COMPETITION COMMISSION

# STAGECOACH GROUP PLC/PRESTON BUS LIMITED MERGER INQUIRY

A report on the completed acquisition by Stagecoach Group plc of Preston Bus Limited

Published: 11 November 2009

The Competition Commission has excluded from this published version of the report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. Some numbers have been replaced by a range. These are shown in square brackets. Non-sensitive alternative wording is also indicated in square brackets.

## Members of the Competition Commission who conducted this inquiry

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# Summary

1. On 28 May 2009, the Office of Fair Trading (OFT), in exercise of its duty under section 22(1) of the Enterprise Act 2002 (the Act), referred to the Competition Commission (CC) for investigation and report the completed acquisition of Preston Bus Limited (PBL) by Stagecoach Group plc (Stagecoach).

2. Stagecoach is an international public transport group with bus and rail operations in the UK and North America. Its operating unit, Stagecoach Northwest, operates bus services from seven depots across Lancashire and Cumbria, including from a freehold depot in Preston. Its Preston depot was the worst performing of the seven northwest depots in 2007. The profitability of the depot worsened significantly from June 2007 and it made operating losses both in 2008 and 2009.

3. Preston Transport Ltd was formed in 1986 to take over Preston Borough Council's Transport Department. In 1993 the company was sold to its employees, but over time employee ownership has declined and by 2008, only 94 employees held shares. PBL operated 125 buses from a freehold depot and employed approximately 300 people before the merger. PBL provided intra-urban bus services in the Preston area. Up to June 2007, the company was profitable, averaging profits of £157,000 in the four years to March 2007. The financial health of the company deteriorated rapidly from June 2007 and by September 2008 PBL was in severe financial difficulties.

4. The share purchase agreement providing for the sale to Stagecoach Bus Holdings Ltd of all the share capital of PBL was signed on 23 December 2008. The merger was completed on 23 January 2009.

5. We are satisfied that Stagecoach and PBL are enterprises for the purposes of the Act, and that they have ceased to be distinct as a result of these transactions. Based on Stagecoach's estimates of the share of commercial and tendered mileage operated in the Preston area, PBL had a share of supply of around 54 per cent and Stagecoach had a share of around 42 per cent. The share of supply test is therefore satisfied in respect of the supply of bus services in the Preston area.

6. We found that the sequence of events that concluded with the acquisition of PBL by Stagecoach began in 2006. Shortly after a meeting between Stagecoach and PBL in July 2006 at which PBL rejected Stagecoach's expression of interest in an acquisition of PBL, Stagecoach developed a plan for expansion in the Preston area and less than one year later launched a number of intra-urban services in direct competition with PBL. This expansion had a number of characteristics which have caused us to conclude that it was not driven by normal commercial considerations and that conditions of competition in the period preceding the merger were accordingly abnormal. Most notably, between the date of their launch in June 2007 and the acquisition, Stagecoach's intra-urban services in Preston suffered considerable losses, which were not compensated for by profits elsewhere in its Preston operation. PBL's financial position deteriorated rapidly in the months that followed and its owners were ultimately left with little choice but to sell PBL to Stagecoach.

7. In our view, Stagecoach's actions in Preston since July 2006, including the continued operation of heavily loss-making routes in direct competition with PBL, were not consistent with its stated objective of gaining a minority share of the intra-urban Preston market in order to improve the profitability of its Preston depot. It seemed to us that the outcome of the period of abnormal competition that resulted from these actions was governed primarily by the scale of losses both protagonists were prepared and

able to support, given the level of financial resources available to them and, critically to the eventual outcome, the period for which each was able to do so.

8. We did not, therefore, regard it as appropriate to adopt a counterfactual to this merger by reference to the situation prevailing in the market and for PBL at the time of the merger. Specifically, we did not accept (as Stagecoach argued) that we should assess the counterfactual immediately pre-merger and so find that PBL was a failing firm and that Stagecoach would inevitably have ended up with as high a share of the market for bus services in Preston as it now has following the merger.

9. We concluded that the most recent period of normal competition should form the starting point for the assessment of the counterfactual (ie the degree of competition that would have been expected to occur without the merger). On this basis, we took the starting point for our assessment to be the situation that prevailed in late 2006 and early 2007, before the beginning of the period of abnormal competition, and went on to consider whether there were reasons to expect that, in the absence of a merger between them, PBL and Stagecoach would have respectively continued to run their bus operations in Preston in a manner similar to that in the most recent period of normal competition. Having reviewed the available evidence, we reached the view that PBL would indeed have continued to run its bus operations in Preston in much the same way as it had done in previous years. Stagecoach Preston would also, we expected, have continued to operate its old routes while seeking improved profitability, possibly as part of Stagecoach Northwest or in the hands of another operator. The competitive conditions against which it is appropriate to assess the competitive effects of the merger would therefore, we expected, have been similar to those which existed before the commencement of abnormal competition in 2007.

10. We found that the markets for tendered and commercial bus services in the Preston area were distinct. In relation to commercial services, we found that from the demand-side perspective, the relevant market could be defined as the supply of services on point-to-point journeys within the Preston area. We recognized, however, that there was scope for supply-side substitution. Given that Stagecoach and PBL were the only two competitors of sufficient scale that were either actually or potentially present on each flow, we found it convenient to aggregate the competitive conditions on individual flows for the purposes of our competitive assessment and consider the supply of commercial bus services in the Preston area as a whole. Other forms of transport should not be included in the relevant market and further segmentation according to the different types of customers is not necessary.

11. We found that before June 2007 PBL was constrained by Stagecoach in the form of both actual and potential competition. This constraint manifested itself in the provision of a comprehensive network of frequent services and low fares. Stagecoach was constrained by actual and potential competition from PBL to a lesser extent than PBL was by Stagecoach. The constraint imposed by potential competition from PBL took three forms: *(a)* a possibility that PBL might enter on its routes; *(b)* a constraint from PBL's high frequencies and low fares which were set by PBL to pre-empt entry on PBL's routes; and *(c)* Stagecoach's expectation that PBL would be purchased by another, more efficient, operator that could enter into more direct competition with Stagecoach. We found that following the merger entry on the scale that could counteract the loss of competition we identified was unlikely to occur.

12. We have concluded that by removing the constraints, both actual and potential, exerted on each other by Stagecoach and PBL, the merger has resulted in a substantial lessening of competition (SLC) in the market for the provision of commercial bus services in the Preston area. This can be expected to lead to a worsening in the

price and non-price factors in relation to which the parties exerted a competitive constraint on each other, either directly or as potential competitors.

13. We have also concluded that the merger would not be likely to result in an SLC in the market for the provision of tendered bus services in the Preston area.

14. We examined a number of possible remedies, including: a divestiture of PBL; other divestiture packages including a divestiture of a sub-group of routes (excluding a depot); behavioural remedies aimed at facilitating new entry and expansion; and behavioural remedies aimed at controlling outcomes.

15. As a result of the extensive changes made by Stagecoach to the PBL business, in particular the transfer of a substantial proportion of PBL's commercial services shortly after the merger to Stagecoach's Preston operation, PBL as currently constituted is not capable of competing with Stagecoach. We considered, however, that a reversal of the changes made by Stagecoach to the business was practicable and that, in the hands of a new owner, PBL was capable of being reconfigured as a commercially viable business. We concluded that divestiture of a reconfigured PBL to a suitable purchaser would result in Stagecoach facing a competitor of sufficient scale and with sufficient coherence of operations to restore substantially or fully the degree and nature of the potential and actual competition lost as a result of the merger. Such a divestiture would therefore be an effective remedy.

16. We concluded that a partial divestiture package comprising only routes and related assets, but excluding a depot, would not be capable of remedying the loss of both actual and potential competition resulting from the merger.

17. Due to their substantial intrinsic risks, we had little confidence that anti-retaliation measures would have any more than a marginal effect in addressing the SLC we had found. We did not consider that these risks could be adequately addressed by changing the design of the remedy.

18. We concluded that behavioural remedies to control fares, service levels and/or operating profit would not be effective in remedying the SLC at all and would only be of limited effectiveness in addressing the adverse effects of the merger.

19. We therefore concluded that only a divestiture of a reconfigured PBL would be an effective remedy.

20. We considered whether this remedy would be proportionate to the SLC and adverse effects we had found. In doing so, we estimated the likely size of the detriment caused by the SLC, the relevant costs of the divestment and relevant customer benefits. We found that Preston City Council's (PCC's) exposure to PBL's pension liability should be taken into account during the divestiture process and concluded that the remedy should preferably be implemented via a sale of shares, rather than an asset sale. We found that the only relevant customer benefit that had resulted from the merger was integrated ticketing. The evidence showed that this benefit was likely to accrue to a very small proportion of customers and that its value was likely to be significantly lower than our estimate of the customer detriment resulting from the merger, which we expected to be substantially avoided by putting in place an effective remedy. We concluded that the relevant consumer benefit arising from this merger was not so significant that it would justify modification of our remedy decision.

21. We therefore concluded that Stagecoach should be required to divest a reconfigured PBL to a suitable purchaser within a suitable divestiture period. While we are not requiring behavioural commitments from Stagecoach in relation to the divested busi-

ness, we would be prepared to consider a time-limited restriction on Stagecoach's activities as they affect competition with the divested business, for a limited period of no longer than 12 months, where this can be demonstrated as being necessary to enable the purchaser to establish itself as an effective competitor.

# Findings

## 1. The reference

1.1 On 28 May 2009, the OFT, in exercise of its duty under section 22(1) of the Act, referred to the CC for investigation and report the completed acquisition of PBL by Stagecoach.

1.2 The reference requires us to determine:

*(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 an SLC within any market or markets in the UK for goods or services.

1.3 We published a summary of our provisional findings on 3 September 2009 and the full provisional findings report on 7 September. We are required to report by 12 November 2009. Our terms of reference are in Appendix A, together with an explanation of how we have conducted our inquiry and the steps we took to ensure that there were no actions taken during the course of our inquiry which might prejudice the reference or impede the CC's ability to take any remedial action that might be determined to be necessary, including measures to ensure that there was no further integration between Stagecoach and PBL.

1.4 This document (including its appendices) constitutes the final report that we must publish under section 38(1) of the Act. Non-commercially-sensitive versions of the main-party and third-party written submissions and summaries of hearings with third parties are on our website[1] along with other documents relevant to this inquiry. We cross-refer to them where appropriate.

1.5 In the course of the inquiry, we received evidence from a number of Stagecoach senior managers and from three former directors of PBL. We have explicitly attributed views or actions to specific individuals, without naming them, where appropriate due to the substance of the argument being made or where the views of different individuals diverged. Otherwise, we refer to the views or actions of senior management collectively as Stagecoach and the former management of PBL.

## 2. The companies

### *Stagecoach*

2.1 Stagecoach is an international public transport group with bus and rail operations in the UK and North America. It employs around 30,000 people and runs around 12,000 buses and trains. Results for the year to 30 April 2009 showed that group companies had an operating profit of £172.2 million on revenue of £2,103.3 million. Its largest division is UK Bus with an operating profit of £125.6 million (73 per cent of the group total) on revenue of £830.8 million (39 per cent of the group total).

2.2 UK Bus has a headquarters team in Perth. It manages 18 geographically distinct operating units, each with its own managing director, operations director and engineering director. One of these is Stagecoach Northwest, based in Carlisle, which is

[1] www.competition-commission.org.uk/inquiries/ref2009/preston/index.htm.

responsible for seven depots, four in Cumbria (Barrow, Carlisle, Kendal and West Cumbria) and three in Lancashire (Chorley, Lancaster and Preston).

2.3 Stagecoach Bus Holdings Ltd is a subsidiary of Stagecoach and is the holding company for most of UK Bus. It was the company that acquired the shares in PBL. Some of its subsidiaries hold operator licences. Those that are active in the north-west region include Stagecoach (North West) Ltd, which has authorization for 420 vehicles, and Ribble Motor Services Ltd, which has authorization for 200 vehicles including those operated from its Preston depot, but is otherwise dormant.

2.4 The accounts of Stagecoach (North West) Ltd for the year to April 2008 state that it was operating a fleet of 536 buses and employing 1,322 people in and around Cumbria and Lancashire. There was a pre-tax loss of £24,000 on turnover of £47.6 million. It was operating predominantly local bus services, carrying around 108,000 passengers a day.[2]

2.5 In 2001 Stagecoach sold three of its north-west depots to Blazefield Holdings (now a subsidiary of Transdev). Stagecoach had considered selling its Preston depot too, but decided to retain it because it supported other parts of the Stagecoach business in the region.

2.6 Stagecoach operates in Preston from a freehold depot in Frenchwood Avenue. The Preston operation also manages and supports an outstation[3] located in Fleetwood. Stagecoach leases stands and space at the bus station in Preston city centre from PCC. Since the beginning of 2007, its fleet has grown from 88 to 120 buses.[4] With an operating margin of [✂] per cent generated from £[✂] million of revenue, Stagecoach's Preston depot was the worst performing of the seven north-west depots in 2007. Stagecoach told us that the low profitability of the depot was due to its reliance on inter-urban services.

2.7 The profitability of the depot worsened significantly from June 2007: it made an operating loss of almost £[✂] million in 2008 and of £[✂] in 2009. The financial performance of Stagecoach's Preston depot is discussed in detail in Appendix B.

### *PBL*

2.8 The company was formed as Preston Transport Ltd in 1986 to take over Preston Borough Council's Transport Department. In 1993 the company was sold to its employees, each of whom was allowed to subscribe £1,000 for 1,000 shares in Preston Transport Holdings Ltd (PTHL), a non-trading holding company. The shares were widely held and were valued annually by a firm of accountants. When they left the company or retired, employees were required to sell their shares to the Employee Benefit Trust (EBT). Although new employees were allowed to buy shares, in practice very few had done so, possibly due to a significant increase in the valuation of the shares shortly after privatization. Over time, employee ownership had therefore declined and by 2008, only 37.7 per cent of the ordinary shares were directly owned by employees. There were 94 employee shareholders, of whom 58 had the maximum holding of 1,177 shares (0.45 per cent of the total). The EBT held the remaining 62.3 per cent. About 200 employees of PBL did not hold shares in PTHL.[5] The former management of PBL told us that over the next ten years many more of the

[2]Directors' report in statutory accounts.
[3]This facility houses [✂] buses and [✂] staff.
[4]Includes the Frenchwood depot and Fleetwood outstation.
[5]Average employee numbers in financial year 2008 were 295. There were 94 shareholders listed in the annual return dated 16 October 2009.

employee shareholders would have left, and that ultimately the remaining share-holders or the directors may well have considered selling the company.

2.9 PTHL had two wholly-owned subsidiaries, PBL and PBL Trustees Ltd. PBL met all the expenses of the two other group companies. EBT is a separate entity, which has been entirely funded through loans from PBL.

2.10 PBL operates from a freehold depot at 221 Deepdale Road, which currently houses 95 buses and 249 staff. Before the merger there were 125 buses and approximately 300 staff.[6] The depot is also used by PBL for its CVRM[7] business, which has a contract with PCC to maintain and refuel its vehicle fleet. Management accounts show that this contract gave it revenues of almost £[✂] million in the year to March 2008 out of total revenues of £[✂] million, and a contribution of about £[✂] out of a total for the company of £[✂] million, providing PBL with a significant, steady income stream.

2.11 Like Stagecoach, PBL leases stands and space at the bus station owned by PCC.

2.12 In the four years to March 2007, PBL's operating profit before exceptional items averaged £157,000.[8] Its defined benefit pension scheme,[9] which had been closed to new members since 1986 but had remained in place for existing members, went into deficit in 2003. In the year to March 2006, PBL had to pay pension contributions of £438,000, compared with £157,000 in the previous year. This increase, which had led to a small operating loss, brought about the closing of the scheme for future service in 2006. The company returned to profitability and by May 2007, PBL had an annualized trading profit of £234,000 on revenues of £11.36 million.

2.13 PBL had a positive cash flow from operations in each of the four years to March 2007, and had built up a cash balance of £1.75 million by March 2007, despite £2.7 million of capital expenditure during that financial year. However, the financial health of the company deteriorated rapidly from June 2007: by December 2007, losses for the calendar year amounted to £379,000 on revenues of £11.4 million and by June 2008 annual trading losses had reached over £1 million. Detailed analysis of the performance of PBL since 2003, including the performance of its bus operations, is set out in Appendix C and Appendix G, paragraphs 52 to 56.

2.14 PBL's ownership structure had a profound impact on the way the company was managed and its financial results. This was described to us by Stagecoach as an aversion to change and a tolerance for inefficiency. However, others commented on the public service ethos of the company, which manifested itself in the high level and reliability of service provision across its comprehensive network.

## 3. The acquisition and the relevant merger situation

### *The acquisition*

3.1 KPMG approached Stagecoach in mid-September 2008, on behalf of PBL. An indicative offer was made on 10 October. After further discussions between the parties, a revised offer was submitted on 27 October, which was accepted. Following due

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[6]Numbers given to us by Stagecoach have varied between 295 and 306.
[7]Commercial Vehicle Repairs and Maintenance.
[8]We use an average to eliminate some of the variations in the cost of the defined benefit pension scheme.
[9]The scheme was originally a local government pension scheme, which was transferred to the West Midlands Passenger Transport Authority when PBL was sold to its employees, who had previously been local government employees. The scheme is described in Appendix D, paragraphs 4 to 10.

diligence and further negotiations centred on the pension fund liability,[10] the share purchase agreement was signed on 23 December.

3.2 The acquisition was completed on 23 January 2009. PBL's Managing Director immediately left the company and Stagecoach promptly proceeded with an integration of the combined local bus services in Preston.

## *The sale price*

3.3 Stagecoach set out the calculation underlying its preliminary offer. It estimated that PBL was making significant losses (around £1.7 million on annual revenue of £10.6 million), while its own depot was managing a little better than breakeven because of its services outside Preston itself. Stagecoach thought that the combined business could be restructured to achieve an operating margin of [✂] per cent. This suggested that there could be an operating profit of £[✂] million on PBL's revenues and earnings before interest, taxation, depreciation and amortization (EBITDA) of around £1.7 million. An EBITDA multiple of 3.5 times would give a base value of around £6 million. Stagecoach had been reluctant to go beyond a multiple of [✂] times, because of the apparently precarious position of the business and the significant restructuring that would be needed to get to the desired margin.

3.4 Stagecoach also estimated the future cash flows for PBL. Although Stagecoach estimated that its cost of capital was [✂] per cent, it had used a rate of [✂] per cent to reflect the risk in the model. A low case, assuming growth in revenues and costs of [✂] per cent a year and annual maintenance capital expenditure of £750,000, gave a net present value of just over £[✂] million. A high case, with revenue and cost growth of [✂] per cent and £[✂] of capital expenditure, gave a net present value of just under £[✂] million.

3.5 In relation to tangible assets, Stagecoach accepted the £[✂] million valuation of the depot recently carried out on PBL's behalf and valued the bus fleet at £[✂] million.

3.6 Stagecoach said that it was clear that the valuation range on a debt-free basis was between £6 million and £8 million (between 57p and 75p per £ of turnover). This was the enterprise value from which net debt would have to be deducted to give the equity value, the amount left for the shareholders. Net debt consisted of:

| | *£m* |
|---|---|
| Hire purchase | [✂] |
| Council debenture | [✂] |
| Less: Cash in bank | [✂] |
| Pension net deficit | [✂] |
| Sub-total | [✂] |
| Intercompany | |
| Due to PTHL | [✂] |
| Due from EBT | [✂] |
| | [✂] |
| Overall net debt | 3.2 |

3.7 Stagecoach's final offer reflected an enterprise value of £[✂] million less target net debt of £[✂] million, giving an equity value of £[✂] million. Actual net debt at completion was £[✂] million, increasing the equity value by £[✂]. The payment of this equity value to PTHL allowed it to make a distribution to its shareholders, including the EBT.

[10]The issues relating to the pension liability in the context of the sale of PBL are described in Appendix D, paragraphs 21 to 32.

### *Jurisdiction*

3.8 Under section 35 of the Act, and pursuant to our terms of reference (see Appendix A), we must investigate and report on whether a relevant merger situation has been created.

3.9 Under section 23 of the Act, a relevant merger situation is created if two or more enterprises have ceased to be distinct within the statutory period for reference and if either the share of supply test or the turnover test specified in the Act is satisfied. The turnover test requires the value of the turnover of the enterprises being taken over to exceed £70 million, and the share of supply test requires that as a result of the merger, the enterprises ceasing to be distinct create or enhance a share of supply of at least 25 per cent of goods or services of any description in the UK, or a substantial part of the UK.

3.10 We are satisfied that Stagecoach and PBL are enterprises for the purposes of the Act, and that they have ceased to be distinct as a result of the transaction described in paragraphs 3.1 and 3.2.

3.11 Stagecoach's overall share of the supply of local bus services in Great Britain is around 13.8 per cent.[11] Following the acquisition, its share of supply in the UK as a whole would be below 25 per cent. We have therefore considered whether the share of supply test is satisfied in respect of a substantial part of the UK.

3.12 We considered whether Preston was a substantial part of the UK within the meaning of the Act. In the House of Lords judgment in *R v MMC and another ex parte South Yorkshire Ltd*,[12] it was held that for a given area to be a substantial part of the UK it must be 'of such size, character and importance as to make it worth consideration for the purposes of the Act'. The case was concerned with the share of the supply test under the Fair Trading Act 1973; however, the same principles will apply to the share of supply test under the Act.

3.13 Preston City covers an area of 142 km$^2$ and has a population of around 132,000.[13] The Greater Preston area, including the districts of South Ribble and Chorley covers an area of 458 km$^2$ and has a population of over 340,000. Preston was granted 'city' status in 2002 and is the commercial and administrative centre of Lancashire. With over 32,000 students, its university is one of the largest in the UK. We note that the CC has found in a number of cases that a local market, centred around a particular town or city, could be regarded as a substantial part of the UK.

3.14 Having regard to the above factors, we consider that Preston City is of such size, character and importance as to make it worthy of consideration for the purposes of the Act and hence 'a substantial part of the UK' for those purposes.

3.15 In assessing whether the share of supply test is satisfied, we have considered Stagecoach's calculations which refer to a wider area than Preston City, and include Penwortham and Bamber Bridge.[14] Prior to the merger, Stagecoach and PBL provided the vast majority of local bus services in Preston and undoubtedly well above the 25 per cent threshold. Stagecoach calculated that on a mileage basis, the merged entity has a 96 per cent share of commercial services and a 92 per cent share of tendered services, as shown in Table 1.

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[11]Source: *Bus Industry Monitor 2007*.
[12]*[1993] 1 WLR*, p23.
[13]ONS mid-2007 Population Estimates.
[14]The aggregate market shares for the two companies would be similar if the calculation was confined to Preston City alone.

TABLE 1 **Share of supply of local bus services* in the Preston area†**

| | | | *per cent* |
|---|---|---|---|
| | *Commercial* | *Tendered* | *All local bus* |
| Stagecoach | 42.8 | 38.2 | 42.3 |
| PBL | 53.4 | 53.8 | 53.5 |
| Merged entity | 96.2 | 92.0 | 95.8 |
| Other | 3.8 | 8.0 | 4.2 |

*Source:* Stagecoach.

*Excludes schools, college and private works contract.
†Bus services which operate within Preston and sections of routes from Preston to another destination, which are applicable to the Preston area. In this case, the Preston area includes Penwortham and Bamber Bridge.

3.16 We also considered whether the share of supply test would be met if we included in the reference area the wider contiguous areas in which one of the parties to the merger operates. This approach is similar to the approach UK competition authorities have taken in previous cases relating to the provision of local bus services.[15]

3.17 Stagecoach has local bus operations throughout Lancashire. Lancashire has a population of 1.168 million,[16] 1.9 per cent of the UK, and covers 1.3 per cent of the UK land area (3,079 sq km). The Monopolies and Mergers Commission and the CC have found in previous cases that a similar area constituted a substantial part of the UK. Stagecoach's share of supply of local bus services in Lancashire is about 30 per cent and the parties' combined share of supply is 39 per cent.[17] The share of supply test would therefore also be met under this approach.

3.18 We therefore concluded that the share of supply test was satisfied and that a relevant merger situation had been created.

## 4. Background to the provision of local bus services in the Preston area

4.1 This section sets out the background to the bus market in Preston. We first outline the regulatory regime which governs the provision of local bus services, including the role of the Traffic Commissioner and local authorities. We then consider the characteristics of Preston which affect the demand for local bus services.

### *The regulation of bus services*

4.2 The regulation of local bus services is explained in detail in Appendix E. In this section, we provide an overview of the roles of the Traffic Commissioner and local authorities.

#### *Regulation of commercial services and the role of the Traffic Commissioner*

4.3 Over 80 per cent of local bus services in Great Britain are provided on a commercial basis. Operators of commercial bus services are required to register 'local services'

[15]For example: *Stagecoach Holdings plc and Lancaster City Transport Limited: a report on the merger situation between Stagecoach Holdings plc and Lancaster City Transport Limited*, December 1993, Cm 2423; *Arriva plc and Lutonian Buses Ltd: a report on the merger situation,* November 1998, Cm 4074.
[16]ONS mid-2007 population estimates.
[17]Estimates based on all concessionary fare reimbursements excluding tendered services where fare revenues are retained by LCC. The share of supply would be even higher if Cumbria was included in the calculation (as with the Stagecoach Holdings plc and Lancaster City Transport Limited merger inquiry, December 1993), as Stagecoach's share of supply in Cumbria exceeds 90 per cent, based on concessionary fare reimbursements.

with the relevant Traffic Commissioner[18] and to operate the services in line with the details of the registration. They are otherwise free to decide what frequency of service to offer and fare levels.

4.4 A bus operator needs to apply for a public service vehicle operator's licence from the relevant Traffic Commissioner and must meet three statutory criteria for eligibility: the applicant must be of good repute, have appropriate financial standing (ie the Traffic Commissioner needs to be satisfied that an operator has sufficient finance to run a business properly) and be professionally competent.

4.5 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.

4.6 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.

4.7 The Traffic Commissioner may take regulatory action against operators which have failed to comply with a condition or undertaking which has been attached to the licence, eg a failure to comply with the timetables they have submitted, or poor maintenance of an operator's vehicles.

4.8 Apart from any restriction in its operator's licence conditions, an operator which meets the normal minimum standards may only be prevented from providing a service[19] 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 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 have generally regulated 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.

4.9 The Traffic Commissioner can also restrict a bus company's operations (including preventing it from operating a service altogether) if the bus operator is found to have 'intentionally interfered with another operator'. The North West Traffic Commissioner told us that 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 within the meaning of the Competition Act 1998.

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[18]The relevant Traffic Commissioner for Preston is the Traffic Commissioner for the North Western Traffic Area (the North West Traffic Commissioner).
[19]Different rules apply in London and areas with quality partnerships or quality contracts.

