could not have made a revised bid, PBL might have gone into administration.

27. Arriva thought that other bus operators, itself included, would have been interested in acquiring some or all of PBL's business from the administrator, who would have been left with the pension deficit. However, it could not give an example of a successful administration; generally bus companies seemed to have avoided administration.

28. [✄]

Prepack administration

29. Another possibility was a prepack administration. Under such an arrangement a potential buyer enters into negotiations with the principal creditors and, in return for an agreed payment to them, acquires the business, together with some of its assets and liabilities. The buyer does not acquire the company which retains unwanted assets and most of the liabilities.

30. A prepack administration would have enabled PBL to sell its trading assets (depot, buses, and employees) to fund an agreed settlement of its debts. The employee-shareholders and EBT would have lost the value of their investment and PCC's guarantee would have been invoked.

31. [✄] Arriva said that it had been given legal advice that before entering into a prepack scheme it should get assurance from PCC that it would not be pursued for the full deficit as a prejudice action. If PCC had refused, any prepack proposal would have fallen apart.

32. There would have been several administrative hurdles for a prepack administration arrangement. The Traffic Commissioner told us that if a bus operator went into administration, it would lose its licence. If, instead, it were acquired before formal insolvency by another licensed operator, the acquiring company could apply for services on the failing company's routes to be registered and the 56-day notice period could be reduced or waived.

Insolvency

33. As an alternative to a prepack arrangement, an administrator could have traded on and sought to achieve a sale of the business as a going concern. Stagecoach thought that an administrator would have been highly likely to have ceased to trade PBL shortly after appointment. The administrator would have needed some further external funding. The usual source in such a situation would be a secured creditor, but in this case HSBC had no incentive to provide it. It was therefore highly likely that the administrator would proceed to liquidation of PBL's assets.

34. [✂] Stagecoach said that if the Traffic Commissioner had become aware of PBL's financial situation, its operating licence would have been curtailed or revoked.

35. Stagecoach said that once liquidation commenced, it would have immediately registered the remaining PBL routes, and PBL's custom on the overlapping services would have transferred to Stagecoach services. This would have reduced the price that any third party might have been willing to pay for its assets. The assets available in liquidation would have excluded the newer vehicles in PBL's fleet which would have been reclaimed by the hire-purchase company. The liquidator, seeking to achieve the best result for creditors, would have put the depot up for sale and appointed a bus broker to market the remaining vehicles. It was unlikely that a third party would have wished to purchase any of these assets for operating local bus services in Preston.

CC evaluation

36. Arriva had been looking to acquire both PBL and Stagecoach Preston (which would have raised the same competition concerns as the current merger), but its offer of £[✂] million (excluding pension liability) had not been conditional on it acquiring Stagecoach Preston. Arriva told us that at the time Stagecoach was invited to bid it had not withdrawn its offer, and was seeking further details on PBL's liabilities as part of its due diligence process.

37. Arriva, or any other bus operator acquiring PBL, would have faced competition on all its key routes from Stagecoach, and would have taken on an operation that was losing around £[✂] every month. However, the presence of a relatively well-resourced competitor would have caused difficulties for Stagecoach. It was making substantial losses on its Preston intra-city operations owing to the abnormal competition between it and PBL.

38. In the absence of a bid from Stagecoach, Arriva could have been persuaded to undertake a further look at acquiring PBL. By this time PBL's directors, with the company's cash resources running out, would have been more prepared to accept a bid that left little or nothing for the shareholders, and would have been more concerned to preserve as many jobs as possible.

39. If an alternative purchaser could not have been found, it is likely that PBL would have entered administration. We cannot determine with any accuracy what would have happened as a result—it is possible that Arriva or other bus operators would have entered PBL's routes either with their own assets or with PBL's, purchased from the administrator.

40. Faced with a competitor with greater financial resources than PBL, neither Stagecoach nor its new competitor would have an incentive to continue at such an abnormal level of competition. It is therefore possible that a retrenchment of services would ensue.

41. The other obstacle to a sale was the pension scheme deficit. In principle, all parties (PCC, the WMPTA and PBL) appeared to have an incentive to find a compromise that would prevent PBL from going into liquidation. [✂] Stagecoach, after receiving assurances from PCC and the WMPTA had agreed to do this in the absence of a bid from Stagecoach, we could not establish with certainty that an agreed solution for the pension scheme deficit could be reached.

42. The uncertainties resulting from the state of capital markets in autumn 2008, the uncertain outcome of the interactions between the vendors, the bidders, the pension

fund and PCC that would have continued throughout the negotiations and, above all, the uncertainties relating to Stagecoach's own competitive behaviour during that time prevent us from concluding whether a trade sale or administration was more likely. However, even if PBL had gone into administration, we cannot be certain that no operator other than Stagecoach would have commenced services on at least some of PBL's routes, using buses, facilities and staff that they already owned or which they acquired from an insolvent PBL. We are not therefore satisfied that Stagecoach would inevitably have ended up with as high a share of the market for bus services in Preston as it now has as a result of the merger.

Market definition

Introduction

1. Market definition is not an end in itself, but is often a useful exercise for identifying competitive constraints. In past bus merger inquiries, the CC has tended to focus on the competitive effect of the merger rather than the market definition.

2. There are typically two dimensions to the definition of a market: the product market, which should include all products that impose a significant competitive constraint on the product in question, and the geographic market which should include all the neighbouring areas to which sufficient customers would switch to purchase the product or from which suppliers could 'import' the product to impose a constraint. In transport inquiries the delineation between the product and geographic aspects of market definition is less clear-cut. For example, one can view purchasing a ticket for a journey from point A to B by bus as an element of the product offering or as a geographic aspect of the offering.

3. Wherever possible, the CC adopts the SSNIP test (or hypothetical monopolist test) to define markets. This involves starting with a narrow 'candidate' market and widening it until sufficient alternatives are included such that a hypothetical monopolist of these products could profitably impose a small but significant non-transitory increase in price (SSNIP) which is typically 5 per cent. In this way, we ensure that all important competitive constraints are included within the market we define. Stagecoach has submitted that SSNIP as traditionally applied is not an appropriate tool to understand the competitive constraints in bus markets. For the reasons outlined below, we disagree and propose to use the hypothetical monopolist test for the purposes of delineating the relevant market in this inquiry.

4. Finally, it is useful to clarify the terminology that we employ. A 'route' is defined as an end-to-end service. Routes in the Preston area are taken to include all routes that serve any location in the Preston area even if they begin in, end in, or serve for the majority of their journey, locations outside the Preston area. A 'flow' is defined as any connection between two specified points. Flows might correspond to an end-to-end route, but they might also correspond to shorter journeys between intermediate points on a route (eg bus stops or fare stages).

Consumer demand for bus services

Flow-by-flow approach to consumer demand

5. Passengers need to travel from an origin (eg their home) to a destination (eg a supermarket). As we explained above, such a journey between two points is defined as a flow. Given that a passenger wants to make a journey from a given origin to a given destination, in principle no other flow will be a substitute for this passenger. However, it is possible that following a 5 per cent price increase (or worsening of other aspects of the retail offer, such as for instance the frequencies of services) a passenger might substitute one flow for another if this other flow were sufficiently close to the original one.

6. Stagecoach submitted that most passengers in Preston were unlikely to change their route in response to a fare rise of 5 per cent. Stagecoach explained that unless there were two transport corridors which run parallel with each other and are within easy

walking distance of one another, passengers would not switch between different flows in response to such ‘insignificant’ price changes.

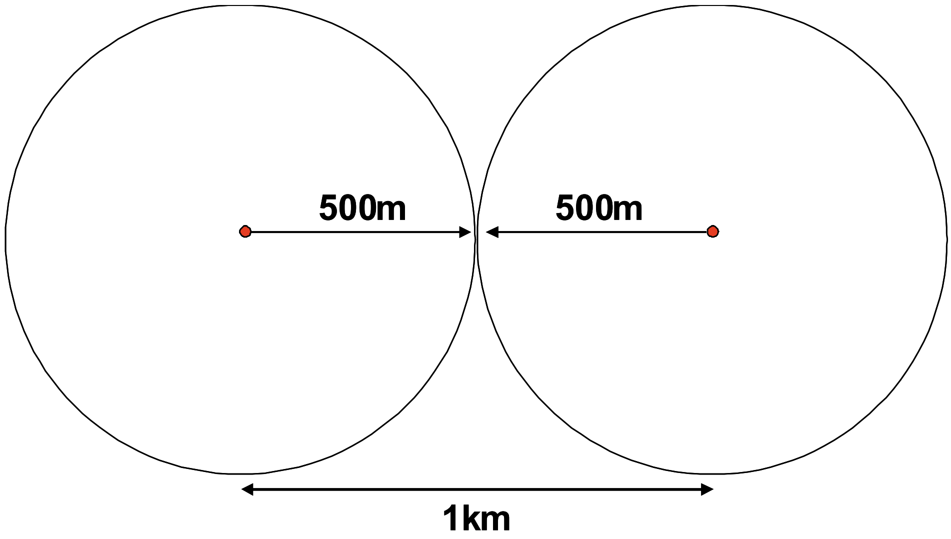
7. However, Stagecoach agreed that in principle two flows within reasonable distance could be considered as substitutes. It submitted that the stops on potentially substitutable flows did not need to be located within walking distance to each other for the flows to be substitutes. It submitted that it was only necessary that consumers who are located between the stops could walk to either of them without, however, specifying what the required distance should be. Finally, Stagecoach submitted that in Preston demand-side substitution between non-overlapping routes would be extremely limited.

8. The latest National Travel Survey (2002) published by the DfT reported the average time taken to walk to the nearest bus stop by population size. In urban areas with a population of between 25,000 and 250,000 (Preston city has a population of over 130,000 inhabitants) 89 per cent of bus passengers walk for 6 minutes or less to reach their bus stop, 9 per cent walk for between 7 and 13 minutes and only 2 per cent walk for 14 minutes or more. If, following the findings of the National Travel Survey, we assume that bus passengers walk a maximum of 6 minutes to reach their bus stop and that they only walk at 5 km an hour then we can conclude that a typical bus stop will draw its passengers from a 500-metre radius.

9. This suggests that flows that involve bus stops that are 1 km or more apart will have negligible competitive interaction with one another (see Figure 1).

FIGURE 1

Overlap based on 1 km distance between bus stops/fare stages



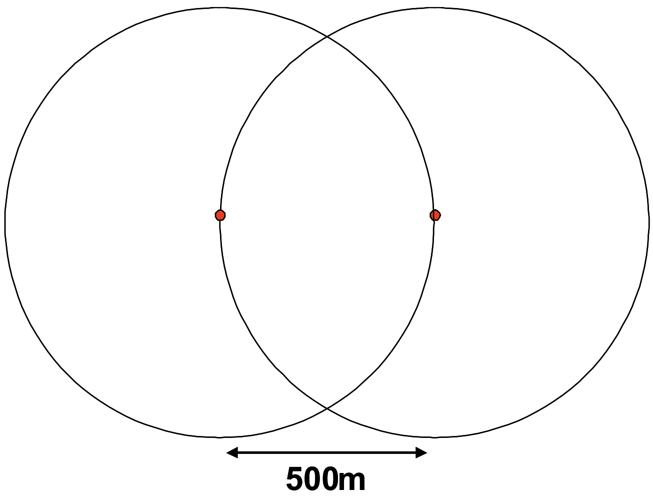
Source: CC.

10. Without knowing anything about the distribution of passengers within the 500-metre radii, it is difficult to determine how far apart two different flows need to be in terms of their start and end bus stops to be considered substitutable by passengers. However, reducing the distance between bus stops to 500 metres appears to increase the proportion of passengers in overlap areas (ie who could walk to/from either bus stop within the 6-minute walk time) to a significant proportion (see Figure 2). If we assume an even distribution of customers it appears that for each of the bus stops, close to 40 per cent of the passengers in the isochrone come from the overlap areas. We

therefore conclude that any two flows which have both their origin and destinations within 500 metres of one another are in the same market. We note that a similar approach was taken in the Arriva/Sovereign inquiry.

FIGURE 2

Overlap based on 500-metre distance between bus stops/fare stages



Source: CC.

11. We asked Stagecoach to apply this rule in its submission of flow data, but this did not seem to generate more overlap flows.

12. Furthermore, distance is not the only factor that will influence the substitutability of bus services. Frequency, length of journey and timetable scheduling are also important. It is conceivable that a SSNIP on a given cluster of flows (deemed to be in the same market) could be profitable even if there were other bus operators offering services that:

(a) had an appreciably lower frequency;[1] and/or

(b) served the route at appreciably different times.[2]

13. In relation to these points Stagecoach submitted that timetable overlap between two services was an important feature of the degree of demand-side substitutability. In this regard Stagecoach noted that a daytime-only service and an evening-only service were unlikely to place significant competitive constraints on one another. However, Stagecoach did not believe that frequency and journey time necessarily precluded substitution from taking place between two different bus flows. Stagecoach told us that in principle, changes in the relative prices of two services with somewhat different frequencies and journey times could still generate substitution between them, as customers traded off the various competitive dimensions against one another.

14. It is very difficult to form a view on what level of timetable and frequency overlap is necessary to include services within the same market. In the absence of any

[1]We note that services with appreciably different frequencies are unlikely to be substitutes for each other in the sense that following a SSNIP, consumers would not consider waiting for a considerably less frequent service worth their while.
[2]We note that two services serving the same flows with the same frequency, but one running on the weekdays and the other on weekends, are unlikely to be substitutes for most consumers within the SSNIP framework.

quantitative analysis on this point and in the interests of pragmatism we adopted the 'rules' used in previous inquiries and adapted when necessary.

(a) In Arriva/Sovereign and FirstGroup/ScotRail, the CC concluded that on 'frequent services', ie services running every 10 minutes or less, for a competitor to be effective it would have to run with a frequency of no more than 10 minutes greater than the incumbent.[3] On 'less frequent' services, the CC considered that a longer gap between competing services would not be inconsistent with effective competition as passengers were more likely to plan their journey according to a timetable. On these 'less frequent' services, competitors running with frequencies no more than twice as long were considered effective.[4,5]

(b) In FirstGroup/Scotrail, the CC identified two potential relevant markets for 'in hours' travel (7am to 7pm Monday to Saturday), and 'out of hours' travel (7pm to 7am Monday to Saturday, and Sunday all day). Two services were considered to be a part of the same market if there were at least a partial overlap between the two types of travel.[6] In addition to this division, we could divide travel into peak and off-peak travel, and commuter (weekdays) and leisure (weekends and bank holidays) travel.

15. Stagecoach broadly agreed with the approach outlined in paragraph 14, but noted that the approach outlined under point *(a)* should be viewed as an analytical tool rather than a definitive description as to what services might constrain each other.

The importance of a network

16. Whilst some passengers may only be interested in making one or a series of point-to-point journeys along a single flow, others may be interested in making one or a series of multiple journeys across several distinct and possibly interconnecting flows. For the latter group of customers, the different flows are complements to one another (in so far as they will tend to make use of them together).[7] We therefore needed to consider whether it was appropriate to widen the relevant market beyond individual flows and define a 'network' market for demand-side reasons. If the evidence were to indicate that a significant group of customers valued making network journeys, this would suggest that competition between networks (rather than over individual flows) was an important element of the process of rivalry. This has implications for our understanding of competition and also the nature of expansion/entry that needs to occur to replicate any loss of competition that is identified: if competition between networks is important then new entrants will likely need to enter on a large scale to be able to compete effectively.

17. Stagecoach submitted that, on the basis of demand-side substitution, we should define the geographic market on the basis of point-to-point journeys (ie flows). It submitted that a network approach would not be appropriate for demand-side substitution given the features of the market in Preston and that it would be inconsistent with precedent for mergers involving operators of a single mode of transport.

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[3]That is if a service was operated every 10 minutes or less the rival service would need to be operated no less frequently than every 20 minutes in order to constitute an effective competitor.
[4]That is if a service was operated every 30 minutes the rival service would need to be operated no less frequently than every hour.
[5]*Arriva plc and Sovereign Bus & Coach Company Ltd, a report on the acquisition by Arriva plc of Sovereign Bus & Coach Company Ltd*, 7 January 2005, Appendix F, paragraph 18.
[6]*First Group plc and the Scottish Passenger Rail franchise, a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited*, June 2004, Annex G, paragraph 22.
[7]Technically, if two products are complements the cross-price elasticity between them is negative, ie if the price of one increases the demand for the complementary product will fall.

Stagecoach also submitted that the OFT had been incorrect to adopt a network approach alongside the more usual flow-by-flow approach in its decision to refer the acquisition of PBL by Stagecoach.

18. According to Stagecoach, only few passengers in the Preston area travelled on extensive cross-conurbation journeys necessitating more than one bus and, of those who did travel across the city, PBL's Orbit service and Stagecoach's 19/22 service covered most 'cross-Preston' journeys.

19. We tried to estimate the numbers of passengers that use a network of services in the Preston area. Stagecoach submitted a variety of figures that could be used:

(a) Stagecoach submitted that based on its cross-UK experience, a typical estimate of passengers requiring more than one bus service to complete their journeys was [✂] per cent.

(b) Stagecoach submitted that in 2003/04 Lancashire County Council developed an initiative to establish a multi-operator day ticket. Stagecoach, which was involved in this initiative, carried out research on passengers passing through Preston Bus Station to establish what percentage of them were using two or more bus services to make their journey. The research revealed that [✂] per cent of passengers passing through the bus station were making these journeys. Stagecoach submitted that this figure was an overestimate. This is for three main reasons:

(i) Some of the switching passengers have switched from inter-urban to intra-urban service.

(ii) The research was carried out at Preston Bus Station, which is the hub for changing services. The research therefore does not represent the entire population of bus passengers in Preston, many of whom do not travel to Preston Bus Station.

(iii) The research was carried out on a bank holiday, which would have led to a higher degree of switching than would be the case on a normal weekday due to a greater amount of inter-urban travel. Stagecoach told us that this was because on a bank holiday a greater number of passengers travelled through Preston to make day trips to Blackpool, Morecambe, the Lakes, Manchester etc. We note, however, that research on a bank holiday will miss important information on commuter travel. Stagecoach agrees with this proposition.

(c) Stagecoach told us that in terms of revenue, daily and weekly multi-journey network tickets accounted for [✂] per cent of Stagecoach's and [✂] per cent of PBL's ticket revenues excluding concessionary income.[8] Stagecoach later clarified that revenue from network tickets represented [✂] per cent of its intra-urban revenues and [✂] per cent of its inter-urban revenues including concessionary income.

(d) In terms of passenger numbers, Stagecoach stated that network tickets accounted for [✂] per cent of PBL's passengers and a 'slightly higher' proportion for Stagecoach. Stagecoach later provided more detailed information which suggested that [✂] per cent of all PBL passengers purchased a network ticket in 2008. The equivalent figures for Stagecoach were [✂] per cent for passengers on intra-urban services and [✂] per cent for passengers on inter-urban services.

[8] Stagecoach advised that this data was based on an estimate by [former PBL Director Y], rather than a statistical estimate.

We note that when we focus on fare-paying passengers, [✂] per cent of PBL's and [✂] per cent of Stagecoach's fare-paying passengers purchase a network ticket.

(e) Stagecoach advised that network tickets were not a good proxy for network use since many consumers purchased those tickets in order to obtain a discount on their regular one-route journeys. Stagecoach did not provide any guide as to what proportion of the network-ticket-buying consumers this might represent, arguing that the difficulty to do so arose from the limitations in the information recorded by ticket machines. Existence of these difficulties was later confirmed by Arriva, which told us that its ticket machines, the industry standard Wayfarer and TSS, did not allow it to establish whether passengers were using network tickets to make multi-service journeys or just as single route return tickets.

(f) Stagecoach further submitted that 'there is significant level of switching between bus routes at Preston's central Bus Station, principally due to people changing from local buses to inter-urban bus routes, or vice versa'. Stagecoach told us that this effect was not relevant to the merger as PBL operated only intra-urban bus services. Finally, Stagecoach was unable to quantify the extent of such switching.

