Anticipated acquisition by Firstgroup plc of Truronian Limited

ME/3533/08

The OFT's decision on reference under section 33(1) given on 28 March 2008. Full text of decision published on 11 April 2008.

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

PARTIES

1. **First Devon and Cornwall Limited** (First) is a wholly owned subsidiary of FirstGroup plc, a publicly owned company listed on the London Stock Exchange. FirstGroup plc operates public transport businesses in the UK and US.

2. **Truronian Limited** (Truronian) operates commercial and tendered bus services and other related transport services in central Cornwall. Truronian is a private limited company. Truronian's turnover in the financial year ending 30 September 2006 was £7.83 million.

TRANSACTION

3. First will purchase the entire issued share capital of Truronian. The parties notified the transaction to the OFT by way of a Merger Notice on 13 February 2008. The OFT's extended statutory deadline for deciding whether to refer the transaction to the Competition Commission (CC) is 28 March 2008.

JURISDICTION

4. As a result of this transaction First and Truronian will cease to be distinct.

5. The parties overlap in the supply of commercial and tendered local bus services in Cornwall, which the OFT considers to be a substantial part of the UK. The parties' combined share of supply of commercial and of tendered local bus services in this area exceeds 25 per cent. Therefore, the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is

met. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

MARKET DEFINITION

Product scope

6. In previous cases, the OFT and the CC have distinguished between commercial local bus services and tendered local bus services.[1] This distinction was supported in this case by the parties, each of which provides both commercial and tendered services. Tendered services are subsidised (in whole or in part) by the local authority in order to provide transport services in areas where operators would otherwise find it unprofitable to operate commercial services. Bus operators bid for contracts for tendered services. These contracts are re-tendered every few years and cover key aspects of the services, which may include fares, timetables and frequencies. Hence, competition in tendered services occurs at the bidding stage rather than in the operation of the service. In this case, at the time of the merger both First and Truronian operated tendered services under contracts with Cornwall County Council (Cornwall CC).

7. Many of the commercial operators in the area where Truronian and First are active also operate tendered services. However, supply-side substitution between tendered and commercial services may not be symmetric, as tendered operators may find it more difficult to start to operate commercial services than the other way around. These two types of service have very different pricing mechanisms. An operator of a tendered service begins operations with effectively a guaranteed revenue stream, which makes investments and other business decisions less risky.

8. On the demand side, passengers are unlikely to differentiate between a tendered service and a commercial service. Some overlaps exist between commercial services run by First and tendered services run by Truronian. Taking a cautious approach, the OFT has therefore analysed each of these overlaps in order to confirm that they do not raise competition concerns.

9. The CC has previously considered the degree of substitutability between different modes of public transport, such as between local bus services and train services, and has concluded that this varies on a case-by-case basis. The parties submitted that First's rail services will rarely be a close substitute for Truronian's local bus services. The OFT has analysed each of the overlaps identified by the parties. However, as no competition concerns

[1] See, for example, the OFT's decisions of 18 March 2008 regarding the completed acquisition by Go North East of Stanley Taxis and of 10 January 2008 regarding the anticipated acquisition by Greater Manchester Buses South Limited of A. Mayne & Son Limited, citing earlier cases.

arise regardless of how the product market is defined, it is unnecessary to conclude on the issue in this instance.

10. The parties submitted that travel by car (whether by taxi or private vehicle) will represent a close substitute for travel by local bus or rail. Previous decisions have considered whether private car transport is a separate market from public transport. As no concerns arise in this case on the narrowest frame of reference, it is unnecessary to conclude on this issue in this instance.

Geographic scope

11. As the overlapping activities of the merging parties are limited to the supply of bus services in Cornwall, the OFT has restricted its assessment to this area. In previous cases, the OFT and the CC have considered local markets in commercial services on the basis of competing services on point-to-point flows, as a particular origin/destination combination is not likely to be substitutable with other origin/destination combinations from a passenger's point of view.[2]

12. In line with past cases, the OFT in this case has considered individual flows as the relevant geographic frame of reference for commercial services. The possibility of competing operators entering these or similar flows is discussed in the section on barriers to entry below.

13. For tendered services, the parties both operate tendered services for Cornwall CC. Accordingly, the appropriate geographic frame consists of Cornwall.