*The role of the local authorities*

4.10 Local authorities' role in relation to buses is twofold: at a strategic level, they are charged with tackling congestion and pollution by encouraging people to switch from car to other transport modes, including buses, and promoting transport integration. Local authorities seek to achieve these aims by investing in improved facilities such as bus shelters and bus lanes, but also by introducing measures, such as parking charges, to encourage modal switch. They have a statutory duty to set out their policies in a local transport plan and a bus strategy, the latter being produced in consultation with bus operators.

4.11 In addition, local authorities subsidize services, for example school buses, socially necessary services and concessionary fares.

*Strategy and investment in infrastructure*

4.12 Lancashire County Council (LCC) has a target of restricting traffic growth to 5 per cent and achieving an increase of 25 per cent in bus and non-motorized transport, via the provision of improved infrastructure and travel information, in partnership with local bus operators. This has included two park-and-ride facilities in south and south-east Preston; and the provision of real time information.

4.13 LCC has also been involved in the development of four 'quality bus routes' within Preston, in partnership with PBL and PCC: service 33/35 to Tanterton (December 1999); services 19/22/23 to Preston Hospital (June 2004); Preston 'Orbit' service (October 2006); and Preston to Gamull Lane (March 2007). Improvements to each route included new bus stops and bus shelters, better timetable information, new traffic management measures and new low-floor buses. Four of the buses used by PBL on the Orbit service belong to LCC.

4.14 As part of its strategy, LCC has also introduced traffic-calming measures, which we were told can sometimes impede the efficiency of bus operations.

*Tendered services*

4.15 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 services in rural areas or late evening and Sunday services. 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. Under the Education Act 1996, local authorities can also secure the provision of school buses. LCC procures these in Lancashire. We refer to these collectively as tendered services.

4.16 Contracts for these tendered services usually specify 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.

4.17 In financial year 2007/08, PBL received £[✂] from LCC (equivalent to [✂] per cent of traffic revenue) in subsidies for tendered routes and school contracts, while Stagecoach Preston received £[✂] million (equivalent to [✂] per cent of total revenues) for tendered services.

*Concessionary fare schemes*

4.18 For many years local authorities have provided concessionary fare schemes for elderly and disabled people. When making concessionary fare schemes, local authorities are required to have as an objective the provision of compensation to operators such as they are no worse off as a result of the scheme. Such schemes must be open to all operators of local bus services and local authorities may compel operators to join a scheme. The Concessionary Bus Travel Act 2007, the provisions of which apply from 1 April 2008, extended concessions to travel throughout England and provides, inter alia, for: free bus travel for those eligible from 9.30am until 11pm weekdays and all day weekends and bank holidays, across England; the mechanism by which bus operators are reimbursed; and the scope of the concession.

4.19 Preston has had a concessionary fare scheme since the 1970s for persons over 70 and we were told that, as a result, the recent introduction of the national scheme had not been a substantive change compared with other parts of the country. The recent changes have nevertheless increased bus patronage. We understand that concessionary fares represent around [✂] to [✂] per cent of all PBL journeys. They represented [✂] per cent of PBL's traffic revenue in 2007/08 and [✂] per cent of Stagecoach Northwest's total revenue.

*Statutory ticketing schemes*

4.20 Local authorities have the power 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. There is no statutory ticketing scheme in the Preston area, but we understand that LCC considered such a scheme in 2003 and that it 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 areas.

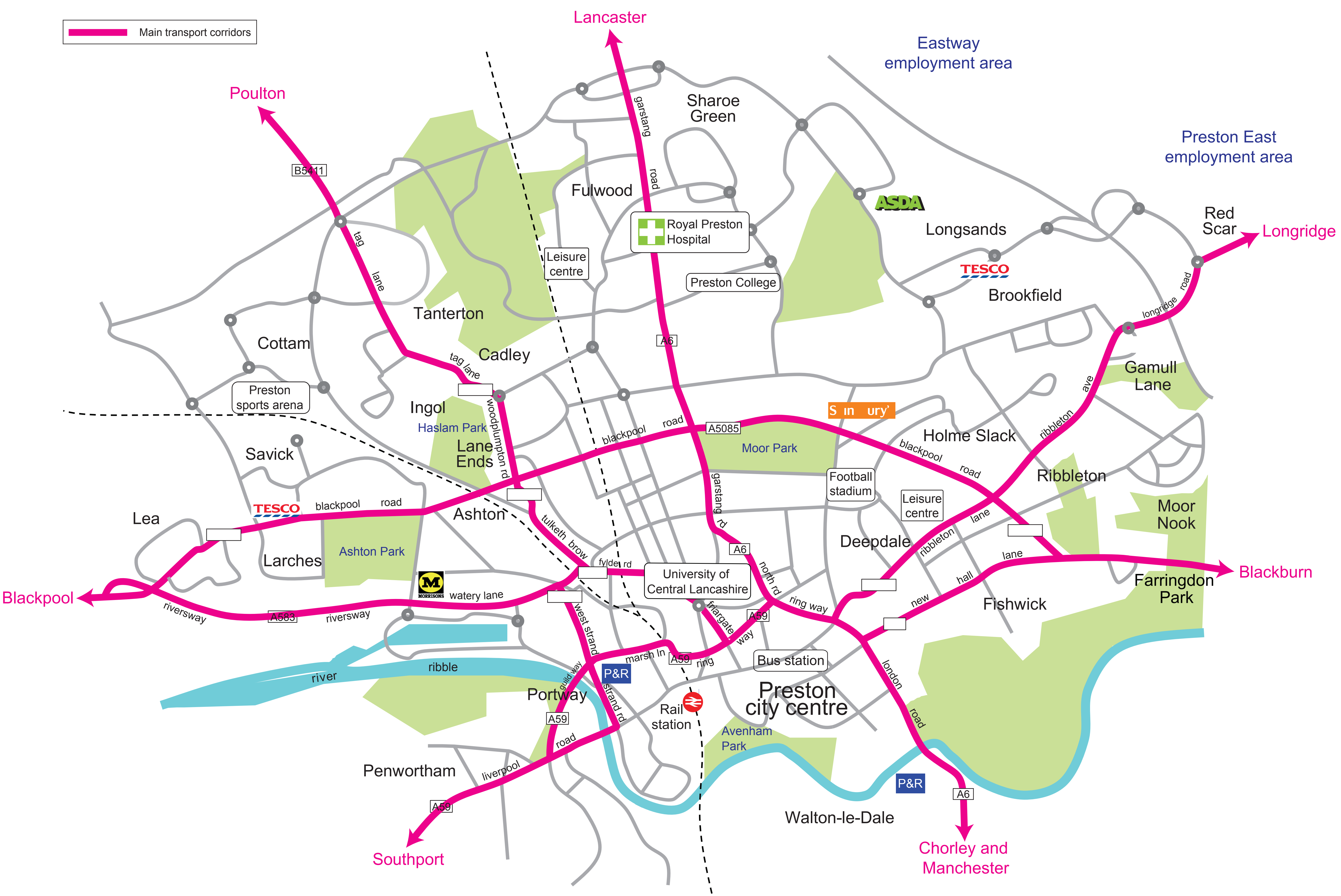
## *Bus usage in the Preston area*

4.21 The River Ribble forms a natural boundary to the south of Preston. The city centre, which includes the central business district and main shopping area, is situated to the far south, with the rest of the city, including the main populated areas, spread out to the north. Many of the key sites are spread out across the city: the Royal Preston Hospital, Eastway Employment Area to the north; the Preston East industrial park, adjacent to the M6 junction (4 miles east of Preston), the Riversway retail and business park to the west; and the university, which is centrally located. The village of Penwortham is situated on the south bank of the Ribble and is effectively integrated with Preston through its fast transport links across the river.

4.22 Preston City has a number of transport corridors that are used intensively for long periods of the day and are subject to high levels of congestion, particularly in the afternoon peak from 2.30 to 6.00pm. Figure 1 shows the key corridors and sites in Preston.

FIGURE 1

**Key sites and transport corridors in Preston**



4.23 With a population of around 132,000 concentrated in about 142 sq km, the population density of Preston City is 929 people per sq km, compared with 358 for England and Wales. Average earnings are below the British average and Preston has some of the most deprived areas in the country. These include, in particular, the wards of Fishwick, St Matthews, Deepdale, and Ribbleton to the east of the city centre. Full-time students represent 10.6 per cent of the Preston population, 3.6 per cent more than the average for England and Wales. Car ownership per household is below the average for England and Wales and journeys to work by bus are correspondingly higher: 11 per cent of journeys to work are made by bus or coach in Preston, compared with 7.4 per cent in England and Wales.

4.24 In general, bus operators told us that they considered Preston to be 'good bus territory'. The existence of a number of housing estates, high level of business activity and the good mix of social economic groups from a bus operator's perspective were quoted as positive features of the Preston market.

4.25 The former management of PBL told us that patronage in Preston had generally been stable over the years, although the introduction of free local travel for the over 65s in 2006 and the introduction of the national concessionary scheme in 2008 had resulted in an increase in the number of passengers. The number of bus passenger journeys made in the Preston area was 887,500 in May 2007. Although this increased to 996,600 in May 2008, it has since the merger, on Stagecoach's current figures, decreased to 918,900 (May 2009).

## 5. Events that led up to the merger situation

### *Introduction*

5.1 We examined the rationale for the merger, Stagecoach's strategy in the Preston area, the financial performance of its services in Preston and the interactions between Stagecoach and PBL during the 18 months that preceded the merger. This section summarizes our findings. More detail can be found in Appendices F and G.

5.2 From 24 June 2007 to the time of the merger, the supply of bus services in Preston was characterized by a significant increase in the number of buses operated within Preston and numerous timetable and fare changes. These events were referred to in the press and some public forums (including the House of Commons) as 'bus wars'. As we discuss in paragraphs 5.23 to 5.35, extensive losses were incurred by both Stagecoach and PBL over this period; given the extent of those losses and other attendant characteristics (as described in paragraphs 5.10 to 5.12 and paragraphs 5.47 to 5.53), we refer, where necessary for the purposes of this document, to the period during which these events took place as the 'period of abnormal competition'.

### *Chronology of events that took place from 2006 to 2008*

5.3 PBL's operations were traditionally focused on serving intra-urban routes in Preston city centre, north of the Ribble. Its network had been relatively settled over the years. Until June 2007, Stagecoach operated two intra-urban services, both from Preston Bus Station to Penwortham, south of the Ribble. Stagecoach also operated (and still operates) the vast majority of inter-urban services to and from Preston.

5.4 On 21 July 2006, a meeting took place between [Stagecoach Director A], [Stagecoach Director B] and [former PBL Director X], during which Stagecoach enquired about the possibility of buying PBL and requested this to be taken to the management board of PBL. This expression of interest was rejected by PBL, and shortly afterwards Stagecoach developed a high-level plan for expansion in the Preston area.

5.5 In the eight months following the meeting, a number of changes to Stagecoach services were implemented. PBL also launched its Orbit service (in partnership with LCC, as explained in paragraph 4.13), to link the hospital, main employment sites and residential areas to the east of the city. This required some amendments to PBL's other routes. Meanwhile, Stagecoach ordered 25 buses, hired 55 drivers and two operations staff and prepared detailed plans for new services to be launched in summer 2007.

5.6 Between 24 June and 28 August 2007, Stagecoach launched five new intra-urban services in direct competition with PBL: service 11 to Gamull Lane; service 9 to Moor Nook; circular services 19 and 22 to the Royal Preston Hospital; and service 33 to Tanterton.

5.7 We saw from an internal Stagecoach communication that it was closely monitoring any service changes being implemented by PBL. During the period following the launch of its new services, Stagecoach varied its services on many occasions. It also launched an additional service to Larches in October 2007, having previously noted PBL's service expansion in this part of the city in June 2007. In addition, it reviewed and changed fares several times, always increasing them.

5.8 Throughout this period, PBL was similarly maintaining a close review of Stagecoach's services. In response to Stagecoach's actions, it launched services in competition with Stagecoach's long-established routes to Penwortham and Southport and registered a new service to Larches. PBL also changed the frequencies of its own services on several occasions. The purchase of ten additional vehicles was also agreed by its board of directors in autumn 2007 in order to defend its established routes north of the Ribble.

5.9 Four meetings between Stagecoach and PBL took place between December 2007 and July 2008.[20] Stagecoach told us that in the first of those meetings, PBL confirmed that it was not for sale.[21] Stagecoach suggested the possibility of a statutory Quality Partnership; and also put forward the option of PBL acquiring Stagecoach's Preston intra-urban operations. The proposal was for a TUPE transfer of the 55 drivers and the purchase of the 25 buses at a price of £[✂] per bus (or £[✂] million across the 25 buses). The option of renting rather than buying the buses was also mentioned. [Former PBL Director X] also told us that the proposal included a £[✂] contribution towards the drivers' training costs, but Stagecoach denied this. Although the former management of PBL said that it considered the offer to be very good, it turned it down on legal advice. We noted that Stagecoach had paid £[✂] million for the buses, that its new services were heavily loss making and that it expected that PBL would need to make at least some of the drivers redundant.

### *The development of Stagecoach's operations in the Preston area*

5.10 As explained in paragraph 5.6, between June and August 2007, Stagecoach launched five intra-urban services, marketed as the Preston Citi network.[22] Stagecoach gave us several reasons for this move. It told us that it sought to pre-empt the acquisition of PBL by another operator, as it was concerned that a competi-

[20]4 December 2007, 28 April 2008, 20 May 2008 and 17 July 2008.
[21]In the course of our inquiry, Stagecoach changed its position on what happened during the 4 December 2007 meeting. We explain this in detail in paragraph 43 of Appendix F.
[22]Other established Stagecoach services were later included under the Preston Citi umbrella brand.

tor with a more proactive approach to network development might threaten its own operations around Preston. It also told us that a more efficient owner of PBL would make it more difficult for Stagecoach to gain market share in Preston; as explored in more detail in paragraphs 5.45 to 5.63, it told us that it intended to establish a significant minority share (perhaps 20 to 25 per cent) of the Preston market, thereby improving the profitability of its Preston depot. Finally, Stagecoach said that in addition to gaining market share, it wanted to grow the market in Preston.

5.11 Appendix F (paragraphs 2 to 7) explains the difficulties we encountered in gathering evidence from Stagecoach in order to understand its actions and sets out in detail the range of evidence we considered. We found it particularly difficult to reconcile statements made to us by various Stagecoach directors with available contemporaneous documents (including minutes of meetings and internal emails) and the evidence received from other parties, in particular evidence provided to the North West Traffic Commissioner by [former PBL Director X]. We noted some inconsistencies between Stagecoach's written submissions to us and the North West Traffic Commissioner and subsequent verbal statements made by its directors, which are described in detail in Appendix F.

5.12 In seeking to understand for ourselves Stagecoach's actions, we assessed all the evidence carefully and made the following observations:

*(a)* Stagecoach's long-term aspiration to acquire PBL appears to have gathered momentum in early 2006 (as set out in Appendix F, paragraphs 8 to 13) and resulted in the meeting with PBL's management on 21 July 2006, during which Stagecoach expressed its interest in acquiring PBL.

*(b)* Stagecoach's expression of interest was promptly rejected by PBL's board of directors.

*(c)* Although we heard conflicting reports of what was said at the meeting (set out in Appendix F, paragraphs 14 to 20), it seems likely that in the course of the 21 July meeting, [Stagecoach Director B] made reference to the possibility of increased competition by Stagecoach in Preston in the context of PBL's refusal to sell. However, given the conflicting accounts, we do not place any decisive weight on this.

*(d)* Two weeks after the meeting, Stagecoach produced what was referred to as a 'business plan' for new services in Preston, which included high-level cost estimates but for which no revenue estimates were made and no strategic rationale was set out (as detailed in Appendix F, paragraph 22).

*(e)* Twenty-five new buses were provisionally ordered for this plan by late autumn 2006, based on 'rough and ready figures of what it would take to establish a credible level of competition in Preston' and not as part of Stagecoach's normal internal bidding process for new buses, as explained in Appendix F, paragraphs 23 and 24.

*(f)* A £[✂] million investment in new buses and the recruitment of 57 staff were carried out, apparently without any financial appraisal or documented plan.

*(g)* The projected cost and revenue from the new services were included in the 2007/08 Preston budget in January 2007 and detailed marketing plans prepared by February 2007.

*(h)* Stagecoach's new services were all launched in direct competition with PBL's most profitable routes; and Stagecoach's fares were set below those of PBL, with significant discounts offered on daily and weekly tickets.

*(i)* Although the new services were allocated a code name ('Project Biscuit'), we saw no internal document setting out Stagecoach's aims and objectives in Preston or revenue expectations.

*(j)* There did not seem to be any significant gaps in PBL's network of services and Stagecoach's new services largely duplicated PBL's services but with some limited differences in routings.

*(k)* Stagecoach told us that only a small proportion of customers in Preston valued networks of routes operated by a single operator. Therefore, the decision to launch an extensive portfolio of services across Preston was unlikely to have been driven by strong network effects.

*(l)* Other than the possible future prospect of PBL being taken over by a third party, there did not seem to be any urgency or strategic reason for the timing of the expansion that we could identify or that Stagecoach provided any evidence of.

*(m)* Despite the considerable uncertainties (Stagecoach itself said that it was unable to forecast the revenue) and risks involved, Stagecoach launched its planned new services over a period of nine weeks rather than as a progressive build-up of services. The reason Stagecoach gave us for launching the new services in rapid succession was the benefit the launch of a portfolio of services under a common brand (Preston Citi) achieved in terms of promotional cost and impact.

*(n)* On 4 December 2007, PBL confirmed that it was not for sale and Stagecoach explored other ways of ending the period of abnormal competition which it had initiated on 24 June (as detailed in Appendix F, paragraphs 43 to 46).

*(o)* In the event, the abnormal competition subsequently continued until the merger, although the scale of Stagecoach's losses was gradually reduced.

### *The intervention of the North West Traffic Commissioner*

5.13 The intervention of the North West Traffic Commissioner is described in detail in Appendix F, paragraphs 48 to 60. In the following paragraphs, we set out the salient aspects of her investigations to the extent relevant.

5.14 Shortly after the launch of the Preston Citi network, complaints began to arrive at the North West Traffic Commissioner's office. There was a series of complaints received throughout July 2007, largely focusing on the apparent problems resulting from Stagecoach operating services in direct competition with PBL. All but one of the complaints were against Stagecoach. One particular letter, which the North West Traffic Commissioner's office thought was largely impartial, detailed issues relating to traffic congestion and passenger loading problems. The North West Traffic Commissioner imposed a traffic regulation condition, effective from 30 July 2007, in order to deal with these issues.

5.15 Having received further complaints from both PBL and members of the public, including councillors who criticized the 'tactics' used by Stagecoach and detailed concerns of fellow passengers regarding safety, the North West Traffic

Commissioner initiated an investigation into Stagecoach's behaviour. In a letter[23] to the North West Traffic Commissioner, [former PBL Director X] referred to the 21 July 2006 meeting with Stagecoach, adding:

> I firmly believe that Stagecoach is abusing the powers that a large operator has when it comes to the deliberate interference with a relatively small operator. Their local operation cannot support the £4 million[24] investment they have publicised as having made nor the loss their services must be making. Their aims from the threats they made to me are very clear as are the subsequent actions and comments they make to our staff about us soon going out of business.

5.16 We also noted a statement submitted by a PBL employee to the North West Traffic Commissioner, which alleged that [Stagecoach Director B] had told him that PBL should have accepted the offer made by Stagecoach and 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 exchange had never taken place.

5.17 Stagecoach told us that we should attach limited weight to the statements made by [former PBL Director X] or certain PBL employees to the North West Traffic Commissioner or to us, as [former PBL Director X] had orchestrated a campaign of complaints to the North West Traffic Commissioner,[25] which according to Stagecoach should cast doubt on the honesty of [former PBL Director X]. We did, however, note that [Stagecoach Director C] told us that he had known [former PBL Director X] for many years, and described him as honest. We also noted that lobbying by companies is not unusual and is not in itself generally regarded as evidence of dishonesty. We considered the evidence provided to the North West Traffic Commissioner which related to the July 2006 meeting between Stagecoach and PBL, recognizing the context in which it was provided, alongside other contemporaneous sources. We did not assess evidence provided to the Traffic Commissioner about the tactics used by either party or the third-party complaints she received.

5.18 Following complaints from Stagecoach that she was not being even-handed, the North West Traffic Commissioner postponed the Public Inquiry, which she had originally intended to hold on 28 February 2008, PBL also being called to the Public Inquiry on 23 May 2008.

5.19 In May 2008, the North West Traffic Commissioner heard representations from both PBL and Stagecoach. She told both parties that it was her preference that the operators should resolve their problems among themselves rather than through the public forum of an official inquiry, which had been rescheduled for 10 June 2008. Following negotiations between PBL and Stagecoach, it was agreed that both operators would allow 20 per cent of their services to be monitored.

### *The effects of the launch of Stagecoach's new services and PBL's response*

5.20 Changes in services, frequencies, fares, passenger numbers, revenues and profit between May 2007 and the time of the merger are analysed in detail in Appendix G.

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[23] Dated 20 September 2007. At the request of the North West Traffic Commissioner, [former PBL Director X] later produced a statement describing the 6 June 2006 and 21 July 2006 meetings with [Stagecoach Director B] and [Stagecoach Director A]. The statement, prepared at the request of the North West Traffic Commissioner and dated 8 February 2008, was based on detailed records of the meetings, which [former PBL Director X] had prepared shortly after the meetings, as explained at the end of the statement.

[24] This includes a £[✂] million investment in low-floor buses for Stagecoach service 2.

[25] We note that such allegations were put to the Traffic Commissioner by Stagecoach.

*Passenger numbers*

5.21 Between May 2007 and May 2008, the number of passengers carried within Preston increased by about 12 per cent. The trend was largely reversed following the merger with a significant decline in the number of passengers by May 2009. The decline was mitigated to a certain degree by the growth of patronage on Stagecoach's inter-urban routes. This growth is likely to be attributable in large parts to the implementation of the national concessionary fare scheme in April 2008. A small proportion of the decline in the number of passengers by May 2009 may also have reflected a decline in the number of bus passengers in the UK as a whole due to the recession.[26]

5.22 However, while the overall numbers grew, PBL's passenger numbers fell sharply. Between May 2007 and May 2008, the number of passengers travelling on PBL's services declined from around 790,000 to about 730,000 passengers a month. The number of passengers using Stagecoach's Preston inter-urban and intra-urban services on the other hand grew from around 90,000 to 270,000 passengers a month over the same period.

*The effects of Stagecoach's new routes on its Preston depot's profitability*

5.23 In 2007, Stagecoach's Preston depot generated an operating margin of [✂] per cent from £[✂] million of revenue. The profitability of the depot worsened significantly from June 2007 and it made an operating loss in both 2008 and 2009. Although it was clear that its new services were initially loss making, Stagecoach told us that by the time of the merger, the new services, which by then had been operating for over 18 months, were breaking even. This was based on an incremental cost allocation methodology developed specifically for the 'Project Biscuit' services, rather than the full cost allocation methodology[27] normally used across all of Stagecoach's depots to assess the performance of established routes. Stagecoach told us that in launching the new services it aimed to improve the profitability of its Preston depot, which suggested to us that it was planning to operate these services on an ongoing basis. We therefore examined the profitability of the new routes using both incremental costing (used by Stagecoach to monitor the performance of its new services) and the normal cost allocation methodology used by Stagecoach to monitor the performance of all routes across its UK depots. The detail of this analysis is presented in Appendix G, paragraphs 21 to 46.

5.24 On an incremental cost basis, the Preston Citi routes made a loss after incremental costs of £[✂] in 2007/08, compared with a turnover of £[✂]. In the first nine four-week periods of 2008/09, before the acquisition of PBL, the routes produced an incremental loss of £[✂] (compared with a turnover of £[✂]). Additionally, Stagecoach estimates that in 2007/08 it had lost revenues of £[✂] on its service to Penwortham (route 3) as a result of PBL's response to Stagecoach's launch of new services. Including this as an additional cost would result in the loss (as calculated above) increasing to £[✂] in 2007/08. Although we were not provided with an estimate for 2008/09, it seemed to us that PBL's continued competition on route 3 could have had a similar impact in that year (since the conditions of competition on this route remained broadly similar in 2008/09 until the merger), thus worsening the loss to an estimated £[✂].[28] We were of the view that the cost of PBL's retaliation

[26]The DfT's Bus and Light Rail statistics suggest, however, 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 in the previous year.

[27]Which allocates all costs to all services on a pro-rata basis to hours, miles and peak vehicle requirement (PVR). The PVR is the maximum number of buses required to maintain planned services on a bus route or network.

[28]In addition, these losses do not take into account the cost of capital.

was a part of the overall cost of Stagecoach's expansion strategy in Preston and this strategic loss would be incurred at some level regardless of the accounting method used. Whilst illustrating the impact of this strategic loss above, we did not include this loss in our detailed analysis (in Appendix G) as it depended on PBL's strategic response rather than being an inherent part of Stagecoach's expansion strategy. This is a conservative approach as it does not take account of all the losses the company needed to bear during the period of abnormal competition.

5.25 However, we considered that Stagecoach would have eventually applied the cost allocation methodology used for all other services operated from the Preston depot and all its other depots in the UK. This seemed to us a reasonable basis on which to assess the longer-term profitability of the routes, following the initial period of high growth that is characteristic of any new service. We noted that growth in the number of passengers carried on Stagecoach's new services had stabilized by the end of 2007 (as shown by Appendix G, Figure 4). Using Stagecoach's normal cost allocation methodology, we found that each new intra-urban route was loss making at the allocated direct cost[29] level until the acquisition of PBL and total allocated direct losses incurred across these six routes were £[✂] million over the 20 four-week periods following the launch of the new services until the acquisition of PBL. This compared to allocated revenues of £[✂] million across the same period. On Stagecoach's normal cost allocation basis, the routes were far from covering their allocated direct costs by January 2009 and it appeared that, all other things being equal, absent the merger, it would have taken Stagecoach at least 15 more four-week periods to reach a breakeven point. We thought it likely that it would take even longer because passenger numbers were growing relatively slowly and further fare increases would be increasingly difficult to implement, in particular given that Stagecoach was pricing at very similar levels as PBL immediately prior to the merger. Looking at it another way, all other things being equal, a significant price increase of £[✂] per passenger or [between 20 and 30] per cent would have been required to cover allocated direct costs.[30] Based on the same assumptions and allocated depot and head office overheads of around £[✂] per period, a price increase of [between 60 and 70] per cent would be required to cover Stagecoach's allocated overheads and cost of capital, which is 8.5 per cent (as per Stagecoach's 2008/09 annual report).[31] The detail of these calculations can be found in Appendix G, paragraphs 38 and 46.

5.26 Stagecoach told us that as a general rule it would expect new services that are not in competition with another bus operator to break even within six months. Stagecoach was, however, not able to offer a similar general rule for services launched in a directly competitive situation, stating that there was too much uncertainty to be able to forecast revenue under such circumstances. A number of Stagecoach executives expressed different views on how quickly they would expect such services to break even. Stagecoach also provided us with examples of new services which it claimed illustrated that it had previously engaged in competition for a number of years without achieving profitability. For the reasons set out in Appendix G, paragraph 19, we did not consider these to be suitable benchmarks. The evidence we received from other large operators suggested that their normal expectation was that new routes should

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[29]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. The total allocated losses across the six routes amounted to £[✂] million over the 20 four-week periods.