20. Research carried out by the public transport consultancy TAS in 2003 for LCC suggested that 15 per cent of the interviewed passengers in Preston changed services when making their journeys.

21. [Former PBL Director X] suggested that the reason why the numbers of customers changing buses in Preston might be high was due to the layout of the routes, which created a radius with a centre at Preston Bus Station and without a natural orbit. For instance, if passengers from Ribbleton (ie east of Preston) wanted to go to the Royal Preston Hospital, they had to travel via Preston Bus Station and change services. This situation changed with the introduction of the orbit service by PBL two years ago.

22. In addition, one of the small bus companies which operates in the vicinity of Preston, Coastal Coaches, told us that the network was a barrier for competition. It told us: 'if an operator operates 50 routes in a city and sells a day-tripper ticket, then it means that the person who purchases that ticket can travel on the X5 to Garstang, the X10 to Chorley, the 602 to Freckleton and whatever for the day. I cannot compete with that because I only run one route.' However, Stagecoach told us that this travel pattern was very unusual and would only be relevant to a small subset of passengers.

23. LCC told us that customers in Preston valued a network of routes although it did not have any formal estimate of how many. It told us that a number of major attractions, such as the hospital, were located about 2 miles from the city centre and thus required interchange from many parts of the Preston and South Ribble area at Preston Bus Station. LCC also told us that a new entrant to the Preston market would 'almost certainly need to compete with network tickets to be fully successful'.

24. It would appear that around one-third of all passengers of both companies purchase network tickets, although it is unclear which proportion uses them as true network tickets. We have two benchmarks for the 'true' network use in the Preston area, a [✂] per cent estimate by Stagecoach and a 15 per cent estimate by an independent consultancy TAS. Both figures suggest a higher network use than is the national average for Stagecoach ([✂] per cent). We note, however, that the TAS research also made a separate estimate of the network use in Preston for PBL, Stagecoach and Fishwicks finding that 23 per cent of PBL passengers made multi-service jour-

neys, while only 8 per cent of Stagecoach's and 7 per cent of Fishwicks' passengers made such journeys. On the basis of these company-based estimates, Stagecoach's network use would be [✂]. However, we also note that this estimate was made in 2003 when Stagecoach was not running any Preston city intra-urban services. The low number of network use for Stagecoach (8 per cent) and a higher network use for PBL (23 per cent) would therefore suggest that only a small number of passengers in the Preston area were switching between inter- and intra-urban services, while a far higher proportion was switching between different intra-urban services within Preston city.

25. Finally, the generally radial layout of the Preston bus network may encourage network use. We note that there is currently an orbit service in Preston (former PBL services 88a/88c) which has proven very popular.[9] This suggests that a large number of customers value cross-Preston trips that otherwise would have had to be done by changing services. We note that the introduction of this service would have avoided the need to change services at Preston Bus Station for some passengers, although probably not for all. We also note that pre-merger, the parties provided a highly overlapping, dense network of services.

Constraints from other forms of transport

26. We considered whether any other forms of transport should be included in any of the relevant markets we have identified. Stagecoach told us that passengers chose between a wide range of options when making journeys. Depending upon the individual passenger or group of passengers and the journey which that passenger wishes to make, Stagecoach claimed that car, taxis, cycling, walking and rail services could all be potential substitutes for local bus services, particularly in the medium to long run when available choices will be wider. This is because as bus travel becomes more expensive, or of a lower quality, people may purchase bicycles or cars or otherwise change their travel patterns.

27. Stagecoach conceded that some of these options might take too long to be included within a market definition based on the sustainability of prices over a one- to two-year period, but it considered that some options were available within the time period. However, Stagecoach also submitted that if some of these options were not to be considered as part of the relevant market, they nonetheless provided a competitive constraint from outside the market.

28. In terms of a formal market definition Stagecoach considered that the relevant product market from a demand-side perspective was therefore at least as wide as an 'all public transport' market on the given flow for the journey which the passenger wished to take (where these options, namely rail and coach, were available).

29. Stagecoach submitted that walking and cycling might also be sufficiently viable options on shorter flows.

30. Stagecoach further submitted that taxis might be a viable alternative for some trips, in particular where a group of people were travelling together over modest distances. Furthermore, taxis also compete with buses for off-peak shoppers business and late evening leisure traffic.

[9]This service was the PBL service that generated [✂] revenue and was the [✂] service in terms of passenger numbers in the period from January 2007 to April 2009 for which we have data. In addition, the service provided the [✂] in September 2008 (a period at which PBL did detailed route costing). We note that this service was developed together with LCC and is partly supported.

31. Stagecoach submitted that the 'private car represents both a threat and an opportunity to its business'. Stagecoach has taken a number of measures to encourage modal switch from car to bus across the UK. These were:

(a) restructuring inter- and intra-urban networks to offer frequent direct services;

(b) restructuring ticket ranges to offer a simple range of fares;

(c) extensive fleet replacement;

(d) focusing local managers on delivering high quality of service;

(e) developing park & ride operations;

(f) developing a new luxury bus concept;

(g) a national advertising campaign; and

(h) Stagecoach's Home Movers campaign offering new home owners a pack with local bus information and vouchers for free weekly tickets.

32. Stagecoach further submitted that the potential for modal switch between car and bus was central to Stagecoach's strategy for its services in Preston. This is because Stagecoach will need to improve PBL's profitability following PBL's recent losses. Some of this will be achieved through efficiencies and some through encouraging bus patronage.

33. Finally, Stagecoach submitted that there was some indicative evidence that travellers were willing to substitute bus for car journeys. For example, during the period of the fuel protests in 2000, bus usage increased by as much as 30 per cent in some locations. At a Preston level, Stagecoach reported a 'noticeable impact' on demand of its park & ride services following the reduction of long-stay car parking charges by 11 per cent in April 2009. However, we note that Stagecoach did not provide any concrete evidence how the drop in car parking charges influenced its patronage within the SSNIP framework.

34. With respect to Stagecoach's argument that the relevant product market was no smaller than all public transport, ie including buses, coaches and rail, Stagecoach agreed that, in practice, rail was not an alternative for intra-urban bus services in Preston. Similarly, there are only a limited number of coach services that stop on intra-urban bus stops in Preston.

35. With respect to walking and cycling, it is possible that for a proportion of the passengers these will be substitutes on very short distances. However, this proportion is likely to be small. Stagecoach objected to this finding, arguing that the evidence from the Stagecoach/Eastbourne/Cavendish inquiry suggested that the proportion of customers who were likely to switch to walking and cycling following a SSNIP was unlikely to be small. The evidence Stagecoach is referring to is a survey of Eastbourne customers. There are a number of reasons why the Eastbourne survey is unlikely to support Stagecoach's argument. First, Preston is different in size, demography and geography to Eastbourne. Second, Stagecoach itself recognized that its Eastbourne survey was not directly applicable to Preston. Third, in the Stagecoach/Eastbourne/Cavendish inquiry, the CC expressed concerns about the design of the survey.[10]

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[10] *A report on the completed acquisitions by Stagecoach Group PLC of Eastbourne Buses Limited and Cavendish Motor Services Limited*, CC, 22 October 2009, paragraphs 5.20 and 5.21.

Finally, as we discuss in paragraph 39, own-price elasticity of bus travel is a better estimate of the cumulative effect of the constraints posed by other forms of transport on bus travel.

36. With respect to the constraint posed by taxis, we have spoken to two Preston private hire companies, Ribbleton Taxis and [✂]. We note that [✂]. Both companies considered bus and taxi/private hire business to be quite separate, serving different consumer needs. This information was echoed by the small local bus operators we interviewed.

37. With respect to the constraint posed by cars, it is difficult to see how the measures that Stagecoach mentions as resulting from cars being perceived as a threat and an opportunity for the bus business are specifically targeted at cars. As regards the car-parking charge reduction, Stagecoach did not provide any concrete evidence of the impact that this change has had on its patronage or of steps that it has taken to mitigate this impact. Moreover, we note that for the purposes of the market definition, the relevant changes have to take place within the SSNIP framework, ie the changes have to be small and occur within a short period of time, typically a year. Initiatives aimed at encouraging longer-term modal shift would generally fall outside the scope of market definition. Finally, as regards the 2000 fuel crisis, the switching from bus to car was caused by a supply shock (ie the unavailability of fuel) rather than being a response to a SSNIP.

38. Furthermore, as noted in the Arriva/Sovereign inquiry and the FirstGroup and NEG inquiries before it, there is an extensive and complex array of elasticities available in the transport literature on the demand for different modes of transport used for point-to-point journeys. Stagecoach has brought two of these to our attention. First, Stagecoach mentioned the 2006 meta-analysis by a consortium of academic departments entitled 'Demand for Public Transport' (the DFPT study) which found that the short-run (one to two years) elasticity of demand for bus travel (ie own-price elasticity of demand) is –0.42, the medium-run (five to seven years) elasticity of demand for bus travel is –0.56 and the long-run (12 to 15 years) elasticity of demand of –1.01. Second, Stagecoach mentioned the elasticities for different types of customer groups estimated by Wardman and Shire (2003) in their analysis of bus travel in Scotland. (See Annex 1 for an array of elasticities.)

39. We note that for the purposes of market definition, we would consider only short-term price elasticities as a guide of substitutability of bus travel with other modes of transport as such elasticities give an estimate of substitutability within the SSNIP framework. We also note that all of the short-term own price elasticities that we found are very low and suggest that it would be profitable to increase prices following a SSNIP (see Annex 1 for elasticity estimates and Annex 2 for illustration). We also note that the available service level elasticities are similarly low. Finally, we note that the elasticities that we identified in Annex 1 provide on their own sufficiently strong evidence that other means of transport are not good substitutes for bus travel.

40. Stagecoach recognized that all of these elasticities were sufficiently low that they implied that price increases would be profitable in both the short and long run, even at off-peak times. According to Stagecoach's calculations a 5 per cent price increase would tend to reduce demand by 2 per cent in the short run, potentially rising to 5 per cent in the long run (and for concessionary passengers there would be no reduction in demand). This suggests that a SSNIP would be profitable on a bus-only basis, ie that car and other forms of transport are not a strong competitive constraint within the regions and during the time periods that the data was estimated on.

41. However, Stagecoach also told us that:

(a) 'This is the case at the level of the bus industry on a national basis; consequently this is independent of any mergers. As such these estimates of elasticity of demand do not appear to be consistent with profit maximising behaviour by bus operators.'

(b) 'These estimates were derived from data that does not include recent changes in concessionary fares, especially the move to free travel for concessionaries under the national scheme in 2006.'

(c) 'Stagecoach does not consider that a 5 per cent price rise (which would be approximately 10p for either a single or return ticket given Stagecoach's policy of pricing in 10p increments) would be sufficient to persuade passengers even to switch between operators let alone travel modes.'

42. Stagecoach's argument presented in paragraph 41*(a)* appears to be confusing the elasticity faced by the bus industry as a whole with the elasticity faced by an individual bus operator. Just because there is scope for price increases (due to inelastic demand) at the *industry* level does not mean that there is scope for price rises at the *firm* level—this depends on the firm elasticity of demand. The firm elasticity of demand is generally more elastic or sensitive that the market price elasticity of demand because firms face competition from other firms which make price increases less profitable. Furthermore, low industry elasticities would be consistent with a finding that other modes of transport are a poor substitute for bus services. This is because these industry elasticities show the degree of constraint that a hypothetical monopolist would face from outside options. Moreover, these estimates are in line with other estimates that we have located in relation to bus elasticity of demand (see Annex 1).

43. It is unclear how Stagecoach's argument presented in paragraph 41*(b)* would bias the elasticity estimates downwards (in absolute terms) ie make fare paying passengers seem less price sensitive than they actually are. If anything it would result in passengers who were previously somewhat price sensitive becoming not price sensitive at all.

44. Stagecoach's argument presented in paragraph 41*(c)* will be discussed in paragraphs 71 to 74.

45. Furthermore, the DFPT study quoted by Stagecoach also found that *(a)* the cross-price elasticity of bus use with respect to car cost was 0.55, and *(b)* the cross-price elasticity of car use with respect to bus cost was 0.06. The first cross-price elasticity *(a)* tells us what impact the change in car travel costs will have on the use of bus services. The second price elasticity *(b)* tells us what impact the change in bus travel costs will have on the use of car travel. Both of those cross-price elasticities are very low.[11]

46. Other findings of the DFPT study explain this situation: over the last 23 years (a period over which the study has been carried out) car ownership has increased considerably as cars have become more affordable. This has contributed to the decline

[11]Stagecoach submitted to us that the 0.55 cross-elasticity did not seem particularly low at all and asked us to explain why we reached this conclusion. As we explained in paragraph 39, low own-price elasticity of demand for bus travel in itself suggests that other means of transport are not a good substitute for bus travel. We also note that own-price elasticity of demand is a measure of the cumulative effect of all competitive constraints on a given firm (or in this case on a given industry). This cumulative effect can be represented as a sum of cross-elasticities with respect to other modes of transport and the elasticity of opting out, ie the number of consumers who decide not to travel following a price increase. Given that we concluded that own-price elasticity of demand is very low (see Annex 2 for an illustration), it naturally follows that one of its components will be at least as low if not lower.

in bus travel (a fall by one-third in the last 23 years). This means that while short-term price increases in bus travel cost will lead only to modest switching away from bus travel, a long-term decrease in the cost of car travel will have a more important impact on the bus industry. We note here that within the SSNIP framework, we are concerned only with small changes (5 per cent) within a short period (typically one year).

47. In FirstGroup/Scotrail the CC noted that over the past 20 years fares have increased in real terms by some 40 per cent, whereas the inflation-adjusted cost of using private car has been broadly unchanged. This suggested that the cost of using private car has imposed little competitive constraint on changes in bus fares even in the long term. In this period, we have seen a shift in demand from public to private transport, but to a large extent this may reflect other factors, in particular the extent to which rising real incomes increase car ownership and usage. Finally, the CC found that despite the shift from public to private transport, the operation of bus services had generally remained profitable.[12]

48. We note that both Arriva and Go-Ahead identified the car as a threat to bus travel. Go-Ahead told us in Brighton (where it faces little head-to-head bus competition) it sees the private car as a key competitor. It told us that the rates of car ownership were high but recent market research conducted by the bus company showed that bus users were also car owners who had chosen to leave their cars at home because of the perceived difficulty in parking in the centre of the town and the convenience of buses as an access mode to and from the centre. Arriva recalled a recent GfK NOP survey that it commissioned which showed that 46 per cent of its passengers could have used a car either as a driver or a passenger to make their journey. Arriva summarized its position about the impact of cars as follows: 'as people get wealthy, they move to the car; if the price of the bus travel increases too much (or the quality of service falls), people make fewer journeys'. We believe that Go-Ahead's and Arriva's evidence confirms that while the car does exert some constraint on bus travel, it does not do so in the SSNIP framework.

49. We note that the CC FirstGroup/Scotrail Inquiry, the DFTP study and Arriva all agreed that the increase in disposable income had led to a shift from bus to car. This long-term trend represents changing characteristics of the economy and travel habits of UK customers and therefore falls outside the SSNIP framework, which analyses the impact of small price increase within a shorter time period

50. Finally, we note that car ownership in Preston is below the average for England and Wales and below the average for Lancashire and the North-West (see Table 1).

TABLE 1 **Car ownership per household**

Area	*Average number of cars per household*
Preston	0.99
Lancashire	1.12
North West	1.02
England & Wales	1.11

Source: Lancashire local transport plan 2006–2010, Table 4.4.3a based on Census 2001.

51. To conclude, the available evidence suggests that while other modes of transport, in particular private car, may impose some degree of competitive constraint on bus

[12] *FirstGroup plc and the Scottish Passenger Rail franchise, a report on the proposed acquisition by FirstGroup plc of the Scottish Passenger Rail franchise currently operated by ScotRail Railways Limited*, 28 June 2004, Appendix D, paragraph 5.

travel, this constraint does not materialize within the SSNIP framework. Other modes of transport should therefore not be included in the market definition.

Supply of bus services

52. The ability of bus operators to switch their capacity to another flow in reaction to a SSNIP on that flow within a short period of time (typically less than one year) would suggest that the relevant market may be wider than individual flows or routes. It might therefore be appropriate to widen the relevant market on the basis of supply-side reaction.

53. Stagecoach's experts, Oxera, submitted that:

> supply-side substitution is an important consideration in defining the relevant geographic market in the bus industry. Because bus operators are generally able to shift or expand their operations to new routes at relatively low cost, and within a relatively brief time, the relevant market is likely to be wider than point-to-point markets from the supply-side perspective. The constraint which defines the boundary around the relevant market is the cost of moving buses and drivers from their home depot to the centre of Preston or other relevant points where a Preston service can commence. Thus, the revenue collected from bus operations in Preston needs to cover at least the cost incurred from operating the bus services and the cost of the 'dead-runs', on which no revenue is generated. The exact drive-time boundary for supply-side substitution would have to be determined by various factors, such as fuel, wage and maintenance costs.

54. Oxera further submitted that '[i]n *Arriva v Chester City Council*,[13] the supply-side substitution argument was accepted for the purposes of geographic market definition. The 30-minute isochrones around Chester City were considered as the central scenario. Sensitivity of the results was tested by considering 25- and 35-minutes isochrones.'[14] Oxera carried out a similar isochrone analysis on behalf of Stagecoach for the Preston area and produced estimates of market shares of the competitors in the Preston area suggesting that based on the choice of isochrone, the merged entity would have between 23 to 48 per cent of the relevant market. (See Table 2.)

TABLE 2 **Stagecoach's estimates of supply-side-based market shares**

per cent

Bus operator	*35 minutes*	*30 minutes*	*25 minutes*
Stagecoach and PBL	23	43	48
First Manchester	18	0	0
Blackpool Transport	16	0	0
Transdev Blazefield	10	19	21
Arriva	7	0	0
Holmeswood Coaches	5	10	6
Others	21	28	25
Total	100	100	100

Source: Oxera, Results of Mapping Analysis.

[13] www.bailii.org/ew/cases/EWHC/Ch/2007/1373.html.
[14] We note that the 30-minutes isochrone was also accepted by the OFT in the case of abuse of dominant position by Cardiff Bus, CA98/01/2008, 18 November 2008.

55. We agree with Stagecoach that bus companies which have depot facilities sufficiently close to Preston to serve the Preston area should, in principle, be able to adjust bus capacity across routes at short notice to take advantage of profitable opportunities within the SSNIP framework. We note that such an adjustment could take the form of switching capacity from an existing route on to a new route or adding new capacity on to a new route. Bus operators told us that reliability and predictability of bus services are greatly valued by consumers. Most operators also told us that it was important for them to maintain good relations with the community they were serving. It is therefore unlikely that a bus operator would be able to discontinue or at least considerably reduce an existing service at short notice without alienating its customers.[15] We therefore believe that it is more likely that any supply-side reaction would need to take the form of expansion rather than switching.

56. We note that our existing guidelines recognize supply-side substitution in the following context:

> In defining the product market, the CC will consider the potential for supply-side substitution, which occurs when a price rise prompts other firms to start supplying, at short notice, an effective substitute to the product in question. Supply-side substitution will usually come from firms with existing facilities, providing similar products and/or operating in adjacent areas. …
>
> It is not always straightforward to distinguish supply-side substitution from potential new entry. The difference is typically one of timing and/or investment: supply-side substitution occurs in the short run with little or no investment required, whereas new entry is likely to occur over a longer period and may require more significant investment. … In order to consider a competitor's response as supply-side substitution, therefore, the response should, normally, be likely to occur within a year of the price rise …[16]

57. The 2009 draft merger guidelines restate this approach:

> Supply-side reactions from competitors usually occur in the short run with little or no investment required, whereas new entry might occur over a longer period and require significant investment. A competitor's supply-side reaction would normally occur within a year of a price rise … and would not involve significant investment …[17]

58. The evidence that we have collected indicates that the only two firms which would be able to exert a significant supply-side constraint in this way are Stagecoach and PBL. This is because prior to Stagecoach's entry on to PBL routes and PBL's response in June 2007, both companies had a depot in Preston with spare capacity. Both companies were also already providing bus services on some of the future overlap routes. This allowed them to adjust their capacity quickly and without significant investment.[18]

[15]We note that this would not prevent bus operators from reconfiguring their networks and redeploying their resources in the medium or longer term.
[16]*Merger references: Competition Commission Guidelines*, *CC2,* June 2003, paragraphs 2.20 and 2.21.
[17]*Merger Assessment Guidelines, Consultation Document*, April 2009, paragraph 4.70.
[18]Stagecoach submitted to us that the CC ignored the fact that PBL did not have substantial pre-merger spare capacity at its depot. We note that while PBL's depot might have been almost at full capacity prior to the acquisition, this situation was the result of increased competitive activity which took place specifically to respond to competition from Stagecoach.