14. In some cases, it is also appropriate to consider wider network markets (that is, a collection of interconnected services in a particular area). This is because, on the demand side, passengers buy network or multi-modal tickets which allow them to travel on different operators' buses or different modes of transportation; and, on the supply side, bus companies organise themselves in wider networks around bus depots and fleets and within these networks existing operators can relatively easily switch buses between routes. The OFT found that the parties' revenue generated by the sale of network tickets in Cornwall accounts for only a negligible proportion of their total turnover, indicating that the relevance of wider networks compared to individual flows or routes in Cornwall is minimal.

[2] See footnote 1. A flow consists of (part of) a route from a point at which passengers get on the bus to a point at which they get off.

HORIZONTAL ISSUES

Tendered services

15. According to information provided by the parties, there are 72 fully tendered bus services in Cornwall, 25 of which are operated by Truronian. Western Greyhound and Summercourt operate six routes each and OTS operates four routes. All remaining operators (including First which runs two fully tendered routes) run between one and three routes each.

16. On the basis of information on weekly tendered mileage provided by the parties, Truronian and First are the largest and third largest operators in Cornwall with shares of supply of [40-50] per cent and [10-20] per cent, respectively. The second largest operator is Western Greyhound, with a share of supply of [20-30] per cent. There are 19 other operators active in Cornwall, although none represents more than [0-10] per cent of supply on a weekly tendered mileage basis.

17. On the basis of bidding data provided by the parties, the OFT has analysed the constraint that will be lost as a result of the acquisition of Truronian by First. The parties provided a list of 48 tenders organised by Cornwall CC during the period 2005 – 2007.[3] These 48 contracts were awarded in four rounds: March 2005, Spring 2006, July 2006, and August 2007.

18. Apart from First and Truronian, there are 20 other bus operators which currently run tendered services for Cornwall CC and may be expected to submit a bid in future tenders. During the four rounds of tenders organised in the period 2005 – 2007, eight operators other than First and Truronian managed to win at least one contract.[4] The parties competed against each other in only [ ] out of a total of 48 tenders. Across the four rounds of tenders, one of the parties managed to win in approximately [ ] per cent of tenders in which they both participated, [ ]. In [ ] of these [ ] tenders the parties faced competition from two or more operators. The parties faced competition from only one other operator in [ ] of these [ ] tenders. In the other [ ] tenders, the parties were the only bidders.

19. Cornwall CC was not concerned about a possible detrimental impact of the merger on competition for tendered services. It did not consider that the transaction would have any impact on its ability to negotiate the provision of tendered bus services in the future, although it raised the possibility that less competition in some areas could lead to higher prices for some tendered services.

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[3] The list included tenders for evening and weekend 'extensions' of commercial services which are excluded from the data relating to fully tendered services discussed in paragraphs 15 and 16.

[4] It should be noted that one operator that successfully bid for contracts during the 2005-2007 period has now been acquired by another operator.

20. The OFT notes the significant number of other operators of tendered services in Cornwall who have bid in past tenders and who might be expected to bid in future tenders. However, in light of the fact that the parties were close competitors in a number of tenders, in particular being the only bidders in five tenders, the OFT cannot confidently rule out the possibility of competition concerns arising as a result of the reduction in the number of bidders for tendered services. Accordingly, the OFT has considered below whether the prospects and incentives for entry and/or expansion are sufficient to address these potential competition concerns.

Commercial services

21. First and Truronian overlap in the provision of commercial bus services on six flows.[5]

22. On four of these flows the parties currently face no competition from other operators.[6] However, on two of these four flows the evidence on differences in frequencies indicated that the parties are not particularly close substitutes.[7] The OFT recognises that the generalised cost to passengers of a journey must be assessed in the round and in this case the service frequencies of the parties' respective services were such that customers might not consider these services as effective competitors on those flows. This was reflected in the different numbers of passengers travelling on each party's service. Moreover, on all four flows, including the two flows where First and Truronian would be considered as closer substitutes, the OFT found that the overlap in each case is limited to short sections of a larger route or involves a limited number of passengers as a proportion of the entire route (less than 10 per cent of the total number of passengers on the route in each case).[8] Accordingly, First's incentives to do anything to cause passengers to switch from one service to another on the small overlap section could be tempered by the risk of causing a greater negative impact on the profitability of the remainder of the route.

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[5] The overlapping commercial flows are: between Truro bus station and Tremough; between Truro bus station and Carnon Downs; between Truro bus station and Devoran; between Tremough and Helston; between Truro bus station and Threemilestone; and between Truro bus station and Truro railway station. The OFT also identified another commercial overlap between Truro bus station and Tresilian. However, on the basis that First runs an hourly service and Truronian only runs a very limited service on Wednesday, the OFT concluded that the parties services do not effectively compete on this flow and did not consider it further.