[30]Assumes: [✂] as the average number of passengers and average revenue per customer of £[✂] and direct allocated costs of around £[✂] per period.

[31]Stagecoach told us that this was overstated as buses were purchased on hire purchase agreements, typically at base rate + [✂] per cent, and are variable. According to Stagecoach, the cost of capital in the period June 2007 to January 2009 therefore varied from [✂] to [✂] per cent. We noted, however, that Stagecoach applied a cost of capital of [✂] per cent to value PBL. We therefore consider 8.5 per cent to be a reasonable estimate.

cover their direct costs within a year or so. It is clear from the above figures that the new Citi routes were taking considerably longer than that to reach profitability.

5.27 By December 2007, Stagecoach began to express some concern over the losses it was incurring on all its new routes, and these were recorded in the minutes of directors meetings in February 2008. Measures taken to address this issue included: a bus from service 19/22 was reallocated (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 £[✂].

5.28 In June 2008, underlying performance was still causing concern and Stagecoach subjected all services to scrutiny. Reductions in the number of buses operated and other options were to be considered, although these were postponed until the autumn for an unrecorded reason. [Stagecoach Director C] confirmed to us that he was concerned that progress was slower than he would have liked, but added that he was satisfied that progress was being made.

5.29 Stagecoach told us that it had been expecting further growth and consistent profitability, as PBL would have had to increase fares and to cut service frequencies resulting in further passenger and revenue growth for Stagecoach. By the time of the merger, the routes were approaching breakeven on an incremental cost basis (as shown in Appendix G, Figure 1), but incremental costs were due to increase soon and, on Stagecoach's normal cost allocation basis, the new services were far from covering their allocated direct costs.

5.30 Stagecoach told us that by operating the new services, it aimed to gain 20 to 25 per cent of the Preston market and thus improve the profitability of its Preston depot. It seemed to us that absent a radical change in the competitive situation, such as the significant if not total retrenchment of PBL or its acquisition by Stagecoach, there was no reason for Stagecoach to think that these new services were likely to improve so significantly so as to achieve an improvement in the profitability of the Preston depot. In fact, it seemed more likely to us that these services would remain essentially unprofitable or at best marginal. It was hard to see how Stagecoach could expect to recoup its investment of £[✂] million in new buses on this basis.[32] We noted that Stagecoach significantly reduced service provision within Preston immediately after the merger (in many cases to its pre-June 2007 level and in all cases to considerably lower levels than the levels that existed during the period of abnormal competition). This suggests that, contrary to Stagecoach's assertions, only a very substantial withdrawal of PBL or Stagecoach from Preston's intra-urban services would have allowed a significant improvement in the profitability of Stagecoach's intra-urban services, let alone Stagecoach's Preston depot, absent the merger.[33]

5.31 We noted that the consolidation savings identified by Stagecoach prior to the merger assumed a reduction in service levels but no radical redesign of the network, and that

[32]Although it would of course remain open to it 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.
[33]Stagecoach could have withdrawn completely from its new services without having to exit the Preston market. This is because prior to the expansion, Stagecoach's operations in Preston were profitable. Given that Stagecoach's Preston depot was not as profitable as Stagecoach would have wanted, and given that Stagecoach incurred significant losses as a result of its expansion on PBL routes, it would of course have been preferable for Stagecoach to retain at least some share of the Preston market. The situation for PBL was different. While PBL could have accommodated Stagecoach's entry if Stagecoach only took a minority share of the Preston market, PBL had a large depot to support and could not afford to withdraw significantly from its existing services as such a withdrawal would entail a significant decline in its revenue and a destabilization of its entire business.

following the merger, Stagecoach significantly cut down the level of service provided on the intra-urban Preston network.

*The impact of Stagecoach's actions on PBL's finances and the sale of PBL*

5.32 We analysed the change in contribution on PBL's key routes that were contested by Stagecoach. This showed that revenues and profits had fallen dramatically between June 2006 and September 2008. As of June 2006,[34] the annual direct[35] contribution on the key PBL routes on which Stagecoach later launched new services was £[✂] million. By September 2008, this had fallen to £[✂].

5.33 Before Stagecoach launched the new services, these key routes had provided most of PBL's commercial bus operation profits. They suffered a revenue decline of £[✂] million and a direct contribution decline of over £[✂] million a year between 2006 and 2008. An additional £[✂] annual contribution was lost on other routes; these included £[✂] losses on route 3 which PBL started to operate in competition with Stagecoach's established service in response to Stagecoach's entry on to PBL's services. The exact cause of the losses on other routes is difficult to establish due to the combined impact of the Orbit service, the closure of some of the routes by PBL and the direct competition of Stagecoach's new intra-urban services with sections of these routes. The route contribution analysis is set out in detail in Appendix G, paragraphs 53 to 55.

5.34 In order to defend its position against Stagecoach's new intra-urban services operated with a fleet of 25 new buses, PBL purchased ten new vehicles funded through the disposal of ten buses and a new hire-purchase facility. The modernization of the fleet had the effect of running down cash balances and increasing levels of debt.

5.35 By December 2007, the directors of PBL had become very concerned about the considerable degradation of the financial health of the company. As noted in Appendix H, paragraphs 14 and 15, in March 2008, PBL considered proposals for improving the efficiency of the company and making savings. Some frequencies were reduced and the loss-making service 2 to Southport and service 87 to Lea withdrawn, but proposals for other service changes were not pursued because of the loss of revenues that would result (as set out in Appendix G, paragraphs 57 to 59). Some other steps were subsequently taken to reduce costs. In April 2008, PBL sought advice from KPMG on its strategic options. KPMG's May 2008 report showed that profit before tax and interest in 2006/07 was £0.2 million and in 2007/08[36] it fell to a £1 million loss. The PBL budget for 2008/09 showed a forecast full year loss of £[✂] million. By September 2008 the monthly loss was approximately £[✂]. PBL was not in a position to sustain annual losses on this scale; the KPMG report shows that PBL's overdraft facility limit was expected to be breached in October 2008 and says that 'Due to forecast trading losses, the Company is not viable in its current form should Stagecoach continue to operate in direct competition with PBL'. Following Stagecoach's launch of new services on PBL's key routes, PBL had turned from a profitable business (albeit not making large profits) to a loss-making business.

5.36 KPMG set out four options: to trade on; to invest; to sell the company; or to liquidate. The directors agreed that the best option was to find a trade buyer for PBL.

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[34]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).
[35]Pre-capital costs.
[36]Eleven months actual and one month forecast.

5.37 KPMG contacted seven bus operators, but not Stagecoach, as PBL's directors did not want to alert their competitor to the extent of the cash drain at PBL. Of the seven companies approached, one (Transdev) stated that it had no interest in acquiring PBL, but the others signed a non-disclosure agreement and received an information memorandum prepared by KPMG. Recipients were invited to submit preliminary offers on the assumption that the final salary pension scheme would be excluded.

5.38 Preliminary offers were received from two companies:

*(a)* On 17 July 2008, Arriva submitted a bid of £[✂] million for PBL's share capital, based on the net assets in the information memorandum. Following further discussions, Arriva increased its offer to £[✂] million on 1 August 2008.

*(b)* On 24 July 2008, Go-Ahead submitted an offer of £[✂] million for the entire share capital, but assuming that PBL would be sold debt-free. At that date, PBL had debt of £2.2 million, excluding the pension scheme deficit, so acceptance of this offer would have required a cash contribution from shareholders of £[✂] million.

5.39 Arriva had also made offers for Stagecoach Preston. In its first approach, Arriva had offered net asset value, debt free and £[✂] million goodwill for the Preston and Fleetwood business. The second offer, submitted shortly afterwards, on 1 August 2008, was a £[✂] increase over the first one, but Stagecoach did not accept it. Arriva told us that Stagecoach had not responded to its revised bid. We noted that Stagecoach was fully aware at that time that both Arriva and Go-Ahead were bidding for PBL.

5.40 [✂] Arriva told us that it was waiting in late August to make a second bid for PBL, due by 5 September. However, it had identified inadequacies in the electronic due diligence data room, which had not been rectified by 5 September, thus Arriva told us that it had been unable to make a second bid. Arriva was concerned about its ability to return the business to profitability while Stagecoach continued to compete in the manner it had been competing since June 2007. [✂]

5.41 Although PBL's cash outflow had not been as fast as expected, the continuing losses and delays in the sale process overrode the directors' concern about the reaction of staff to an approach to Stagecoach and by mid-September KPMG contacted Stagecoach on behalf of PBL.

5.42 Thus, the effect of Stagecoach's actions in Preston since June 2007 was to make PBL an unattractive acquisition target for other potential bidders and left little choice to its directors but to accept an offer from Stagecoach, 30 months after Stagecoach's original approach.

5.43 Commenting on this, Stagecoach told us that PBL was still 'a reasonably attractive target over a lengthy period of time prior to and during the period of intense competition. The problem is that PBL was incapable of taking appropriate decisions, including the decision to approach third parties to sell before it was too late. It was only in June 2008 that PBL started the actual sale process. Six months had been lost'.

5.44 However, we noted that until Stagecoach's new intra-urban services were launched, there did not seem to have been any particular reason for PBL to seek a buyer. We found it difficult to reconcile the suggestion of Stagecoach that PBL should have sought a buyer prior to the launch of its new intra-urban services with its vigorous denials that it made known to PBL, during the meeting which took place in July 2006, its intent to launch services on PBL's routes in the way that it did. In addition, the effect of the new Stagecoach services on PBL's profitability was very swift, with PBL moving into trading losses by October 2007. PBL would have found it difficult to sell from then onwards and the outcome might well have been the same. Finally, it did not seem to us to be either irrational or unusual for a company to be exploring a range of options before committing to a sale.

*Stagecoach's market share objective*

5.45 [Stagecoach Director C] told us that although he did not have a market share objective in mind when the decision was made to launch the new intra-urban services, he would have been content with operating 25 buses in the intra-urban market and that a 25 per cent share of the market[37] would have been respectable. This comment was later followed by the following written statement by [Stagecoach Director C]: 'I reiterate unequivocally that in launching intra-urban services in Preston in June 2007 it was not Stagecoach's intention to either force Preston Bus out of business or to sell to Stagecoach. I expected competition to win a long-term minority share of the Preston intra-urban market to take some time and to be hard fought.' In a subsequent hearing, [Stagecoach Director B] surmised that an investment in 25 buses in Preston would have delivered a 20 per cent share to Stagecoach.

5.46 However, as noted in paragraph 5.12, Stagecoach has been unable to produce any internal document supporting the view that its ultimate ambition was a minority share of the Preston market. We found it surprising that in the space of one month, Stagecoach abandoned its long-term ambition to acquire the whole of the Preston intra-urban market in favour of such a modest target. In addition, Stagecoach did not mention this target in any of its early submissions to us. The first mention of a target of a minority share was in response to a direct question from us in a hearing.

5.47 We found that Stagecoach launched five services over a short period of time (around nine weeks), largely duplicating PBL's most profitable commercial routes, which represented [most] of PBL's direct contribution[38] (see Appendix G, Table 6, for more detail). Although PBL had a fleet of 127 buses in total, a significantly lower number of these buses served commercial routes.[39] Based on PBL's route-costing data, we estimated that PBL operated 49 vehicles on the routes which Stagecoach targeted with its new intra-urban services. Given that Stagecoach's new services were supported by 25 new vehicles, the level of supply on these crucial routes increased by approximately 50 per cent, following Stagecoach's entry.

5.48 Stagecoach expanded on to 9 out of PBL's 14 commercial services (services 7, 8, 11, 14, 16, 19, 21, 22/23, 24/25, 31, 33/35, 34/44, 36 and 88/89). Out of these 14 services, services 21 and 36 had not been commercially viable prior to Stagecoach's expansion and were discontinued soon after by PBL. Service 88/89 was supported by Kick Start funding and therefore partly tendered. Stagecoach launched services

[37]Stagecoach did not clarify what 'market' meant in this context, and we noted the vagueness of the comment made: we asked Stagecoach whether, in launching its new services, it had any idea about the market share it wanted. [Stagecoach Director C] replied:

> In truth, no. What would I have settled for? I think if eventually we had established the 25 buses we originally put in, I was comfortable with that as a reasonable number. I would not have expected it to be any more than that. I might have even settled for a bit less at the end of the day, not much, there or thereabouts. I guess my rationale was that Preston Bus were an operator running about 100 vehicles, with a fleet of 120-odd, 130. A quarter of that would be a respectable share.

[38]Pre-capital costs.

[39]For example, the PVR requirement for school and contract work was 23 (some of these were used to a limited extent on commercial services at peak time, due to increased congestion); for the park-and-ride services it was 7, and for the Orbit service it was 13.

that replicated—in their entirety or on their key corridors—9 out of the remaining 11 services (Appendix G, Annex 1).[40]

5.49 Stagecoach's expansion created seven new overlap route segments[41] and introduced intra-urban services on two more segments which were previously served only by Stagecoach's inter-urban routes. As we explained in Appendix G, paragraph 5, Stagecoach introduced high frequencies on its new services. On each of the new nine overlap route segments Stagecoach introduced comparable frequency to the frequency already offered by PBL. On two out of the nine overlap route segments Stagecoach matched PBL's frequency exactly; on four segments it offered a higher frequency; and on the remaining three segments it offered a marginally lower frequency than PBL (Appendix G, Annex 2). Finally, we also noted that Stagecoach introduced low fares on its new intra-urban services, in some cases nearly halving PBL's fares (see Appendix G, paragraph 6).

5.50 Stagecoach's new intra-urban services also overlapped (albeit to a lesser extent) with other PBL routes, as virtually all its services used the key corridors in and out of Preston, all of which were now served by frequent Stagecoach services. Thus PBL's entire network, with the exception of the park-and-ride services and service 14 to Fairfax Road,[42] was affected by Stagecoach's new intra-urban services. In addition, a number of the 89 buses operated from Stagecoach's Preston depot in 2006/07 were used on inter-urban services, overlapping to an extent with PBL services. We noted that Stagecoach increased the frequency of some of those services, most notably route 2/2A to Longridge,[43] which also affected PBL.

5.51 Stagecoach was therefore operating about half of the frequencies on the key corridors served by a large majority of PBL's services. The effect, as noted in paragraph 5.32, was to reduce the contribution of PBL's key routes by almost two-thirds and turn PBL from a profitable into a loss-making business.

5.52 Finally, we considered that the number of new buses allocated by Stagecoach to its Preston intra-urban services in early 2007 could not in itself be relied on as a useful indicator of the ultimate market share ambitions of Stagecoach in Preston. A company of the size of Stagecoach had the ability, at any time, to supplement its fleet of 25 new buses with more vehicles, for example by bringing them from other parts of the group (eg from its reserve fleet) if necessary or indeed to redeploy the buses to other parts of the group if they were no longer needed.[44] Indeed, between June and October 2007, the PVR across the routes operated from the Stagecoach Preston depot increased by 30 from 74 to 104[45] (rather than 25) and Stagecoach was able to allocate three buses to route 32 (between Preston and Larches), even though this route had not been envisaged in the original plan.

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[40] We note that with the exception of services 11 and 19/22, Stagecoach did not replicate exactly PBL's routes.
[41] We defined overlap segments in Appendix G as consecutive overlap flows creating route segments. We used overlap segments for ease of comparison because while PBL's and Stagecoach's services overlapped heavily, they did not overlap exactly, with some consecutive flows being served by both companies but using differently routed services.
[42] The overlap of the new intra-urban services with PBL's service 7 was, however, relatively limited.
[43] The PVR relating to the service 2/2A route was increased by 1.5 in the second half of 2006/07.
[44] Stagecoach argued that it would have been limited in its ability to operate more buses in competition with PBL by the capacity of its depot, which, it said, was operating at full capacity by October 2007. We noted that this somewhat contradicted Stagecoach's other submission that operators could compete from depots within a 30-minute isochrone, which would imply that in principle it would have been able to compete with PBL from its other Lancashire facilities. We also noted that Stagecoach would only have needed additional parking space for these additional buses, which may have been available at its Fleetwood outstation or elsewhere in Preston. Finally, Stagecoach would have had the option of reallocating depot capacity from its less profitable inter-urban routes to intra-urban services.
[45] This is consistent with Stagecoach's budget data which shows that the number of licensed vehicles increased from 89 in 2006/07 to 119 in 2008/09.

5.53 The scale and nature of Stagecoach's expansion described in paragraphs 5.45 to 5.51 would not seem to us to suggest that it was only aiming at gaining a minority share of the Preston intra-urban market. In our view, it was 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.

5.54 Stagecoach also advanced the argument that a Quality Partnership scheme (QPS), which it had suggested to PBL during the December 2007 meeting and again in April 2008, would have allowed both PBL and Stagecoach to retrench. [Stagecoach Director C] told us that a QPS could be used to 'improve and develop the market' and that 'PBL would have to stop their practices regarding service timing and would learn to share a contested (but larger) market where the frequency of both Stagecoach and PBL would be lower than during the period of intense competition'. Stagecoach said that its suggestion was evidence that it was aiming to create a market share in Preston rather than seeking to weaken PBL and/or acquire PBL. We noted that in putting these proposals forward, Stagecoach's own objective, as stated in internal correspondence, was to 'help to cement our presence in the network and nail the concept of a "bus war"'.[46]

5.55 We also noted that the possibility of specifying registration restrictions in a QPS was introduced by the Local Transport Act 2008 and that it was only from 6 April 2009 that a QPS could specify requirements as to frequencies and timings of services. We understand that it is for the LTA to determine whether to include such requirements in a scheme and such requirements may only be included if there are no 'admissible objections' from 'relevant operators'.

5.56 [Former PBL Director X] told us that the QPS proposals effectively amounted to sharing the town network with Stagecoach and would involve frequency reductions for PBL in Stagecoach's favour. The business could have been profitable but sharing the network would have placed PBL in an extremely weak position, especially since PBL would have lost the commercial advantage it had over Stagecoach of having very good customer loyalty. However, [former PBL Director X] said that he never gave serious consideration to the proposals as, in his view, it was very unlikely that the project would have gained the financial and political support necessary for LCC to be able to deliver it. Drawing upon his previous experience of agreeing and implementing such schemes with LCC, [former PBL Director X] told us that even if a QPS could be agreed to with Stagecoach, it would take years to introduce, and this was time that PBL did not have, given the actions of Stagecoach to operate its heavy loss-making routes on top of PBL's longstanding network.

5.57 LCC told us that whilst preliminary discussions had taken place, no outcome was ever determined.

5.58 Stagecoach provided us with correspondence between itself, LCC and PBL, which took place in autumn 2008 and related to the possibility of a QPS in Preston. We noted that these discussions took place at a time when Stagecoach and PBL were in negotiations over the sale of PBL to Stagecoach and were therefore not relevant to the assessment of the development of market share prior to the acquisition proposals. We did, however, note that the more detailed proposals discussed in autumn 2008 did not include any requirement as to frequency or timing of service.

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[46]Source: Stagecoach internal email.

5.59 We also noted that even Stagecoach's own management was sceptical of the effectiveness of such schemes: in an internal email written in August 2008, [Stagecoach Director A] described the process as 'a bit complex and bureaucratic' and [Stagecoach Director E] said that Stagecoach had an aversion to registration restrictions.[47]

5.60 Accordingly, we were inclined to put only relatively little weight on Stagecoach's argument regarding the interpretation to be placed upon these tentative considerations of a QPS with PBL and later LCC. In our view, the discussions which took place between Stagecoach and PBL between December 2007 and July 2008 tend to suggest that both of the parties were of the view that their levels of operation at the time were not sustainable in the long run and that, absent some sort of agreement between them (either to consolidate the operations or to retrench), partial retrenchment by either Stagecoach or PBL was not straightforward, given the abnormal nature of the competition instigated by Stagecoach in Preston.

5.61 Finally, Stagecoach argued that it was PBL's irrational response to its new services that was largely to blame for the company's demise. We recognized that there would have been a number of possible reactions to the launch of Stagecoach's new services open to PBL's management at the time. It might, for example, have de-registered services or held steady rather than invest. We did not think it was possible to establish with any degree of certainty what other outcomes might have resulted from different strategic decisions by PBL and subsequent behaviour of Stagecoach, given the number of variables that would need to be considered and lack of factual evidence to assist us in making such an assessment. However, we did not consider that the de-registration of services by PBL or a decision to hold steady would have been significantly more likely to have allowed PBL to maintain a significant ongoing presence in the Preston area: there was nothing to prevent Stagecoach, with the resources available to it, from then further increasing the number of buses it operated in the Preston area whenever it wished to do so. We also found it difficult to reconcile Stagecoach's argument that it wanted to grow the Preston intra-urban market, while at the same time arguing that it wanted to acquire only some 25 per cent of the Preston intra-urban market by expanding on PBL's routes and expecting PBL to retrench.

5.62 In our view, the reaction of PBL was not unusual in the context of the bus industry. Indeed, Stagecoach itself in its 4 August 2006 'Business Plan' had anticipated some retaliation from PBL in response to its new services, and concluded that Stagecoach would need to consider reinforcement of its existing services (particularly service 3, as explained in Appendix F, paragraph 22), whereas during our inquiry Stagecoach stated that it was not predictable that PBL would seek to attack Stagecoach in the event of expansion on to PBL's routes.

5.63 In conclusion, we found it difficult to reconcile Stagecoach's claimed objective to gain a minority share of the Preston market with the evidence that we analysed on route entry and did not find its supporting arguments on QPSs or PBL's reactions convincing.

### *The rationale for the acquisition*

5.64 Stagecoach told us that selling to it was always PBL's best option, but that it had never expected to be invited to make an offer. Stagecoach told us that following PBL's approach in September 2008, it had weighed up the risks and opportunities of

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[47] See Appendix F, paragraph 46.

acquiring PBL, including the possibility that Arriva might purchase the business, which would have left Stagecoach with only the share of the Preston market it had built in the previous 18 months, instead of the near 100 per cent share that the combined entity would represent. We considered that this was consistent with Stagecoach's decision to pay £[✂] million for the business. Stagecoach also told us that an important factor in its considerations was the political, reputational and public relations fallout that would have resulted from PBL's failure.

5.65 Stagecoach told us that the economic rationale for the acquisition was that it considered that it could operate the combined businesses on a profitable basis and expand its customer base. It had been evident to Stagecoach for some time that PBL was not trading well. According to Stagecoach, it appeared to be inefficient and to make sub-optimal use of its network. Stagecoach further commented that PBL's inefficient schedules were evidenced by the number of buses and staff enjoying extended idle times at the bus station. According to Stagecoach, PBL continued to pay above-average wages with premium payments for overtime and weekend working; the average age of the fleet remained high despite some regular investment; and the trading accounts demonstrated little reaction to the pressures created by (among other things) rising pension and fuel costs. Stagecoach also criticized PBL for having an excessive spare fleet by industry standards, for continuing to operate poorly loaded service journeys and for bidding for local authority contracts at prices below what would be necessary for a high-cost operator to achieve a return. Finally, Stagecoach was critical of PBL's extensive cross-subsidization of Sunday and evening services.

5.66 Stagecoach told us that it anticipated that considerable cost savings and synergies could arise from operating the existing Citi services and those of PBL as a combined urban network. Stagecoach also considered that, by investing in quality of service improvements, it would be able to increase overall bus usage in Preston including on PBL's routes.

5.67 We consider in turn each of these arguments.

### *Efficiency, synergies and cost savings*

5.68 We asked both [former PBL Director X] and [former PBL Director Y] whether PBL had operated inefficient schedules and whether its spare fleet had been too big. They both told us that the level of spare fleet and schedules were set to deliver a reliable service in a congested city. Higher spare fleet levels were also needed because of restrictions caused by the garage layout. In addition, the remaining Optare MetroRider buses in the fleet were becoming very unreliable and time-consuming to repair. [Former PBL Director X] added that had additional buses not been required for competitive reasons, the MetroRider buses would have been replaced, thus reducing the spare vehicle capacity by about four buses.

5.69 [Former PBL Director X] accepted that PBL paid higher wages than average to most of the staff, but commented that this was a deliberate policy associated with PBL being an employee-owned company. This seemed to us to be a matter of management policy but one which did not necessarily result in lower quality of service or higher prices than those of other operators given the more modest level of profitability which it aimed to achieve. We recognized that the relatively small scale of PBL compared with the likes of Stagecoach resulted in higher procurement costs, in particular in relation to fuel. Stagecoach also asserted that PBL had been slow to deal with its rising pension costs: we noted that the company closed the scheme in February 2006, less than three months after receiving advice from KPMG that this would be the right course of action.

5.70 [Former PBL Director Y] told us that certain working practices were inefficient, for example the financial cost and supervisory time to ensure that weekend work was covered was excessive and there was a lack of flexibility efficiently to cover seasonal or significant fluctuations in demand. He also commented that there were skill shortages; that systems needed updating; and that overhead costs were higher than those of comparable bus companies.

5.71 The low prices, high service provision and relatively low returns were matters of management policy rather than evidence of underlying inefficiency: [former PBL Director X] explained to us that PBL, due to its size, did not have the ability to bring in additional resources to fight outbreaks of intense competition. Operating high-quality, frequent services on an ongoing basis to deter competition had therefore been its chosen strategy.[48] Similarly, [former PBL Director Y] explained that the company targeted profits of £[✂], as higher profits would only have resulted in wage inflation in this employee-owned business or attracted entry into the market.

5.72 Even though the employee ownership of PBL may have resulted in some inefficiencies, they did not, in our view, necessarily result in higher prices or poorer quality of service. PBL's failure was also, in our view, not the result of any inefficiency, but resulted from Stagecoach's greater willingness and ability to support the significant losses incurred during the period of abnormal competition.

5.73 We noted that Stagecoach's assessment of potential consolidation savings assumed a reduction of competition volume (down to the level of service provided before Stagecoach's entry on to PBL's routes) and no radical redesign of the network. Savings on overhead costs were estimated at £[✂] (and £[✂] had been achieved by the time we discussed this issue with Stagecoach). We noted that, given Stagecoach's stated objective to increase the operating profit of the combined Preston operation to [✂] per cent, most, if not all, efficiency savings generated by Stagecoach would probably go towards improvements in profitability and would be unlikely to be passed on to customers.

*Quality and service improvements*

5.74 PBL's former management told us that providing a comprehensive network and low fares were a deliberate policy and that reliability was considered extremely important. A number of third parties told us that the quality of service provided by PBL was very good. LCC in particular commented that PBL was good in terms of frequency and level of service and that there were more evening and Sunday services on a commercial basis in Preston than in other towns in Lancashire. We noted that VOSA's proactive monitoring[49] of PBL's services in July 2006 showed a very high level of compliance: all frequent services were compliant and only 2.8 per cent of scheduled services were not. We also noted positive comments made by Go North East in the trade press.[50]

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[48] Stagecoach argued that to operate frequent services to deter competition was contrary to the position taken by the OFT in its recent report (*Local Bus Services: Report on the market study and proposed decision to make a market investigation reference*, OFT, August 2009—see www.oft.gov.uk/shared_oft/consultations/oft1112con.pdf) and, in so far as it provided more than the market required, inefficient: the OFT's concern, however, is about overbussing as a short-term response to entry rather than the ongoing provision of a comprehensive network of services to its customers, which we find difficult to regard as objectionable.