59. In our view, the other existing operators of commercial services in the Preston area, Transdev, Blue Bus and Fishwicks, cannot exert the same degree of constraint. First, Blue Bus and Fishwicks are considerably smaller in size (see Appendix K for more details). Although, in theory, Blue Bus and Fishwicks may be able to expand to some degree and thus constrain the parties on some flows, they are unlikely to have the scale or financial resources necessary to provide the same degree of constraint as the merging parties for each other.[19] Second, Transdev currently operates only one inter-urban commercial service in the Preston area and although, as a national operator, it has access to more important resources than local operators Blue Bus and Fishwicks, it would only be able to expand its services in the Preston area to a limited degree [✂].[20]

60. With respect to the supply-side competitors identified by Stagecoach (see Table 1), we note that some of those competitors, First Group, Arriva, Transdev and [✂], are not at this stage considering entry into the Preston market and would not be willing to enter the Preston market as a result of SSNIP. With respect to Holmeswood Coaches, we understand that at present this company only operates tendered services. We also note that neither of those companies ran at any point any intra-urban services in Preston. It is also unclear that these companies would be able to expand on a scale that would be sufficient to constrain the merging parties. We note that prior to the parties' entry on each other's routes, they both had considerable spare capacity at their Preston depots. Stagecoach did not present any evidence that this would be the case for the supply-side competitors it identified. Finally, it would seem more appropriate to analyse the constraint posed by these companies when we discuss entry in Appendix K.[21]

61. The entry of Stagecoach on PBL's routes and PBL on Stagecoach's routes from June 2007 onwards provides an interesting natural experiment where both parties showed that they were capable of seemingly fast expansion on the rival's network (see Appendix F for more details).

62. Finally, it is important to distinguish a competitive constraint relevant for the purposes of defining a relevant market through the application of the SSNIP test and the actual competitive constraint faced by a competitor on a given flow. Under the SSNIP framework, we assume that if an incumbent bus operator on a given flow were to increase its fares (or reduce services) by 5 per cent, another bus operator that is present in the relevant market but does not at present operate services on that particular flow would be capable of a supply-side reaction that would defeat such price increase. In reality, however, the incumbent operator may take action to reduce the degree of competitive constraint arising from the supply-side reaction of the other competitors present in the relevant market.

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[19] Stagecoach submitted to us that it was not clear why an entry by two small operators with ten buses would have less impact than entry by one larger operator with 20 buses. Moreover, one of the operators present, Blue Bus, has a history of growing its operation to approximately 70 buses. We agree with Stagecoach that unless we find strong demand-side complementarities and a need for network competition, it is possible that a cumulative constraint posed by a number of small competitors will have the same effect as a constraint posed by a larger competitor. However, as we discuss in Appendix K, none of the bus operators already present in Preston is either capable or willing to supply commercial intra-urban services in the Preston area, with the exception of Blue Bus which is very small and has no intention of repeating its experience of larger-scale growth in Bolton.

[20] Stagecoach submitted to us that the CC ignored the presence of Transdev in the Preston area. We note that we have discussed the possibility of Transdev to switch or expand services in the Preston area rapidly. Transdev told us that its capacity to supply intra-urban services in Preston is limited [✂]. See Appendix K for more details.

[21] Stagecoach submitted to us that the CC did not explain why it chose to deal with the supply-side arguments by Stagecoach in Appendix K. First, we note that it makes no material difference to the outcome of the CC's inquiry at which stage these constraints will be considered. Second, we note that given that apart from Blue Bus and the merging parties, we were unable to identify any competitor that, following a 5 per cent increase in price or worsening of other aspects of the retail offer, would be able and willing to expand or enter the Preston intra-urban bus market in the medium or longer term, it follows that we did not identify any competitor that would be able and willing to expand or enter the Preston intra-urban bus market within a shorter SSNIP framework.

63. To conclude, we note that:

(a) Supply-side reaction in the bus industry is more likely to come from rapid expansion than switching of existing capacity.

(b) In the Preston area, only Stagecoach and PBL were capable of expanding on each other's flows with little investment at a short notice. They therefore exercised a constraint on each other on all of their flows. We note that when the competitive conditions are similar or identical on the great majority of flows in the Preston area, we can aggregate for convenience these flows and consider the loss of the competitive constraint on all flows together.[22]

(c) Whether we widen the relevant market on the basis of supply-side substitution or consider expansion by existing rivals in the competitive assessment (which was the practice in the previous transport inquiries), we will arrive at the same substantive outcome. This is because both approaches ultimately analyse the strength of rivalry between Stagecoach and PBL. The extent to which any rivalry between the two companies has been lost will be analysed in detail in Appendix J.

Application of the SSNIP test

64. The generally accepted conceptual approach to market definition, which is used by the CC, is the hypothetical monopolist test (also known as the SSNIP—small but significant non-transitory increase in price—test). The principle behind the test is that a market is defined as a product, or collection of products, the supply of which can, hypothetically, be monopolized profitably.[23]

65. Stagecoach submitted that the SSNIP test was not appropriate for observing switching decisions in bus services (especially for passengers enjoying concessionary fares):

(a) because fares are not the only consideration for passengers; and

(b) because a 5 per cent increase is not particularly significant in monetary terms when talking about bus fares.

66. Stagecoach provided the following example to illustrate the second point:

> With the exception of some long journeys on the Orbit service which are £1.50, the highest adult single fare in Preston is £1.20. A 5 per cent price increase on that figure is equivalent to 7.5p. A passenger who would be willing to wait for a competing service to save 5 to 10p would suggest that such consumer has a very low valuation of their own time. Assuming a five minute wait until an alternative service arrived, passengers willing to wait would have to value an hour of their time as being worth 60p or less.

[22] *Merger Assessment Guidelines, Consultation Document*, April 2009, paragraph 4.51.
[23] In conducting a SSNIP test, an initial candidate market, which should be the smallest market possible, is first defined. If a profit-maximizing hypothetical monopolist in that candidate market could not profitably impose a SSNIP, due to customers switching to other products, then the candidate market is expanded. The process is repeated until a market is found in which a SSNIP could be profitably imposed.

67. Stagecoach further submitted that in 1997, the DfT estimated the value of time for non-commuters at 5.9p per minute and 6.6p per minute for commuters. Given the rate of inflation over the past 12 years, these figures are likely to be considerably higher now. Stagecoach concluded that there was little prospect that there would be a meaningful level of switching due to on-route competition in response to a 5 per cent price rise, other than on routes where two operators both run services at high frequency.

68. On the first point, we note that following its expansion on PBL flows, Stagecoach introduced identical single fares to PBL and competed intensely on the remainder of the fares. It would therefore appear that fares are an important aspect of bus competition in the Preston area.

69. However, we accept Stagecoach's argument that fares are not the only factor taken into consideration by passengers when making their switching decision. We have heard from a variety of third parties (including public authorities and large and small bus operators) that frequency and reliability are also important. We also note that during the inquiry Stagecoach told us that even before its expansion on PBL routes, Stagecoach would monitor PBL's fare levels and to some extent passenger levels to see if there was surplus or insufficient capacity at certain times and to see whether it could use its spare capacity to offer lower fares. This would suggest that Stagecoach was reacting to both frequency and fare changes by PBL.

70. We note that this finding does not in our view invalidate the SSNIP test. It is also possible to think of the SSNIP test as small, but significant worsening of fares, frequencies or punctuality, or some combination of those factors. For example, in the Groceries inquiry, the CC used a SSNIP framework that encompassed a number of elements of the retail offer in addition to price, in particular quality, range and service (QRS).[24]

71. On the second point, we do not accept the proposition that a 5 per cent price increase is insignificant to passengers. Stagecoach's survey evidence suggests that most passengers undertake regular journeys and while 5 to 10p may not be sufficiently significant on an individual basis, it may become so over a longer period. The following example illustrates this point:

> Let's assume that there are two bus operators on a particular route offering a service at the same frequency and the same price –£1.20. Let's also assume that a commuting passenger undertakes two journeys every working day of the week and further assume four weeks of holiday a year. Now assume that one of the operators increased the fare price by 5 per cent to £1.26. Switching away would save this passenger a mere 6p per journey. However, over a period of one year, this saving would be £28.80. Similarly, taking PBL's pre-merger weekly network ticket of £9, a 5 per cent increase in price would represent 45p a week, but £21.6 a year. It is feasible to assume that in a situation where one operator implemented such a price increase, consumers could adapt their travel pattern in order to avoid the more expensive operator.
>
> Similarly, let's assume that there are two bus operators on a particular route offering together a service of ten buses an hour evenly spread over the hour so that customers only wait a maximum of 6 minutes for

[24] *The supply of groceries in the UK market investigation*, April 2008, paragraphs 4.1 and 4.2.

each bus. Let's also assume that the two operators merge and that following the merger they reduce their service by 10 per cent to nine buses an hour, thus increasing the maximum waiting time by approximately 1 minute. Even if we were to accept that in monetary terms 1 minute waiting time represents 6.6p for a commuter,[25] the value of the additional waiting time incurred by one commuter following the merger over a period of a year would be £21.10.

72. We note that [former PBL Director X] told us that in September 2008, PBL 'took the opportunity' to increase fares following a fare increase by Stagecoach. He told us that while this was not specifically a tactical move, PBL would not have 'dared' increase its fares if it represented 'too big a difference'. We found that on 14 September 2008, Stagecoach increased its range of single ticket fares from £0.70 to £0.75, £0.90 to £0.95 and £1.00 to £1.10. Shortly after on 23 September 2008, PBL increased its range of single ticket fares from £0.60 to £0.70, £0.80 to £0.90, £1.00 to £1.10 and £1.20 to £1.30. This example shows that the parties clearly believed that relatively small fare changes would have an impact on consumer behaviour. Neither of the parties increased prices to levels significantly different than those charged by the other, this despite the fact that both companies were experiencing losses on those routes where they were competing head-to-head.

73. Moreover, [former PBL Director X] also told us that even before Stagecoach entered on PBL routes, on those flows where Stagecoach and PBL overlapped, Stagecoach's pricing followed PBL's by around 5p to 10p, while on the remainder of flows where Stagecoach was not facing competition from PBL, it was charging considerably higher fares. Again this would suggest that small changes in price were an important aspect of the bus competition in the Preston area.

74. Finally, we note that a 5 per cent price increase is not required under the SSNIP test in all circumstances. It is only important that a price increase is 'small, but significant'. We note that on this point the 2009 draft merger guidelines stipulate:[26]

> For the SSNIP test, the Authorities will normally apply a price increase of 5 per cent whilst assuming that all other prices remain unchanged. However, in some markets a different price increase may be postulated. This could be above or below 5 per cent. The guiding principle in this regard is that the price increase applied should be one that is judged small but significant in the particular market under consideration and is assumed to last for a non-transitory period.

75. To conclude, the evidence in paragraphs 5 to 63 suggests that when we apply the hypothetical monopolist test to bus travel in the Preston area, we find that:

(a) Consumers make point-to-point journeys therefore only services provided on those flows can be considered as substitutes.

(b) Changes in fares will cumulatively give consumers an incentive to change a service operator and therefore will provide a constraint on bus operators on given flows following a small but significant fare increase.

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[25] We note that this figure is derived from a 12-year-old study and is likely to be a considerable underestimate as it would suggest that commuters value an hour of their time at under £4, which is lower value than the minimum wage (£5.73 per hour).
[26] *Merger Assessment Guidelines, Consultation Document*, April 2009, paragraph 4.55.

(c) Changes in other dimensions of competition such as frequency or punctuality will influence the decision of existing bus operators to offer bus services on given flows in response to a small but significant worsening in these parameters.

(d) Operators with existing capacity can in principle expand on to competitors' routes following a small but significant increase in price or worsening of other parameters of competition. In the Preston area, it would appear that only Stagecoach was capable of expanding rapidly and on a scale that could constrain PBL and vice versa.

(e) Only bus travel will be able to constrain the merging parties within the hypothetical monopolist framework. This is because the price elasticity of demand for buses in the UK is low both in the short and long run[27] and cross-price elasticities with respect to other relevant modes of transport are low. Similarly, non-price elasticities of bus travel are equally low. (See Annex 1 for more details.)

Subgroups of customers

76. Stagecoach submitted that older passengers who qualified for a free concessionary pass would be less price-sensitive; conversely, students tended to be more price-sensitive. Stagecoach further submitted that commuter and cash-paying adults valued reliability and punctuality more highly than price. Stagecoach provided elasticity estimates for different types of customers based on analysis undertaken by Wardman and Shires (2003). These were:

(a) leisure demand for fee-paying adults: –0.49 in the short run, –0.96 in the long run;

(b) commuter demand for fee-paying adults: –0.33 in the short run, –0.64 in the long run;

(c) leisure demand for children: –0.56 in the short run, –1.09 in the long run; and

(d) commuter demand for children: –0.37 in the short run, –0.72 in the long run.

77. Stagecoach's arguments seem intuitive. Concessionary passengers do not directly pay for their travel and therefore will not respond to changes in price. Similarly, commuters will be dependent on the bus service to get to work and likely to have low price elasticity. We note, however, that all these elasticities are low.

78. We note that bus operators can and do price discriminate between the different groups of customers by using different ticket types. Since competitive constraints are similar for all groups, it seems pragmatic to aggregate across consumer groups. We note that doing so is unlikely to change our conclusions. This is primarily because none of those subgroups appears likely to switch away from bus travel to any other form of transport following a SSNIP.

Tendered services

79. Tendered services are those which the local transport authority considers meet a passenger need and which cannot be provided on a viable commercial basis. We

[27] Most estimates of own-price elasticity of bus travel that we found show inelastic demand (ie elasticity between –1 and 0). The only elastic estimate we found was a Dargay and Hanly (2001) estimate of long-term elasticity for high fare of –1.35, which is still rather low. See Annex 1 for more details.

need to decide whether tendered services should be in the same market as commercial services or whether we should define a separate market for each.

80. Stagecoach considered that it was appropriate to define separate markets for commercial, tendered and partly tendered services. Stagecoach further submitted that tendered services must be operated in accordance with the relevant conditions of contract and, as a result, the operator of a tendered service has very little discretion as to how it runs the service.

81. Tendered services also tend to operate on different routes (or parts of routes) or times of the day from commercial services. Indeed if a commercial service were active at the same time on the same route presumably there would be no need to put this out to tender. It seems unlikely therefore that commercial and tendered services would be demand-side substitutes.

82. Stagecoach further submitted that there was no scope for supply-side substitution of buses to or away from tendered routes as the level of service was a contractual commitment. Stagecoach told us that for tendered services competition occurred 'for the market' at the time of tendering rather than within the market.

83. However, Stagecoach also told us that there were economies of scale [*sic* scope] between tendered and commercial services as bus depot capacity could be used to service either of the services. In addition, if a service is tendered for the peak period, the operator can redeploy the buses used for off-peak services.

84. In relation to supply-side substitutability, Stagecoach submitted that there was no scope for *short-term* supply-side substitution of buses to or away from tendered services as the service levels were contractual commitments.[28]

85. To support its view Stagecoach cited:

(a) Stagecoach/Scottish Citylink in which the CC considered the fact that on certain flows one service was commercial and the other tendered to be a valid reason not to consider the flow in detail for the purposes of the overlap analysis.

(b) Arriva/Darlington in which the OFT recognized that the dynamics of competition between tendered and commercial services are very different.

86. With respect to supply-side substitutability, we agree with Stagecoach that operators of tendered services have very little scope to alter these services in the short to medium term. We also agree that some of the key competitive features such as price and frequency may be set by the local authority. With respect to demand-side substitutability, we agree that tendered services cover areas or times of the day/week where commercial services could not be viably provided. Although it is in theory possible that commercial and tendered services may overlap alongside the main corridors and that tendered services may therefore have some knock-on effect on commercial services, in practice the extent of this effect will be minimal. This is because tendered services generally have lower frequencies and/or are provided at different times than commercial services (eg late night or Sunday services). We note that in the Preston area tendered services would have been filtered out of our overlap analysis on the basis of insufficient frequency. Finally, we also note that we have considered service 88a/88c as a commercial service despite it currently being sup-

[28]However, Stagecoach noted that there were some economies of scale between the service types as bus depot capacity could be used to service either and buses and drivers used for peak services could be used on commercial services at other times of the day at a very low incremental cost.

ported by Kick Start funding. This is because this service is destined to become a fully independent commercial service at the end of the supported period.

87. Taken together we consider that the absence of likely demand-side and supply-side substitution between tendered and commercial services indicates that these markets are distinct.

A literature overview regarding bus market elasticities

Elasticity type	*Elasticity estimate*	*Source*
Own-price elasticities		
Own-price elasticity of demand for buses in the UK in the short run (1–2 years)	–0.42	The demand for public transport: A practical guide
Own-price elasticity of demand for buses in the UK in the long run (12–15 years)	–1.01	The demand for public transport: A practical guide
Own-price elasticity of demand for buses in the UK in the medium run (5–7 years)	–0.56	The demand for public transport: A practical guide
Urban Bus fare own–price elasticity	–0.5	Review of fare elasticities, Wardman and Shires 2003
Bus fare own–price elasticity	–0.46	Review of fare elasticities, Wardman and Shires 2003
Bus Leisure short–run elasticity in non-PTE areas	–0.49	Review of fare elasticities, Wardman and Shires 2003
Bus own–price elasticity for elderly people	–0.24 (concession) –0.62 (full fare)	Review of fare elasticities, Wardman and Shires 2003
Bus own–price elasticity	–0.36 (short run) –0.70 (long run)	OXERA: Literature Review of Elasticities
Bus own–price elasticity (short run)	–0.30 (peak) –0.40(off-peak)	OXERA: Literature Review of Elasticities
Bus own–price elasticity	–0.43 (short run) –0.74 (long run)	Demand for local bus services in England, Dargay and Hanly 2001
Own–price elasticity (short run)	–0.13 (low fare) –0.79 (high fare)	Demand for local bus services in England, Dargay and Hanly 2001
Own–price elasticity (long run)	–0.23 (low fare) –1.35 (high fare)	Demand for local bus services in England, Dargay and Hanly 2001
Cross-price elasticities		
Urban cross-elasticity, bus use with respect to car cost	0.55	The demand for public transport: A practical guide.
Urban cross-elasticity, car use with respect to bus cost	0.06	The demand for public transport: A practical guide.
Urban cross-elasticity, bus use with respect to rail cost	0.08	The demand for public transport: A practical guide.
Elasticity of bus demand with respect to Motoring Costs	0.65 (short run) 1.12 (long run)	Demand for local bus services in England, Dargay and Hanly 2001
Non-price elasticities		
Service-level elasticity	0.48 (short run) 0.83 (long run)	Demand for local bus services in England, Dargay and Hanly 2001
Bus elasticites with respect to wait time	–0.39 to –1.17 (depending on trip type)	The demand for public transport: A practical guide
Generalized cost elasticities for Bus journeys	–0.3 to –1.7 (depending on trip type and income)	The demand for public transport: A practical guide
Bus elasticity with respect to in-vehicle time	–0.38 (leisure) –0.43 (commuter) –1.01 (business)	The demand for public transport: A practical guide
Bus own elasticity with respect to journey time	–0.66	Oxera Consumer survey analysis
Elasticity of demand for bus with respect to journey time of train	0.41	Oxera Consumer survey analysis
Bus elasticity with respect to hedway between buses	–0.25	Oxera Consumer survey analysis
Bus elasticity of demand with respect to access and egress time	–0.77	Oxera Consumer survey analysis

Implication of bus market own-price elasticities of demand for the SSNIP

1. We assume a 10 per cent price increase and the maximum possible margin under the Lerner condition—100 per cent. We note that the higher the margin the more difficult it is to achieve a profitable price increase. Such assumption is therefore very conservative. For simplicity, we also assume a £10 weekly ticket and 100 customers.