[49] Monitoring carried out on VOSA's initiative, rather than as a result of a complaint or request by the Traffic Commissioner.

[50] *Buses*, June 2007: 'In terms of quality and control and not being confused by where it is going, it is unrivalled … I have never seen a Preston bus without a destination blind, a driver in uniform or a ticket machine. They are its core values, old fashioned quality standards.'

5.75 Some third parties commented on the quality of PBL's bus fleet and [former PBL Director X] told us that it sought to maintain its buses to high standards (which resulted in higher engineering costs). We noted that, excluding buses used for school services,[51] the average age of PBL's fleet in June 2007 was 6.7 years compared with [✂][52] for Stagecoach's Preston fleet before it launched its network of services in direct competition with PBL. By the time of the acquisition, the average age of PBL's fleet (excluding school buses) had decreased to [✂] years, compared with [✂] years for Stagecoach's Preston fleet. We also noted that the quality of the bus fleet had been significantly improved by the delivery of 18 low-floor, easy access buses for the Orbit service, of which [✂] were provided by LCC and the Department for Transport (see Appendix C, paragraph 16).

5.76 We noted that following the merger, Stagecoach cancelled two services (services 24 and 25), which were replaced by revisions to Stagecoach's inter-urban services. Several members of the general public wrote to us to complain about the impact of these changes on quality of service.

### *Conclusion*

5.77 The sequence of events that concluded with the acquisition of PBL by Stagecoach was commenced in 2006: shortly after a meeting between Stagecoach and PBL in July 2006 at which Stagecoach's expression of interest in an acquisition of PBL was rejected, Stagecoach developed a plan for expansion in the Preston area and less than a year later launched a number of intra-urban services in direct competition with PBL. The period of abnormal competition that ensued resulted in a rapid degradation of PBL's financial position and ultimately its sale. It also resulted in considerable losses for Stagecoach.

5.78 In order to achieve its aims, Stagecoach seemed prepared to suffer heavy losses for a considerable period of time by industry standards (see Appendix G, Annex 3). Although it had taken some action to reduce the scale of those losses, including withdrawal of one service and some fare increases, by the time of the merger, about 18 months after their launch, its new intra-urban services were still generally not covering their incremental costs and there could not have been any reasonable expectation that these services would generate a significant positive return in the near future, absent a radical change to the competitive situation in Preston.

5.79 We were not convinced by Stagecoach's arguments that it was PBL's inefficiencies and poor management which had resulted in its financial difficulties; nor by Stagecoach's argument that, at most, by winning market share from PBL it would be likely to weaken PBL to an extent, but only by virtue of competitive behaviour which was entirely legitimate in attempting to win a minority market share. Instead, it seemed to us that the outcome of the abnormal competition in Preston was governed primarily by the scale of losses both protagonists were prepared and able to support, given the level of financial resources available to them and, critically to the eventual outcome, the period for which each was able to do so.

5.80 In our view, the main cause of PBL's failure was its limited ability to sustain over a prolonged period of time the losses that resulted from competition with the heavily loss-making services introduced by Stagecoach, although it is also possible that some of the decisions made by PBL's management may have brought forward the

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[51] School buses (which are used to a limited extent on commercial services at peak time, due to increased congestion) were on average 18.7 years old, thus the age of the PBL's entire fleet was on average 9.8 years old.
[52] This number includes school buses. As of May 2007, there were six PVRs allocated to school contracts and the average age of Stagecoach's fleet would be slightly lower if these were excluded from the calculation.

failure of the business. Although there may have been other responses open to PBL, the evidence we have seen suggests that PBL's managers could not identify any alternative than to defend PBL's position by increasing the frequency of its services and retaliating on some of Stagecoach's routes.[53]

5.81 Stagecoach repeatedly denied that its entry to the market was part of any acquisition strategy. Much of the evidence we have seen would be consistent with an objective of driving PBL out the market; but other evidence may suggest otherwise, and objectives may indeed change over time. However, we do not need to conclude on Stagecoach's intentions and they are not critical to our analysis given that we are satisfied that the effect of its actions during the period of abnormal competition was to drive PBL out of the market. Stagecoach's entry into PBL's routes caused considerable damage to PBL's profitability and ultimately resulted in its owners' decision to sell. Even though there was some improvement in the financial performance of Stagecoach's new services by autumn 2008, PBL had come under severe financial pressure well before then, with the result that its shareholders had little realistic option but to sell to Stagecoach.

5.82 Hence Stagecoach's conduct in the two-year period that preceded the merger had the effect of driving PBL out of the market and/or rendering it unattractive to a potential purchaser, conduct that Stagecoach pursued with little regard for profit and normal commercial considerations. The character of Stagecoach's entry into the Preston intra-urban market in the period that led up to the merger situation and its effects on both its own Preston operations and on PBL are relevant in our consideration of the counterfactual, ie what would have happened had the merger not occurred, including whether the effects of the merger should be assessed on the basis that PBL was a 'failing firm' at the time of the merger, as Stagecoach has argued.

## 6. Counterfactual

6.1 In a submission to us, Stagecoach made the following arguments:

*(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.

*(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.

6.2 Stagecoach's starting date for its assessment of the counterfactual is September 2008, when Stagecoach was approached by KPMG. Given the circumstances of this merger described in Section 5, and for the reasons set out in the following paragraphs, we do not consider that this is an appropriate basis for the counterfactual analysis. For completeness, our detailed consideration of Stagecoach's submission that PBL was a failing firm is set out in detail in Appendix H.

[53] This is explained in detail in Appendix G, paragraphs 56 to 59.

6.3 The CC's guidance[54] on the counterfactual states:[55]

> In applying the SLC test, the CC will evaluate the competitive constraints on firms with the merger compared to the situation that would have been expected to prevail without the merger (sometimes referred to as the 'counterfactual'). The counterfactual will be that situation which the CC expects to arise in the absence of the merger under consideration and will, in many cases, relate to the existing, pre-merger, competitive conditions. However, in certain circumstances the CC may need to take account of other factors, such as expected changes in the structure of the market or alternative developments that may be expected in the absence of the merger. This is in order to reflect as accurately as possible the CC's expectation of the rivalry which will occur in the absence of the merger.

6.4 We also, however, consider that in assessing the counterfactual it is appropriate to disregard steps taken by the acquiring company which had the effect of bringing about the merger. As explained in detail in Section 5 (in particular, in paragraphs 5.10 to 5.12, 5.23 to 5.30 and 5.47 to 5.51), we received extensive evidence that Stagecoach's conduct in the 18 months that preceded the merger was pursued with little regard for profit and normal commercial considerations. This abnormal competition from Stagecoach in our view had the effect (and must have been expected to have the effect) of removing PBL from the market or marginalizing it as a competitive threat to Stagecoach (including by rendering it an unattractive acquisition to third parties). Given the nature of Stagecoach's behaviour and the significant losses incurred by both companies, we do not consider that the competition that took place during this period reflects the rivalry that could be expected to occur in the absence of the merger. Nor, for the same reason, do we accept that we should assess the counterfactual on the basis that PBL was a 'failing firm' at the time of the merger and that Stagecoach would inevitably have ended up with its current high share of the market for bus services in Preston irrespective of the merger.

6.5 The appropriate starting point for the assessment of the counterfactual is therefore the period that preceded the launch of Stagecoach's new services in Preston as representing normal, pre-merger market conditions.

6.6 Starting with the situation that prevailed in Preston until early 2007, we considered what could have been expected to happen to PBL and Stagecoach's bus operations in Preston in the absence of a merger between them.

### *PBL's options*

6.7 The financial position of PBL up to March 2007, its last financial year-end before Stagecoach launched its new services, is described in paragraphs 2.12 and 2.13. We noted that PBL had made a profit before tax in each of the four financial years to 2007. It had also built up cash balances of £1.75 million at March 2007.

6.8 We asked PBL's former management whether PBL was successful and had adequate finance before competition intensified in 2007. They told us that, although the business was not making a large profit, it was making sufficient profit for it to continue to invest in vehicles, and it had quite a modern fleet, including buses for its Orbit

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[54] The identification of the appropriate counterfactual is quite distinct from the identification of the merger situation in paragraph 3.10. The counterfactual is not a statutory test but an analytical tool used to assist in answering the question posed by section 35 of the Act.
[55] *Merger References, Competition Commission Guidelines, CC2*, June 2003, paragraph 1.22.

services, some of which had been publicly funded (see Appendix C, paragraphs 15 to 19, for more details on the age of PBL's bus fleet).

6.9 Stagecoach considered that PBL was not particularly well managed, and that PBL's model of employee ownership was likely to prove unsustainable in the long term. We noted PBL's levels of profitability, its generation of cash in the years before 2007, and also its decision to close its defined benefit pension scheme to future service in order to stem the deficit. We did not think that any inefficiency that might have existed was significant enough materially to affect PBL's performance in the counterfactual. We also considered that the company's low profits and high density of services, combined with a strong cash position, would have deterred most operators from challenging PBL's position.

6.10 PBL's former management told us that when shareholders left the company, they had to sell their shares to the EBT. Later, they could retain them for two years after leaving. There had been 262 shareholders initially, but we found that the number had fallen to 94 by October 2008. PBL's former management said that the share price, which was calculated annually by a firm of accountants, had risen sharply once the debt incurred at the 1993 buyout had been repaid, reducing the incentive to buy any new shares offered. Given the age profile of the remaining shareholders, PBL's former management thought that over the next ten years many of them would have left and the benefit for the employees of employee ownership would have diminished. It was therefore possible that PBL would eventually have been sold to third-party owners. However, we saw no reason to think that it would have ceased to operate as a result.

### *Stagecoach Preston*

6.11 As we set out in paragraph 2.6, before Stagecoach's launch of its new services in 2007 Stagecoach Preston was performing poorly relative to other Stagecoach depots. Management had identified the lack of scale in its intra-urban business as a cause of this underperformance. However, we noted that the Preston depot made an operating profit of £[✂] in the year to April 2007, that it had operated its network for several years, and that the depot was important to Stagecoach's other operations elsewhere in Lancashire. We received no evidence to indicate that the Preston operations would not have continued in the counterfactual. We recognized that, if profitability remained below Stagecoach's requirements, one option would have been for Stagecoach to sell its Preston operations to another bus operator. In April 2001 Stagecoach had sold its operations in Bolton, Blackburn and Burnley to Blazefield Holdings (see paragraph 2.5), so a sale would not have been unprecedented. Nevertheless we saw no reason to think that it would have ceased to operate as a result.

6.12 During the inquiry, [Stagecoach Director C] confirmed his view that two efficient companies could continue to operate viably in the Preston urban environment. For many years both Stagecoach and PBL had operated independently of each other. There was no reason to suppose that the Stagecoach business would not have survived. He had some reservations about PBL, as it was then structured, but with more efficient management, the two separate businesses could have continued almost indefinitely as they had done before the period of abnormal competition.

### *Conclusion*

6.13 We therefore concluded that the appropriate benchmark against which to assess the competitive effects of the merger was the competitive situation which prevailed before the launch of new intra-urban services by Stagecoach in 2007. PBL would most likely have continued to operate buses in Preston in much the same way as it had done in preceding years. Stagecoach Preston would also most likely have continued to operate on its old routes while seeking improved profitability in one way or another, whether as part of Stagecoach or in the hands of another operator.

## 7. Market definition

### *Introduction*

7.1 Market definition is not an end in itself. Its purpose is to provide a framework for the analysis of the competitive effects of the merger. Further details of our consideration of market definition are set out in Appendix I.

7.2 Market definition normally identifies a collection of products or services, and an appropriate geographic area, that delineates the market. In transport inquiries, however, the boundaries between the product and geographic aspects of market definition may not be clear-cut. For example, one can view purchasing a ticket to journey from A to B by bus as an element of the product offering or as a geographic aspect of the offering, and we have for this purpose considered these two aspects together.

7.3 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 the SSNIP test as traditionally applied is not an appropriate tool to understand the competitive constraints in bus markets. The detail of its arguments is set out in Appendix I, paragraphs 65 to 67.

7.4 For the following reasons, we disagree and have used the hypothetical monopolist test for the purposes of delineating the relevant market in this inquiry:

*(a)* Stagecoach's fare policies in Preston show that fares are an important aspect of bus competition in the Preston area.

*(b)* In any event, the SSNIP framework can be applied flexibly to the factors that drive customer behaviour in the specific market under consideration. In particular, it can be applied to changes in frequencies or punctuality, or some combination of those factors (as demonstrated by the range of non-price elasticities set out in Appendix I, Annex 1).

7.5 This section considers in turn: the degree to which there is demand-side substitution between flows following a SSNIP test; whether passengers value access to a network of bus services; the degree to which other forms of transport provide a competitive constraint; and whether we should define a separate relevant market for particular consumer groups or for tendered and commercial services.

### *Consumer demand for bus services*

7.6 Passengers need to travel from an origin to a destination. Such a journey between two points is defined as a flow. For the purposes of considering demand-side substitution, our starting candidate market is bus services on a particular flow.

7.7 We considered whether enough passengers might consider substituting between alternative flows to render a 5 per cent increase in price (or a small but significant diminution of service, such as reductions in frequency, hours of operation or quality of the buses) on one 'candidate' flow unprofitable. Passengers will only consider options that allow them to complete the same desired journey. As passengers will need to walk to and from bus stops, it is possible that they would be willing to walk to alternative bus stops where substitute routes are positioned close together.

7.8 In line with the approach taken in previous inquiries, we worked on the basis that any two flows that have both their origins and destinations within 500 metres of one another could be considered as possible demand-side substitutes. We would expect this to be applicable both in the case of a fare increase or a diminution of service (such as a cut in frequency). The arguments and evidence put forward by Stagecoach on demand-side substitution between individual flows are discussed in detail in Appendix I, paragraphs 5 to 15.

7.9 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 bus services along different flows are complements to one another (in so far as they will tend to make use of them together).[56] We therefore considered whether it was appropriate to define a 'network' market as a result of demand-side complementarities. If we found that the Preston area could be described as a network market and that the merger had led to an SLC, that would suggest that only large-scale entry capable of offering a competing network would countervail any SLC finding. In our view, the evidence on demand-side complementarities in Preston, which we discuss in Appendix I, paragraphs 16 to 25, was inconclusive.

7.10 We also considered whether any other forms of transport should be included in any of the relevant markets we had identified. Stagecoach argued that the relevant market should include at least 'all public transport', that walking and cycling might also be sufficiently viable options on shorter flows and that substitutability between private car and bus journeys should also be taken into account. In our view, the available evidence, which we set out in Appendix I, paragraphs 26 to 50, suggested that few customers would switch from bus to another mode of transport following a SSNIP and other modes of transport should therefore not be included in market definition. In particular, estimates of the price elasticity of demand for bus travel other than in the very long run[57] tend to be low, suggesting that insufficient passengers would switch to alternative modes of travel in the event of a fare increase so as to render the fare increase unprofitable. This would also apply to service reductions.

### *Supply of bus services*

7.11 We now address whether the market should be expanded because of the potential for reactions on the supply side by rival bus companies. For example, if rival bus companies are able to 'enter' or increase services on a particular flow, by substituting resources from one service to another service, or with new capacity on a sufficient scale and sufficiently rapidly to render a price increase or diminution of service by a hypothetical monopolist on a flow unprofitable, then it may be appropriate to widen the market beyond that flow.

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[56]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.
[57]At least 15 years.

7.12 Stagecoach told us that because buses were themselves mobile, this meant that bus capacity could be shifted from one route to an alternative route relatively easily and at short notice. Stagecoach accepted that the constraint which defined the boundary was the cost of moving buses and drivers from their home depot to the centre of Preston or other relevant points where a Preston service could commence. This cost would be defined by various factors, such as fuel, wage and maintenance costs.

7.13 We agreed 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 relatively short notice to take advantage of profitable opportunities within the SSNIP framework. The validity of this premise is illustrated by the large-scale expansion of Stagecoach on to PBL's routes, following less than a year of planning and the subsequent rapid expansion of PBL on to two of Stagecoach's routes.[58]

7.14 There are three other operators of commercial services in the Preston area—Blue Bus, Fishwicks and Transdev. These operators overlap with the merging parties primarily alongside the main corridors leading to Preston Bus Station from the south. None of the three operators provides a sufficiently extensive service in the Preston area to exert a competitive constraint on Stagecoach or PBL.[59] Moreover, Blue Bus and Fishwicks are considerably smaller in size and do not have the same access to resources as PBL and Stagecoach. Of the two, only Blue Bus said that it would be willing to expand in the Preston area, albeit to a very limited degree. While Transdev, as a national operator, has access to significant resources, it would only be able to expand its services in the Preston area to a limited degree [✂]. Other operators with depots not far from Preston have never operated intra-urban commercial services in Preston and told us that they would not consider entering Preston as a result of a SSNIP test.[60]

### *Subgroups of consumers*

7.15 Stagecoach submitted that different groups of customers—in particular, older passengers, students, commuters and cash-paying adults—displayed different levels of price sensitivity. We agreed with this general premise, but noted that the elasticities for all the customer groups were relatively low and did not identify a sufficiently large difference between the elasticities of the different groups to indicate that the analysis should be further split along these dimensions.

7.16 Since competitive constraints are similar for all groups, it seemed pragmatic to aggregate across customer groups.

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[58] Stagecoach noted that one of the services with which PBL entered on Stagecoach's routes, service 2 to Southport, was filtered out of our analysis on the basis of insufficient frequency and thus should not be regarded as effective competitive constraint. We agree with Stagecoach.

[59] In the case of the Preston intra-urban market, Blue Bus, Transdev and Fishwicks have been filtered out as a competitive constraint on Stagecoach and PBL since they do not overlap with most Stagecoach and PBL services or only do so at low frequency. As noted in Appendix I, 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. We followed the methodology established in our Arriva/Sovereign and FirstGroup/ScotRail inquiries. According to this methodology, 'frequent services', ie services running every 10 minutes or less, are constrained by other services with a frequency of no more than 10 minutes greater than the incumbent's; and 'less frequent' services are constrained by services with frequencies of no more than twice as long as the incumbent's.

[60] The reasons given to us by other bus operators for not wishing to enter the Preston area are varied. These reasons are discussed in detail in Appendix K.

### *Tendered services*

7.17 We also considered whether tendered services were in the same market as commercial services. In most cases, tendered services do not overlap with commercial services, otherwise there would be no reason for Councils to put these services out to tender.

7.18 Stagecoach argued that tendered services could not compete with overlapping commercial services or other tendered services on the basis of price and/or frequency, as these were set by the local authority for a specific period and there was no scope for short-term supply-side substitution of buses to or away from tendered services, to compete with other tendered or commercial services, as the service levels are contractual commitments.[61] We agreed with Stagecoach and, for the reasons set out in Appendix I, paragraphs 79 to 87, conclude that the markets for tendered services and for commercial services in the Preston area are distinct.

7.19 Therefore, to understand the impact of the merger on tendered services, we examined the nature of competition between Stagecoach, PBL and other bus operators in bidding for contracts to supply tendered services.

### *Conclusions on market definition*

7.20 We therefore concluded that:

*(a)* Consumers undertake point-to-point journeys. From a demand-side perspective, this is the basis for market definition in the Preston area.

*(b)* Although we found some evidence that passengers using Preston city intra-urban services value interconnections more than do Stagecoach's passengers on average in the UK, overall the evidence is not sufficiently strong for us to conclude that the relevant market could be described as a network market as a result of demand complementarities.

*(c)* It is possible to widen the relevant market on the basis of supply-side reaction. Only Stagecoach and PBL were able to pose a significant constraint on each other on every non-overlap flow. Out of the other operators present in the Preston area—Blue Bus, Fishwicks and Transdev—only Blue Bus said that it might offer a constraint on a limited number of non-overlap flows if it expanded on a sufficient scale.

*(d)* Other forms of transport should not be included in the relevant market. Although we acknowledge that the demand for car and bus travel interact, any constraint from car on bus travel will only be felt over the long term and following substantial changes in consumers' travel habits or disposable income rather than following a SSNIP test.

*(e)* Further segmentation according to the different types of customers is not necessary.

*(f)* The markets for tendered and commercial services are distinct.

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[61] 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 tendered services could be used on commercial services at other times of the day at a very low incremental cost.

7.21 In relation to commercial services, from the demand-side perspective, the relevant market could therefore be defined as the supply of services on point-to-point journeys within the Preston area. We, however, recognized that there was scope for supply-side substitution. Given that Stagecoach and PBL were the only two competitors with significant frequency that were either actually or potentially present on each flow, we found it convenient to aggregate the competitive conditions on individual flows for the purposes of our competitive assessment and consider the supply of commercial bus services in the Preston area as a whole. The role of Blue Bus, Fishwicks and Transdev is further analysed in our assessment of entry and expansion. The role of actual and potential competition between Stagecoach and PBL is further analysed in our assessment of the competitive effects of the merger.

## 8. Assessment of the competitive effects of the merger

### *Theories of harm*

8.1 In our statement of issues published on 7 July 2009, we identified five possible ways in which the merger might result in an SLC. These theories of harm are as follows:

*(a)* the elimination of actual competition on overlap flows;

*(b)* the elimination of potential competition on non-overlap flows;

*(c)* the elimination of network competition;

*(d)* the chilling of competitive activity in the Preston area;[62] and

*(e)* the elimination of competition on tendered services.

8.2 For the reasons outlined in Sections 5 and 6, we considered that the effects of the merger should be measured against a level of competition similar to that which existed prior to Stagecoach's launch of its network of intra-urban services in summer 2007.

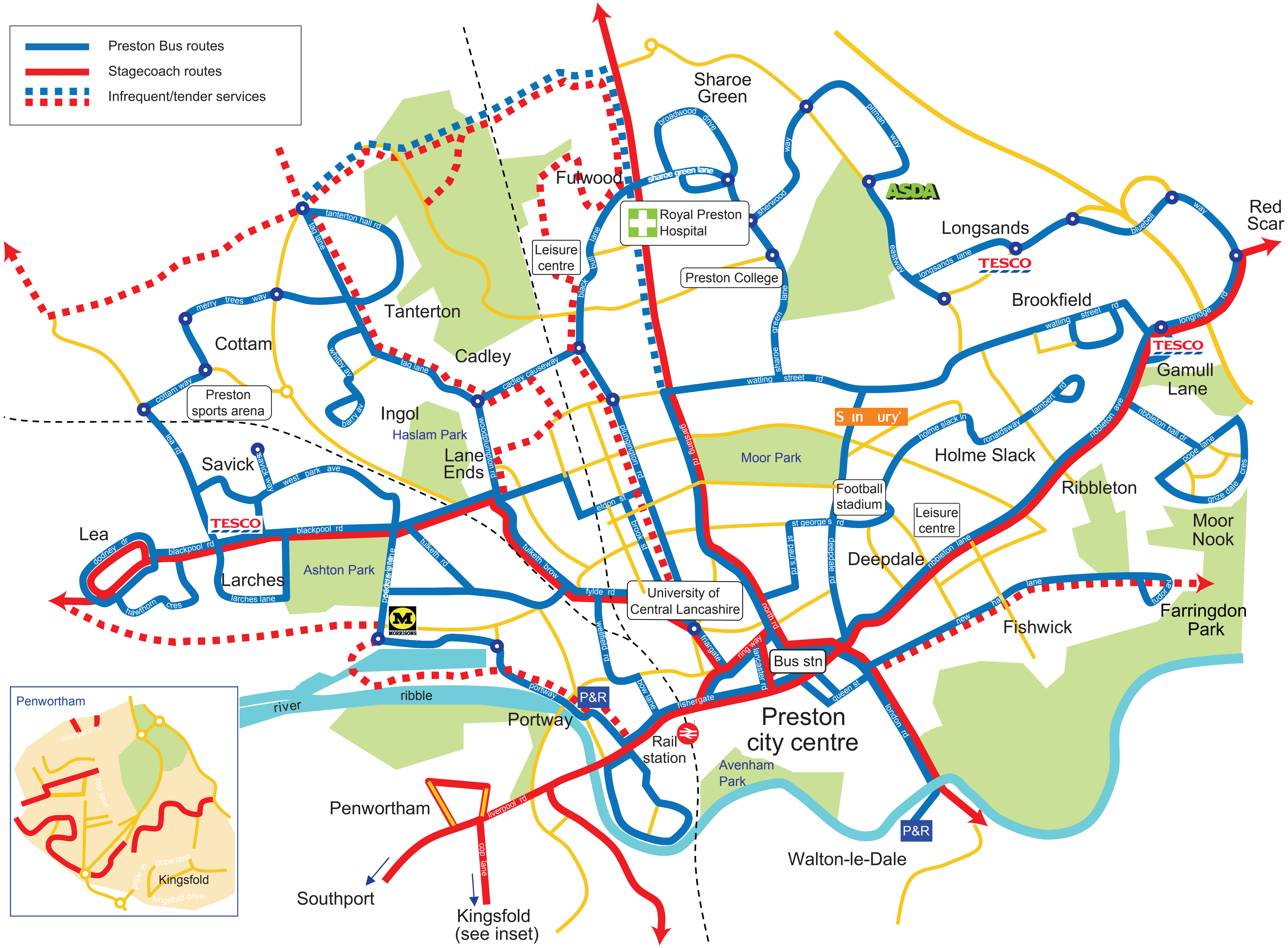
### *Competition in commercial services*

8.3 Before June 2007, PBL focused on serving intra-urban routes in the Preston city centre, north of the River Ribble, while Stagecoach focused on serving inter-urban routes and operated two intra-urban routes, both running from Preston Bus Station to Penwortham, south of the River Ribble. A map showing the bus services operating in the Preston area at May 2007 is shown in Figure 2.

[62] This is considered in the context of our analysis of barriers to entry in paragraph 8.27.

FIGURE 2

**Preston Bus and Stagecoach services in Preston, May 2007**



8.4 Between them, PBL and Stagecoach provided nearly all local commercial bus services within and around Preston. The dense network of intra-Preston services provided by PBL extended across all major corridors and served all residential areas and major service and employment sites north of the Ribble. In addition to its services to Penwortham, Stagecoach served all the main regional destinations from Preston, including Morecambe, Blackpool, Chorley, Bolton, Liverpool, Blackburn, Lancaster and Manchester. In June 2007, only one commercial intra-urban route was served by a competitor: this was the Preston–Broadgate service operated by Blue Bus. Only a handful of commercial inter-urban routes were served by other operators: Fishwicks operated services between Preston and Chorley and Preston and Leyland; and Transdev a service from Preston to Burnley. In addition, only PBL and Stagecoach had large depots in Preston (with licences for 150 and 120 vehicles respectively). Although Blue Bus had a depot in the city, its licence was for 12 vehicles only.