2. The table below uses the array of the relevant short-term point estimates of bus market own-price elasticities identified in Annex 1. The elasticities are consistent with each other and fall within the interval of –0.36 to –0.46.

3. All of these estimates suggest that a 10 per cent price increase would be profitable even under the highest possible margin.

	England, Dargay and Hanly estimate (low fare)	*Oxera estimate*	*DFTP estimate*	*England, Dargay and Hanly Estimate*	*Wardman & Shires estimate*	*England, Dargay and Hanly estimate (high fare)*
Weekly ticket (£)	10	10	10	10	10	10
Price increase (%)	10	10	10	10	10	10
New weekly ticket (£)	11	11	11	11	11	11
Surcharge per ticket (£)	1	1	1	1	1	1
Elasticity of demand	**–0.13**	**–0.36**	**–0.42**	**–0.43**	**–0.46**	**–0.79**
Margin (%)	*100*	*100*	*100*	*100*	*100*	*100*
Original number of customers	100	100	100	100	100	100
Retained customers	98.7	96.4	95.8	95.7	95.4	92.1
Customer lost	–1.3	–3.6	–4.2	–4.3	–4.6	–7.9
Extra income (£)	99	96	96	96	95	92
Lost income (£)	–13	–36	–42	–43	–46	–79
Results of 10% price increase (£)	**86**	**60**	**54**	**53**	**49**	**13**

Source: CC study.

Assessment of the competitive effects of the merger

1. The type of harm that could have ensued following the merger will depend on our choice of counterfactual. As we explained in Section 6 of the report, we found that the correct counterfactual is the period before the abnormal competition between Stagecoach and PBL, that is before June 2007. Under this counterfactual, the relevant competitive constraint posed by Stagecoach on PBL and vice versa during the period following June 2007 is not relevant. We therefore need to focus on the type of competitive constraint, if any, that existed between the parties before June 2007.

Elimination of competition in commercial services

Actual competition between the parties

2. Stagecoach, the former management of PBL and some third parties told us that before June 2007, PBL served intra-urban routes in the Preston city centre, north of the River Ribble, while Stagecoach served inter-urban routes and intra-urban routes south of the River Ribble. We found that before June 2007, PBL did not operate any inter-urban services or services into the south of the River Ribble. Stagecoach operated only two intra-urban services, service 3 and 3a (formerly 132 and 133), both running from Preston Bus Station to Penwortham, south of the River Ribble. The remaining services operated by Stagecoach were inter-urban commercial services. In addition, Stagecoach operated a handful of tendered inter-urban services (services 4, 75 and 101).

3. We have analysed the degree to which the parties' services overlapped in May 2007. We used parties' flow data and applied filters that discarded services that did not run at the same time of the day or had considerably different frequencies. As we explain in Appendix I, such filters have been used in previous transport inquiries. We found that in May 2007, PBL already overlapped with Stagecoach and derived 26.4 per cent of its revenues from these overlaps. PBL did not overlap with any other company. (See Table 1.) There were two main areas of PBL's overlap with Stagecoach:

   (a) The area from Preston Bus Station along the main corridor to the east of the city: PBL's service 8 to Moor Nook and service 11 to Gamull Lane overlapped with Stagecoach's inter-urban service 2/2a to Longridge.

   (b) The area from Preston Bus Station along the main corridor to the west of the city: PBL's services 24/25 and 89 to Lea, service 31 to Savick and services 33/35 to Tanterton overlapped with Stagecoach's inter-urban services 61, x61 and 68 to Blackpool.

4. Conversely, Stagecoach derived comparatively a smaller proportion of its total revenue from flows on which it overlapped with PBL (9.8 per cent). On this basis, it is possible that before June 2007 the constraint between PBL and Stagecoach arising from actual competition was asymmetric. Following the merger this constraint has been removed, which means that Stagecoach will be able to internalize the consumer switching that would follow a SSNIP or a corresponding worsening of other aspects of the retail offer such as, in particular, a decrease in frequencies.

5. Finally, there are three other operators of commercial services in the Preston area—Blue Bus, Fishwicks and Transdev. Blue Bus and Transdev were entirely filtered out of our analysis on the basis of insufficient frequencies or different service hours.

Fishwicks was virtually filtered out for the same reasons. It is therefore unlikely that either of the three companies posed an actual competitive constrain on Stagecoach and PBL (see Table 1).

TABLE 1 **The estimated degree of overlap between the parties in Preston**

	May 2007 %
PBL	
Total revenue from Stagecoach overlaps	25.9
Total revenue from Fishwicks overlaps	0.0
Total revenue from Stagecoach/Fishwicks overlaps	0.5
Total revenue from all overlaps flows	**26.4**
Total revenue from non-overlap flows	**73.6**
Stagecoach	
Total revenue from PBL overlaps	9.8
Total revenue from Fishwicks overlaps	0.0
Total revenue from PBL/Fishwicks overlaps	0.0
Total revenue from all overlap flows	**9.8**
Total revenue from non-overlap flows	**90.2**

Source: CC from information supplied by Stagecoach.

6. Stagecoach submitted that:

> while it is helpful to consider the percentage of revenue which is derived from overlap routes, this does not provide a comprehensive overview of the relationship between the two companies and other factors should not be ignored. In May 2007, only 26.4 per cent of PBL revenue was derived from overlap routes. This makes it plausible that Stagecoach may not have been the key constraint on PBL. One must consider what proportion of passengers of PBL would switch to Stagecoach in the event of PBL increasing its prices by 5–10 per cent. In the context of diversion ratios, then with a small overlap percentage, it is certainly possible that car usage, walking, etc. would have the highest diversion ratio. Moreover, it is likely that in the case of a 5–10p price increase per ticket, many customers would choose to stay with PBL, so the actual amount of additional revenue internalised for a SSNIP as a result of that merger may in fact be very small.

7. We disagree with Stagecoach. First, actual competition between the parties was only one type of competitive constraint that could have existed between the merging parties, the other being potential competition. As we explain in detail below, the threat of potential competitive response from Stagecoach would have made a price increase by PBL unprofitable. We note that elimination of either actual or potential competitive constraints could have led to an SLC. Second, as we have concluded in Appendix I, cars or any other modes of transport do not pose a sufficient competitive constraint on bus travel.

Potential competition between the parties

8. In addition to the actual head-to-head competition that PBL faced from Stagecoach, it is possible to argue that the two companies constrained each other through the threat of potential competition.

9. On the subject of potential competition, the draft Merger Assessment Guidelines stipulate:[1]

> Unilateral effects may also arise from the elimination of potential competition. There are two ways in which the removal of a potential entrant could lessen competition by weakening the competitive constraint on an incumbent supplier:
>
> - The first is where the merger prevents actual entry that would, or could, without the merger, have increased competition to above pre-merger levels. This can occur if a merger is between an incumbent and a firm which plans actual entry. This is sometimes referred to as 'actual potential competition'. Actual potential competition constrains the merged firm only if and when entry occurs.
>
> - The second is where the merger removes an existing constraint on the incumbent's behaviour imposed by the threat of entry. This is sometimes referred to as 'perceived potential competition'. Unlike the constraint from actual entry, which by definition has not arisen under pre-merger conditions, a constraint from perceived potential competition does exist in the pre-merger environment. Such competition gives an incentive to the incumbent to respond to this threat, for example by offering lower prices or more favourable non-price terms, partially to deter actual entry.'

10. In this case, the only plans for entry that we know of are the plans by Stagecoach to expand on PBL routes following its failed approach of PBL in July 2006. From PBL's viewpoint, Stagecoach became its 'actual potential competitor' in July 2006 when it became aware that Stagecoach might soon start running services on its routes. Before July 2006, Stagecoach could have been a 'perceived potential competitor' for PBL.[2]

11. The EC Horizontal merger guidelines provide useful guidance on when a merger between potential competitors can have anti-competitive effects and how to assess it:[3]

> A merger with a potential competitor can generate horizontal anti-competitive effects, whether coordinated or non-coordinated, if the potential competitor significantly constrains the behaviour of the firms active in the market. This is the case if the potential competitor possesses assets that could easily be used to enter the market without incurring significant sunk costs. Anticompetitive effects may also occur where the merging partner is very likely to incur the necessary sunk costs to enter the market in a relatively short period of time after which this company would constrain the behaviour of the firms currently active in the market.
>
> For a merger with a potential competitor to have significant anti-competitive effects, two basic conditions must be fulfilled. First, the potential competitor must already exert a significant constraining

[1] *Merger Assessment Guidelines, CC Consultation Document*, April 2009, paragraph 4.108.
[2] We note that no such distinction is likely to be necessary for actual competition as there were very few changes to the network between July 2006 and June 2007.
[3] *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 031, 05/02/2004,* paragraphs 59–60.

influence or there must be a significant likelihood that it would grow into an effective competitive force. Evidence that a potential competitor has plans to enter a market in a significant way could help the Commission to reach such a conclusion. Second, there must not be a sufficient number of other potential competitors, which could maintain sufficient competitive pressure after the merger.'

12. We note that both PBL and Stagecoach had a large depot and existing operations in the Preston area and sufficient financial means to expand on to each other's network. This was demonstrated by the ease with which Stagecoach expanded on PBL's routes and PBL retaliated by expanding on Stagecoach's routes after June 2007.[4]

13. We also note that there were no other potential competitors with sufficient financial means and nearby depots to act as potential competitors in the same way as Stagecoach and PBL.[5] As we discuss in Appendices I and K, Blue Bus and Fishwicks do not have the required scale or means to pose the same degree of constraint on Stagecoach and PBL as Stagecoach and PBL themselves. In addition, Fishwicks told us that it did not wish to expand its services at present. Transdev, which as a national operator arguably has access to larger financial resources than small-scale local operators like Fishwicks and Blue Bus, told us that it could only expand its service in Preston to a limited degree [✂].

14. It would therefore seem that Stagecoach and PBL were the only two companies capable of posing a 'significant constraining influence' on each other in the Preston area. Our next step is to establish whether they were doing so.

15. When describing the competition that has taken place in the Preston area in the past five years, Stagecoach submitted that 'PBL sought to protect its business by operating a commercial network of frequent local bus services along the main corridors and serving key housing estates. Service frequencies were kept high to attempt to avoid gaps in service and avoid high individual passenger loadings. Another aim was to dissuade competition'. Stagecoach reiterated to us during the inquiry that PBL kept high service levels to prevent entry.[6] This comment would suggest that over the long term, PBL felt constrained in its operations in Preston. Given that only Stagecoach had the ability to constrain PBL in a significant manner, such constraint had to come from Stagecoach.

16. We also investigated whether PBL exerted a similar constraint on Stagecoach. Stagecoach told us that it had been monitoring PBL's activities on overlap and non-overlap flows. It also told us that on overlap flows, Stagecoach would monitor PBL's fare levels and to some extent passenger levels to see if there was surplus or in-sufficient capacity at certain times. Stagecoach would seek to apply fare levels for local journeys which reflected the fact that it had spare capacity at almost zero cost and seek to offer cheaper fares for some of those journeys. This would suggest that Stagecoach felt constrained by PBL's high frequencies and low fares which were set by PBL to pre-empt entry on PBL's routes.

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[4]We note that PBL's response may not have been as substantial as Stagecoach's expansion (it has indeed attracted deriding comments from Stagecoach, see paragraph 24) and that PBL did not have the same financial means as Stagecoach, but PBL was still considerably larger and better placed to expand on Stagecoach's routes than any other competitor in Preston.
[5]Stagecoach submitted to us that the CC ignored the fact that neither PBL nor Stagecoach [✂] at their Preston depots. We note that even though [✂] prior to the acquisition, this situation was the result of increased competitive activity between the parties initiated by Stagecoach's expansion on PBL routes and PBL's response.
[6]Stagecoach further clarified that its statement only meant that PBL kept a high frequency of services and made no comment on the quality of PBL's services.

17. We asked Arriva and Go-Ahead about the competitive constraint that existed between the merging parties. Both companies bid[7] for the PBL business when it came up for sale in summer 2008 and carried out an assessment of local competitive conditions before bidding. Go-Ahead told us that it factored the fact that PBL was competing intensely with Stagecoach into its bid for PBL. It further told us that had PBL come up for sale before June 2007, it would have again factored Stagecoach's presence in its bid albeit at a lower level.

18. Similarly, Arriva told us that at the time it made its initial bid for PBL, it hoped that it could also acquire Stagecoach's Preston intra-urban operations. We further asked Arriva whether it would have been interested in purchasing PBL before June 2007. Arriva told us: 'we would have been interested but we would have been conscious that there was the potential for Stagecoach to compete. We would probably have looked at trying to buy Stagecoach at the same time.' Arriva also told us that had Stagecoach's business come up for sale before June 2007, it would have factored PBL's presence in its bid for Stagecoach. However, the consideration of PBL in the bid for Stagecoach would not have been as important as the consideration of Stagecoach in the bid for PBL. This is because PBL did not have the same resources as Stagecoach.

19. Stagecoach submitted that PBL's business model as an employee-owned business was unsustainable in the long term. After its failed approach in July 2006, Stagecoach thought that a sale of PBL to another buyer was possible. Stagecoach further submitted that while PBL had little interest in becoming a more efficient operator, reconfiguring its network or expanding, a future purchaser might take a different approach and threaten Stagecoach's operations around Preston. This statement suggests that while Stagecoach did not feel strongly constrained by PBL in its then form, it feared that if it were acquired by another more efficient competitor, it would become a competitive threat for its business. Acquisition of PBL by Arriva or Go-Ahead would clearly materialize these concerns. [Stagecoach Director C] told us that Stagecoach expected PBL to sell its business to an operator other than Stagecoach and that selling to another, more efficient, better organized operator, would make it more difficult for Stagecoach to gain market share in Preston.

20. If we accept this argument, Stagecoach had three options for eliminating this threat: *(a)* acquiring PBL, *(b)* competing PBL away, or *(c)* acquiring a sufficient part of the Preston intra-urban market to make the market unattractive for a large competitor. Competition concerns aside, the first option is the least risky because the second and third options still leave the possibility that a weakened PBL will be sold off to a competitor. The fact that Stagecoach made an offer to PBL in September 2008 beating the other two bidders, Arriva and Go-Ahead, is entirely consistent with the strategy outlined by Stagecoach in paragraph 19.

21. Stagecoach told us that the CC had ignored another option *(d)* whereby Stagecoach sought to acquire a sufficient part of the Preston intra-urban market to ensure that it had already consolidated such a position prior to (in Stagecoach's view) inevitable, eventual acquisition of PBL by a more efficient competitor from which it might have been more difficult to win a share of the Preston intra-urban market. According to Stagecoach, this is the option that it has pursued. Stagecoach further specified that it only sought a minority share, about 25 per cent, of the Preston intra-urban market.

22. We are unconvinced that Stagecoach pursued option *(d)*. This is mainly because the scale and scope of Stagecoach's expansion (see paragraphs 5.45 to 5.51 of the

[7]Arriva clarified that it only made an initial bid for PBL.

report for more details) and the fact that Stagecoach was prepared to incur considerable losses which involved not covering its average variable costs on the newly-launched routes for an unusually long period of time after its expansion (see Appendix G for more details). Finally, as we conclude in paragraph 5.53 of the report, it was, in our view, predictable from the outset that Stagecoach's entry on all of PBL's key routes would cause considerable damage to the viability of PBL, rather than merely enable Stagecoach to acquire a minority share of the market.

23. In its initial submission, Stagecoach further submitted that after the failed approach in July 2006, it considered launching services in Preston in summer/autumn 2006. Stagecoach's internal documents show that in August 2006, Stagecoach considered increasing frequencies on the service 2/2a which overlapped with PBL's service 11 to Gamull Lane to every 10 minutes.[8] Stagecoach further considered introducing a service in competition with PBL's service 16 to Farringdon Park and a service in competition with PBL's service 35 to Tanterton. At the same time, Stagecoach considered reinforcing its only intra-urban services 132 and 133 to Penwortham. [Former PBL Director X] told us that Stagecoach did increase frequencies on some of its services. [Stagecoach Director C] told us that in November 2006 Stagecoach had ordered 25 new minibuses for use in Preston and in February 2007 gave its agreement for these buses to be deployed in Preston. From March 2007 onwards, we found further internal evidence detailing a very similar expansion plan to the one outlined in summer 2006.

24. We further analysed the internal documents of both PBL and Stagecoach. PBL's minutes from board meetings suggest that PBL was monitoring Stagecoach's activities. We had at our disposal minutes from January 2006 onwards. Unsurprisingly, the monitoring became more intense following Stagecoach's approach in July 2006. In the case of Stagecoach, we have not been able to locate similar evidence, although as explained above, Stagecoach told us that it regularly monitored PBL's activities. We have nonetheless found one document that comments on PBL's commercial strategy. This is an email from [Stagecoach Manager K] to [Stagecoach Director A] and [Stagecoach Director B]. In this email, [Stagecoach Manager K] commented on PBL's planned response to the impending Stagecoach's expansion on PBL routes. This email makes a rather barbed comment about a seemingly inadequate response by PBL.[9]

Network competition

25. We set out as a theory of harm the removal of network competition. Before June 2007, this competition was potential rather than actual. Given that our evidence on demand-side complementarities was inconclusive, we do not need to conclude whether the merger led to the elimination of network competition.

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[8] Service 2/2a overlapped with PBL's service 11 to Gamull Lane up until 30 March 2008 when it was split into two separate services, service 2/2a to serve Preston—Southport and service 1 to serve Longridge.

[9] Excerpt from the email dated 23 May 2007.

'2 Preston–Penwortham–Longton–Tanterton–Banks–Southport
Only four return trips per day Mon-Sat with no extra on Mon-Fri

...

3 Preston–Penwortham (same route as our service)
A bit more substantial effort here, with a frequent Monday to Saturday service as follows:

...

According to Rob, for plans which have supposedly been sitting on the shelf for months or years on end, they really did look as though they'd been cobbled together at the 11th hour!'

Conclusion on the loss of competitive constraint

26. The evidence above seems to suggest that before July 2006, in addition to the existing competition on the overlap flows, Stagecoach was PBL's perceived potential competitor on the remainder of its operations. This constraint changed when Stagecoach approached PBL in July 2006 and made reference to the possibility of increased competition by Stagecoach in the context of PBL's refusal to sell. From July 2006 to June 2007, Stagecoach became the actual potential competitor for PBL.

27. It is also likely that fearing the potentially increased competition from Stagecoach, PBL tried to fend it off by a combination of passive competitive behaviour (ie not expanding on 'Stagecoach's territory') and pre-emptive measures (eg maintaining high frequencies to avoid a gap in service that might attract entry).

28. However, the evidence also seems to suggest that the constraint between PBL and Stagecoach was asymmetric and that even though Stagecoach was constrained by PBL, it was not constrained by PBL to the same degree as PBL by Stagecoach. It would also appear that Stagecoach feared the acquisition of PBL by a more efficient operator which would be able to impose a stronger competitive constraint on the Stagecoach business in Preston than the actual constraint from PBL.

29. In both cases, the merger has led to a loss of a significant competitive constraint. In the case of PBL, it was the loss of actual and potential competition from Stagecoach. In the case of Stagecoach, the loss of actual and potential competition from PBL also occurred, although it was less strong than in the case of PBL. In addition, Stagecoach lost a constraint arising from potential competition that might have occurred had PBL been purchased by another operator. It follows that unless we establish that entry is likely to follow a potential worsening of the retail offer by the merged entity, we will conclude that the merger has led to an SLC. As we discuss in Appendix K, it is unlikely that entry on a scale that might constrain the merged entity will occur in the foreseeable future. It is therefore likely that the merger has led to an SLC.

Elimination of competition in tendered services

30. Both merging parties have been active in bidding for tendered services in Preston. These services are tendered as contracts to run a particular service to a given specification for LCC, which is the purchaser of these services. As we have discussed in Appendix I, competition in tendered services takes the form of competition for the market rather than competition in the market. We have analysed the process and results of bidding for two types of tenders—school services and non-commercial routes.

31. LCC provided us with historic bid data since 2002. In that period, there were 26 tenders issued by LCC for bus services that would not be viable on a commercial basis. Both Stagecoach and PBL have bid for these services. In addition, 31 other companies have bid for one or more of those tenders. Stagecoach was very active—it bid for 24 tenders, winning 15. PBL was far less active—it bid for six contracts, winning three. There were only five contracts where both PBL and Stagecoach bid. In total, either Stagecoach or PBL won an LCC tender 69 per cent of times. In terms of contract value, Stagecoach's and PBL's contracts were worth 65 per cent of the total value of tenders in the Preston area. (See Table 2.)

TABLE 2 **Statistics of non-commercial services in the Preston area**

		%
Number of tenders 2002–2009	26	100.0
Number of times Stagecoach bid	24	92.3
Number of times PBL bid	6	23.1
Number of times both Stagecoach and PBL bid	5	19.2
Proportion of PBL bids of Stagecoach bids		*20.8*
Proportion of Stagecoach bids of PBL bids		*83.3*
Number of times either Stagecoach or PBL bid	25	96.2
Number of times Stagecoach won	15	57.7
Stagecoach success rate		*62.5*
Number of times PBL won	3	11.5
PBL success rate		*50.0*
Number of times either Stagecoach or PBL won	*18*	*69.2*
Number of times someone else than Stagecoach or PBL won	8	30.8
Total value of general tenders	£2,248,806	100.0
Total value of general tenders won by Stagecoach	£1,443,133	64.2
Total value of general tenders won by PBL	£22,523	1.0
Total value of general tenders won by others	£783,150	34.8
Total value of general tenders won by PBL & Stagecoach	£1,465,656	65.2
No of bidders other than Stagecoach & PBL that ever bid	31	

Source: LCC's submission to the OFT.

32. In addition to non-commercial routes, there were 41 school contracts put to tender in the Preston area since 2002. PBL was more active in this market than Stagecoach—it bid 29 times winning 17 contracts. Stagecoach bid 16 times winning only once. In addition to PBL and Stagecoach, there were 25 other bidders for school services. Both PBL and Stagecoach bid for 30 contracts and won 18 of them. In terms of the value of the contracts won, both parties represented 48 per cent of the total value of school contracts. (See Table 3.)

TABLE 3 **Statistics of school contract in the Preston area**

		%
Number of contracts 2002–2009	41	100.0
Number of times Stagecoach bid	16	39.0
Number of times PBL bid	29	70.7
Number of times both Stagecoach and PBL bid	14	34.1
Proportion of PBL bids of Stagecoach bids		*87.5*
Proportion of Stagecoach bids of PBL bids		*48.3*
Number of times either Stagecoach or PBL bid	30	73.2
Number of times Stagecoach won	1	2.4
Stagecoach success rate		*6.3*
Number of times PBL won	17	41.5
PBL success rate		*58.6*
Number of times either Stagecoach or PBL won	18	43.9
Number of times someone else than Stagecoach or PBL won	23	56.1
Total value of school contracts	£829,403	100.0
Total value of school contracts won by Stagecoach	£19,500	2.4
Total value of school contracts won by PBL	£376,579	45.4
Total value of school contracts won by others	£433,324	52.2
Total value of school contracts won by PBL & Stagecoach	£396,079	47.8
Number of bidders other than Stagecoach & PBL that ever bid	25	

Source: LCC's submission to the OFT.

33. Both parties represent a relatively sizeable proportion of both non-commercial route and school service tenders. This proportion has further increased following the merger (the parties now represent 65 per cent in terms of volume and 45 per cent in terms of value of contracts). It is therefore possible that, as a result of the merger, Stagecoach might worsen its bid offer to the main customer, LCC.

34. LCC told us that it was not concerned about the impact of the merger. It believed that there were still many competitors left. It also told us that historically, PBL only bid for services within the Preston city area and did not bid for any inter-urban routes, focusing rather on school contracts. LCC believed that PBL and Stagecoach did not generally compete against each other. The data we have seen seems to support the suggestion that the parties were specializing in different types of tendered services, but we would not go as far as LCC to say that they were not competing. (See Tables 2 and 3.)

35. We have also spoken to a number of competitors and they too did not in general express any concerns about the merger with respect to tendered services. Small competitors who represent a vast majority of the bidders felt confident to bid against Stagecoach. Walton Coaches suggested that the merger might be advantageous for small operators on the grounds that Stagecoach did not like operating school services and now that it owns PBL, PBL may not be bidding for them any more.

36. [✂]

37. For completeness, we note that in 2003, PBL and LCC entered into discussions about launching an orbit service in Preston. This service was launched in 2006 and became known as services 88a and 88c or 'Preston Orbit'. It received a subsidy of £355,520 in revenue support over three years from the DfT within the framework of the 'Kickstart' project. At the end of the three-year period, the service was supposed to be run on a commercial basis although LCC told us that a further £50,000 a year would have been available for two years in support in the event that the service did not become commercially viable. [Former PBL Director X] told us that PBL had identified a need for an orbit service in Preston but would not have been able to launch it without government support.

38. We note that the orbit service is quite unique for a number of reasons: *(a)* its subsidy was only meant to help it reach a breakeven point; thereafter, the orbit service should become commercially viable; *(b)* it relied primarily on a subsidy from the DfT and to a lesser extent LCC; and *(c)* it was initiated by PBL and developed in collaboration with LCC rather than being put up for general tender by LCC. Given these particular characteristics, we did not consider the orbit service within our analysis of the impact of the merger on tendered services in the Preston area.

39. To conclude, we do not believe that the merger has led to an SLC in tendered services. This is for the following main reasons:

(a) there has been a steady stream of small competitors bidding for and winning public contracts;

(b) these competitors generally feel confident to bid for these contracts;

(c) the merging parties did not overlap very heavily before the merger, with PBL focusing on school contracts and Stagecoach on non-commercial services; and

(d) the purchaser of these services, LCC, was unconcerned about the merger.

Entry and expansion

1. Entry (or the threat of entry) by a potential entrant, or expansion (or the threat of expansion) by a firm that is already active on a flow(s) in the Preston area could constrain the merging parties post merger. For this to be the case, entry and expansion need to be easy, timely and sustainable.

2. In evaluating barriers to entry and expansion in the Preston area we recognized that these might differ in importance with the scale[1] of entry or expansion and the size[2] of the firm seeking to enter or expand. Ultimately, we were interested in establishing whether entry and/or expansion were feasible in the Preston area on a scale that was sufficiently large to constrain the merged firm.

3. We note that given the relatively modest overlap existing between the parties on tendered local bus services and the existence of several credible alternative providers, we focused our analysis on commercial services. We also note that in the absence of strong demand-side complementarities, ie a 'network effect', such constraint does not have to come from a large operator, but can in principle also come from entry or expansion by a number of small firms.

4. We define 'entry' as the establishment of a new commercial bus service operation in the Preston area. Firms that might enter the market in this way are termed 'potential entrants'. This is distinct from the concept of entry on to new commercial routes by firms that already have a commercial presence in the Preston area, albeit a minor one: this will be referred to as 'expansion'. Firms that might expand in the market in this way are termed 'existing competitors' even though they may not be competing on all flows in the Preston area.

5. Finally, our analysis of entry and expansion was twofold. We tried to establish both the *ability* and the *willingness* of existing bus operators within and in the vicinity of the Preston area and large national operators to launch intra-urban services in the Preston area following the merger between Stagecoach and PBL.

Barriers to entry and expansion

6. We considered the following possible barriers to entry and expansion in the bus industry:

   (a) regulatory barriers;

   (b) access to facilities, the most important of which appears to be depots;

   (c) the importance of scale;

   (d) network effects arising through network ticketing; and

   (e) strategic barriers arising from the threat of an aggressive competitive response by an incumbent.

[1] ie the scale of their operations in the Preston area.
[2] ie the size of their overall business.

Regulatory barriers

7. There are a number of regulations affecting the provision of commercial local bus services (see Appendix E for more details). An essential requirement is that a bus operator must have a licence to operate, a Passenger Carrying Vehicle licence (PCV). This is granted by the Traffic Commissioner subject to satisfying certain criteria over the bus company's financial standing, repute and professional competence. This licence can be revoked if the operator does not satisfy one of these criteria.

8. Once a bus company has a licence to operate services, it must then give 56 days' notice to register the routes it wishes to operate. After this notice has been given, the operator is bound to operate the registered services according to its stated timetable. Any changes in the frequency or hours of operation of bus services, or changes, additions or removal of routes must also be registered with the Traffic Commissioner.

9. There are two main exceptions to this rule. First, if a service is registered as frequent (ie its frequency is at least six buses an hour, equivalent to a frequency of at least every 10 minutes), the bus operator running this service can increase its frequency further without registration with the Traffic Commissioner. However, it cannot reduce the frequency. Second, if there is some reason to believe that services would not be operated, for instance following a default of an operator whose services are taken over by another operator, the Traffic Commissioner can waive or reduce the 56 days' notice for the new operator in order to ensure that passengers enjoy continuity of service.

10. In addition to service registration, the Traffic Commissioner can also prevent a bus company from operating a particular service. This can be done for two reasons: safety and fair competition. With respect to safety, the Traffic Commissioner can prevent unsafe vehicles or drivers from providing bus services. With respect to fair competition, if there has been 'intentional interference with another operator', the Traffic Commissioner can prevent a bus company from operating a route or attach a condition reducing the number of vehicles that the company is going to operate. According to the Traffic Commissioner, such interference would generally mean any action that prevents a competitor from physically running its services and does not necessarily have a connotation of anti-competitive behaviour as competition authorities would use it.

11. To conclude, we did not find that regulation of the bus market would represent a significant barrier to entry.

Access to facilities

12. A new operator wishing to run commercial local bus services in the Preston area would require:

    (a) buses and drivers;

    (b) a depot or a place to park its buses and a place to carry out maintenance and refuelling;

    (c) access to back office functions, such as IT, administration, payroll etc; and

    (d) access to stands at Preston Bus Station.

13. We did not consider that sourcing buses, hiring drivers and back office functions represented a significant barrier to entry or expansion in this local market. We therefore focused on depots and the activities that revolve around depots such as maintenance and refuelling and the consideration of whether the access to Preston Bus Station represents a barrier to entry.

Access to stands at Preston Bus Station

14. The issue of access to bus stands at Preston Bus Station was raised by one operator, Blue Bus. According to this operator, the distribution of bus stands was a major barrier to expansion for its services. We note that Preston Bus Station is very large, unusually so for a town of the size of Preston. It is therefore unlikely that the lack of space will be a problem for bus operators in Preston. For Blue Bus, the main reason for discontent was its inability to use the same bus stand as other operators with which it is in competition on a given route. According to Blue Bus, Preston City Council, which is responsible for allocating the stands, allocated them in clusters to PBL and Stagecoach, which means that passengers would need to cross the bus station in order to find a competing service.

15. When we asked whether Blue Bus thought that when Stagecoach entered on PBL routes and vice versa, the fact that the competing services were not leaving from the same stand inhibited the parties from competing with each other, Blue Bus told us that it did not, but the main reason for that was the frequency of the services. Blue Bus told us that if a service runs every ten minutes or more frequently, then passengers can make the choice by walking to either stand; whereas when a service operates less frequently, passengers would go to the stand offering the more frequent service. When both services are next to each other, passengers could see which ones they want to get on and what time they depart.

16. It is possible that in a situation where the only way that an operator can enter a commercial route is by filling the gaps in frequency of an existing operator rather than offering a service with competing frequency, it may put the new entrant at some disadvantage if customers have to cross the station in order to reach the other, less frequent service. It is also entirely plausible to expect customers to cluster around the more frequent service.

17. We discussed this issue with other operators in the Preston area, in particular Fishwicks which, like Blue Bus, runs services from Preston Bus Station in competition with Stagecoach. No one else considered the distribution of bus stands to be a concern. We visited the bus station during our site visit in Preston. The bus station is organized around a central island from which the bus stands spring. We found it relatively easy to cross the station to reach another stand. Finally, we note that Preston Bus Station is due to be demolished in 2011. We concluded that the distribution of stands at Preston Bus Station was unlikely to be a major barrier to entry.

Access to depots

18. Bus companies use depots to park and maintain their vehicles and as a diesel station. Depot capacity can be sourced by acquiring an existing depot; by acquiring a suitable site and building a brand new depot; by renting (part of) an existing depot owned by another (larger) operator; or by sharing a depot with other operators (including coach operators, road hauliers etc). Stagecoach gave us the example of the Cavendish/Renown model that operated in Eastbourne before Stagecoach's acquisition of Cavendish. Cavendish used parking land to 'outstation' buses remote from their parent depot owned by Renown. Stagecoach told us that this model was in

common use throughout the industry and offered a simple means of cheap entry. Finally, Stagecoach further submitted that refuelling did not have to be done on-site and that it was aware of smaller operators in the Preston area using petrol stations giving the example of Red Line Travel. Red Line Travel told us that it did have a depot with a fuel tank. It used petrol stations for refuelling only occasionally.

19. Stagecoach told us that there were many industrial sites in and around Preston on which a depot could be established. Stagecoach further submitted that it would cost in the range of £1.5–2 million to construct a sizeable custom-built bus depot on a vacant industrial site. However, sizeable industrial units could be used as depots with minimal modifications. An example of this was the depot established by Stagecoach in an industrial unit in Barnstaple where the only capital costs incurred were around £[✂] spent equipping the unit with vehicle lifts, a fuel tank and other engineering equipment. The cost would have been lower if either fuelling or maintenance had been carried out at third-party premises. According to Stagecoach, it is important that such premises can be rented and need not be bought, leading to considerably lower entry and expansion costs. The cost per sq foot in Preston is £4.00.

20. We discussed the issue of finding suitable land for a depot with other operators present in the Preston area. One of them, [✂], confirmed that there was ample land for a new depot in Preston, while another, Walton's Coach Hire told us that there was not enough land for a depot.

21. We further note that during our site visit in Preston, the Stagecoach Northwest Engineering Director told us that the cost of rebuilding PBL's or Stagecoach's depots in Preston would be £[✂]–£[✂] million.[3] However, Stagecoach also told us that covered depots like PBL's and Stagecoach's would no longer be built as they were not considered to be suitable. This was confirmed by Blue Bus who told us that 'nobody would build a covered combination for a bus depot. They would just build covered accommodation for a maintenance facility, a small office, and an open parking area'. This would be considerably cheaper.

22. For illustration, Stagecoach provided a list of depots recently constructed by Stagecoach:

(a) In Dover in 2007, Stagecoach built a [✂]-vehicle bus depot at the cost of £[✂] million including land.

(b) In Skegness in 2009, Stagecoach, built a [✂]-vehicle bus depot at the cost of £[✂] million including land.

(c) In Herne Bay, Stagecoach built a [✂]-vehicle bus depot at the cost of £[✂] million (£[✂] million for land and £[✂] million for construction; [✂]).

(d) In Ashton, Manchester, Stagecoach converted an existing building into a [✂]-vehicle bus depot. This involved [✂].

(e) In Barnstaple, Stagecoach [✂].

23. Stagecoach also provided a list of depots that were currently used by bus or coach companies near Preston that their owners could use to enter the Preston bus market. This list was based on the methodology which assumed a 30-minute isochrone around the target market. Stagecoach provided this information in the context of

[3] [✂]

supply-side substitution. As we have noted in Appendix I, the evidence presented in this document regarding the propensity of the potential competitors identified by Stagecoach to start supplying intra-urban services in the Preston area suggests that these companies should be treated as potential entrants rather than supply-side substitutes (see paragraphs 64 to 72 for more details). We note in particular that none of these companies told us that they would be capable or willing to start supplying intra-urban services in the Preston area following a small but significant increase in price or worsening of other aspect of the bus service offer within a short period of time, which is the test for supply-side substitution (see Appendix I for more details).

24. Stagecoach further argued that:

> the constraint which defines the boundary around the relevant market is the costs of moving buses and drivers from their 'home' depot to the centre of Preston or other relevant points where a Preston service can commence. Thus the revenue collected from bus operations in Preston needs to cover at least the cost incurred from operating the bus services and the costs of the 'dead-runs', on which no revenue is generated. The exact drive-time boundary for supply-side substitution would have to be determined by various factors, such as fuel, wage and maintenance costs.

Table 1 provides a summary of Stagecoach's findings.

TABLE 1 **Availability of depots in the Preston area**

Operator	*Location*	*Distance from Preston Bus Station*	*Capacity (vehicles)*	*Notes*
Alpha Coach	N/A	6 min	29	Coach services
Cosgroves	Fulwood	8 min	12	N/A
Red Line Travel	Longton	8 min	[✂]*	Coach and tendered services
Blue Bus	Penwortham	10 min	15*	Commercial and tendered services
Holmeswood Coaches	Leyland	15 min	15	Coach and tendered services
Fishwicks	Leyland	15 min	38*	Commercial services
Stagecoach	Chorley	20 min	64	Commercial and tendered services
Coastal Coaches	Warton	20 min	9*	Coach and tendered services
Holmeswood Coaches	Blackburn	21 min	22	Coach and tendered services
Walton's Coach Hire/ Bank View Travel	Freckleton	21 min	17*	Coach and tendered services
Darwen Coach Services	N/A	21 min	10	Coach and tendered services
Transdev Blazefield	Blackburn	22 min	131	Commercial and tendered services
Longridge Coaches	Ribchester	23 min	8	Coach services
Kenmore Coaches	N/A	24 min	11	Coach services
Abbey Coaches	N/A	24 min	12	Coach services
Archway Travel	N/A	25 min	16	Coach and tendered services
Cumfy Bus	N/A	25 min	[✂]*	Tendered services
Tyrers	Chorley	29 min	N/A	Tendered services
Holmeswood Coaches	Ormskirk	30 min	35	Coach and tendered services
First Manchester	Wigan	35 min	200	Commercial and tendered services
Arriva	Skelmersdale	35 min	45	Commercial and tendered services
Blackpool Transport	Blackpool	35 min	[✂]*	Commercial and tendered services

Source: Stagecoach, CC hearings with bus operators.

*We updated these figures with information gathered from the companies.
Note: N/A = not applicable.

25. We have also discussed the issue of the depot location with other bus operators. Arriva and Transdev told us that they would normally require a depot within 30 minutes of the operated route. However, Go-Ahead told us that it would normally require a depot within the built-up area that it was serving. Veolia would require a depot within 25 to 30 miles from the area it was serving.

26. There is only one large bus operator within a 30-minute drive-time of Preston Bus Station, Transdev, with a depot located at 22 minutes. There are three more large operators present within a 30- to 35-minute drive-time of Preston Bus Station—Arriva, First and Blackpool Transport. We asked these operators whether they would be able to supply intra-urban services in the Preston area from their existing depots. The responses were as follows:

(a) Transdev, which is the only company among the four which already operates services in Preston, albeit inter-urban, told us that it would only be able to operate intra-urban services in Preston with limited scope and coverage from Blackburn, which would probably limit the provision of such services to the eastern side of Preston. In the discussions with the OFT, Transdev submitted that it could operate two to three routes in Preston without having a depot there; however, it also submitted that the real concern in running services to Preston would be dead mileage and its fleet capacity.

(b) Arriva told us that it would be possible for it to supply inter-urban services from its depot in Skelmersdale, but not intra-urban services in the Preston area.

(c) First told us that it would not be able to operate intra-urban services in Preston from its nearest depot.