8.5 Using parties' flow data, after applying filters that discarded services that did not run at the same time of the day or had considerably different frequencies, we found that in May 2007, there were two main areas of PBL's overlap with Stagecoach:

*(a)* the area from Preston Bus Station alongside 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 services 2 and 2a to Longridge; and

*(b)* the area from Preston Bus Station alongside 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 and x61 and 68 to Blackpool.

8.6 PBL derived 26.4 per cent of its Preston revenues from these overlaps, while Stagecoach derived only 9.8 per cent of its Preston revenues from them.[63] Nonetheless, PBL considered that Stagecoach had always been competing on that part of the inter-urban network which came within the town, Stagecoach tending to follow PBL's fares. Stagecoach told us that on overlap flows, it monitored PBL's fare levels and to some extent passenger levels to see if there was surplus or insufficient capacity at certain times.

8.7 In addition to this actual head-to-head competition, we found extensive evidence that the two companies constrained each other through the threat of potential competition. The way in which this threat manifested itself in the period to June 2007 is explained in detail in Appendix J, paragraphs 8 to 24. We set out in the following paragraphs the key evidence and conclusions from this analysis.

8.8 For the purposes of this report, we distinguish between 'actual potential competition', whereby 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.

8.9 [Former PBL Director X] told us that as regards the nature of competition between PBL and Stagecoach before July 2006, PBL had never entered on Stagecoach's routes and was always apprehensive that Stagecoach could increase its services or put on new routes. By keeping fares low and frequency high across its network, PBL had aimed to pre-empt entry on its routes. We noted that by doing so, PBL exerted a constraint on Stagecoach's growth. [Stagecoach Director A] confirmed that PBL

[63]In this context, Preston revenues are defined as all revenues derived from flows within the Preston area, as estimated by Stagecoach.

maintained high frequencies on almost all its services as a general protection from entry and that Stagecoach was monitoring PBL's fare and passenger levels to see whether there was insufficient capacity at different times and if so offer cheaper fares.

8.10 Following the 21 July 2006 meeting between Stagecoach and PBL, the status of Stagecoach changed from that of a 'perceived potential competitor' to that of an 'actual potential competitor' to PBL on these routes where they were not already an actual competitor. The credibility of this threat was derived from both parties' extensive neighbouring networks, the growing incidence of overlapping flows, the location of their large depots and sufficient financial means, albeit not equal, to expand on each other's routes. We note that although both Stagecoach and PBL were the largest operators in the Preston area, Stagecoach's financial capacity was superior to PBL's. Other local operators (Blue Bus and Fishwicks) did not pose the same level of threat, due to their significantly smaller presence and available resources. PBL confirmed that its large cash balance would have deterred small operators from entering its routes.

8.11 Importantly, the threat of potential competition (both perceived and actual) had a significant constraining influence on both parties, although to a different degree. Stagecoach and PBL told us that PBL sought to protect its business by operating frequent local bus services. Internal PBL records also show that the company actively monitored Stagecoach's activities. In addition, potential acquirers of PBL told us that the presence of Stagecoach in the Preston area would have been factored into a bid for PBL, and vice versa. Stagecoach's competitor monitoring activities and fare policy for local journeys suggested that it perceived PBL as its potential competitor. Although Stagecoach did not appear to feel strongly constrained by PBL, it feared that if PBL were acquired by another competitor, it would become a threat to its own business (see Appendix F, paragraph 8).

8.12 Given that our evidence on demand-side complementarities was inconclusive, we did not need to conclude whether the merger had led to the elimination of network competition.

8.13 Therefore, we concluded that in the case of PBL, the merger has resulted in 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. The constraint imposed by potential competition from PBL took three forms: *(a)* a possibility that PBL might enter on its routes; *(b)* a constraint from PBL's high frequencies and low fares which were set by PBL to pre-empt entry on PBL's routes; and *(c)* Stagecoach's expectation that PBL would be purchased by another, more efficient, operator that could enter into more direct competition with Stagecoach.

### *Competition in tendered services*

8.14 We now turn to our consideration of the market for the provision of tendered services, which is reviewed in more detail in Appendix J, paragraphs 30 to 39.

8.15 Competition in the market for tendered services takes the form of a bidding process. Both merging parties have been active in the market, which can be subdivided into two different types of contracts: school services and non-commercial routes. We analysed bidding data provided to us by LCC for both types of contracts.

8.16 In the period since 2002, there were 26 tenders for non-commercial services and 41 tenders for school contracts in the Preston area. Both companies actively bid in the two markets, in competition with 31 other companies for non-commercial contracts and with 25 other companies for school contracts. Stagecoach won 15 tenders for non-commercial services and one school contract. PBL on the other hand won three bids for non-commercial contracts and 17 school contracts. Both parties represented a relatively sizeable proportion of both non-commercial route and school service tenders.

8.17 Nevertheless, we did not believe that the merger had reduced competition in tendered services for the following main reasons:

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

*(b)* these competitors generally felt 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.

### *Market entry/expansion*

8.18 In this section, we assess the extent to which entry (or the threat of entry) into the supply of commercial bus services in the Preston area would act as a competitive constraint on the merging parties post-merger. Stagecoach told us that entry did not occur very often but that the possibility of entry ‘keeps it on its toes’.

8.19 The focus of our analysis is on commercial bus services; given the relatively modest overlap existing between the parties on tendered local bus services and the existence of several credible alternative providers in this market, we do not expect the merger to result in an SLC on tendered services. Our consideration of barriers to entry and supporting evidence is set out in detail in Appendix K.

8.20 For entry to act as a constraint on the merged entity, it needs to be easy, timely and sustainable. In order for it to be an effective constraint, it needs to have sufficient potential impact on the profitability of the merged entity that it would be willing to alter its actions, and not take advantage of any market power, so that it does not attract entry against it. It is doubtful whether very small scale entry, perhaps on just one route with a very small number of buses, would be sufficient to induce Stagecoach to change its pricing and service strategy for the whole (or a substantial part) of the Preston area. We consider that there would need to be a credible threat of repeated entry by several small players, or alternatively a larger-scale entry (or where entry is on a small scale, the entrant has an ability to expand easily) would be required to act as a constraint.

8.21 We identified five possible types of barriers to entry: regulatory barriers; access to facilities, the most important of which appears to be depots; importance of scale; network effects arising through network ticketing; and strategic barriers following from the threat of an aggressive competitive response by an incumbent.

8.22 The regulatory requirements placed on bus operators are described in detail in Appendix E, paragraphs 3 to 17, and do not in our view represent a significant barrier to entry.

8.23 One bus operator, Blue Bus, argued that access to stands at Preston Bus Station was a significant barrier to entry. Blue Bus’s concern was with the distribution of stands, rather than the number of available stands. The other bus operators we talked to did not recognize this issue and our own visit to Preston Bus Station led us to believe that it was easy for passengers to cross the station to reach another stand. We therefore concluded that the distribution of stands at Preston Bus Station was not a major barrier to entry.

8.24 We considered whether the lack of availability of bus depots in the Preston area constituted a barrier to entry. Stagecoach told us that there were many industrial sites in and around Preston on which a depot could be established and 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. Stagecoach further submitted that there were several depots outside Preston, from which bus operators could enter the Preston market. We discussed this issue with a range of operators, both large and small. Neither category of operator generally considered access to land suitable for a depot in the Preston area as a significant barrier to entry. However, having a depot with spare capacity and pre-existing operations within or from Preston represent an advantage for bus operators. We accepted that, in principle, other depots within 30 minutes' drive-time of Preston could be used to supply intra-urban services in the Preston area. However, based on the evidence we received from the four large operators present within 30 to 35 minutes of Preston Bus Station, it appeared unlikely that any of them would be able to start supplying intra-urban services in Preston on a similar scale as the merging parties from their existing depot. In addition, we have not found any evidence that cumulative entry on a similar scale by a number of smaller competitors could be expected to occur in the foreseeable future.

8.25 We considered whether economies of scale, access to finance and a greater ability to take risks significantly favoured larger operators. We found that there were some economies of scale, in particular in relation to procurement, but this did not prevent small operators from competing, generally by filling gaps in service created by large operators. However, the difficulty of raising finance to purchase new vehicles and higher exposure to risk limited the small operators' ability and appetite to expand into new routes. This was illustrated by the propensity of small operators to favour competition for tendered services, which generally do not involve volume risk. We considered that the sunk costs would vary according to the size of entry or the operator. This was, however, not a determinative issue in this case.

8.26 We discussed the importance of network tickets with small bus companies operating in the Preston area. These companies told us that they were unable to compete in the provision of such tickets, and for some of them, this issue was an impediment to growth. However, a network advantage could in future be mitigated by the introduction of a multi-operator ticket by LCC. We also considered whether Preston could support two competing networks, but received conflicting evidence: both Stagecoach and PBL believed that two networks in direct competition within Preston could be commercially viable, while other large operators appeared less sure that the Preston market could support two competitors. We noted that the views of operators with limited knowledge of the Preston market might have been distorted by recent events in Preston.

8.27 Third parties, particularly small operators, may also be deterred from entry or expansion in the provision of local bus services in Preston by the expectation of aggressive retaliation from the incumbent operator. We heard from a number of small operators that Stagecoach's aggressive stance in Preston and elsewhere in the North-West of England had dampened their appetite for expansion. Larger operators, although less vulnerable, also factored the risk of retaliation in their decision to enter a market.

8.28 In our view, taken together, the above barriers to entry are likely to deter future entry or expansion in the Preston area of such a scale that would remove the loss of actual and potential competition we have identified. We tested our analysis by asking the five large national bus operators who had expressed an interest in purchasing PBL in the summer of 2008 whether they would be able to supply intra-urban services in the Preston area from their current facilities or willing to expand in order to supply intra-urban services in the Preston area in the future. Three of them (First, Go-Ahead and Veolia) gave a negative response to both questions. One operator (Arriva) was unsure about its capability to supply intra-urban services in the Preston area from its current facilities, but considered that expanding into Preston would be commercially unattractive. We noted that Arriva's preferred strategy for Preston was the acquisition of both PBL's and Stagecoach's Preston depots. The last operator (Transdev) would be able to supply intra-urban services in the Preston area from its existing depot, albeit only to a limited degree. It did not, however, consider Preston to be an attractive market for two operators whilst the market both in Preston and elsewhere was in decline.

8.29 We also asked six small operators if they would be willing to enter or expand in Preston as in the absence of strong evidence on demand-side complementarities, a cumulative entry or expansion by a number of small operators might in principle provide a similar constraint as entry by one large operator.[64] With the exception of Blue Bus, which would be prepared to expand on a route-by-route basis, none of the small operators wanted to enter the commercial services market. In any event, the possible expansion of Blue Bus would not address the loss of actual and potential competition because of its small scale and limited access to resources.[65]

8.30 To conclude, with the exception of a limited number of services that Blue Bus may introduce if it finds arrangements at Preston Bus Station acceptable, we have not identified any companies that would be willing to enter or expand their services in the Preston area in the near future.

### *Conclusions on the competitive assessment*

8.31 We found that in relation to commercial services:

*(a)* Before June 2007, PBL was constrained by Stagecoach in the form of both actual and potential competition. The nature of the potential competition changed in the period after July 2006 when Stagecoach became an 'actual potential competitor' as opposed to a 'perceived potential competitor' that it had been in the period before July 2006. The nature of actual competition remained broadly the same throughout the period before June 2007.

*(b)* Stagecoach was also constrained by actual competition from PBL but to a lesser degree than PBL was by competition from Stagecoach. It was also constrained by potential competition from PBL. This took three forms: (i) a possibility that PBL might enter on its routes; (ii) a constraint from PBL's high frequencies and low

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[64] Stagecoach suggested that the combination of the constraints posed by the potential entries by Transdev and Blue Bus would provide a similar constraint as posed by Stagecoach before the merger. We note that it is doubtful that Transdev and Blue Bus would be able to provide the same degree of constraint as Stagecoach, given their limited capacity to expand, and in any event this entry combination is unlikely to occur [✂].

[65] Stagecoach told us that we had placed undue weight on the opinion of third-party operators in so far as they were unlikely at present to enter the Preston market. This is because commercial strategies can quickly change. We have analysed both the ability and willingness of third parties to enter the Preston market. With respect to the parties' ability, only Blue Bus and Transdev have the ability to enter the Preston market; however, both to only a limited degree. With respect to the parties' willingness, the third parties' views have not changed since beginning of the inquiry [✂], and we have not seen any reason why these views should not be regarded as genuine.

fares which were set by PBL to pre-empt entry on PBL's routes; and
(iii) Stagecoach's expectation that PBL would be purchased by another, more efficient operator that could enter into more direct competition with Stagecoach.

8.32 The merger has eliminated actual and potential competition between the parties on a flow-by-flow basis. This constraint is likely to have been asymmetric with PBL being constrained by Stagecoach, while Stagecoach feeling more constrained by the possibility that PBL might be acquired by a more efficient operator.

8.33 We found that entry on the scale that could counteract the loss of competition we identified is unlikely to occur.

8.34 We did not find that the merger would lead to a loss of competition in relation to tendered services.

## 9. Conclusions on the SLC test

9.1 We have therefore concluded that the merger has resulted in an SLC in the market for commercial bus services in the Preston area as a whole. This can be expected to lead to a worsening in the price and non-price factors in relation to which the parties exerted a competitive constraint on each other, either directly or as potential competitors.

9.2 We have also concluded that the merger has not resulted in an SLC in the market for the provision of tendered bus services in the Preston area.

## 10. Remedies

10.1 Having concluded in paragraph 9.1 that the merger situation has resulted in an SLC, we have, under section 35 of the Act, to decide on three questions concerning remedial action, namely:

*(a)* Should the CC itself take action to remedy, mitigate or prevent the SLC or any adverse effects resulting or expected to result from the SLC?

*(b)* Should the CC recommend the taking of action by others, eg government, regulators and public authorities, for the purpose of remedying, mitigating or preventing the SLC or adverse effects resulting or expected to result from the SLC?

*(c)* What action should be taken? The CC should state the action that should be taken and what that action is designed to address.

10.2 The Act requires that the CC shall 'in particular, have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the substantial lessening of competition and any adverse effects resulting from it'.[66] The CC will identify remedies that are effective in addressing the SLC and its resulting adverse effects and will then select the least costly remedy that it considers to be effective. The CC will seek to ensure that no remedy is disproportionate in relation to the SLC or its adverse effects. The CC may also have regard to any relevant customer benefits (RCBs) arising from the merger.[67] Having identified the least cost, least intrusive remedy or package of remedies that the CC is confident will be effective, the CC may

[66] Section 35(4).
[67] Section 35(5).

take into account 'the effects of any action on any relevant customer benefits in relation to the creation of the relevant merger situation concerned'.[68]

10.3 Our Notice of Possible Remedies (the Notice), which was published on 3 September 2009, sought comments on the divestiture of PBL. We also invited views on the effectiveness of alternative divestiture packages, including Stagecoach Preston and a partial divestiture package comprising a subset of routes or services of either PBL or Stagecoach Preston but without a depot. We also sought views on behavioural remedies aimed at facilitating new entry and expansion and on behavioural remedies to control market outcomes. We received comments on this Notice and subsequently in the process from Stagecoach and a number of third parties.

### *Structural remedies*

10.4 A divestiture remedy would seek to restore the loss of actual and potential competition in Preston resulting from the merger, by either creating a new source of competition through disposal of a business or set of assets to a company not currently active in the Preston bus market or by strengthening an existing source of competition through disposal to an existing market participant independent of the merger parties.

10.5 To be effective in restoring the rivalry lost as a result of the merger, a divestiture remedy should involve the sale of an appropriate divestiture package to a suitable purchaser through an effective divestiture process. In considering the design of any divestiture remedy, we had regard to each of these three critical elements and to the need for the divestiture to present an acceptable risk profile.[69] In order to provide a remedy which is practicable and effective in addressing the SLC, it is important that the divestiture package should be saleable to a suitable purchaser. The question of saleability, in this case, required a consideration of the likely attractiveness of the package to potential purchasers, including its financial viability.

10.6 In addition, in analysing the effectiveness of the various structural remedies identified in the Notice, we took account the impact of the significant restructuring of PBL and Stagecoach Preston operations that took place shortly after the merger (and before the acceptance of interim undertakings by the OFT) and the related issue of the current financial performance of PBL.

#### *An appropriate divestiture package*

10.7 In identifying an appropriate divestiture package, the CC will normally take, as its starting point, all or part of the acquired business. This is because restoration of the pre-merger situation in the markets subject to an SLC will generally represent a straightforward remedy.[70]

10.8 In accordance with our guidelines, therefore, we would normally expect that the divestiture of a commercially viable PBL would be effective in remedying the SLC because it would re-establish the structure of the market expected in the absence of the merger and thereby restore the level of competition (actual and potential) that existed prior to the launch of Preston intra-urban services by Stagecoach in summer 2007. We noted that PBL had competed as a viable, independent company since

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[68]In making the assessment, we applied the framework on the assessment of the risk profile of divestiture remedies set out in *Merger Remedies: Competition Commission Guidelines, CC8*, November 2008, paragraph 1.14.
[69]*CC8*, paragraph 3.3. describes the categories of risk that may impair the effectiveness of divestiture remedies.
[70]*CC8*, paragraph 3.6.

1993, alongside Stagecoach Preston, and had been profitable in the five years up to and including the financial year ended March 2007.

10.9 However, PBL became loss making in 2008 and 2009 during the period of abnormal competition and remained loss making following the merger. As set out in Appendix L, Stagecoach made a number of changes to PBL's services following the completion of the acquisition in January 2009, which contributed in large part to a material decline in the extent of its network and a [✂] per cent fall in revenue, and since the acquisition there has been no independent commercial and financial management at PBL to take action to restore profitability. In its current form we did not consider that PBL was capable of competing effectively with Stagecoach. Consequently, we concluded that the divestiture of PBL, in its current form, would not be effective or practicable in remedying the SLC, both because PBL's current service offering was less extensive than it had been under normal competitive conditions, and also because PBL was currently not commercially viable.

10.10 Given that divestiture of PBL in its current form was unlikely to be an effective and practicable remedy, we looked at several other possible divestiture packages:

*(a)* a partial divestiture of a subset of routes operated by PBL and associated assets within Preston but without a depot;

*(b)* divestiture of a reconfigured PBL; and

*(c)* divestiture of Stagecoach Preston.

*Partial divestiture: a subset of routes with no depot*

10.11 We first considered whether the divestiture of a subset of routes including associated assets but without a depot could constitute an effective and practicable remedy, having noted that the divestiture of routes had been used as a remedy in previous CC bus merger inquiries, for example *Stagecoach/Scottish Citylink*. We incorporated within this analysis the possibility for such a subset of routes to be divested to one or more purchasers as we had found that in the absence of strong demand-side complementarities, several competitors could in principle provide collectively a constraint on the merged entity on a route-by-route basis (see paragraphs 78 to 80 of Appendix K).

10.12 Stagecoach stated in its response to the Notice that the scope of a suitable package might be an operation of around 20 buses containing routes pertaining to the Gamull Lane (service 11) and Lea/Larches (services 87 and 89) overlaps. Stagecoach told us that this divestiture package would be sufficient to restore the level of actual competition that existed in May 2007. This pair of PBL services would compete with Stagecoach services 1 (Longridge) and 68 (Blackpool) respectively, as these Stagecoach services overlapped on parts of these routes. Stagecoach services 1 and 68 were major inter-urban routes and contributed a significant proportion of Stagecoach Preston's on-bus revenues.

10.13 Stagecoach explained that following its network review, which was implemented in March 2009, services 68, 87 and 89 replaced PBL services 24 and 25 that had previously served the Lea/Larches destinations. A divestiture of routes 87 and 89 would therefore not fully restore the head-to-head competition that existed on these routes in May 2007 unless there were corresponding adjustments to route 68. It may nevertheless be possible to identify the routes that were subject to actual competition on these corridors in the period up to May 2007, and to isolate this subset of routes from either PBL or Stagecoach Preston with a view to divesting such a package.

10.14 However, under this scenario, Stagecoach would continue to operate the majority of the intra-urban services in Preston, which used to be operated by PBL, and also the vast majority of inter-urban services in and out of Preston. A significant source of competitive constraint on the intra-urban services operated by PBL was the threat of competition from Stagecoach. Similarly, Stagecoach was constrained by the presence of PBL in the Preston market. As explained in paragraph 8.10, the credibility of this threat and the resulting constraint posed by potential competition on both Stagecoach and PBL was derived from both parties' extensive networks, the growing incidence of overlapping flows, the location of their large depots and sufficient, albeit unequal financial means to expand on each other's routes. The divestment of a subset of two routes as proposed by Stagecoach would therefore not be capable of remedying the loss of potential competition in the Preston area.

10.15 We noted that increasing the scope of any route-based package beyond that proposed by Stagecoach might, in theory, be more effective in remedying the SLC that we found. Stagecoach did not make any further specific proposals for larger route-based divestment packages. We thought that, to be effective in restoring the potential and actual competition lost as a result of a merger, any divestiture of routes would have to be of sufficient scale to reinstate rivalry between two operators each with extensive and coherent neighbouring networks of commercial services within and around Preston. Consideration of a divestment of routes on the scale needed to result in such a situation immediately raises operational issues, in particular relating to the location and identity of the depot from which these routes would be operated.

10.16 There is a risk that the subset of routes specified by Stagecoach, or any alternative package, that did not include a depot would be unattractive to potential purchasers. As noted in Appendix K, the only commercial operators with a depot within a 30-minute drive-time of Preston Bus Station are Blue Bus, Fishwicks and Transdev. The depots owned by Blue Bus and Fishwicks are small in comparison with the depots operated by PBL and Stagecoach Preston. The depot owned by Transdev would allow it to serve only the east part of Preston, but this operator told us [✂] it would be uneconomical if the depot was more than 5 miles from the city centre. Based on the evidence set out in paragraph 8.24 and in Appendix K, no other commercial operator has a depot sufficiently close to Preston for it to be likely that they would find it commercially attractive to use their existing depot to supply intra-urban services in the Preston area. Furthermore, the evidence we received from potential purchasers indicated that acquisition of a package of routes but without a depot was an unattractive and high-risk means of entering the Preston market: with the exception of one operator which would be willing and able to acquire two routes from Stagecoach (provided that behavioural undertakings prevented Stagecoach from increasing frequencies on the acquired routes for three years), all the potential purchasers we talked to expressed a strong preference for the inclusion of a depot in the divestiture package.

10.17 We considered whether the difficulties resulting from lack of depot facilities in the Preston area could be overcome through a mechanism to facilitate depot access in Preston. Stagecoach told us that it would be willing to offer overnight parking and refuelling on commercial terms at either the PBL or Stagecoach Preston depots, but it would not be willing to provide maintenance. We noted that in its response to the Remedies Notice in the Stagecoach/Eastbourne inquiry, Stagecoach gave various reasons why it considered that granting depot access to a competitor would be unworkable in practice, particularly if depot access were to go beyond the provision of overnight parking and refuelling services. Potential purchasers also highlighted practical difficulties associated with depot sharing and told us that, to operate frequent intra-urban services of the type that may be included in the package, they would require a dedicated Preston depot from which to operate. We thought that the extent of depot sharing that Stagecoach was prepared to offer was insufficient to meet the requirements of potential purchasers, and we also thought that an arrangement that went beyond the provision of overnight parking and refuelling could give rise to practical problems, including the risk of conflicting priorities and interests between employees of independent, competing bus companies at a shared depot and issues associated with ring-fencing commercially sensitive information. We also noted that any depot access arrangements would need to be monitored and enforced by the OFT, which would result in additional costs (and potentially a lack of flexibility that could hamper day-to-day operations) as they would need to be formalized in undertakings. We concluded that depot-sharing arrangements would be unattractive to potential purchasers, and that such arrangements would give rise to a number of practical difficulties and costs in design, operation and monitoring. We concluded that mechanisms to facilitate depot access, as part of a remedy to the SLC we found, were unlikely to be effective or practicable.

10.18 We considered whether it would be possible for Stagecoach to sell several individual routes or combinations of route packages, without a depot, to more than one purchaser. In theory, this might remedy the SLC through the transfer to a number of owners of the various routes formerly operated by PBL. However, it would not reinstate the rivalry that had been lost as a result of the merger, between two operators each with extensive and coherent neighbouring networks of commercial services within and around Preston. Moreover, as noted in paragraphs 10.16 and 10.17, for each potential purchaser that did not have access to a depot it would be necessary to overcome this practical difficulty. Designing effective depot access mechanisms for more than one purchaser of routes would be particularly complex and their monitoring costly. In addition, it would be necessary to design an effective process to handle multiple bidders for various divestiture packages, and mitigate the risk that bidders would cherry-pick specific routes or request that a particular route was specified for its individual requirements. We concluded that this would not be an effective or practicable approach.

10.19 Another possibility that we considered was that a potential purchaser of a small subset of routes might, in time, develop a new depot or outstation and launch additional services across Preston. However, we saw no evidence to suggest that such an investment proposal was likely to take place with sufficient certainty or timeliness for us to have any confidence that this would result in an effective competitor on a sufficient scale within a reasonable period of time. There is a significant risk that a purchaser of a small set of routes would not seek to expand beyond the acquired routes, or would be constrained from doing so. We concluded that this would not be an effective or practicable approach.

10.20 We concluded that a partial divestiture package comprising only routes and related assets, but excluding a depot, would not be an effective remedy. This is for the following reasons. First, to be effective in restoring the potential competition lost as a result of the merger, any divestiture of routes would have to be of sufficient scale to reinstate rivalry between two operators each with extensive and coherent neighbouring networks of commercial services within and around Preston. Second, for operational reasons, to provide a bus network of this scale in the Preston area it would be necessary for a bus depot in Preston to be included in the divestiture package. Third, arrangements to facilitate depot access would not be practicable. Fourth, a divestiture of routes but without a depot would involve an unacceptably high level of risk that it would not attract suitable purchasers: all of the potential purchasers with which we discussed potential divestiture options—with a single exception, which was only interested in acquiring two routes subject to a high degree of purchaser protection—told us that they would require a bus depot in Preston.

*Divestiture of a reconfigured PBL*

10.21 Having found that the divestment of a subset of routes (and associated assets), but without a depot, would not be an effective remedy, and bearing in mind that PBL was partially integrated into Stagecoach and was not operating as a stand-alone business following the merger, we considered whether and, if so, how PBL could be reconfigured to reinstate the levels of potential and actual competition lost as a result of the merger and that existed in the Preston area before summer 2007.

10.22 In making our assessment, we sought to identify the smallest, potentially viable, stand-alone business that could compete successfully on an ongoing basis and that would effectively remedy the SLC. Such a unit would need to include at least PBL's depot (as explained above, we considered it necessary to include a depot within any divestiture package to achieve an effective remedy) and the operator's licence (which is still held by the legal entity PBL[71]), without which the new owner of PBL could not operate commercial services within Preston.

10.23 Through our remedies process, we found some interest from a small number of bus operators in the acquisition of a reconfigured independent PBL, although this was accompanied by caution, particularly with respect to the asset perimeter and the defined benefit pension liability. Stagecoach stated in its response to the Notice that divestiture of a reconfigured, viable PBL would be possible. Stagecoach told us that it would be possible to restore PBL to profitability and achieve a successful divestiture, and that a bus network review in Preston and a route-costing exercise at PBL would be necessary steps to achieve this.

10.24 We took the view that, provided the divested business was commercially viable (ie capable of generating profit or positive cash flow going forward), the current and prospective financial performance of a reconfigured PBL would largely affect its value (ie the price that Stagecoach was able to obtain for the divested business) as opposed to its saleability or other aspects of the effectiveness of the remedy. The financial resources of the bidder and its plans for the capital structure of PBL, which we would consider at the time of purchaser approval, would also contribute to the future ability of a reconfigured PBL to compete.

10.25 In order to define the scope of the divesture package, we first considered what services and assets would need to be included to minimize composition risks.[72] As a starting point for the divestiture package, we thought that risks would be minimized if the package resembled PBL as it was configured in May 2007, as PBL had been a viable stand-alone business at that time. Nevertheless we considered whether it would be practical to define the scope of the package otherwise without creating risks (eg to its competitiveness or viability) or practical difficulties, and we therefore examined the following:

*(a)* commercial services;

*(b)* tendered services and other commercial activities; and

*(c)* identification and inclusion of key assets.

10.26 We discuss each of these issues in turn.

[71]The named individuals under the licence registration are currently [✂] and [✂] of Stagecoach.
[72]Composition risks are risks that the scope of the divestiture package may be too constrained or not appropriately configured to attract a suitable purchaser or may not allow a purchaser to operate as an effective competitor in the market (see *CC8*, paragraph 3.3).

- *Commercial services*

10.27 Following the completion of the acquisition, Stagecoach substantially reduced the commercial services operated by PBL. These changes came into effect on 22 March 2009. This network review resulted in a reduction in the number of passengers on PBL-operated vehicles of more than [✂] million passenger trips[73] a year and contributed in large part to a decline in total revenue of [✂] per cent, compared with the previous year. PBL's commercial revenue[74] was £[✂] million in 2008/09 and is expected to decline to £[✂] million in 2009/10—a £[✂] million decrease (before adjusting for recent fare increases). Further details of the financial consequences of these changes are set out in Appendix L. The relative distribution of passenger numbers in the Preston area between Stagecoach and PBL between May 2007 and May 2009 showed that the PBL market share in Preston fell from [✂] per cent in 2007 to [✂] per cent in 2009.[75]

10.28 We concluded that the PBL network of commercial services following the March 2009 changes was too small to form the basis of an appropriate divestiture package. We thought that this composition risk could be addressed through a reversal of the transfer of some or all of the commercial services that were carried out by Stagecoach in March 2009.

10.29 We noted that there might be practical difficulties in reversing all service changes to the extent that the relevant services no longer existed and/or had been absorbed into the existing services either at PBL or Stagecoach Preston during the March 2009 network review. The starting point for the process of reversing these changes would therefore be to identify comparable services currently operated by Stagecoach (ie from its Frenchwood depot) and restore the route registrations to PBL. We identified Stagecoach routes [✂] as meeting this criterion. Using passenger numbers in May 2009, we estimated that the revised PBL market share that could be achieved by adding back these routes would be approximately [✂] per cent, which is lower than that enjoyed by PBL in May 2007, but higher than the share in May 2009.

10.30 We examined the impact on PBL's revenue that would result from this reconfiguration of PBL's commercial services. We estimated that, based on the fares in operation since 21 September 2009, a large proportion of the decline in PBL's annual commercial revenue between 2008/09 and 2009/10 would be redressed through this reconfiguration of PBL. As set out in Appendix L, approximately £[✂] million commercial revenue would be reinstated as a result of the route reconfiguration and PBL's total revenue would be approximately £[✂] million after other relevant adjustments, which is close to the average annual turnover achieved by PBL in the four years to 30 March 2007[76] of £10.58 million.

10.31 For the divestiture of a reconfigured PBL to be an effective remedy, the reconfigured PBL would also need to be a commercially viable business. In order to assess viability, we analysed and reviewed PBL's management accounts for the period April 2008 to September 2009, route costing analysis that had been prepared by PBL's management in 2006 and 2008 and other historical data for PBL. We also analysed information prepared by the Stagecoach Shared Services Centre relating to on-bus weekly and monthly takings for both PBL and Stagecoach Preston and information

[73] The effects of general economic conditions cannot fully be isolated from this decline (see Appendix G). Nonetheless, we considered the changes made on 22 March 2009 to have been the major factor giving rise to the decline in patronage and revenue.
[74] Commercial revenue comprises on-bus and off-bus revenue and excludes concessionary fare reimbursement, tenders and scholars.
[75] The market shares were calculated on the basis of the passenger growth analysis presented in Appendix G, Table 1.
[76] Appendix C, Table 1.

prepared by PBL in relation to tenders in the current financial year. We also asked the Monitoring Trustee (MT) to investigate changes in PBL's financial performance between 2008 and 2009. We considered all of these sources of evidence together before reaching our conclusions. However, we did not forecast profit or cash flow of PBL following the reversal of the March 2009 commercial route changes. We did not consider that it was the CC's role to develop a business plan for running PBL, which would be a matter for potential purchasers. However, in order to satisfy ourselves that a reconfigured PBL would be capable of operating at a profit, we looked at the best available evidence:

*(a)* The first piece of evidence we looked at was the fact that PBL had achieved profitability at levels of revenue consistent with the reconfigured revenue in the four financial years up to and including the year ended March 2007 (Appendix C, Table 1).

*(b)* The second piece of evidence was the strong positive contribution margins achieved by PBL in 2006 on the routes equivalent to those which would be returned to PBL as part of the reconfiguration exercise. In particular, we noted the £[✄] million per year contribution generated by the PBL routes that were in the main transferred to Stagecoach[77] (Appendix G, Table 6).

*(c)* The third piece of evidence was Stagecoach's submissions to us that it would be possible to restore PBL to profitability, which we had no reason to doubt but which could not be demonstrated to us in the form of a business plan at the time of this report.

*(d)* The fourth piece of evidence was the third-party remedies discussions, during which a number of bus operators expressed interest in a reconfigured PBL and their ability to operate commercially viable bus operations in Preston following the acquisition of PBL.

10.32 Stagecoach told us that using historical profitability as a reference point for future prospects of PBL would result in us not taking into consideration a number of other factors contributing to the deterioration in PBL's financial performance.[78] Whilst it is not possible to isolate fully the effect of service changes from these other factors, we have formed a judgement, using the best evidence available to us. Based on this evidence, and in light of the very significant impact of the March 2009 service changes on PBL revenues, we concluded that we had sufficient evidence to satisfy ourselves that PBL was capable of being reconfigured as a commercially viable business if its operating scale was restored in the manner described above. We did not see any reason why reversing these service changes would adversely affect the commercial viability of Stagecoach Preston to the extent that would compromise the effectiveness of this remedy.[79]

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[77]Annual contribution from services [✄] (June 2006). We noted that Stagecoach had identified a number of factors that made it difficult to rely on PBL's historical profitability (eg in 2006) as a guide to its future prospects (including: the effects of the reduction in the LCC concessionary fare scheme, changes in fuel duty, general economic conditions), but we noted that each of these factors were independent of the merger and were issues that faced all bus operators, and as such we would expect these factors to be reflected in the general level of prices and services.

[78]Including changes in: fare levels, competitor actions, economic factors, concessionary fare reimbursement, fuel duty, returns on tendered services. External factors contributed to the issues faced by PBL but were faced by all bus operators in and around Preston, whereas the route transfers had a specific adverse effect on PBL.

[79]Until the launch of the new intra-urban services in 2007, the Stagecoach Preston depot was making a profit (see Appendix B, paragraph 3). We did not see any reason why reversing the March 2009 changes should prevent Stagecoach from returning the depot to its historic levels of profitability.

10.33 We concluded that reversing the changes to commercial services implemented in March 2009 would be necessary for the remedy to be effective. The divestiture package is described further in paragraphs 10.62 to 10.64.

- *Tendered services and other activities*

10.34 In light of our finding of an SLC in relation to commercial bus services in Preston, but not in tendered services, we considered whether a divestiture package excluding tendered services would be effective.

10.35 A divestiture package that excluded such services and associated assets could be identified: for example, school services are currently operated using a fleet of 26 buses and the park-and-ride service also has a dedicated fleet of seven high-quality vehicles. We noted that buses normally used for school services had in recent years also been used on commercial services at peak time to improve service resilience in the network. This practice would need to cease to make it possible to divest only commercial services, and might require additional investment in buses and drivers. In addition, we understand that in practice it is often difficult to draw a clear distinction between commercial and tendered services from an operational point perspective; for example, the local authority has used tenders to extend evening/weekend services for some commercial services (eg service 87) and new services have been supported for a temporary period until they become fully commercial services at a later date (eg Kick Start funding associated with the Orbit services 88A and 88C).

10.36 The exclusion of tendered services from the divestiture package would deprive the acquirer of PBL of the returns on investment generated by the tendered services, and the corresponding contribution to depot overheads and overall profitability of the business. Our analysis showed that tendered services had historically made a substantial positive contribution to the business. PBL continued to bid for new tender opportunities during the inquiry. We understand that in the current financial year, tendered services contribute in excess of £[✄] million annual revenue ([✄] per cent of total PBL revenue in 2009/10). We therefore concluded that the exclusion of tendered services would increase composition risk of the divestiture package, particularly in relation to the financial profile of the divestiture package.

10.37 We consulted third parties as to whether a divestiture package excluding tendered services would be attractive. Although this evidence is mixed, on balance we concluded that a divestiture package that excluded tendered services would have higher purchaser risk than a package that included both commercial and tendered services.

10.38 We concluded that PBL's tendered services should be included in the divestment package.

10.39 The Commercial Vehicle Repair and Maintenance (CVRM) contract[80] is an integral part of PBL that utilizes plant and equipment at the PBL depot, and generates a positive financial contribution. Although not directly relevant to the SLC, a separation of this activity from the commercial bus operations of PBL would result in a significant increase in composition risk, as this contract has historically brought £[✄] in revenue and a contribution of £[✄]. We therefore concluded that inclusion of the CVRM contract in the divestment package would strengthen the financial position of PBL post-divestment, and that its exclusion from the package could result in practical difficulties.

[80]See paragraph 2.10.

10.40 We also concluded—for essentially similar reasons—that other types of ancillary income, such as advertising revenue derived from the PBL fleet, are also a necessary part of the divestiture package.

- *Identification and inclusion of key assets*

10.41 Many of the assets that would need to be included in a divestiture package are readily identifiable and are currently in use by PBL or Stagecoach. These include the fleet, drivers and other employees. There may be additional assets that a purchaser would require for the remedy to be effective, and this would be established during the due diligence and negotiation process. For example, PBL currently has access to bus stands at the bus station in Preston city centre.[81]

10.42 We consulted potential purchasers about which assets would need to be included in a divestiture package. Whilst vehicles were perceived as being less of an issue by large operators, there was agreement among all operators that the PBL depot (and supporting equipment), route registrations, staff and vehicles should be included in the divestiture package.

- *Conclusion on whether a reconfigured PBL would be an appropriate divestiture package*

10.43 We concluded that a reconfigured PBL as set out in paragraphs 10.21 to 10.42 and paragraph 10.62 would be an appropriate divestiture package. In our judgement, a divestiture of a reconfigured PBL would result in Stagecoach facing a competitor of sufficient scale and with sufficient coherence of operations to restore substantially or fully the degree and nature of the potential and actual competition lost as a result of the merger. Such a divestiture would therefore be an effective remedy. We reached this conclusion for following reasons.

10.44 First, the level of head-to-head competition between Stagecoach and the divested business would be of a similar scale to that which existed between Stagecoach Preston and PBL in May 2007.

10.45 Second, while the precise operations and market shares of the two parties would not be identical to those in May 2007, we concluded that the threat of potential competition between Stagecoach Preston and the owner of the divested business would be substantially the same as that between Stagecoach Preston and PBL at that time. A divestment of a reconfigured PBL would reinstate rivalry between two operators each with extensive and coherent neighbouring networks of commercial services within and around Preston from their own large depots.

10.46 In relation to the potential competition faced by the acquirer of the divested business, Stagecoach would continue to have both the financial means and incentive to seek to expand on to the routes operated by the divested business.

10.47 In relation to the potential competition faced by Stagecoach Preston, we foresee two possible outcomes; a divestiture to a large well-funded operator or a divestiture to a smaller operator with similar financial capability as the former PBL. A divestiture of a reconfigured PBL to a large well-funded operator is likely to bring about Stagecoach's expectation of an increased competitive threat arising from the sale of PBL to another competitor (see paragraph 8.11). A divestiture of a reconfigured PBL to a smaller

[81] We understand that Preston Bus Station will be redeveloped in future, and that the number of bus stands may reduce from 80 to 36, but based on our current understanding we do not expect that this would affect the effectiveness of this remedy.

operator with similar financial capability as the former PBL will reinstate an asymmetric constraint similar to that which existed until June 2007.

10.48 We did not consider that it was necessary, for our remedy to be effective, to restore precisely the same conditions of competition that prevailed in Preston before the period of abnormal competition. The aim of this remedy is to reinstate rivalry between two operators each with extensive and coherent neighbouring networks of commercial services within and around Preston from their own large depots. Provided this could be achieved—as we judge to be the case in relation to this divestiture package—we would not necessarily be concerned about an outcome that resulted in Stagecoach having a stronger presence in Preston than in 2007.

10.49 Third, such a divestiture package is likely to be saleable to a suitable purchaser, although we acknowledge that the partial integration of PBL into Stagecoach and weak financial performance of PBL over the last two years, including under the ownership of Stagecoach, may affect value.

*Divestiture of Stagecoach Preston*

10.50 As already stated in paragraph 10.7, in identifying a divestiture package, the CC will take, as its starting point, divestiture of all or part of the acquired business. The CC will also consider a divestiture drawn from the acquiring business if this is not subject to greater risk in addressing the SLC.[82] We therefore also considered whether an equally effective divestiture could be achieved if Stagecoach's Preston business was sold to a suitable purchaser and PBL was retained by Stagecoach.

10.51 In principle, by reinstating two independent operators with large depots, sizeable bus fleets and large teams of drivers, this divestiture also has the potential to be effective in addressing the SLC that we identified. However, this remedy presents a number of risks, which we outline below:

*(a)* interdependency with Stagecoach Group;

*(b)* impact on PBL; and

*(c)* defined benefit pension scheme.

10.52 We assess each in turn.

10.53 Stagecoach told us that Stagecoach Preston was not a separate legal entity, but was a part of Stagecoach Northwest. Unlike PBL, Stagecoach Preston has no history of operating as a stand-alone business and the organizational structure of the business is not designed for operational independence. There is a risk that Stagecoach Preston would face difficulties in operating effectively outside of ownership by Stagecoach. In addition, Stagecoach told us that the Preston depot formed an integral part of a much wider group of routes serving Lancashire, Cumbria, Greater Manchester and Merseyside. Stagecoach also told us that its outstation in Fleetwood depended on support from the Stagecoach depot in Preston, and the Preston depot was an important link in Stagecoach's long-distance Megabus coach network. We concluded that there were shared assets and facilities between Stagecoach Preston and Stagecoach Group, though we have not performed a detailed assessment of the extent of these arrangements.

[82] *CC8*, paragraph 3.6.

10.54 In order to achieve a divestiture of Stagecoach Preston, the divestiture package would need to be specified in detail, and it would need to be carved out of Stagecoach Northwest. All aspects of Stagecoach Preston's dependency on the broader Stagecoach network would need to be identified and commercial arrangements would need to be altered to enable Stagecoach Preston to operate independently or be integrated into the operations of a suitable purchaser. Such a task may be demanding, and could give rise to a number of practical difficulties that may take time to resolve.

10.55 The assessment of whether the sale of Stagecoach Preston could remedy the SLC we have found cannot be considered in isolation from the assessment of whether PBL itself can be restored to a position of commercial viability. Under this remedy option, the task of restoring PBL to profitability would remain with Stagecoach and would not be eliminated altogether.

10.56 Stagecoach told us that Stagecoach Preston operated a defined benefit pension scheme that remained open to existing employees, but was closed to new members. We identified this as a potential composition risk.

10.57 We considered whether Stagecoach Preston would be more saleable than PBL. Stagecoach told us that the inter-urban services had historically delivered limited profitability to its Preston depot (see Appendix B). Stagecoach told us that as a result it might be difficult to attract interest in a divestiture of its Preston operation without the intra-urban routes. We understand that Stagecoach Preston generated a modest positive depot contribution in August 2009. All other things being equal, we concluded, based on this recent financial performance, that the business may be commercially viable and could be capable of attracting purchasers, but that financial performance would affect value.

10.58 We consulted third parties about whether they would be interested in acquiring Stagecoach Preston. We found that some purchasers could be interested in purchasing this operation, but that the business was likely to be less attractive to purchasers than PBL:

*(a)* A potential purchaser, [✂], told us it had less commercial information about Stagecoach Preston than PBL, but considered that it would be easier to sell PBL because it had already gone though a sale process, and was a stand-alone business. By contrast, it would be difficult to assess whether Stagecoach Preston was a business on its own, or whether it relied on other parts of Stagecoach Northwest.

*(b)* A potential purchaser, [✂], told us that [✂].

*(c)* A potential purchaser, [✂], told us that requiring a divestiture of Stagecoach Preston would be very confusing for employees, and there may be cultural or motivational difficulties in bringing them into a new organization in light of the history between PBL and Stagecoach in Preston.

10.59 We concluded that a divestiture of Stagecoach Preston might, in principle, address the SLC we have found, but in our view, the risk profile of this remedy would be substantially higher than that of divesting a reconfigured PBL due to the interdependency with the broader Stagecoach network of services and the absence of a track record of operational independence from Stagecoach Northwest. We therefore concluded that the divestiture of Stagecoach Preston would not be a practicable remedy, would have substantially greater risks and be less effective than a divestment of a reconfigured PBL.

*Conclusions on the appropriate scope of divestiture package*

10.60 We concluded that for a divestiture remedy to be effective, the divestiture package should be based on a reconfigured PBL, allowing scope for adjustments to the asset perimeter to the extent that this is required to successfully implement the remedy. A divestiture of a reconfigured PBL would result in Stagecoach facing a competitor of sufficient scale and with sufficient coherence of operations to restore substantially or fully the degree and nature of the potential and actual competition lost as a result of the merger. Such a divestiture would therefore be an effective remedy.

10.61 We concluded that divestiture packages based on divestitures of routes but without a depot or on divestiture of Stagecoach Preston would not be practicable, would pose substantially greater risks and would be less effective than a divestment of a reconfigured PBL.

10.62 Based on the requirement for an effective remedy, and taking into account the assessment of the financial prospects of PBL set out in Appendix L, we concluded that a suitably reconfigured PBL business would exhibit the following characteristics:

*(a)* PBL would be a substantial and financially viable operator of intra-urban bus services in Preston, providing a network of commercial bus services.

*(b)* The PBL network would include all commercial services currently operated by PBL, including: 7, 11, 14, 19A, 23, 31, 35, 44, 87, 88A, 88C, 89.

*(c)* The divestiture package would also include all current PBL tendered services (including park-and-ride services 1 and 2 and scholars) and all other commercial activities including the CVRM contract and advertising revenue.

*(d)* Certain commercial services [✄] and supporting assets currently operated by Stagecoach would be restored to PBL. We noted that the reversion of these commercial services to PBL would need to be undertaken through a process that avoided operational disruption and ensured that PBL had access to its fleet. The time required to reregister routes is discussed in more detail in paragraph 10.80.

*(e)* The divestiture package would contain all operational assets including the pre-merger PBL fleet (or replacement vehicles of an equivalent age and specification in the event that asset disposals had occurred) and personnel required to operate all services included in the divestiture package, including the PBL depot and allocated bus stands at the bus station.

*(f)* In the event that Stagecoach was unable to sell a reconfigured PBL within the scope set out above, it would be necessary to consider how the package could be improved to achieve a more saleable alternative divestiture package, eg by adding further commercial routes and/or assets remaining at Stagecoach or otherwise enhancing the divestiture package to attract a purchaser, whilst having regard to the effect on the remaining Stagecoach operation.

10.63 As part of the implementation of this remedy, Stagecoach will be required to provide a complete, detailed description of the divestiture package for the CC to approve.

10.64 We recognize the need to preserve some flexibility in the final configuration of the divestiture package, for example in the event that a suitable potential purchaser was identified that wished to purchase a package that was different from the package set out above. We will therefore be prepared to consider variations in the precise scope of this package during the implementation stage, though we will require evidence that such variations will not result in a less effective remedy and that divestiture of a viable PBL can be achieved to a suitable purchaser through an effective divestiture process.

*Suitable purchaser and effective divestiture process*

10.65 In order to be effective in restoring competition between commercial bus services in the Preston area, the divestiture remedy should involve the divestiture of an appropriate divestiture package to a suitable purchaser through an effective divestiture process. We have discussed in paragraphs 10.25 to 10.42 composition risks relating to the configuration of the divestiture package. In this section, we examine purchaser risks and asset risks. Purchaser risks may arise if a suitable purchaser is not available or if Stagecoach disposes to a weak purchaser. Asset risks may arise if the competitive capability of a divestiture is allowed to deteriorate during the course of the process. An effective divestiture process will be required to address these two risks and enable a suitable purchaser to be secured in an acceptable timescale.

*Suitable purchaser*

10.66 Based on our discussions with bus operators, we considered that it was likely that a suitable purchaser could be found for a reconfigured PBL, although the pool of purchasers might be relatively small. In line with standard CC practice, we will assess the business plans of any potential purchaser against the following criteria when evaluating purchaser suitability in the initial divestment phase:

*(a)* independence;

*(b)* capability;

*(c)* commitment to relevant market; and

*(d)* absence of competitive or regulatory concerns.[83]

10.67 If Stagecoach receives interest from more than one prospective buyer, the CC will generally wish to evaluate whether purchasers fulfil the above criteria before any party is granted exclusivity to undertake detailed due diligence.

*Managing asset risk*

10.68 As set out in our guidance,[84] in the case of completed mergers there are greater risks of not achieving an effective solution compared with equivalent anticipated mergers. The CC will take action to limit these risks, and may therefore require greater use of protective measures, such as hold separate undertakings.

10.69 The nature of a bus operation is that it serves passengers' need for transport services by deploying physical assets (buses) and drivers on an appropriate network. Customer loyalty is relatively robust, as passengers face a geographical constraint on migrating to other providers. The majority of the assets can be identified relatively easily, and are generally resilient to neglect due to the regulations that exist in relation to passenger safety and the Traffic Commissioner's oversight of routes.

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[83] *CC8*, paragraph 3.15.
[84] *CC8*, paragraphs 1.31 & 1.32.

Operational assets can be transferred relatively easily if required for a divestiture. The goodwill of the business is, however, more difficult to identify and protect.

10.70 Following the adoption of Interim Undertakings, PBL retained use of the operating assets (eg fleet, employees) required to service its current routes and sole use of the PBL depot. However, the substantial post-merger integration that Stagecoach had commenced had very quickly resulted in a significant dependency of PBL on Stagecoach for an extensive range of support services. Furthermore, the route changes that Stagecoach implemented on 22 March 2009 resulted in a material decline in PBL's revenue. Further details are set out in Appendix L.

10.71 As set out in our guidelines,[85] the parties to a merger may have significant incentives to run down or neglect the business or assets of an acquired business, or other potential divestment package, including by diminishing its management capabilities, in order to reduce future competitive impact should divestiture be required, as well as to realize synergies as quickly as possible if no divestment is required. While acknowledging that Stagecoach might also have some countervailing incentives to develop the profitability of the business that it had acquired, including to preserve the value in the business should divestiture be required, we took a cautious, risk-based approach to this issue, based on the particular circumstances of the case including the steps that Stagecoach had already taken to integrate PBL into its own activities. To this end, we sought to prevent further integration of PBL into Stagecoach, initially by monitoring compliance with the initial undertakings through the appointment of an MT, and subsequently by directing Stagecoach to appoint a Hold Separate Manager (HSM) (see Appendix A, paragraph 7).

10.72 An important asset risk in this particular case is the loss of key personnel, which may lead to deterioration in standards, or the commercial well-being of the business, and financial management and administration which may complicate or delay the sales process or deter purchasers. [✂] and will be important to securing an effective divestiture process. As set out in Appendix L, the MT also identified a number of issues in the procedures and record keeping at PBL stemming from the gaps in the commercial and financial management which, if left unchecked, could limit the CC's ability to take remedial action. We concluded that the HSM should remain in place throughout any divestiture process, in order to address these risks, to manage the business independently until completion and thereby preserve the CC's ability to achieve an effective remedial outcome.

10.73 We also considered whether a Divestiture Trustee should be appointed at the outset of the divestiture period. We concluded that the HSM would be well placed to assist with the preparatory work, with input from Stagecoach in a way that appropriately safeguards the independence and future competitiveness of PBL. We concluded that appointing a Divestiture Trustee at the outset of the divestiture period would not add to the effectiveness of the divestiture process (see also paragraph 10.84).

*Divestiture period*

10.74 Stagecoach told us that before a divestiture process could be started it would be necessary to conduct a commercial network review, which would take two to three months. This would be followed by an independent review lasting one to two months, and then a further two months would be required to register the services. Stagecoach told us that it could commence divestment negotiations with any third party once the

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[85] *CC8*, paragraphs 3.21 & 3.22 and Appendix A.

required service changes had been registered, and that it would be possible to hold ‘in principle’ discussions at an earlier stage.

10.75 One potential purchaser ([✂]) told us that on one occasion in the past, in giving an undertaking to the OFT in lieu of a reference it had undertaken to divest a depot within six months. This period included preparing the information memorandum, approaching bidders and generating interest, and negotiating the transaction. An extension was granted before the business was finally sold.

10.76 One potential purchaser ([✂]) told us that a sales process that did not require the buyer to take on the pension liability would be shorter than one in which the buyer would inherit the liability, due to the time required to obtain a revised actuarial valuation of the pension deficit. A process which required the pension to be inherited by the buyer might take a year. We noted that these comments were made based on a presumption that PBL was operated on an arm’s-length basis from Stagecoach. This potential purchaser ([✂]) told us that in the context of an acquisition of a bus company, pension issues were usually complicated and would need to be appropriately investigated in the due diligence phase.

10.77 Another potential purchaser ([✂]) told us that if the defined benefit pension liability was a finite exposure because there was no future accrual, the matter would be far less of an issue than if the scheme were still open to members, because typically a large part of a pension deficit related to future accrual.

10.78 We noted that the 2008 sales process conducted by KPMG ([✂]) kicked off in early May 2008, and indicative offers were received from two parties in early September 2008 (four months). Discussions with Stagecoach started in September 2008, and concluded in December 2008, with the transaction closing in January 2009 (five months). We also noted that in the prior process, the actuary was able to supply a summary valuation at the request of PCC at relatively short notice, albeit on the basis of a limited scope. Stagecoach would be well advised to put in place steps to obtain a revised actuarial valuation as soon as possible, as this is likely to be a key due diligence request in a sale process.