(d) Blackpool Transport, which is another sizeable bus operator in the Lancashire region (albeit not a national player like Transdev, Arriva and First), told us that [✂].

27. There are only two small bus operators running commercial services within a 30-minute drive-time of Preston Bus Station, Fishwicks and Blue Bus. The remainder of the bus operators within a 30-minute isochrone are very small and specialized in coach and tendered services. In general, the small operators we spoke to did not express particular concerns about the need to have a depot in order to serve the Preston market, although we note that all those operators did have their own depot nearby. They were more concerned about the lack of commercial opportunity or aggressive competition from large operators, Stagecoach in particular. For instance, [✂] (see paragraphs 55 to 63 for more details on strategic barriers). Finally, as a general rule, operators that specialized in tendered services expressed a desire to remain focused on the provision of these services (see Table 4).

28. Finally, Stagecoach further argued that bus companies did not need to carry out their own maintenance and could outsource it to local garages, dealers, small operators and hauliers which would all carry out PCV maintenance. Stagecoach identified the following companies offering maintenance services in Preston: Mercedes, Scania, Thomas Hardie (Volvo) and MAN.

29. We found that:

(a) A depot is likely to be an important consideration in any bus operator's decision to enter or expand given that they represent the single largest cost that bus operators need to incur. However, neither large nor small operators generally mentioned access to depots as a significant barrier to entry in the Preston area. They told us that depots in Preston could be obtained or built if a commercially viable opportunity for entry presented itself. Such opportunity would normally take the form of a gap in the service by the incumbent operator(s).

(b) However, having a depot with spare capacity already present within the target area and already running services within this area does represent an advantage

for bus operators. These operators are well placed to fill any gap in the service or respond to a worsening of the retail offer speedily and with little additional cost. For instance, Go-Ahead told us that it was easier for Stagecoach to roll out a network of routes in Preston because it already had a depot in the town and had a large presence in the area, so it already had a management, engineering and property overhead.

(c) Entry by renting parking space, subcontracting maintenance works, and/or sharing facilities may in principle be an alternative to entry using a fully equipped proprietary depot. However, it appears to be a more suitable option for small-scale operations (as economies of scale cannot be fully achieved without proprietary depot facilities). Whether even small operators would actually operate in this way in practice remains unclear. We note that all operators who run services (both commercial and tendered) in the Preston area have their own depot in the vicinity of Preston.

(d) We understand that a depot that is located further than 30 minutes from Preston is unlikely to be used to serve the Preston intra-urban market. We also understand that having a depot located within a 30-minute drive-time does not automatically mean that its operator will be able to use it to provide intra-urban services in the Preston area. Some operators will require a depot closer to the target market. We note that in the Preston area, the large operator with a depot nearest to the target market—Transdev at 22 minutes from Preston Bus Station—would only be able to use its depot to serve the east side of Preston. It is therefore possible that a narrower isochrone is more appropriate in the case of the Preston area.

(e) Before June 2007, Stagecoach and PBL both had a depot with significant spare capacity. We understand that Stagecoach added 25 buses to its Preston fleet to be used for its expansion on PBL routes and that PBL responded by adding ten buses to its existing fleet to be used for entering on Stagecoach's routes and to retaliate against Stagecoach's entry on its own routes. This reduced the available spare capacity.

Importance of scale

Economies of scale

30. Economies of scale refer to the potential for a large-scale operator to enjoy an advantage because of the ability to operate at a lower average cost that derives from large operations. Where economies of scale are significant this can give rise to a barrier to entry or expansion because new entrants or small firms seeking to expand might find it difficult to achieve the minimum efficient scale.

31. A large-scale operator may also enjoy an advantage because of the operational flexibility of being able to deploy buses over a 'portfolio' of routes from its depots.[4] An operator that serves a set of routes from the same depot can manage costs efficiently by the allocation of resources among its individual routes in response to either a change in demand conditions (eg seasonal demand for bus services in Preston), or a change in supply conditions (eg new entry or expansion on individual

[4]Stagecoach submitted to us that this statement is conflicting with the CC's statement in Appendix I suggesting that 'it is not feasible for a bus operator to considerably reduce an existing service without alienating its customers'. We note that this statement has been made in the context of supply-side substitution and therefore referred to a rapid supply-side response. It does not preclude that a bus operator will wish to redeploy its resources in the medium or longer term in order to maximize the profitability of the business.

routes). Vehicle requirements to meet peak demand or to cover for breakdowns and other faults are also likely to be relatively less costly for large-scale operators.

32. Stagecoach told us that economies of scale existed in local bus services, but that there could also be diseconomies of scale at certain points in the growth process. Costs such as parking space, maintenance and cleaning staff, inspection pits and equipment, and supervision will reduce on average as a fleet increases in size, but there comes a point when one additional vehicle will require a step change in cost which will be higher than the previous average. At a level of 50 or more vehicles, these costs can be spread out to enable efficient additions to the fleet, below this level, the incremental costs and revenues associated with additional vehicles need to be considered.

33. Stagecoach clarified that it defined a depot as a location with a manager and engineering facility. Its smallest maintenance depots are about [✂] buses. Anything less is a sub-depot with limited maintenance or outstation of a parent depot with no maintenance. A small operator can rent parking land, contract out maintenance, accounting and payroll and scale these costs according to size. A large operator will invariably carry out in-house maintenance requiring a depot.[5]

34. Stagecoach also submitted that a large operator would be able to achieve purchasing efficiencies and would pay slightly less for new vehicles and marginally less for fuel than smaller operators.[6] However, Stagecoach told us that a large operator would have greater expenditure in other areas: *(a)* it will generally operate a newer fleet, and *(b)* it will offer higher wages than small operators.

35. Finally, Stagecoach submitted that small operators were able to compete efficiently on a route-by-route basis. Stagecoach provided the following examples of where a small operator entered successfully on its routes in areas where it was the largest operator:

(a) Red Line Buses entered on the Grimethorpe and Hoyland corridors in September 2008 (Yorkshire).

(b) Tates Travel has recently introduced new services in Barnsley (Yorkshire).

(c) Bain's Coaches entered on Stagecoach's route from Oldmeldrum to Aberdeen in 1995 which led Stagecoach to withdraw some of its services (Aberdeenshire).

(d) Nicole Coach's has competed with Stagecoach for at least five years on the route between Stonehaven and Montrose (Aberdeenshire).

(e) Nordi Travel has recently introduced a new service between Livingston and Dunfermline in competition with Stagecoach's services (Fife).

However, at a later stage, Stagecoach agreed that as a general rule entry by small operators was sparse, unpredictable and its sustainability could not be relied upon. Stagecoach later clarified that despite these features, small scale entry did pose a constraint on Stagecoach.

36. Arriva told us that there was difference in approach between small and large operators. Operators like Arriva will want to ensure a good return for shareholders in the

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[5] [✂]

[6] Stagecoach further clarified that hedging strategies can also result in larger operators paying more than smaller operators for fuel, [✂].

medium–short term and may be considering entering on a network basis rather than just one route, while a small operator is more likely to focus on short-term return and one route. Small operators will also tend to enter on routes with large numbers of passengers and use older buses that they will be able to obtain for £7,500 to £10,000. Large operators may enter on routes that are not profitable in themselves, but will act as feeder routes on to more profitable routes within an area. Go-Ahead also suggested that small, low-cost operators could enter and fill in service gaps created by large operators. Transdev told the OFT that the minimum scale for entry to Preston would be [✄] buses.

37. First told us that:

> size is not a barrier to entry. Across the UK there are many operators ranging in size and scale. Efficient businesses operate with one person owning, maintaining and driving a single vehicle. They also operate with fleets of up to 9,000 vehicles. While larger businesses may benefit from price reductions when buying products and services in bulk, smaller ones may benefit from being supplied by local small-scale suppliers, lower overheads and lower staff costs and/or more flexible working conditions.

38. Small operators generally agreed that large operators benefited from economies of scale and that this was putting them at a disadvantage. However, this response was not uniform. Walton's Coach Hire agreed with Arriva that it was key for it to identify a gap in the service and also agreed with First that an operator does not need a minimum scale to operate and can start by running just one route.

Access to finance

39. Small operators also told us that in addition to economies of scale, large operators had better access to finance. For instance, Coastal Coaches told us that access to finance makes it easier for large operators to finance entry. This is likely to be the case as large operators are likely to have a lower cost of capital.

Risk

40. Fishwicks suggested that financial risk was a very important consideration for small operators and that entry on a new route was very risky. Most small operators suggested that bidding for tendered services ensured steady income during the period of the tender and was a way of mitigating risk and growing business for small operators.

41. Stagecoach provided an opposing view suggesting that small-scale entry involved smaller resources and was therefore less risky. However, we understand that the argument small operators are making is not with respect to the absolute size of investment, but rather with the impact that this investment has relatively to the size of the business. It would seem plausible that opening a new route exposes a small business with say ten vehicles more than opening ten routes for a large national operator with say 1,000 vehicles. The risk aversion of small business was confirmed by their unwillingness to enter commercial routes that would not be immediately profitable, while large operators were prepared to sustain unprofitable routes for longer. (See Appendix G for more details.)

42. To conclude, we found that there were economies of scale in the bus industry that favour larger operators. However, small operators can still compete in particular by filling the gaps in service created by large operators. Small operators also face a

more difficult access to finance and higher degree of exposure to risk. In particular, it is more difficult for small operators to enter a new route because they will find it harder to obtain the necessary finance to purchase new vehicles. Moreover, if the entry is unsuccessful, their business will be left financially exposed. This is because the losses cannot be amortized over a larger business base. For that reason, small competitors often focus on tendered services which mitigate these risks.

Network effects

43. In markets with 'network effects', a network operator enjoys an advantage over other operators because of its ability to offer network tickets that consumers value. Network tickets include multi-journey tickets and daily/weekly/monthly zonal tickets that can be used on a number of different routes provided by the operator. Network zonal ticketing allows customers to travel across the local network by changing buses without paying again. In markets where network effects are particularly important, it is likely that entry on or expansion on a small scale would be difficult because such firms would not have the extensive network to enable them to compete effectively with the network operator. In general, multi-operator network tickets (including in practice concessionary tickets) which allow bus passengers to use the same ticket on buses operated by different operators tend to reduce the significance of the network advantage, while operator-specific network tickets increase network effects.

44. We discussed the importance of network and ticketing with small bus companies operating in the Preston area. Coastal Coaches told us that the existence of networks of routes with corresponding network tickets made it impossible for it to compete and therefore deterred it from entering a new route. Blue Bus told us that the existence of networks could to a certain extent prevent it from growing. Walton's Coach Hire was primarily concerned about the difficulty for small operators to offer discounted tickets, such as weekly tickets. Fishwicks told us that Stagecoach provided very keenly discounted weekly tickets that Fishwicks could not afford to compete with. Fishwicks therefore focused its competitive activity on providing high quality of service.

45. As we have noted in Appendix I, Stagecoach told us that 'there is a significant level of switching between bus routes at Preston's central Bus Station, principally due to people changing from local buses to inter-urban bus routes, or vice versa'. We also noted that Stagecoach was unable to quantify the extent of such switching. If Stagecoach is correct, significant switching between inter- and intra-urban services may further increase the barrier to entry for a potential entrant as such entrant might also need to offer inter-urban services in addition to a network or intra-urban services. However, as we noted in Appendix I, the research carried out by independent consultancy TAS in 2003 (ie in a period when Stagecoach was primarily running inter-urban services), suggested that the extent to which Stagecoach passengers changed services was considerably lower than for PBL (8 per cent for Stagecoach and 23 per cent for PBL). This might suggest that the degree of switching between inter- and intra-urban services is more limited than the degree of switching between intra-urban services.

46. Finally, Stagecoach's network advantage could be mitigated by the introduction of a multi-operator ticket. We understand that LCC considered such an option in 2003. In a report prepared for LCC that year, a public transport consultancy TAS found that in Preston only 3.2 per cent of journeys could benefit from the introduction of a multi-operator ticket. When concessionary and pre-paid passengers are excluded, only 2.8 per cent of passengers could make use of such ticket. We also understand that LCC is currently considering introducing a multi-operator Stored Travel Rights Scheme aimed at 16- to 23-year-old people in the Preston and South Ribble area.

Capacity of the Preston area to support two network operators

47. Given that Stagecoach argued that the head-to-head competition between Stagecoach and PBL that took place after June 2007 was unsustainable, we further investigated whether the Preston city market could in the long run support two operators of the size of the merging parties competing with each other head to head.

48. First we note that Stagecoach told us that the main reason why it introduced its intra-urban services in Preston city was to obtain a share of that market. Stagecoach told us that the size of their expansion aimed at obtaining about 25 per cent of that market. This statement in itself seems to suggest that Stagecoach believed that in principle the Preston market could support more than one operator or at least that it was possible for Stagecoach to expand in Preston city and remain in competition with PBL.

49. This view was confirmed by [former PBL Director X] who told us that Preston could support two operators, just not at the level of service offered by the parties during the period of head-to-head competition. However, [former PBL Director X] also told us that it would not have been easy for PBL to cut down its services because it had a large depot to support (see Appendix G, paragraph 59).

50. Transdev submitted that Preston was a 'bus friendly' territory and it could support two large operators; however, it also added that in the current bus market climate with increasing fuel tax, decreasing patronage due to the recession and reduced re-imbursement of concessionary travel, it would not be attractive for two operators.

51. Arriva also submitted that the Preston bus market could support more than one operator; however, at a later stage, Arriva told us that there probably was not enough revenue to be had in Preston in order to justify two full network operators. We understand that this contradiction stems from a disagreement between two of Arriva's senior directors, one of whom believed that two networks could co-exist in Preston, while the other believe that they could not.

52. Go-Ahead told us that the fact that when Stagecoach replicated PBL's network it destabilized PBL showed that there was not enough room in Preston for two networks. When asked whether it would have been possible for two networks to overlap albeit at a lower level, Go-Ahead told us that this would mean that both companies would run approximately 50 vehicles each which would mean a lower base over which to spread overheads and might not be commercially attractive. However, we note that Go-Ahead bid for PBL on the basis that the same level of Stagecoach service would be maintained after the acquisition. This would suggest that it believed that two networks could co-exist.

53. Finally, Stagecoach further submitted that 'If the [CC] asserts that the only reason for [Stagecoach's] entry was to eliminate [PBL] then it cannot also be true that the market can support two operators'. According to Stagecoach, 'this inconsistency is absolutely fundamental to the CC's case. The necessary implication of the market being able to support two network operators is that entry should be characterized as enabling revenue to be grown rather than being in any sense predatory'. We disagree with Stagecoach's argument. It does not follow that Stagecoach would only want to 'eliminate' PBL if Preston intra-urban bus market was a natural monopoly.

54. To conclude, it would appear that both Stagecoach and PBL believed that it was possible for two larger operators to operate a network of inter-urban routes in the Preston area in head-to-head competition with each other. Arriva's and Go-Ahead's positions are unclear. We note that some of the contradiction in Arriva's and

Go-Ahead's response might be caused by the difference in perception of attractiveness of the Preston bus market before June 2007 and after the merger. Finally, Transdev's view seems to be at least to some degree dependent on the current economic situation [✂].

Strategic barriers—threat of an aggressive competitive response

55. Third parties might be deterred from entry into or expansion in the provision of commercial local bus services in Preston if they consider that Stagecoach is likely to react aggressively to new entry. Aggressive competition is likely to have a stronger impact on smaller competitors who will not have financial resources to withstand such competition. We therefore asked the small competitors in the Preston area whether Stagecoach had such a reputation.

56. [✂][7]

57. [✂][8] argued that running commercial services against Stagecoach would be a 'commercial suicide'. [✂] told us that the 'Preston bus war' showed that Stagecoach was ready to compete aggressively and run competitors out of the market. Stagecoach could afford losses as it had the necessary financial backing. [✂] believed that small bus operators would disappear from Preston in the near future either as a result of Stagecoach's behaviour or fear of it.

58. Coastal Coaches[9] believed that the Preston bus war was brought about by Stagecoach's aggressive decision to duplicate PBL's routes. It told us that in a situation of a bus war, a large bus company enters a route with too many buses for the route to remain commercially viable. As a result the small incumbent will no longer find it financially viable to remain on the route. Coastal Coaches also told us that as a result of the merger, it would be less likely to enter commercial routes in Preston. It is concerned that Stagecoach would over-service those commercially thus preventing any other company from entering. Coastal Coaches identified a commercially attractive route from Blackpool to Preston but was concerned that if it were running on the same route as Stagecoach, Stagecoach would offer free rides for a period of several weeks and Coastal Coaches would be unable to compete.

59. Walton's Coach Hire[10] told us that it would consider entering on a commercial route if it thought that there were opportunities to do so, but it did not see any at the moment. It was not concerned by competition from large players and the merger had not altered its perception of the attractiveness of the Preston market or its willingness to enter it. It believed that the 'Preston bus war' involved some 'bullying tactics' on both sides. It was not concerned that it would be subject to the same bullying tactics if it entered into competition with Stagecoach.

60. Blue Bus[11] told us that while aggressive behaviour from a large operator was always a concern for a small bus company, it was not a reason that would prevent it from entering a commercial route within the Preston area. Neither the 'Preston bus war' nor the merger have changed Blue Bus's willingness to enter on a new route in the Preston area.

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[7] [✂]
[8] [✂] is a bus and private hire company [✂].
[9] Coastal Coaches is a coach company with nine coaches. It has recently won a tender for a route from Preston Bus Station to Flyde Coast. It is further interested to enter commercial and tendered services.
[10] Walton's Coach Hire is a bus company with 17 buses running tendered services in the Preston area.
[11] Blue Bus is a bus company with eight buses running a number of tendered and commercial routes in Preston primarily in competition with Fishwicks south of the River Ribble.

61. Fishwicks[12] did not provide a very clear interpretation of the 'Preston bus war'. However, it would appear that it was not concerned by it. It said that since deregulation, no one had a 'divine' right to a route and that entry could happen very quickly. However, Fishwicks expressed concerns about the behaviour of Stagecoach. It told us: '[It] would be foolish in many ways to assume that I could take on the likes of Stagecoach. I just could not; I do not have the resources or the means. [✂]'

62. Finally, strategic barriers may also apply to large operators. When we asked Arriva whether they would enter the Preston market as a result of fare increases or worsening of services by Stagecoach, Arriva told us that if it did so, Stagecoach would react to its competition by improving its services, which would make such entry unprofitable. In general, Arriva would be wary of entering against another large operator just because it allowed its service levels to drop or prices increase.[13] This is because Arriva knows that a large operator has the means to rectify this. If it entered, the large operator would improve its service which would mean that there would be two high quality operators in the market. This is unlikely to justify the investment required for the entry. [✂][14]

63. To conclude, four out of six small bus operators in the Preston area that we spoke to, [✂], Coastal Coaches, [✂] and Fishwicks, told us that Stagecoach had a reputation for aggressive competition which deterred them from competing vigorously in the Preston area. Two of them, [✂] and Coastal Coaches, identified two commercial routes that they would have entered had it not been for fear of Stagecoach's response. Coastal Coaches in particular linked its behaviour to the merger between PBL and Stagecoach. Finally, the capacity to respond to entry by aggressive competition also has an impact on the decision of large bus operators to enter a market served by another large bus operator, such as Arriva, a national operator present within the Lancashire region, [✂].

Potential for future entry or expansion in the Preston area

64. The effects of the SLC that we identified in our competitive assessment (see Appendix J) could be offset if, following the merger, we could expect entry or expansion in the Preston intra-urban market on a sufficient scale to constrain the merging parties. We considered that entry or expansion could plausibly come from large national operators or small commercial services operators with depots within some reasonable distance from the Preston area. We used Stagecoach's analysis of supply-side substitution as a basis for identification of operators within a 30-minute drive-time in Preston. In addition, we considered that at least in theory, large national operators not present within the Preston area should be able to, if they wished to and found the economic conditions acceptable, enter the Preston intra-urban market by setting up a new depot or outstation. We asked both large and small operators about their *ability* and *willingness* to enter or expand in the Preston intra-urban market. The responses of the operators are summarized in Tables 2, 3 and 4 and paragraphs 65 to 72 below.

Large operators

65. We enquired with the three national operators with depots within a 30- to 35-minute drive-time from Preston, Transdev, Arriva and First, whether they would be able and

[12]Fishwicks is a bus company with 38 buses operating a number of commercial routes running between Preston and Leyland primarily in competition with Blue Bus and Stagecoach.
[13]However, Arriva also told us that it would not hesitate to compete where the market or demand could justify the investment.
[14][✂]

willing to start supplying the Preston intra-urban market. Transdev, the only operator that currently serves the Preston area with inter-urban routes, told us that it could supply intra-urban services in Preston from its existing depot near Preston, albeit only to a limited degree. Arriva could only supply inter-urban services from its nearest depot. First could not supply the intra-urban Preston market from its nearest depot. We also note that none of those companies was willing to enter the Preston market in the foreseeable future. Arriva questioned whether the market was large enough for two operators and further suggested that Stagecoach would react to any entry by improving its service. Transdev questioned whether the Preston market was large enough for two operators especially in the current market climate. First told us that it was not actively seeking to enter the market.

66. We further inquired with those large national operators that expressed interest in purchasing PBL in the summer 2008, Veolia and Go-Ahead, whether they were able and willing to start supplying the Preston intra-urban market. Veolia argued that it would need a strong presence in the North-West in order to enter Preston. Go-Ahead did not see any opportunity to enter following the merger. Go-Ahead also suggested that any entry would now have to take place on a route-by-route basis. Furthermore, Go-Ahead also told us that it would not consider entry into a new market following a 5 to 10 per cent price increase. It also told us that if it had a depot in the target area and felt that the incumbent operator was consistently giving a low level of service, it might create an opportunity to enter, but in itself, this would not encourage it to set up a new base.

67. Finally, the last large operator with a depot in the vicinity of Preston, Blackpool Transport, told us [✂].

68. We conclude that Transdev is the only large operator that has the ability to introduce intra-urban services in the Preston area from its nearest depot. However, we note that this ability is restricted to a limited number of services in the east of Preston and would not on its own be sufficient to constrain the merging parties. We also conclude that no large operator has expressed willingness to enter the Preston intra-urban market.

TABLE 2 **Large companies' views on entry and expansion into the Preston market**

Operator	*Present in Preston?*	*Could supply intra-urban services in Preston from nearest depot?*	*Would enter or expand in Preston?*	*Comments*
Arriva*	No	No	No	'If Stagecoach increase prices or reduce quality and we go in, they would react to the competition by improving their services.'
First*	No	No	No	'Whilst not actively considering entry into this market, First reserves its position and may choose to do so at any time in the future.'
Go-Ahead*	No	No	No	'After the acquisition, the market is dead in the water.'
Transdev*	Yes: One tendered & one commercial inter-urban services	Yes, but only to a limited degree	No	'Preston does not make an attractive market for two operators whilst the market both in Preston and elsewhere is in decline.'
Veolia*	No	No	No	'It would not be attractive to open an operation in Preston without some other business in the North West with which to share company sized overhead.'
Blackpool Transport	[✂]	[✂]	[✂]	[✂]

Source: Evidence to the CC from the companies.

*Operators who received the information memorandum for the sale of PBL and replied to our questionnaire.

Small operators

69. We also asked small bus operators with depots located within a 30-minute drive-time from Preston Bus Station whether they would be willing to start supplying commercial intra-urban services in the Preston area.

70. We note that the only two small companies that currently supply commercial services in the Preston area or within a 30-minute drive-time from Preston Bus Station are Blue Bus and Fishwicks. We spoke to both Fishwicks and Blue Bus. Fishwicks told us that Preston was not too far from its Leyland depot and if it wished to, it could start supplying intra-urban services in Preston. However, Fishwicks did not want to expand as it considered it too risky. Blue Bus told us that it would be interested in expanding on a route-by-route basis. Its entry would be influenced by the profitability of each route. Blue Bus's expansion of services would also depend on whether it finds the arrangements at Preston Bus Station acceptable. The maximum size that Blue Bus believes it could reach in Preston is 20 vehicles. We note that the extent to which Blue Bus could expand and thus constraint Stagecoach and PBL is limited. Blue Bus is a small local business currently operating eight vehicles and does not have access to the same financial resources as Stagecoach or PBL.

TABLE 3 **The views of small operators of commercial services on entry and expansion into the Preston market**

Operator	*Nature of business in Preston*	*Would be able to enter/expand the supply of commercial services in the Preston area?*	*Would be willing to enter or expand commercial services in Preston?*	*Comments*
Blue Bus	Commercial and tendered services	Yes, the maximum size in the Preston area would be 20 vehicles	Yes, on a route-by-route basis, but concerned about stands at the bus station	'It is a case of seeing where the potential is for either a poorly-organized service with somebody else, or plenty of passengers, or both.'
Fishwicks	Mostly commercial services	Yes, Preston is not too far from our depot	No, expansion is too risky	'If you went on another operator's route and took half of its business, that would not necessarily be sufficient to make it viable from your own point of view.'

Source: Evidence from small competitors.

71. We further spoke to five small operators with depots within a 30-minute drive-time of Preston Bus Station that currently only offer tendered services (see Table 4). Two operators told us that they would be able to enter into the provision of commercial services but both were deterred from doing so by Stagecoach's reputation for aggressive competition. Two operators mentioned the inability to raise finance as the main reason why they would not be able to expand on to commercial routes in Preston. In addition, one of the two feared Stagecoach's aggressive response if it entered. The fifth operator told us that it was mainly a coach company and therefore never considered whether it would be able to enter commercial services.

TABLE 4 **The views of small operators of tendered services on entry and expansion into the Preston market**

Operator	*Nature of business in Preston*	*Would be able to enter/expand the supply of commercial services in the Preston area?*	*Would be willing to enter or expand commercial services in Preston?*	*Comments*
Coastal Coaches	Tendered services	No, wouldn't be able to raise finance against the large operators like Stagecoach	No, no routes available	'Stagecoach will look at the cash rich routes, over-service them and make it such that I would never get a chance.'
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	Tendered services	Yes	No, would only bid for tenders	'Entry against Stagecoach would be commercial suicide. I would not compete with them, not with their history.'
Red Line Travel	Tendered services	Don't know, never investigated the possibility	No, a coach company rather than a bus company	'I have never given thought to entering commercial routes in Preston. We are primarily a coach company.'
Walton Coaches	Tendered services	No, lacking finance to do so	No, no routes available and unable to compete with Stagecoach on fares	'There are no routes available and even if there were, I would not be able to compete with Stagecoach on fares. All small operators can do is to tender for services.'

Source: Evidence from small competitors.

72. We conclude that the only small operator with a depot located within a 30-minute drive-time from Preston that is both able and willing to expand its services in the Preston area is Blue Bus. We note, however, that Blue Bus does not have sufficient resources to expand on the scale necessary to constrain the merging parties. We

also note that this situation might have been different prior to the so called 'Preston bus war' when small competitors felt more confident to enter against Stagecoach.

Ability vs willingness of bus operators to enter or expand in the Preston area

73. Stagecoach told us that ability to compete was 'a (semi-)permanent feature, depending upon the underlying characteristics of the company such as access to finance, buses, depots in the correct locations, etc'. Conversely, Stagecoach told us that willingness to compete was 'a transitory feature, depending upon the perceived attractiveness of the market, and the strategy of the operator in question. Changes in conditions of competition in Preston could rapidly affect other companies' willingness to compete. The CC should have therefore given substantially greater weight to ability to compete than to willingness'.

74. With respect to the ability to compete, we found that there was an important distinction between large and small operators. Large operators do in theory have the ability to enter any UK bus market of their choosing as they have the financial resources necessary to purchase or build depot facilities or obtain buses. However, we do not believe that it is reasonable to conclude that for this reason, their entry into any market should be automatically presumed.

75. We note that we analysed the ability of large operators to use their existing facilities near to the Preston area and found that apart from Transdev (who could supply intra-urban services to the Preston area to a limited degree), no large operator was able to do so.

76. An understanding of the large operators' willingness to enter the Preston area was therefore crucial to our understanding of the likelihood of potential entry to the Preston area. We note that no large operator expressed willingness to enter the Preston intra-urban market in the foreseeable future. While we agree with Stagecoach that these plans might change, we do not believe it would be correct for us to rely on this theoretical possibility particularly when the large operators told us that they would not enter the Preston intra-urban market in the foreseeable future.

77. Small operators face different challenges. First, their ability to enter or expand will be restricted by their limited financial resources. Second, we found that small operators did not make a clear distinction between their ability and willingness to enter or expand on commercial services. Their inability to compete on commercial routes was intertwined with their unwillingness to supply these services and our attempts to gauge the differences between the two often seemed artificial to the small operators. We note that apart from Blue Bus, no other operator we spoke to was willing to enter or expand its commercial services in the foreseeable future.

Entry or expansion by a combination of operators

78. Given that in our market definition analysis we did not find strong demand-side complementarities (see Appendix I), entry or expansion into the Preston intra-urban market capable of constraining the merging parties could be provided by one larger operator as well as a collection of entry or expansion events by several operators, large or small.

79. We found that apart from Transdev, no large operator had the ability to enter the Preston intra-urban market, although Transdev's ability to do so was limited to the east side of Preston. We also found that Blue Bus was able and willing to expand its

operations in Preston, although again its ability to do so was limited. In theory, we could therefore see two potential entrants in the Preston area.

80. However, in practice this option is not realistic. This is for the following two reasons:

(a) It is unclear that, taken together, Transdev and Blue Bus would have been able to reverse the extent of the SLC found, in particular with respect to the threat of potential competition given the limitations of both operators in the Preston area.

(b) Transdev made it clear that [✂].

Partial integration of PBL into Stagecoach and illustrative reconfiguration of PBL

1. This appendix sets out details of the partial integration of PBL into Stagecoach and details of the current financial performance of the business including an illustration of the reconfiguring PBL.

Partial integration of PBL into Stagecoach

Reduction in PBL network of services and other changes in Preston

2. Since the acquisition, Stagecoach has implemented a number of changes to Stagecoach and PBL services in Preston, including the withdrawal of PBL services [✂]. In addition, passengers who previously used services 24/25 are now served by a combination of services 68, 87 and 89. Stagecoach services 11 and 33 were withdrawn. Services [✂] were also adjusted so that in 2009 Stagecoach-operated services generated approximately two-thirds of the total revenue from the combination of these routes, with PBL generating the remaining one-third, reversing the relative shares from that of 2008. The frequency of PBL service 23 was increased, which partially offset the loss of revenue from the transfer of service [✂]. Most of the changes came into effect on 22 March 2009. The decline in PBL's revenue resulting from these service changes is detailed in paragraphs 13 to 16.

3. Following the acquisition, but before hold separate undertakings were in place, Stagecoach introduced common ticketing arrangements between the companies whereby tickets purchased on a Stagecoach bus could be used on PBL services and vice versa. Stagecoach told us that this was part of a network-wide harmonization of fares and making fares inter-available. Another effect of this has been to make it impractical for PBL and Stagecoach independently to determine fares for multi-journey tickets (eg weekly tickets).

Management and employees

4. Upon completion of the acquisition on 23 January 2009 (and prior to the OFT and CC inquiries), a number of changes to the management and administration of PBL were implemented, including the departure of PBL's Managing Director. The Finance Director subsequently left on 15 March 2009. Responsibility for day-to-day management was passed to the Operations Director and Engineering Director, who both reported to [Stagecoach Director A]. Stagecoach explained that in accordance with its usual management arrangements it would not anticipate having a dedicated Managing Director or Finance Director at PBL going forward as these functions would be fulfilled by regional management.

5. The OFT accepted interim undertakings from Stagecoach on 18 February 2009 and the CC adopted these undertakings on 2 June 2009. On 4 June 2009, Stagecoach told us that PBL was operating autonomously within Stagecoach under the leadership of its Operations Director, and did not propose any additional management at PBL. The Group considered whether a Hold Separate Manager (HSM) was necessary at this time as there was concern that PBL may not have the necessary expertise due to the changes that had been made following the acquisition, but decided to wait for further advice. On 15 June 2009 the CC issued directions for the appointment of a monitoring trustee (MT) to ensure compliance with the undertakings. The

MT began reporting to us on 30 June 2009. Following receipt of the MT's first report, the Group decided that it would not be necessary to appoint a HSM at this time. The MT and the MT's representative (an individual with bus industry expertise), would attend and monitor fortnightly meetings between the Operations Director, Engineering Director and [Stagecoach Director A].

6. As the inquiry progressed it became apparent that the remaining management at PBL was not in a position independently to assess or implement commercial or financial decisions with respect to revenues, costs or investments. PBL's remaining management did not have authority to take steps to assess or take action with respect to commercial issues affecting the company (eg actions necessary to address economic factors, fuel costs and duties, lower levels of reimbursement of concessionary fares). During the inquiry the MT told us about a number of issues arising from gaps in the commercial and financial management of PBL, as set out in paragraph 7. We discussed our concerns with Stagecoach and proposed draft directions for the appointment of an HSM on 24 September 2009 to address these issues. Stagecoach wrote to us on 2 October proposing that the MT's representative should take on a number of management responsibilities without the need for an HSM. We discussed this with the MT's representative on 5 October 2009. We concluded that this arrangement would be insufficient to address the gaps in commercial and financial management that we had identified. The directions were formalized to require the appointment of an HSM on 28 October 2009.

Matters arising from the gaps in commercial and financial management at PBL

7. Upon completing the acquisition of PBL, Stagecoach transferred responsibility for the financial management accounts to the Stagecoach Shared Service Centre (SSC). The MT found evidence that there was a lack of resources in the finance department at PBL.

8. During the course of the inquiry the MT identified a number of issues arising from the gaps in commercial and financial management at PBL. Certain management functions were not being carried out, for example scrutiny of management accounts or performance against budget, and there was no resource at PBL for the preparation of budgets or route-costing analysis, for supporting submission of tenders or for assessing the impact of fare changes. The former PBL Finance Director was re-hired by PBL on a temporary basis and the MT provided additional resources to resolve issues arising at PBL. The issues (a number of which have now been resolved) identified by the Monitoring Trustee included:

   (a) Omission of allocated revenue from Stagecoach to PBL in relation to bus advertising (£[✄] in the period 1–5) and Internet ticket sales (£[✄] for the September period), which resulted in an understatement of PBL revenue.

   (b) Delays in invoicing and non-accrual of un-invoiced income and costs associated with various contracts. Timing problems with invoicing resulted in incomplete revenue from month to month which resulted in an understatement of PBL revenue.

   (c) Other unexplained reductions in PBL revenue. The MT performed a review of revenues on a monthly basis compared with the prior year with the objective of explaining the differences observed. In light of the problems in determining the accuracy and completeness of PBL's revenue it was not possible for anyone to explain fully the reductions or properly assess the extent of transfer of revenue from PBL to Stagecoach due to the partial integration of the route networks and fare policy under common ownership.

(d) Lack of resources to perform a commercial evaluation of tendering proposals submitted by PBL in response to tender opportunities advertised by the local transport authority.

(e) Lack of resources to determine the financial effects of changes to PBL's fare policy or to evaluate future decisions. PBL was also constrained from making independent decisions on fares.

(f) Lack of authority to make commercial decisions or implement investments independently. For example the introduction of a smartcard ticketing system was put on hold by Stagecoach.

(g) Emergence of a large and increasing inter-company debt from PBL to Stagecoach due to Stagecoach funding a substantial proportion of PBL's costs (eg payroll), whereas PBL banked its own cash takings. This inter-company item was partly offset by the value of PBL vehicles transferred to Stagecoach. There was no independent financial management at PBL to determine the correct accounting entries to unwind this creditor balance or to monitor cash levels at PBL.

Staffing, support functions and other arrangements

9. Although the [✂] remained with the business, there were no arrangements in place at PBL to take an independent view on which PBL management and employees were key resources within the business, or to take steps to retain such staff ([✂]) and manage other staffing issues independently of Stagecoach.

10. A number of Stagecoach employees were on loan to PBL. This number varied from week to week and totalled six in the week commencing 19 October. A number of PBL employees exited during the inquiry. Discussion of staffing issues was recorded in the minutes of the fortnightly management meetings and none of the employees who exited was considered a key PBL employee.

11. PBL was dependent on Stagecoach for matters relating to various support functions, including: service publicity; job vacancy advertising; local authority and customer liaison and supporting the ongoing appeal by PBL against the Lancashire Concessionary Travel Agreement 2009/10 which was in legal process; stock control; maintenance of fleet records; fuel deliveries; property; health and safety; service monitoring; engineering KPIs and matters of a regulatory nature affecting the operator's licence; and disciplinary procedures. Support services were supplied by Stagecoach to PBL on standard commercial terms.

Defined benefit pension liability

12. PBL is liable for an annual pension contribution of £0.244 million a year relating to a historical deficit. We understood that the contributions were recharged to PBL in the management accounts. However, it was evident that on the basis of current financial performance, PBL had become dependent on Stagecoach to fund these contributions.

Reconfiguration of PBL

Financial performance of PBL

Financial performance of PBL (2006 to 2009)

13. As shown in Appendix C, Table 1, PBL was profitable in the four years up to and including the financial year ended 1 April 2007. PBL's financial statements also show that it was profitable in 2003. Although PBL generated a positive EBITDA margin in the year ended 30 March 2008, it was loss making at the operating profit level in 2008 and also in 2009, coinciding with the period of abnormal competition during this time.

14. Based on PBL's management accounts, total revenue in the financial year 2008/09 was £10.95 million and, assuming no further changes to the business, will decline by approximately £[✂] million (or [✂] per cent) to an indicative forecast revenue of £[✂] million in the equivalent 52-week period for 2009/10 (before adjusting for recent fare increases).[1] Stagecoach told us that the majority of the reduction in PBL revenue was currently recognized elsewhere within Stagecoach (in particular at the Frenchwood Depot).

15. Stagecoach told us that the main cause of the weak financial performance was a loss arising to concessionary fare reimbursements from LCC; a second cause was a possible mismatch between services levels, patronage, fare levels and costs; and a third reason was current working practices at PBL. We acknowledged that these comments were made by Stagecoach under the limitations on access to detailed information about PBL's performance given the interim undertakings in place.

16. We investigated the recent financial performance of PBL. We concluded that the largest factor contributing to the deterioration in PBL's revenue was the route transfers implemented by Stagecoach on 22 March. Our analysis of PBL's management accounts showed that commercial bus revenue (represented by the total of on-bus and off-bus revenues) was £[✂] million in 2008/09 and is expected to fall to a forecast of £[✂] million in 2009/10, a decline of £[✂] million. We also examined the on-bus revenue on routes affected by the reconfiguration of PBL's network in the same period, and we found that £[✂] million of the decline in PBL revenue could be attributed to changes in on-bus revenue on routes subject to the network revisions.[2] We did not have sufficient information to attribute fully the decline in commercial revenue to individual PBL routes or changes in off-bus revenue. We estimated that in 2009/10 the concessionary revenue reimbursement could be expected to fall from £[✂] million to £[✂] million, and that this decline of £[✂] million revenue would be due to a combination of factors including the reduction in the PBL network, a temporary reduction in fares and the decline in the reimbursement rate paid by LCC. We concluded that the reduction in concessionary fare reimbursements was not the largest cause of the reduction in revenue. A number of external factors, (including economic factors, the reduction in LCC re-imbursement rate and changes in variable costs including fuel duties) contributed to the issues faced by PBL but these were issues faced by all bus operators within and around Preston, whereas the route transfers had a specific adverse effect on PBL.

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[1]We noted that Stagecoach has changed the PBL year-end to 30 April, and that this change of year-end would result in the preparation of PBL's statutory accounts for a 56-week period in 2008/09. For the purposes of comparison, the analysis presented in this appendix was prepared using the following periods: 2008/09 (1 April 2008–29 March 2009) and 2009/10 (30 March 2009–28 March 2010).