10.79 We noted the comments that were made by [✂] that the pensions liability issue could add to the complexity of due diligence, but we concluded that this did not require a change to the length of the divestiture period.

10.80 We considered whether additional time should be included in the divestiture period to take account of the requirement to notify the Traffic Commissioner of planned changes to service registration. We noted there is more than one way the design of the divestiture process might develop (eg whether to re-register routes before or after approaching purchasers). Because we could not determine precisely how the divestiture process would develop, we concluded that it was not necessary to allow additional time to register route changes at this stage. We will monitor this particular aspect as the transaction process develops. We also noted that the Traffic Commissioner told us that she has discretion, which she would be prepared to use in practice, to accept a shorter notice period than 56 days if this were in the public interest (for example, if it were not practical to give the full 56 days’ notice or if passengers’ interests would be prejudiced by requiring the full 56 days).

10.81 In addition to route registration, it would be necessary to transfer vehicles and drivers, and other ancillary services, to PBL. We considered that these issues would not represent insurmountable practical challenges, but would need to reflect existing arrangements, including contractual arrangements with drivers and other employees.

10.82 We concluded that a [✂] would be appropriate for the sale process. We concluded that the time required to perform a reregistration of routes could be absorbed within this period.

10.83 Stagecoach will need to specify the design of a divestiture process to achieve divestiture within this [✂] period. This would include setting out a detailed timetable specifying the steps that Stagecoach will take, and the milestones, starting with preparatory steps, leading through the contact with purchasers, and culminating in the completion of the transaction. The CC will review and approve this process and timetable, in consultation with the MT. The CC, with input from the MT, will then maintain close scrutiny of progress of the divestiture process and achievement of milestones.

10.84 A risk to the effectiveness of the remedy is undue delay or lack of progress in approaching and negotiating terms with suitable purchasers. The appointment of a Divestiture Trustee can be an effective mechanism to bring a transaction to a close. The CC will require strong and persuasive evidence to justify any variation from the agreed timetable, and in the absence of such evidence will proceed with the appointment of a Divestiture Trustee, in line with its guidance.[86]

*Behavioural undertakings alongside divestiture remedy*

10.85 We considered whether it would be necessary to formalize some form of non-compete obligation on Stagecoach for an interim period alongside a divestiture remedy so as to encourage purchaser interest in the divested business and enable the new competitor to find its feet in the Preston market. Given our overriding objective of restoring competition within reasonable timescales, such an undertaking, if required, would need to be narrowly defined, eg relating to a small number of routes, and of limited duration.

10.86 We asked third parties whether commercial transactions involving bus operations are typically accompanied by restrictive covenants to protect purchasers, and whether such arrangements would be required alongside a divestiture of PBL. Two potential purchasers told us that such covenants were typical in the industry, with a period of two years being quoted as standard practice. One potential purchaser—which, however, expressed little interest in purchasing PBL—told us that it would not require a non-compete clause.

10.87 Formalizing such arrangements within undertakings—as opposed to permitting them within sale and purchase agreements—adds an additional level of potential cost and complexity, as responsibility for monitoring and recourse would fall to the OFT, rather than for the parties to enforce through contract. We concluded that it would not be necessary to require Stagecoach to give undertakings to this effect.

10.88 Restrictive covenants are typically a matter for commercial negotiation between the parties and are ordinarily contained in the sale and purchase documentation, which the CC will review as a matter of course during the purchaser approval process to determine whether such arrangements, including the duration, are appropriate. In general, the CC takes a cautious approach to permitting such arrangements, as by their nature they restrict the competitive process and thereby delay the full impact of any divestiture remedy. It would be pro-competitive to avoid the need for such provisions at all, but we may accept a limited period of no longer than 12 months, where

[86] *CC8*, paragraph 3.26.

this can be demonstrated as being necessary to enable the purchaser to establish itself as an effective competitor.

### *Conclusion on the effectiveness of structural remedies*

10.89 We concluded that divestiture of a reconfigured PBL in line with the principles set out in paragraph 10.62 would be an effective remedy to the SLC we found.

10.90 Such a divestiture would need to be made to a suitable purchaser, in accordance with the principles set out in guidelines, and Stagecoach should be allowed a period of [✂] to achieve a divestiture. Should Stagecoach fail to achieve a divestiture within this period or if Stagecoach were to depart from the agreed timetable for achieving such a divestiture, without good reason and supporting evidence, the CC would proceed with the appointment of a Divestiture Trustee.

10.91 We concluded that such a remedy would substantially or fully restore the degree and nature of the potential and actual competition lost as a result of the merger and could be expected to have its full beneficial effect within a period of [✂] months of the final determination of this inquiry, taking into account both the time needed to achieve an effective divestiture and the duration of any time-limited restrictive covenants that were essential to enable the purchaser to establish itself as an effective competitor. We therefore concluded that this would be a timely as well as an effective remedy.

10.92 We did not identify any other structural remedies that would effectively remedy the SLC.

## ***Anti-retaliation measures***

10.93 Measures that prevent Stagecoach from responding aggressively to new entry (or increase the cost to Stagecoach of an aggressive response) might address the SLC and associated consumer detriment in one of two ways:

*(a)* by encouraging new entry that would replace the competition that has been lost as a result of the merger; or

*(b)* by increasing the threat of entry such that—even if entry did not occur—Stagecoach would be constrained in its ability to raise prices or cut service levels by its perception that this would encourage entry to which it would be constrained in its ability to respond.

10.94 In our Notice, we identified two possible ways in which such an measure could be specified:

*(a)* prohibition on retaliation for a fixed period of time after entry; and

*(b)* obligation to maintain retaliation for a fixed period of time.

### *Views of parties*

10.95 Stagecoach told us that an anti-retaliation remedy would be effective in increasing potential competition from existing levels. Stagecoach proposed the following anti-retaliation measures:

*(a)* a prohibition from increasing services to a frequency greater than a third party; and/or

(b) a prohibition from cutting prices below those charged by a third party for a period on a specific route.

10.96 Stagecoach outlined further details of how such a remedy might be specified, including:

*(a)* Stagecoach would undertake not to register any new service or vary any existing service within Preston on another route of the entrant in response to competition against Stagecoach.

*(b)* The restrictions should be limited to a period of two years post-entry on a specific route.

*(c)* If there was no entry during a five-year period from the date of the remedy it should fall away.

*(d)* The remedy should be configured to apply only once in respect of a particular route or overlap.

*(e)* The remedy could be self-regulating, although it would likely require a dispute resolution mechanism. Stagecoach suggested that LCC would be the appropriate third party for dispute resolution.

10.97 Stagecoach stated that an obligation to maintain service and/or price levels at the level of response would be a less effective and more costly remedy than a restriction on Stagecoach's ability to respond to competition. Stagecoach stated that it would be more difficult to monitor and implement restrictions once it had taken action to respond to market entry than restricting this action before it takes place.

10.98 We consulted other bus operators on the effectiveness of such a remedy:

*(a)* One operator ([✂]) told us that it would be very hard to say whether there would be any appreciable effect on market entry because there were many other issues that would be key determinants for an operator deciding whether it wanted to enter a new market. Anti-retaliation might be one factor, but would not be the key factor in a decision whether or not to enter Preston.

*(b)* Another operator ([✂]) told us that behavioural remedies that have been imposed for previous mergers have been extremely difficult to supervise. This party told us that such measures would make no difference to market entry.

*(c)* A third operator ([✂]) told us that behavioural remedies, particularly over a long period of time, could result in a stagnation of the market, particularly if they relate to freezing frequencies or networks. This party said it did not think that a requirement to maintain service and/or price levels would be appropriate for Stagecoach in the event that it responded to entry by increasing services levels and/or cutting price. Stagecoach could withstand the costs of this in a way that a smaller operator could not, and such an undertaking would, in effect, be an endorsement of predatory behaviour.

10.99 We noted that the views expressed to us by these operators were consistent with the findings by NERA in relation to non-retaliation measures put in place during the early 1990s that where such undertakings had been put in place, there had been little or no entry following their application and in some cases there had been some weakening of existing operators.[87] Stagecoach told us that, as the NERA report was 12 years old and described undertakings given in relation to mergers some of which occurred over 20 years ago and which related to the period immediately following bus deregulation in the UK, its continued relevance to the current UK bus industry was at best questionable. We acknowledged these comments, but nonetheless considered that this evaluation of essentially similar remedies in the same sector of the economy was a relevant factor, alongside others, in our considerations.

*Our assessment*

10.100 We first considered the general risks that are intrinsic to this type of remedy and then whether these risks could be adequately addressed by the detailed design of the remedy.

10.101 As stated in CC guidance,[88] the design of behavioural remedies should seek to avoid four particular forms of risk to enable these measures to be as effective as possible:

(a) *Specification risks.* Whether such a measure could be designed to provide sufficient certainty that entry would occur in the event that Stagecoach increased prices or reduced service levels.

(b) *Circumvention risks*. Whether such a measure be designed in such a way that would prevent alternative forms of retaliation that could deter entry.

(c) *Distortion risks.* This type of commitment constrains the ability of an incumbent operator to respond to competition. While such a constraint may be necessary to achieve a more competitive outcome, it involves an intrinsic distortion of the normal process of rivalry.

(d) *Monitoring and enforcement risks.* For such a remedy to be effective, both Stagecoach and potential entrants must expect with a very high degree of confidence that any non-compliance would be rapidly detected and rectified.

10.102 We considered that all four of the above categories of risk were important and they could not be considered in isolation from one another. We noted first that the expectation of aggressive retaliation was only one of several barriers to entry that we found which, taken together, have the effect of deterring entry or expansion in the Preston area (see paragraphs 8.18 to 8.30). The inability of this type of remedy to address all barriers to entry and expansion is, in our view, a significant specification risk. We also noted that monitoring and circumvention risks would tend to reinforce the risk that the remedy would not be effective in generating entry. If potential entrants were concerned about the likely effectiveness of monitoring and enforcement or by the possibility of Stagecoach retaliating in a way that was not prevented by the remedy, this would reduce the likelihood that they would enter in response to an increase in prices or a cut in service levels.

10.103 In evaluating whether the above risks could be addressed through the design of the remedy, we considered the incentives created by Stagecoach's proposal in paragraphs 10.95 and 10.96 that it should be able to match an entrant's offer, but be prohibited from undercutting it on price or frequency.

[87] OFT 200: The Effectiveness of Undertakings in the Bus Industry.
[88] *CC8*, paragraph 4.2.

10.104 We looked first at the suggestion in paragraph 10.95(b) that Stagecoach should be able to match the price offered by a new entrant, but not reduce prices further than this. We thought that, in principle, this could reduce the risk facing potential entrants that entry would be met by a very aggressive pricing response and, as such, might reduce barriers to entry to some degree. However, we thought that a commitment by Stagecoach to soften price competition in the event of entry would risk distorting the competitive process and would reduce the scope for consumers to benefit from new entry.

10.105 Moreover, in the bus market, price is only one aspect of competition; frequency is also important. By itself, a commitment on pricing would not prevent a vigorous response on frequency, for example, by 'overbussing' routes. This informed our judgement that a commitment in relation to price alone would have no more than a very limited impact on incentives to enter. We looked at whether this could be addressed by means of a commitment not to increase services to a frequency greater than that of a third party, such as in paragraph 10.95(a). We saw problems with the specification of this commitment in relation to frequency. For example, if Stagecoach were already active on a route, a commitment to do no more than match the frequency of a new entrant could require a retrenchment of Stagecoach's activities compared with the pre-entry situation. Conversely, if Stagecoach were permitted to maintain its levels of frequency, post-entry, this could result in substantial overbussing on a route following entry, depending on the scale of any new entrant. We did not see how a commitment to 'match but not exceed' frequency could be reasonably applied in the interest of consumers and without prejudice to either Stagecoach or the new entrant.

10.106 We were also concerned about some of the additional conditions included in Stagecoach's proposal in paragraph 10.96. As the SLC that we found was in no way time limited, we saw no justification for the proposal that if there was no entry during a five-year period from the date of the remedy it should fall away; nor could we see a case for configuring the remedy so that it only applied once in respect of a particular route or overlap.

10.107 We concluded that Stagecoach's proposals were unlikely to increase incentives to enter bus markets in Preston to the degree necessary to address the SLC, would be difficult to specify and would risk creating additional distortions.

10.108 We then considered whether an alternative design whereby Stagecoach would be prohibited from any retaliation (price or service levels) for a fixed period of time after entry would give entrants greater confidence that entry would not be undermined in the short term by retaliation. We also considered whether potential entrants would gain greater confidence from Stagecoach's further proposal that the remedy could be specified to prevent Stagecoach from retaliating on an entrant's other routes in Preston.

10.109 We concluded that there was an inherent tension between the effectiveness of this type of remedy and the risk of distorting the competitive process. The more stringent the constraints on Stagecoach's ability to respond, the greater the intervention in the normal competitive process. For example, while a restriction on any form of competitive response might be expected to have the strongest effect on incentives to enter, it would also act as a very severe constraint on Stagecoach's normal competitive behaviour and could substantially reduce the scope for consumers to benefit from new entry.

10.110 As noted above, Stagecoach told us that this type of remedy could be self-regulating, but that it would require a dispute resolution process for which Stagecoach nominates the local transport authority, LCC. We disagreed with Stagecoach. In our view, Stagecoach would continue to have incentives to respond vigorously to entry and the incentives for potential entrants to enter the Preston market would be reduced if entrants were not fully confident that any non-compliance with the remedy would be rapidly detected and reversed, even if a third party were willing to act to provide dispute resolution. We also noted that retaliation need not be restricted to the Preston area—for example, Stagecoach could respond to entry in Preston by entering on routes operated by the new entrant elsewhere in the country. We concluded that it would be very difficult to develop an enforcement mechanism that could be sufficiently prompt and certain in its effect to provide an entrant with sufficient confidence that entry would not be impeded by a vigorous response. In the absence of such confidence, the effectiveness of such a mechanism would be very limited.

10.111 Finally, we considered that, from the perspective of a new entrant, an obligation on Stagecoach to sustain any retaliation for a fixed period of time afterwards would provide very little certainty as to the likely response. Stagecoach may choose to respond aggressively and use the obligation as a way of demonstrating its commitment to sustaining such a response. We shared Stagecoach's concerns that specifying the anti-retaliation measure in this way could prove more costly and less effective than measures designed to prevent retaliation.

10.112 We concluded that anti-retaliation measures would involve substantial intrinsic risks, which meant that we could have little confidence that such measures would have any more than a marginal effect in addressing the SLC. We do not consider that these risks could be adequately addressed by changing the design of the remedy.

### ***Behavioural remedies that control outcomes***

10.113 Behavioural remedies to control outcomes would not remedy the SLC itself but could in principle be used to mitigate the adverse effects of the merger. If it were not possible to remedy the SLC directly, such measures would be intended to limit Stagecoach's ability to exploit the market power created by the merger.

#### *Views of parties*

10.114 In response to the Notice, Stagecoach proposed three alternative remedies that might be considered separately or alongside enabling measures, such as the anti-retaliation measures discussed in paragraphs 10.93 to 10.112. These were:

*(a)* a price cap specifying maximum fare for five years;

*(b)* minimum service levels for a period of five years; and

*(c)* capped operating profit for a period of five years, with the surplus over 10 per cent operating profit being contributed to a local transport improvement fund.

10.115 Stagecoach told us that in order to specify the controls it would be necessary to perform a commercial network review. Stagecoach also proposed, as part of a behavioural remedy—or in conjunction with a small route-based divestment (see paragraph 10.12)—that a QPS under the Local Transport Act 2008 be implemented and agreed with LCC.

10.116 We consulted third parties on the effectiveness of measures to control outcomes and were told that such remedies would tend to distort the market and may not benefit passengers:

(a) One bus operator ([✂]) told us that price caps were operated in Glasgow for ScotRail, which was a different scale of market, and that there were baskets of comparable fares that could be monitored. A disadvantage of price controls was that they ossified a network and made it difficult for operators to respond to new entrants or changes in economic conditions.

(b) Another operator ([✂]) told us that using price caps entailed moving away from the real market. Designing such a remedy would take a lot of time and there were doubts about its effectiveness. There would be difficulties in relating a price cap on fares to cost, such as labour, which was a function of the jobs market. There would be a risk of being overgenerous if the price cap were to be allowed to increase faster than labour costs. Operators would choose whether to invest more or return more to shareholders. If there was a price cap, operators would take advantage in the good years to compensate for when labour costs rose more than fares. This operator also said that the more sophisticated a price cap became, the more time consuming it became, and it was doubtful whether this was a worthwhile exercise if there was a simple structural remedy. According to this party, in the case of Preston, a structural remedy seemed the cleanest option to restore competition to Preston.

(c) Another operator ([✂]) told us that networks which performed the best were the ones where the market was most responsive, and that controlling outcomes would reduce the responsiveness of the market. Deregulation was designed to permit route changes every eight weeks, and this enabled the network to respond to changes in passenger demand. If the network was frozen, it might lose customers.

*Our assessment*

10.117 Our guidance notes that this category of remedy involves significant disadvantages—associated with specification, circumvention, distortion, monitoring and enforcement risks—and that we will only use such remedies where other, more effective remedies are not feasible or appropriate. Where this class of remedy is employed, it is most likely to be used on a temporary basis unless there is no alternative to a continuing regulatory solution.[89]

10.118 We looked at whether any such measure could be adequately specified to address all adverse effects of the merger, without creating further distortions. We thought that specification of an effective remedy of this sort would be particularly challenging for a number of reasons.

10.119 First, we found that the merger would lead to a worsening of both price and non-price factors on which parties had exerted a competitive constraint on each other before the merger. To be effective, a remedy aimed at controlling outcomes would need to address both the pricing of bus services within Preston and also non-price factors, including frequency and timing of bus services and other aspects of service quality.

10.120 Second, we thought that establishing an appropriate starting point for any price or non-price controls would prove problematic. Given the recent history of bus provision in Preston, it is not clear whether current price levels are at competitive levels or are above or below them. Similar considerations apply to service frequencies and other aspects of service quality. Stagecoach submitted that, in order to specify any controls on outcomes, it would be necessary to perform a commercial network review of the

[89] *CC8*, paragraphs 4.28 to 4.31.

entire PBL market. We agreed that some form of review would be needed to establish an appropriate benchmark but that it would not be appropriate for Stagecoach to lead such a review as it would have incentives to seek an outcome that supported its economic interests. This would add further to the cost and complexity of implementing measures to control outcomes compared with the more usual scenario in which the pre-merger situation serves as a good proxy for the counterfactual.

10.121 Third, any control would need to incorporate an appropriate mechanism for allowing controls to be updated in response to external changes, such as increases in costs or change in customer demand. This is not straightforward. In principle, the pricing element of any control could be adjusted by reference to an external index (such as the Retail Price Index (RPI)). Stagecoach identified three possibilities:

*(a)* general inflation indices (such as RPI, RPIX or Consumer Price Index);

*(b)* bus industry indices (in particular, the Confederation of Passenger Transport UK (CPT) index); and

*(c)* a bespoke index designed to reflect costs in Preston.

10.122 None of these measures is ideal. A general inflation index has the potential advantage of simplicity and would be independent of Stagecoach or other bus operators, but would not relate price changes to changes in industry costs. The CPT index provides a measure of average industry costs, both at a national level and in particular regions, but only reflects those operators which take part in the scheme. If a CPT regional index is used, there is a risk that the regional cost index that is to be used as a benchmark is not sufficiently independent of Stagecoach, to be an effective constraint on its pricing. Conversely, if a CPT national index were used, there is a risk that the price control becomes out of line with local costs. We thought that a bespoke 'Preston' index would be costly and complex to specify and could be vulnerable to manipulation.

10.123 We concluded that, while one of the above indices could be used for a short period of time (eg 12 months), there were risks over any longer period that a price control would either become too generous to Stagecoach or too onerous. Over time, either of these outcomes could reduce the effectiveness of the control, would risk creating distortions and require the mechanism to be reviewed. We thought that similar considerations would apply to other outcomes to be specified (eg service frequency or other indicators of service quality): while it might be possible to place restrictions on these aspects of behaviour in the short term, over time there was a risk that these restrictions were likely to become either ineffective or inappropriate as cost and demand conditions developed. We noted, in this context, that price caps and other measures to control outcomes that had been put in place following previous CC inquiries into bus markets had required revision within a few years of operation.[90]

10.124 The specification of a profit control would need to consider additional issues, including the legal and reporting structure of the combined PBL and Stagecoach Preston operations, and the possible accounting estimates and allocations of costs from other parts of Stagecoach that could affect the level of reported profit. We thought that a profit control would be vulnerable to manipulation and would distort Stagecoach's incentives to operate efficiently.

[90]For example, in 2007, the CC took decisions to vary remedies in FirstGroup/SBH (put in place in 2002) and FirstGroup/ScotRail (put in place in 2004).

10.125 We thought that Stagecoach's proposal to implement and agree a QPS with LCC faced similar challenges in terms of specification. This proposal would also depend on Stagecoach reaching agreement with LCC on the terms of any such scheme. LCC told us that it was not currently considering using the extension of powers in the Local Transport Act 2008 to put in place a QPS in Preston. We thought that the need to reach agreement on the terms of a quality partnership with LCC was likely to reduce the timeliness and certainty of this proposal as a possible remedy to the SLC that we found, whether alone or in conjunction with other remedies.

10.126 In addition to the issues related to the specification of an effective mechanism to control outcomes, we noted that any such measure would involve ongoing monitoring and enforcement costs.

10.127 We concluded that behavioural remedies to control fares, service levels and/or operating profit would not be effective in addressing the SLC at all, and are likely to be only of limited effectiveness in addressing the adverse effects of the merger. We think that it is feasible to specify such remedies for short periods, but these could not adequately replicate competitive outcomes and would be prone to increasing distortions in the market over time.

### *Conclusion on the effectiveness of remedy options*

10.128 We concluded that the only effective remedy to the SLC that we found would be divestiture of a reconfigured PBL. The other remedy options that we considered would not be effective and would involve significant additional risks.

### *Cost of remedies and proportionality*

10.129 In assessing the proportionality of effective remedies, we considered:

*(a)* the size of the detriment caused by the SLC;

*(b)* the relevant costs of each effective remedy; and

*(c)* any RCB.

#### *Size of consumer detriment*

10.130 The adverse effects of the SLC we found relate to both price and service levels (including service frequency). As service levels are very difficult to quantify, we have focused on price effects, noting that this would be likely to be an underestimate of the level of detriment from the SLC.

10.131 We considered what would be the most appropriate assumption about the post-merger price increase. Having regard to our assessment of market definition, we would expect that a hypothetical monopolist of bus services in the Preston area would be able to increase prices by 5 per cent. Therefore we think it is appropriate to work on the basis that a minimum price increase Stagecoach could impose would be 5 per cent compared with the price levels that would be expected to prevail absent the merger.[91]

[91] Stagecoach argued that this approach was inappropriate because the application of the hypothetical monopolist test assumed that an entity had a 100 per cent market share and it could not be assumed that whenever a merged entity had a 90 per cent

10.132 In practice, it is likely that the price increase would be higher than 5 per cent. Other bus operators told us that a 5 per cent price increase would not generally be enough to attract their entry into Preston. This is therefore likely to give the merging parties a greater scope for price increases than 5 per cent.

10.133 We noted that a recent OFT study indicated that in areas where only one of the large national groups operates, fares for commercial services are 9 per cent higher than in areas where two or more of the national groups operate services.[92] We recognized that out of the two significant operators in Preston prior to the merger, Stagecoach and PBL, only Stagecoach was a large national operator, PBL's operations being limited to the Preston area. Our estimate of a consumer detriment arising as a result of a 9 per cent price increase is therefore only illustrative.

10.134 Using parties' combined revenue from commercial services operated within the Preston area,[93] (see Appendix M) we estimated that:

*(a)* Following a 5 per cent price increase arising from the merger between the parties, bus passengers in Preston would incur an annual consumer detriment of approximately £[✄] million.

*(b)* Following a 9 per cent price increase arising from the merger between the parties, bus passengers in Preston would incur an annual consumer detriment of approximately £[✄] million.

10.135 Finally, we noted that the consumer detriment arising from the merger did not necessarily have to take the form of a 5 per cent price increase. It could also take a form of a worsening of frequency or a combination of price increase and frequency worsening. Our estimate of consumer detriment, based on a 5 per cent price increase, is therefore illustrative and is likely to be an underestimate of the detriment suffered by the consumers in the Preston area as a result of the merger.

*Costs of effective remedies*

10.136 The CC will seek to select the least costly remedy, or package of remedies, that it considers will be effective. The costs of a remedy may be incurred by a variety of parties, including the merger parties, third parties, the OFT and other monitoring agencies.

10.137 As merger parties have the choice of whether or not to proceed with the merger, the CC will generally attribute less significance to the costs of a remedy that will be incurred by the merger parties than costs that will be imposed by a remedy on third parties. In accordance with our guidance,[94] for completed mergers, we would not normally take into account costs or losses that would be incurred by the merger parties as a result of a divestiture remedy as it is open to the parties to make merger

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market share or less, it would be able to impose a 5 per cent price increase. However, we have found that the merged entity has an effective monopoly in the provision of commercial bus services in the Preston area. We did not find any other competitor which would constrain the merged entity. The three other competitors present in the Preston area—Blue Bus, Transdev and Fishwicks—were filtered out of our analysis on the basis of insufficient frequency and time of the day service (for more details on the filtering methodology, see Appendix I, paragraphs 12 to 15; for the result of the overlap analysis, see Appendix J, Table 1 and paragraph 5). We therefore thought that, for the purposes of our estimation of consumer detriment, it was appropriate to take 5 per cent as a lower bound of the price increase that we would expect from the merger.

[92] Local bus services: OFT Report on the market study and proposed decision to make a market investigation reference—paragraphs 1.13 & 4.59. See www.oft.gov.uk/shared_oft/consultations/oft1112con.pdf.

[93] We based our estimates of consumer detriment on the parties' combined revenue achieved in April 2009 and annualized for a period of a year. We used the other data on our disposal from January 2008 and May 2007 to see how different the results would be if we used them as a basis for our estimation. The differences were small.

[94] *CC8*, paragraph 1.10 and Appendix A, paragraphs 14 & 15.

proposals conditional on competition authorities' approval. These factors apply in this case and we do not consider that any costs or losses that Stagecoach would incur on the divestiture of PBL or in relation to interim measures are relevant considerations.

*Potential third-party costs (defined benefit pension liability)*

10.138 A cost incurred by a third party may be relevant to the cost of the remedy. PCC is the pension guarantor for the PBL pension scheme, an arrangement that was entered into in 1993 when PBL was sold to management (see Appendix D). The merger has resulted in no change to the legal status of this arrangement. Absent the merger, PBL would have continued to fund the pension contributions for which it was liable. However, from a commercial perspective, as a result of the merger, PCC's exposure to the pension risk is probably lower than was the case prior to the merger because Stagecoach Group has greater financial resources that PBL.

10.139 Although Stagecoach has not supplied a formal parental guarantee with respect to funding the pension deficit, the commercial substance of the current arrangements is that Stagecoach is standing in front of PCC with respect to the obligations towards the pension scheme.

10.140 We consulted the pension authority and the pension guarantor on potential remedies:

*(a)* PCC told us that as it was the guarantor of the PBL pension scheme it was very important to PCC that PBL remained as a robust legal entity and continued to make relevant payments to the pension authority.

*(b)* West Midlands Passenger Transport Authority (WMPTA) told us that if PBL did not make the required pension contributions, it would call the guarantee to collect the payments from PCC. WMPTA also told us that there were no restrictions on a change of control of PBL but there was a requirement, under the terms of the pension guarantee, to notify WMPTA of a change of control. WMPTA confirmed to us that this was a matter of notification, rather than consent.

10.141 We identified two broad types of transaction structures that could be used to sell PBL:

*(a)* a sale of shares of PBL would result in a transfer of the pension liability to the purchaser; or

*(b)* a sale of the business and assets of PBL, with the legal entity remaining under Stagecoach ownership, would result in Stagecoach retaining the liability for the pension deficit.

10.142 Neither the transfer of the pension liability to another bus operator via a sale of shares nor the retention of the liability by Stagecoach would trigger a cost for a third party provided that the owner of the PBL shares continued to make the required contributions to WMPTA. We concluded that these third party costs were avoidable. However, we noted that the implications of various potential corporate actions by Stagecoach to implement a divestiture—such as a sale of assets of PBL, distribution of proceeds to the Stagecoach Group, or a winding up of the company—would require careful consideration.

10.143 Stagecoach told us that under the sale of shares scenario, the pension deficit would continue to be an obligation of PBL under the ownership of the third party purchaser, and the PCC guarantee would be unaffected. Stagecoach told us that in the case of a sale of business and assets the pension deficit would remain with PBL, and that

PBL would be left as a trading company whose only asset would be the proceeds from the sale of the business. Stagecoach told us that as PBL would cease to trade, it was highly likely that WMPTA would regard the current deficit payment arrangement as terminated and may require immediate payment of the full annuity buyout liability. In so far as PBL was unable to pay that liability, WMPTA may have to seek payment from PCC as a guarantor.

10.144 We concluded that an effective remedy could be implemented via a sale of the shares of PBL to a suitable purchaser and this is our preference, as it would not give rise to third-party costs. In the event that Stagecoach and a potential purchaser sought to implement the remedy via an asset sale, we would require persuasive evidence to demonstrate that this would not give rise to third-party costs. This review would form part of the approval of the purchaser and the final transaction terms.

10.145 The CC will also seek to ensure that no remedy is disproportionate in relation to the SLC and its adverse effects. In light of our assessment of relevant costs and the likely harm to consumers associated with the merger, we concluded that this case did not represent the sort of exceptional circumstances that would require the CC not to adopt even the least costly and intrusive effective remedy that we identified.

10.146 We concluded, prior to consideration of RCBs, that divestment of a reconfigured PBL would be the only effective remedy and would be a proportionate solution to the SLC that we identified.

*Relevant customer benefits*

10.147 Having identified the least cost, least intrusive remedy or package of remedies that the CC is confident will be effective, the CC may take into account 'the effects of any action on any relevant customer benefits in relation to the creation of the relevant merger situation concerned'.[95]

10.148 RCBs[96] are limited by the Act to benefits to relevant customers in the form of:

*(a)* 'lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom …; or

*(b)* greater innovation in relation to such goods or services'.

10.149 The CC will normally take RCBs into account, as permitted by the Act, once it has decided on the existence of an SLC, by considering the extent to which alternative remedies may preserve such benefits. In essence, RCBs that will be forgone due to the implementation of a particular remedy may be considered as costs of that remedy by the CC. The CC may modify a remedy to ensure retention of a RCB or it may change its remedy selection. It may, for instance, decide to implement a remedy other than prohibition or, in rare cases, it may decide that no remedy is appropriate.[97]

10.150 In deciding whether to modify a remedy in this way, the CC will consider factors including:[98]

*(a)* size and nature of the expected benefits;

[95] *CC8*, paragraph 1.14.
[96] Section 30.
[97] *CC8*, paragraph 1.15.
[98] *CC8*, paragraph 4.45.

(b) for how long the benefit is expected to be sustained; and

(c) whether, as a result of the reduction of competitive pressure in the market, any immediate benefit to customers will be eroded in the future.

10.151 Stagecoach has identified[99] the following benefits resulting from the acquisition:

*(a)* ticketing benefits;

*(b)* provision of change to customers;

*(c)* smartcard ticketing;

*(d)* higher-frequency services;

*(e)* vehicles/fleet improvements;

*(f)* late night services; and

*(g)* lower fares for seven months.

10.152 We consider each in turn.

*Network ticketing and network consolidation*

10.153 Typically, in transport inquiries, integrated transport benefits and the realization of network benefits (eg through-ticketing over previously competing networks) are cited by parties as RCBs.[100] However, in order to accept these as RCBs, the CC would have to be satisfied that they would be unlikely to accrue without the merger or a similar lessening of competition, for example that they would not be achieved through agreement between the parties.

10.154 Stagecoach told us that customers on the integrated PBL/Stagecoach network are now able to travel on any Stagecoach or PBL service within Preston and on various Stagecoach routes in Lancashire and can purchase the full range of Stagecoach tickets for travel within and beyond Preston. Stagecoach said that the removal of this benefit would result in costs for some customers.

10.155 [✂] told us that following the merger, the public now had an opportunity to travel between services with the same ticketing, which [✂] felt was very important. In particular, the ability to travel across town to the hospital on one ticket was seen as a positive move. [✂] was concerned that a divestiture of PBL would result in the loss of this customer benefit. One bus operator ([✂]) also told us that there had been a customer benefit had resulted from the merger for passengers who had previously made a through journey using Stagecoach and PBL buses. Another operator ([✂]) told us that there might be some benefits in terms of a network that was easier for passengers to understand, with less variety of fares and a more integrated, more coordinated network.

10.156 We accepted that the ability of customers to carry out through journeys across the Stagecoach and PBL networks was a benefit which had directly resulted from the merger and that this benefit was less likely to have accrued if PBL had been sold to a company other than Stagecoach. The benefit materialized primarily in terms of lower

[99] Stagecoach response to Remedies Notice.
[100] See paragraph 4.43 of *Merger References: Competition Commission Guidelines, CC2*.

transaction costs for some passengers. We assessed the benefits with reference to the competitive situation which prevailed before the launch of new intra-urban bus services by Stagecoach in 2007 (see paragraph 6.13). At that time, parties' networks were not overlapping to a significant extent with PBL focused on operating intra-urban services within the Preston City boundary and Stagecoach focused on operating inter-urban services and intra-urban services south of the River Ribble.

10.157 We considered whether this benefit could be achieved by other means, in particular whether a statutory bus ticketing schemes could have been set up under the Local Transport Act 2000. We noted that LCC had actively pursued such a scheme in 2003 and had failed to reach an agreement with the operators involved in the negotiations. In particular, operators had disagreed on the way revenues from the ticketing scheme should be allocated. In light of this evidence, we considered that it would have been easier and therefore more likely that through-ticketing would emerge as a result of the merger than as a result of a statutory scheme.

10.158 We therefore concluded that integrated ticketing brought about by the merger was an RCB. We also concluded, for similar reasons, that a divestiture remedy would make it less likely that this RCB would be retained compared with joint operation of PBL and Stagecoach Preston under common ownership.

*Provision of change to customers*

10.159 PBL buses operated an exact-fare scheme, whereas Stagecoach buses provide change to customers. We noted that bus operators are free to adopt a variety of ticketing arrangements, and a variety of systems is in place across the UK. Stagecoach told us that the exact-fare system resulted in inconvenience to passengers, and potential overpayments. Stagecoach told us that it was not possible to quantify this benefit at present.

10.160 We noted that Stagecoach had not completed the introduction of the facility to provide change by the end of our inquiry. We considered whether PBL would have introduced the facility to provide change absent the merger, and concluded that this was possible but unlikely, particularly as PBL valued the efficiency benefits it derived from the current system (eg ability to depart from bus stops promptly). Stagecoach told us that even if PBL had implemented a smartcard ticketing scheme for concessionary fare passengers, it would have retained the cash vaults for fare-paying customers.

10.161 We also considered how customers might benefit from the provision of change. We conclude that for those fare-paying customers boarding a bus without the correct change, the possibility of receiving change could result in such passengers paying a lower price for the same service than if no change was given. However, the convenience of not having to source the correct change in advance of a journey does not meet the statutory definition of an RCB, as a purchaser of PBL, other than Stagecoach, could well decide to implement a similar fare system. In other words, doing so would be a consequence of the commercial policy of the owner of PBL, rather than a benefit accruing directly as a result of the relevant merger situation or a similar lessening of competition.

10.162 We concluded that the provision of change to fare-paying customers was not an RCB.

*Smartcard ticketing*

10.163 We noted that the introduction of smartcard ticketing had not yet taken place at PBL because Stagecoach has delayed implementation pending the outcome of the CC's inquiry. We noted that the introduction of smartcard technology was primarily intended for use by concessionary passengers in Lancashire as part of a county-wide scheme known as 'NoWcard' and that the introduction of this system would have proceeded independent of the merger and that PBL has received a grant for a significant proportion of the costs to implement this scheme. Stagecoach told us that it planned to introduce a more advanced smartcard system that was not only compatible with the NoWcard scheme, but would also be relevant to future commercial applications of the technology.

10.164 We concluded that smartcard ticketing did not meet the definition of an RCB because it would have been introduced irrespective of the merger.

10.165 We also considered to what extent there may be any incremental innovative benefits of the Stagecoach smartcard ticketing technology over and above the minimum specifications of the NoWcard. We noted the absence of any live commercial application and considered that any future application would take time to be adopted by passengers and there was no certainty that any such application would emerge in the foreseeable future.

10.166 We therefore concluded that any such future benefit of the Stagecoach smartcard ticketing system is uncertain and in any event is not likely to be so great that it would affect our choice of remedies.

*Higher-frequency services*

10.167 Stagecoach told us that a number of services[101] were currently operating at higher frequency than had been the case in early 2007. However, Stagecoach also told us that 'it may not be possible to preserve all services at these levels', due to the current poor profitability of bus operations in Preston.

10.168 Stagecoach told us that it would be willing to agree to minimum levels of service if it retained all or a significant proportion of PBL as part of either stand-alone behavioural remedies or a behavioural remedy to supplement a partial divestment. Stagecoach stated that it was difficult to quantify this benefit at present, but a possible approach would be to apply a value of time to passengers based on average waiting times. Stagecoach also stated that there could be a cost to passengers if additional waiting time was required as a result of non-transferable tickets between multiple operators on the same route.

10.169 Before June 2007 there were two operators constraining each other in the Preston area, PBL and Stagecoach; following the merger, Stagecoach will have an effective monopoly of commercial bus services in the Preston area. It is therefore reasonable to expect that in the medium term, and in the absence of entry or of exogenous market growth, the frequencies can be expected to drop below the June 2007 levels.[102]

[101]Services: 8, 9, 16, 19, 22, 23, 31, 33 and 44.
[102]Stagecoach argued that the CC had not provided any evidence to support this comment. In particular, it said that the CC did not appear to have undertaken any work which considered the elasticity of demand with respect to frequency, or produced evidence on the potential cost savings which could arise from such frequency reductions. We did not accept this argument for several reasons. First, in 2007 there were two competitors in the Preston area constraining each other. Following the merger,

10.170 We therefore consider that there is no evidence that the merger has resulted or could be expected to result in the near future in a sustainable increase in service frequency in the Preston market.

10.171 We therefore concluded that the level of service provision in the Preston market did not qualify as an RCB.

*Vehicles/fleet improvements*

10.172 Stagecoach told us that the merger had resulted in fleet improvements, including: the elimination of step entrance minibuses on services 7, 14, 31, 44 and 87; the removal of a number of old PBL buses from service, and a reduction in the average age of vehicles from [✂] to [✂] years; and the introduction of larger vehicles on some routes, including service 19. This view was echoed by one bus operator ([✂]) which told us that following the merger, Stagecoach represented a better resourced company running the buses in Preston than prior to the acquisition.

10.173 We considered that an operator's decisions with respect to fleet investment is independent of the merger situation and that, absent the merger, there may be a greater incentive for independent operators to compete on non-price factors, such as the specification of the fleet in use on the network. The evidence that we saw about the quality of the bus fleets operated by PBL and Stagecoach Preston (see paragraph 5.75 and Appendices B and C) did not support the proposition that Stagecoach was more likely than PBL to make investments in its fleet. Moreover, given Stagecoach's ability to move its assets between its various local operations, there is no certainty that Stagecoach's initial investment in the fleet will be sustained following the merger. We concluded that Stagecoach's investment in the Preston bus fleet does not meet the definition of an RCB.

*Late night services*

10.174 Stagecoach told us that since 22 March 2009 it had operated an increased number of late night services on services [✂], and that PBL's working practices meant that it was not possible to operate services [✂] after 11pm before these services were transferred on 22 March 2009 from PBL to Stagecoach's Frenchwood depot.

10.175 We noted that bus operators are generally free to choose which services to register and operate. If late night services are commercially attractive, there is no reason to believe that another purchaser of PBL would not seek to implement such services. We conclude that the provision of late night services is a customer benefit which does not meet the statutory definition of an RCB as this benefit could have accrued without the creation of the relevant merger situation or a similar lessening of competition.

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Stagecoach has an effective monopoly of commercial bus services in the Preston area with little prospect of new entry that would constrain Stagecoach's behaviour. As we have established that frequency as well as price is an important parameter of competition in the bus market, it follows that a loss of competition can be expected to lead to worsening of these parameters, ie increases in price and/or reductions in frequency. Second, the CC has presented an array of elasticities applying to the bus industry (see Appendix I), including non-price elasticities, which demonstrate that no other modes of transport are a good substitute for bus travel and therefore, in the absence of competition from other bus operators, it is likely to be profitable for a monopoly operator of bus services in an area to exploit market power by raising prices and/or lowering frequency. Third, Stagecoach did not demonstrate that the merger would lead to efficiency savings that would lead to increased frequencies.

*Fares*

10.176 Stagecoach told us that PBL passengers had benefited from reduced fares for a period of seven months (we noted that Stagecoach and PBL increased fares in September 2009). Given that we found that the merger has led to an SLC, it follows that Stagecoach has the incentive and ability to increase prices and/or cut service levels, and we would expect it to act on these incentives. We concluded that there is no RCB in relation to fare levels as a result of the merger.

*Quantifying customer benefits arising from integrated ticketing and network consolidation*

10.177 Having found that integrated ticketing constitutes an RCB, we now turn to the quantification of this benefit, in order to assess whether our remedy choice should be modified to preserve this benefit. Evaluating the magnitude of this type of benefit is necessarily a matter of judgement and we sought to acquaint ourselves with the available evidence in order to form our view.

10.178 When it considered the possibility of introducing multi-operator ticketing in Preston, LCC commissioned an independent consultancy, TAS, to carry out research reporting in 2003 to establish how many customers would potentially benefit from a multi-operator ticket. The report was made available to us by TAS with the permission of LCC. This research found that only around 3.2 per cent of journeys could make use of such a ticket in the Preston area.[103] We note, however, that this figure is likely to be an overestimate of the proportion of passenger journeys that would benefit from this RCB for the following reasons:[104]

*(a)* TAS's figure is based on a survey which interviewed passengers of all operators in the Preston area, including Fishwicks in particular, and not just those of Stagecoach Preston and PBL.

*(b)* The TAS research cited above also noted that not all passengers who could make use of a multi-operator ticket under any scheme will do so in practice. According to TAS, experience in other cities comparable to Preston shows that only 1.5 per cent of passenger journeys have actually made use of multi-operator tickets. While TAS found that 3.2 per cent was the proportion of passengers who could potentially benefit from multi-operator tickets in the Preston area, it used 1.5 per cent for its estimate of the expected multi-operator ticket sales.

*(c)* Some customers (eg concessionary fares) already benefit from the ability to travel on all operators' buses without having to purchase multiple tickets. These customers would not benefit from the RCB, even if they travel on routes previously operated by multiple operators. While the TAS survey did consider concessionary passengers, the fieldwork was carried out in 2002, which was before the introduction of the two new concessionary schemes in 2006 and 2008 which further increased the numbers of concessionary passengers. We note that the TAS survey found that when pre-paid and concessionary passengers are

[103]Task Note 2: *Demand Forecast for Multi-Operator Day Ticket*, TAS, January 2003, Table 3 and paragraph 5.1.
[104]Stagecoach told us that the TAS report 'does not take account of the potential to achieve market growth through the use of multi-operator tickets.' We note that the TAS report did analyse this eventuality. It estimated that, on the basis of a price elasticity estimate of –0.54 and a through journey price of £2.00, the expected growth in the ticket sales would be 1.89 per cent. We note that this percentage is applied on the proportion of existing customers who could benefit from a multi-operator ticket. This percentage of a percentage delivers only a very small increase in overall numbers of expected multi-operator ticket sales (Task Note 2, *Demand Forecast for Multi-operator Day Ticket*, TAS, January 2003, Table 5). We noted that this market growth would have a negligible impact on our calculations.

excluded, the proportion of customers who would potentially benefit from a multi-operator ticket would be 2.8 per cent.[105]

10.179 Using the TAS estimate of 3.2 per cent as an upper bound of the proportion of customers that might benefit from this RCB, we calculated that the maximum number of passenger journeys that might possibly benefit from integration of Stagecoach's and PBL's network would be just under [✂] million a year out of the total of [✂] million.[106]

10.180 As set out in paragraph 10.134, the detriment arising from a 5 per cent price increase would amount to around £[✂] million annually or a £[✂] surcharge on every passenger journey (see Appendix M).

10.181 We considered the scale of the RCB that would be needed, in order to outweigh the consumer detriment arising from the merger, which would be avoided by introducing an effective remedy. Because we concluded that a divestment of a reconfigured PBL would be effective in restoring the potential and actual competition lost as a result of the merger and would do so in a timely manner, it is appropriate to compare the RCB against the full consumer detriment associated with the merger. We took a conservative approach, taking an upper bound of the RCB and comparing this with the consumer detriment associated with a 5 per cent price increase.

10.182 While it is not practicable to measure the potential benefit of network ticketing to the passengers who might use it, we compared the size of the detriment to the full cost of the tickets that these passengers currently use in order to assess what benefit those customers would have to receive in order to outweigh the detriment. The only way the consumer detriment suffered in relation to all passenger journeys would be outweighed by the RCB arising from the network integration affecting a maximum of 3.2 per cent of passenger journeys would be if those 3.2 per cent passenger journeys benefited in the order of £[✂] million annually. We have estimated that the average customer benefit in relation to each of these 3.2 per cent of passenger journeys using the newly integrated network would have to be at least £1.17 per passenger journey for this to be so. Given that a passenger journey currently costs appreciably less than this (at £[✂] on average or £[✂] following a 5 per cent price increase), we think it is unlikely that this will be the case. Because of the nature of the assumptions and estimates involved these are only illustrative comparisons but we did not think that it was realistic that the average customer benefit per passenger journey would be of this magnitude (see Appendix M).

10.183 This analysis indicated to us that, even on very cautious assumptions, the benefits of remedying the SLC through an effective divestiture remedy were likely to outweigh any RCBs associated with network ticketing that might be lost as a result of divestiture.

10.184 Stagecoach took an alternative approach to evaluating the scale of the RCB. It estimated that approximately [✂] to [✂] per cent of customers in the Preston area would be affected if integrated ticketing benefits were lost as a result of our remedy. According to Stagecoach, this amounted to approximately [✂] to [✂] passenger journeys per year. Based on a saving of £0.50 to £1 per journey, Stagecoach estimated that the cost to passengers would be in the range of £[✂] to £[✂] a year.

10.185 We conducted our own analysis of Stagecoach's estimate (see Appendix M). We agreed that it was sensible to use annual passenger journeys as the basis of analysis

[105] Task Note 1: *Through Passenger Survey Results*, TAS, January 2003, paragraph 8.5.
[106] We again used combined passenger trip figures provided by the parties for the period of April 2009 and annualized it.

and did not have fundamental objections of principle to building up an estimate of the annual value of RCBs in this way.

10.186 However, we did not agree with the values that Stagecoach had used to construct its estimate.

10.187 First, we noted that Stagecoach's estimate for the use of the network was [✂] to [✂] per cent. We could not verify this figure and preferred to use the survey-based estimate of the independent consultancy TAS, which was 3.2 per cent as an upper bound of the value of the proportion of journeys that were affected. For the reasons given above, we noted that this figure was likely to be an overestimate,[107] and considered that 1.5 per cent as cited in paragraph 10.178(b) could represent a reasonable lower bound.

10.188 Second, while we agreed that it was right to use annual passenger journeys as the basis of analysis, we noted that Stagecoach used approximate estimates, while we believed it more sensible to use parties' post-merger passenger numbers from April 2009 as a basis for calculation.

10.189 Third, we did not believe that it was sensible to apply a £0.50 to £1 saving per journey. This is for the following reasons:

*(a)* Stagecoach derived this saving from an estimated £0.50 to £2 per day saving. It was unclear how Stagecoach calculated this per day saving.

*(b)* Even if we assumed that Stagecoach's estimate of per day saving was accurate, we did not agree with the way in which Stagecoach had derived an estimate of a per journey saving from this estimate. In particular, the way Stagecoach derived a per journey saving from the per day saving suggests that Stagecoach assumed that consumers making cross-network journeys would make a maximum of two journeys per day. While we agree that per day travel is likely to include an out-ward and return journey, we do not believe that simply halving the estimated per day saving is a sensible way to proceed. This is because if consumers are to benefit from network travel through integrated ticketing, they will have to be able to use one ticket for a journey for which previously they would have had to use at least two tickets. If we assume an outward and return journey, network travel will involve four passenger journeys.[108,109]The estimated per day saving of £0.50 to £2 will therefore need to be spread over four passenger journeys rather than two. This would produce a range of per journey savings of £0.13 and £0.50.

[107]Stagecoach argued that the TAS figure that CC used omitted those passengers who commuted to Preston from the outside Preston using Stagecoach's inter-urban routes. The TAS survey does include these passengers in the analysis of through journeys which we used. It only omits them from the analysis of journeys' costs which we did not use. The example of Penwortham–Royal Preston Hospital in paragraph 10.189*(b)*is for illustration purposes only and does not preclude that service switching will take place from Stagecoach's inter-urban routes on to Preston intra-urban routes.

[108]The following example demonstrates this point: if a customer based in Penwortham wants to get to the Royal Preston Hospital and back again, before the merger this customer would have had to use both Stagecoach's and PBL's services twice. This means that this customer would have to buy four single tickets (or two return tickets, one for each company, at the price of a little less than two single tickets). Post-merger, this customer will be able to purchase only two single tickets (or one return ticket) arguably at a lower price than the two single tickets pre-merger.

[109]Stagecoach told us that the TAS methodology did not consider four journeys per day. This is incorrect, the TAS methodology explicitly assumed that each passenger will undertake four journeys per day and based its estimate of the expected multi-operator ticket sales on this assumption (TAS's Task Note 2, paragraph 4.1 and Table 4). The TAS research does discuss the fact that research for a large bus operating company has shown that the average journeys per day are lower than four, but explained that this was in the case of a single operator (TAS's Task Note 2, paragraph 4.2). Stagecoach also told us that it 'anticipated that the CC might believe that multi-operator trips were twice as likely to be sampled.' We made no such assump-tion.

(c) Given that the average per-journey fare is £[✂],[110] a £1 per journey saving—the upper end of Stagecoach's range—appears unrealistic.

10.190 We applied the Stagecoach methodology, using what we considered would be more appropriate inputs, namely:

(a) Total number of passenger journeys: [✂] million a year.

(b) Proportion of consumer journeys affected by the RCBs: an upper bound of 3.2 per cent and a lower bound of 1.5 per cent.

(c) Per journey savings where consumers benefit from the RCB: a lower bound of £0.13 and an upper bound of £0.50. We noted that this assumption derived from Stagecoach's estimates of per day savings, which themselves need to be treated with some caution.

10.191 This analysis suggested that the value of the RCB might lie between a lower bound of £0.02 million and an upper bound of £0.15 million annually (see Appendix M). Even if the upper bound of this range were taken, this indicated that the RCB was less than half the size of the consumer harm associated with a 5 per cent price increase. Moreover, it seemed unlikely to us that the true value of the RCBs was towards the upper end of this range for the following reasons:

(a) It is possible that the RCB would be retained absent the merger, albeit this is less likely than with the merger: there are other ways to retain the RCB, including network ticketing agreements, which may be developed absent the merger.

(b) We consider that the upper bound estimate of 3.2 per cent of passenger journeys that would benefit from this effect is likely to be an overestimate for the reasons set out in paragraph 10.178.

(c) We also consider that the upper bound of passenger savings per journey is likely to be an overestimate, as it is nearly two-thirds of the average price per journey.

10.192 Based on the above analysis, we concluded that the benefit of an integrated network was likely to accrue to a small proportion of passenger journeys. The detriment resulting from the merger on the other hand would affect all passenger journeys in the Preston area. Based on our assessment of the likely scale of this RCB, we concluded that this benefit was likely to be small in relation to the harm associated with the SLC that would be remedied by an effective divestiture remedy. We concluded that the RCB of network ticketing was not of such a magnitude to justify modification of the remedy.

*Conclusions on RCBs*

10.193 We concluded that, of the consumer benefits identified by Stagecoach, only network ticketing met the definition of an RCB. We quantified the benefit of network ticketing

[110] Stagecoach told us that TAS research found that the average cost of an adult through passenger journey was £2.07 and £3.68 for those who used return tickets, which was considerably different to our estimate of £[✂] and invalidated our conclusion. We did not agree. First, we note that Stagecoach does not consider equivalent estimates. TAS's £2.07 through journey is equivalent under the CC methodology to two journeys forming together an outward network using journey, ie the CC equivalent would be £[✂]. Similarly, TAS's £3.68 return through journey is equivalent under the CC methodology to four journeys forming together an outward and return network using journey, ie the equivalent under the CC methodology would be £[✂]. Second, we thought that the TAS's average in an overestimate of the level of average fares that is relevant to our consideration. This is because it averages fares of PBL, Stagecoach and Fishwicks. Fishwicks' fares were on average higher than Stagecoach's or PBL's (TAS's Task Note 1, tables 7 and 8.)

and concluded that it would be small in relation to the harm that we expect to arise from the merger. None of the benefits raised, individually or collectively, represent so significant a benefit that it would justify modification of the remedy. We therefore concluded that we should not modify the remedy in order to preserve the RCB of network ticketing.

### *Conclusion on remedies*

10.194 We concluded that the effective and proportionate remedy to the SLC that we found was the divestiture of a reconfigured PBL and that this remedy should not be modified in the light of our consideration of RCBs.