[2]PBL services: [✂].

17. At the current reduced level of revenue and current costs, PBL is loss-making. On an annualized basis using data from April to August 2009, assuming no further changes to the business since that time period, it is likely that PBL will generate a loss, at the level of depot contribution (ie before head office costs) in the region of £[✂] million in 2009/10. Whilst the revenue of PBL has reduced since the prior year, there has not been a corresponding reduction in the operating costs of the business. This may be indicative of a number of factors, including the relative profitability of routes retained by PBL and those transferred to other parts of Stagecoach or reregistered by it, costs employed in the business and other external factors. In light of the gaps in commercial and financial management at PBL since the completion of the acquisition the cost structure of PBL was not under review and no mitigating actions were under way to restore the business to profitability.

Balance sheet

18. The ongoing losses of PBL resulted in a decline in the strength of PBL's balance sheet from a position of [✂] at the date of the acquisition[3] to [✂][4] in September 2009.

Illustrative reconfiguration of PBL revenue

19. We considered how PBL could be reconfigured to achieve an effective remedy. This would involve a reversal of service changes made by Stagecoach on 22 March 2009, restoring the services [✂], based on the current revenue for these services within Stagecoach. Alongside this, it would be likely that PBL would review its commercial network more broadly, and examine its cost structure to align it with the revenue base. For the reasons set out in paragraphs 10.31 and 10.32 of the main report we have not prepared a profit forecast.

20. During the inquiry, PBL obtained consent from the CC to increase fares from 21 September 2009. We understand that based on the pattern of fares in operation, the blended fare increase across the PBL services is [✂] per cent. Applied to the current run-rate of commercial revenue (ie before the reconfiguration of PBL services), this would result in a revenue uplift of approximately £[✂] million a year, excluding concessionary revenue.

21. The analysis of on-bus revenue indicates that a revenue uplift of approximately £[✂] million could be expected to flow to PBL from restoring the services [✂], based on the current year revenue for these services within Stagecoach adjusted for the September 2009 fare increase. We understand that the Stagecoach data does not include off-bus ticket sales.

22. During the inquiry, the MT reviewed the revenue of PBL and identified a number of other adjustments that are required to the management accounts including the reversal of some or all of the recharge of PBL ticket sales to Stagecoach, which would add approximately £[✂] million off-bus revenue a year.

23. The preceding steps total £[✂] million of incremental revenue. Based on the blended fare increase of [✂] per cent and the shift observed between on-bus and off-bus

[3]As at 5 January 2009, unaudited management accounts.
[4]As at 21 September 2009, unaudited management accounts.

ticket sales, this uplift is less than the £[✂] million fall in on-bus and off-bus revenue from £[✂] million to £[✂] million between 2008/09[5] and 2009/10.[6]

24. We would expect that a more detailed analysis performed for the purposes of due diligence during the divestiture process may result in revisions to these estimates. For example, the MT reported to us that bus advertising revenue had not been allocated to PBL management accounts in periods 1–5, amounting to £[✂] million a year.

Concessionary fares

25. We understand that in 2008/09 the concessionary revenue reimbursement with LCC was approximately £[✂] million. This appears broadly consistent with the PBL management accounts for 2008/09, which showed concession revenue to be £[✂] million.

26. The annualized management accounts for 2009/10 indicate that PBL will receive in the region of £[✂] million of concessionary fare reimbursement (ie a reduction of £[✂] million year on year). This decline is partly due to Stagecoach's decision to reduce the size of PBL's network following the 22 March route changes, but also reflects PBL's fares during this period as well as the reduction in the reimbursement rate.

27. The increase in PBL fares in September 2009 will have a positive effect on PBL's LCC reimbursement of approximately [✂] per cent (approximately £[✂] million a year based on the PBL network immediately after the 22 March 2009 changes). A re-configuration of PBL to include services [✂], based on the current reimbursement rates and the fares in operation since 21 September 2009 would further offset the fall in concessionary fare revenue, adding approximately £[✂] million additional revenue per year. The analysis we performed on the reconfiguration of PBL indicated that the annualized level of concessionary revenue would be in the region of £[✂] million after the reinstatement of routes and the fare increases. The reversal of the route changes and higher fare levels would not offset the decline in the LCC reimbursement rate for concessionary fares and this issue affects all bus operators in the region, and is independent of the merger.

Result of illustrative revenue reconfiguration

28. As set out above, based on the information available to us, we estimated the revised annual revenue for PBL following the reconfiguration. Our estimate of annual local bus revenue[7] was £[✂] million (compared with £[✂] million estimated for 2009/10). The £[✂] million difference between the two values was £[✂] million revenue stemming from the reconfiguration of the PBL routes, and a £[✂] million stemming from the fare increases on 21 September 2009 applied to the routes operated by PBL at that date. The revised total revenue[8] of PBL was estimated at £[✂] million per year ([✂] per cent below 2008/09). As shown in Appendix C, Table 1, the average annual revenue of PBL for the four years ended 30 March 2007 was £10.58 million. The reconfigured total revenue of PBL was therefore estimated to be [✂] per cent [✂] the average revenue in this four year historical period.

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[5]Source: management accounts.
[6]Source: management accounts for 20 weeks ended August 2009, annualized to 52 weeks.
[7]Local bus revenue comprises commercial revenue, tenders, scholars and concessionary fares.
[8]Total revenue comprises local bus revenue and miscellaneous revenue, including the CVRM contract and advertising.

Effect on Stagecoach Preston

29. The effect of transferring routes from Stagecoach back to PBL would have a corresponding negative impact on the revenue of the respective Stagecoach operation (eg Frenchwood depot). The effect would be a reversal of the increase in Stagecoach Preston revenue that stemmed from the route transfers after the acquisition.

Estimate of consumer detriment and relevant customer benefits

1. This appendix sets out details of the estimate of consumer detriment and RCB.

TABLE 1 **Calculation of the size of consumer detriment**

Step	*Variable*	*Value £m*
S1	Combined revenues of Stagecoach and PBL in April 2009	[✂]
	(Based on the data provided by the parties in response to the CC questionnaire, Data Request, Question 7.)	
S2	Annual combined revenues for Stagecoach and PBL	[✂]
	(Based on the April 2009 figure which was annualized, ie S2=(S1/5)*52. This is because the April 2009 figure is based on a five-week accounting period (Stagecoach's practice) and there are 52 weeks in a year)	
S3	Annual consumer detriment following a 5% price increase	[✂]
	(Calculated as the annual combined revenues for Stagecoach and PBL multiplied by 5%, ie S3=S2*0.05.)	
S4	Annual consumer detriment following a 9% price increase	[✂]
	(Calculated as the annual combined revenues for Stagecoach and PBL multiplied 9%, ie S4=S2*0.09.)	

Source: CC calculations based on Stagecoach data.

TABLE 2 **Estimate of the required RCB—CC's methodology**

Step	*Variable*	*Value*
S1	Combined passenger journeys of Stagecoach and PBL in April 2009 (Based on the data provided by the parties in response to the CC questionnaire, Data Request, Question 7.)	0.88m
S2	Annual combined passenger journeys for Stagecoach and PBL (Based on the April 2009 figure which was annualized, ie S2=(S1/5)*52. This is because the April 2009 figure is based on a five-week accounting period (Stagecoach's practice) and there are 52 weeks in a year)	9.19m
S3	Combined revenues of Stagecoach and PBL in April 2009 (Based on the data provided by the parties in response to the CC questionnaire, Data Request, Question 7.)	£[✂]
S4	Annual combined revenues for Stagecoach and PBL (Based on the April 2009 figure which was annualized, ie S4=(S3/5)*52. This is because the April 2009 figure is based on a five-week accounting period (Stagecoach's practice) and there are 52 weeks in a year)	£[✂]
S5	The maximum percentage of passenger journeys that could benefit from an integrated network (Based on the TAS survey.)	3.2%
S6	The maximum number of passenger journeys that could benefit from an integrated network (Calculated as the annual combined passenger journeys multiplied by 0.032, ie S6=S2*S5.)	0.29m
S7	Average per-journey price (Calculated as annual combined revenues divided by annual combined passenger journeys, ie S7=S4/S2.)	£[✂]
S8	Average per-journey price following a 5% price increase (Calculated as per-journey price multiplied by 1.05, ie S8=S7*1.05.)	£[✂]
S9	Consumer detriment incurred by all passenger journeys following a 5% price increase (See Table 1 for calculation.)	£[✂]
S10	Average per-journey discount that the network-using journeys would need to obtain if their RCB were to outweigh the consumer detriment to all journeys arising from a 5% price increase (The RCB can be calculated as a benefit obtained by each network-using journey multiplied by the number of the network-using journeys, ie S10*S6. If the post-merger consumer detriment is to be defeated by the RCB arising from the network integration, the RCB needs to be at least as high as the consumer detriment identified, ie S9 ≤S10*S6. By solving this equation we obtain the benefit that network-using passenger journeys would need to obtain in order to generate a benefit that would match the identified consumer detriment, ie S10 ≥S9/S6.)	≥£1.17

Source: CC calculations based on Stagecoach and TAS data.

TABLE 3 **Estimate of the RCB arising from the merger—Stagecoach's methodology**

Step	*Variable*	*Value*
S1	Combined passenger journeys of Stagecoach and PBL in April 2009	0.88m
	(Based on the data provided by the parties in response to the CC questionnaire, Data Request, Question 7.)	
S2	Annual combined passenger journeys for Stagecoach and PBL	9.19m
	(Based on the April 2009 figure which was annualized, ie S2=(S1/5)*52. This is because the April 2009 figure is based on a five-week accounting period (Stagecoach's practice) and there are 52 weeks in a year)	
S3	The minimum percentage of passenger journeys that could benefit from an integrated network	1.5%
	(Based on the TAS survey, indicates a typical use of network if a similar town to Preston)	
S4	The maximum percentage of passenger journeys that could benefit from an integrated network	3.2%
	(Based on the TAS survey, indicates the maximum number of passenger journeys that could benefit from an integrated network in the Preston area)	
S5	The minimum per-day saving for network-using passengers	£0.50
	(Lower bound of the Stagecoach's estimate)	
S6	The maximum per day saving for network-using passengers	£2
	(Upper bound of the Stagecoach's estimate)	
S7	The minimum per-journey saving for network-using passengers	£0.13
	(Calculated from the lower bound of Stagecoach's estimates of per day savings by assuming that a typical daily pattern of the network use would involve at least four journeys. We understand that this is in line with the approach taken by TAS. S7=S5/4)	
S8	The maximum per-journey saving for network-using passengers	£0.50
	(Calculated from the upper bound of Stagecoach's estimates of per day savings by assuming that a typical daily pattern of the network use would involve at least four journeys. We understand that this is in line with the approach taken by TAS. S8=S6/4)	
S9	The minimum RCB arising for network-using passengers	£0.02m
	(Calculated as the lower bound estimate of the network-using passenger journeys times the lower bound estimate of a per-journey saving, ie S9=S2*S3*S7)	
S10	The maximum RCB arising for network-using passengers	£0.15m
	(Calculated as the upper bound estimate of the network-using passenger journeys times the upper bound estimate of a per-journey saving, ie S9=S2*S4*S8)	

Source: CC calculations based on Stagecoach and TAS data.

Glossary

Act	Enterprise Act 2002.
Actual competition	A company operating bus services within Preston on particular routes or **flow**s in competition with **PBL** or **Stagecoach**. Also referred to as head-to-head competition.
Actual potential competition	A distinction can be made between 'actual potential competition' where one of the parties is actually planning to enter the other party's market, and 'perceived potential competition' where the behaviour of one of the parties is constrained merely by the theoretical possibility of entry by the other firm.
Arriva	Arriva plc. A UK-based transport company that operates buses and trains in the UK and Continental Europe. Its UK Regions business represents about two-thirds of the UK Bus division.
AVC	Average variable costs.
Biscuit management accounts	A specific set of management accounts prepared at each period end for the **new intra-urban routes** based on **incremental costs**.
Blue Bus	Rojay Services Limited, trading as Blue Bus. A bus operator running services within the **Preston area**.
BSOG	Bus Service Operators Grant is a grant paid by the **DfT** to reimburse bus operators for some of the excise duty paid on the fuel consumed in operating eligible local bus services.
Bus route	A service provided by a bus under a particular number.
Commercial services	Bus services other than **tendered services**.
Concessionary fare scheme	A scheme made by a county or district council under the Transport Act 1985 enabling the elderly, the disabled or children to travel on buses free or at reduced fares. The Concessionary Bus Travel Act 2007 provides that everyone aged 60 and over or disabled can travel free, off-peak, on all local buses in England.
CVRM	The Commercial Vehicle Repair and Maintenance business of **PBL**.
Demand complementarities	When the utility of one product or service is enhanced by the provision of additional similar products or services. In this context, passengers may value a **network** of routes more than individual routes if it allows them more easily to make a variety of journeys.
Depot	A facility where buses can be stored when not in service, and which may include maintenance and refuelling facilities.
DfT	Department for Transport.

EBIT	Earnings before interest and tax. It is derived by deducting depreciation and amortization from **EBITDA**.
EBITDA	Earnings before interest, tax, depreciation and amortization.
EBT	Employee Benefit Trust. The **PBL** EBT owned a majority of the ordinary shares of **PBL**.
EV	Enterprise Value, a measure of a firm's value equal to the market values of: *(a)* the firm's issued shares (equity value); plus *(b)* its net debt (total debt less cash and liquid investments); plus *(c)* minority interest and associates.
First Group	FirstGroup plc. One of its divisions, First UK Bus, is the largest bus operator in the UK.
Fishwicks	John Fishwick and Sons Limited, a long-established provider of bus and coach services in Lancashire, including services within the **Preston area**.
Flow	A flow is any connection between two specified points. Flows might correspond to an end-to-end route, but they might also correspond to shorter journeys between intermediate points on a route (eg bus stops or fare stages).
FRS, FRS17	Financial Reporting Standard. FRS17 Retirement Benefits. FRS17 sets out the accounting treatment for defined benefit pension schemes, such as the arrangements for **PBL** employees transferred from the **LGPS** to the **WMPTA** Superannuation Scheme when the company was sold to its employees in 1993.
Go-Ahead	The Go-Ahead Group plc. Its Bus division is one of the larger UK bus operators.
Incremental costs	Those costs that are included in **Stagecoach**'s **Biscuit management accounts**; these represent the additional costs incurred by **Stagecoach** in operating the **new intra-urban routes**.
Inter-urban route	Route that runs between urban centres.
Intra-urban route	Route that runs within a single urban centre.
Keolis	Keolis (UK) Limited, a subsidiary of Keolis SA, a French transport group.
KPMG	KPMG LLP. The auditor of **PBL** and **PTHL**, which advised them on the sale of **PBL**.
LCC	Lancashire County Council.
LGPS	Local government pension scheme.
Local Transport Plan	Sets out a local authority's local transport strategies and policies, and an implementation programme.
LTA	Local transport authority.

Multi-operator ticket	Tickets which are accepted by other operators as well as by the operator that issued it.
Network	A collection of interconnected routes. This can be defined in relation to a particular operator's services or a wider geographical area.
Network ticket	Used mainly to refer to tickets that allow travelling on more than one route, usually over a period of time, for example weekly or monthly, only on the services of one operator.
New intra-urban routes	The new routes 11, 9 (16), 19/22, 33 and 32 which **Stagecoach** launched between June and October 2007.
OFT	Office of Fair Trading.
On-bus revenue	Income taken on the bus as a result of direct ticket sales.
Orbit service	The Orbit service was introduced by **PBL** in October 2006, supported by Kickstart funding and by **LCC**.
Overlap flow	A **flow** on which two or more transport operators operate bus services.
Own-price elasticity	The extent to which, for example, demand for a bus service would respond to an increase in price.
Pax	Passenger numbers.
PBL	Preston Bus Limited, formerly Preston Transport Limited, the principal bus operator in Preston until its acquisition by **Stagecoach**.
PBL Trustees Limited	A wholly-owned subsidiary of **PTHL** which acted as the principal trustee of the **EBT**.
PCC	Preston City Council (Preston Borough Council until Preston achieved City status in 2002). Owner of **PBL** until the employee buyout in 1993.
Perceived potential competition	See **actual potential competition**.
Potential competition	Potential for head-to-head competition on **bus route**s that in itself acts as a significant competitive constraint.
Preston area	The area around and within Preston served by **PBL** and/or **Stagecoach** before the merger, but excluding areas served only by Stagecoach's **inter-urban routes**.
Preston Citi	The service **network** set up by **Stagecoach** in 2007, in competition with most of the intra-urban services then operated by **PBL** in the **Preston area**. Also known as the Citi network. This incorporated routes 1, 2/2A, 3/3A and the **new intra-urban routes.**
PTHL	Preston Transport Holdings Limited, the parent company of **PBL**.

PVR	Peak vehicle requirement, the maximum number of buses required to maintain planned services on a **bus route** or **network**.
Quality Partnership	A Quality Partnership Scheme (QPS) is a statutory scheme introduced by the Transport Act 2000. QPSs are made by the local transport authority following consultation with bus operators provided they meet required quality standards and provide undertakings to the Traffic Commissioner about standards of service. The undertakings may include: service frequency and timings; emissions and noise; driver training; punctuality; and reliability. The undertakings are provided in exchange for access to facilities provided by the transport authority such as bus lanes, bus shelters, lighting, seating and passenger displays.
ROCE	Return on capital employed. A measure of the rate of return of a business.
Route	An end-to-end service. Routes in the **Preston area** are taken to include all routes that serve any location in the **Preston area** even if they begin in, end in, or serve for the majority of their journey, locations outside the **Preston area**.
SLC	Substantial lessening of competition.
SSNIP Test	Small but significant non-transitory increase in price: a conceptual approach used to help define the relevant market or markets.
Stagecoach	We use the term 'Stagecoach' to refer to any UK subsidiary or division of **Stagecoach Group plc**, as the context requires. We also refer as appropriate to **Stagecoach Northwest** and **Stagecoach Preston**.
Stagecoach Bus Holdings Limited	A wholly-owned subsidiary of **Stagecoach Group plc**. It is the holding company for most of **Stagecoach UK Bus**. It purchased **PBL** from **PTHL**.
Stagecoach Group plc	See **Stagecoach**. It is the ultimate holding company of **Stagecoach Bus Holdings Limited** and **Stagecoach (North West) Limited**.
Stagecoach Northwest	A division of **Stagecoach UK Bus**, which manages seven **depot**s in Cumbria and Lancashire.
Stagecoach (North West) Limited	A wholly-owned subsidiary of **Stagecoach Bus Holdings Limited**. It is the legal entity which covers most of the activities of **Stagecoach Northwest**.
Stagecoach Preston	**Stagecoach**'s operations in the **Preston area**.
Stagecoach UK Bus	Also 'UK Bus'. A Stagecoach division which carries on most of Stagecoach's bus operations in the UK.
Tendered services	Services operated under contract to local authorities, which seek tenders for doing so; these services are not operated commercially.

Total allocated costs The allocated costs by route from **Stagecoach**'s management reporting documents; these are split into allocated direct costs, allocated depot costs and allocated head office costs.

Traffic Commissioner Appointed by the Secretary of State for Transport, have responsibility in their area for the licensing of the operators of buses and coaches and the registration of local bus services.

Traffic Regulation Conditions The **Traffic Commissioner** may determine traffic regulation conditions at the request of a local authority. The conditions apply to all local services in the area specified and may be used only when required to prevent dangerous traffic conditions, reduce severe traffic congestion or reduce noise and air pollution.

Transdev Transdev Blazefield Limited, which provides local bus services in Yorkshire and Lancashire under the Transdev name.

Veolia Veolia Transport UK Limited. It has been operating buses in the UK since 2005. It is a wholly-owned subsidiary of Veolia Environnement SA.

VOSA Vehicle and Operator Services Agency. It monitors services on behalf of the Traffic Commissioners.

WMPTA West Midlands Passenger Transport Authority.