[6] The four overlapping commercial flows on which the parties face no competition are: between Truro bus station and Tremough; between Truro bus station and Carnon Downs; between Truro bus station and Devoran; and between Tremough and Helston.

[7] Between Truro bus station and Tremough and between Truro bus station and Carnon Downs.

[8] The parties were unable to provide revenue figures on a flow-by-flow basis for the overlapping flows. They were able to provide passenger numbers for each flow and for the total route. In determining whether each flow forms a significant part of the total route, the OFT has considered it reasonable to use passenger numbers as a proxy for revenue.

23. On the two remaining overlap flows (which Western Greyhound, Hopleys Coaches, and Summercourt also serve), the OFT also considered on the basis of the evidence available to it that the parties may only compete against each other to a limited extent.[9] This is due to the differences in service frequency which result in differences in the number of passengers using each party's service. In addition, these overlaps only represent shorter sections of much longer routes. One of these overlapping flows accounted for slightly more than 10 per cent of the total number of passengers on the entire route. The other flow accounted for [less than 10 per cent] of total passengers on the parties' routes.

24. As mentioned above, in taking a cautious approach, the OFT also considered the overlaps between First's commercial and Truronian's tendered services.[10] Once again, it considered that the parties' services on most of these overlapping flows may only compete to a limited extent, either because of the differences in the frequencies of the services or because of differences in the directness of the route taken in the overlap section. As such, the services offered on these overlap flows may not be regarded by customers as realistic alternatives. Moreover, the overlaps identified represent short sections of often much longer routes. Many of the overlaps occur because of the limited roads that link the areas to be covered by tendered services in Cornwall, meaning that commercial and tendered services have to use the same roads for part of their journey. In these circumstances, First's incentives to adjust fares or frequencies post-merger may be limited if the overlap flows account for only a small proportion of the total route. However, evidence on frequencies on a small number of these overlaps indicated that the parties' services might effectively compete. Therefore, in taking a cautious approach, the OFT has not been able confidently to exclude competition concerns in relation to all overlaps between First's commercial and Truronian's tendered services.

25. The OFT also considered four overlaps between a First rail service and a Truronian bus service. The OFT found that there are significant differences in journey times between these bus and rail services (bus services taking considerably longer). In light of this, the OFT concluded that, on a generalised cost basis, travellers are unlikely to consider these two modes of transport as close substitutes on the overlap flows. The OFT also noted that most services operated by Truronian on these bus/rail overlaps are tendered; therefore, after the merger First, even if it had the incentive to do so, would have only very limited ability to alter frequencies and fares on these flows to benefit its rail operations.

[9] The two overlapping commercial flows on which the parties face competing services from third parties are: between Truro bus station and Threemilestone; and between Truro bus station and Truro railway station.
[10] The parties identified 16 overlaps between their commercial and tendered services.

26. In conclusion, the OFT considers that the overlaps between First's rail services and Truronian's bus services do not raise competition concerns. The OFT has received robust evidence to suggest that most of the overlaps between the parties' commercial bus services and the overlaps between First's commercial and Truronian's tendered bus services will not raise any competition concerns. However, some residual overlap flows remain where the parties may be close competitors, in particular including some flows where they face no alternative operator. The OFT has not been able to exclude completely the possibility of competition concerns arising in relation to these flows. Accordingly, the OFT has considered below whether the prospects and incentives for entry and/or expansion are sufficient to address any residual potential competition concerns.

Barriers to entry and expansion

27. The OFT considered whether there are significant barriers to entry (or expansion) into the market for local bus services in Cornwall.

The extent of barriers to entry and expansion

28. The merging parties submitted that barriers to entry and expansion into local bus markets in Cornwall are low and noted that even a monopolist on a point-to-point flow would have limited or no ability to raise fares or reduce frequencies. According to the parties, entry (and expansion) are made even easier in Cornwall than elsewhere because local bus operators (in particular, the smaller ones) have the option of parking their buses in car parks and in lay-bys overnight, as an alternative to using full depot facilities. The parties indicated that a well-established entry strategy for new providers of bus services in Cornwall is to start operating tendered services (which have fewer capital requirements and are less risky than commercial services) and then to expand from this basis to start running commercial services along the same routes as an existing established operator such as First, running slightly in front of those services. The evidence available to the OFT showed that entry in the market for tendered bus services in Cornwall is relatively easy. There is no need for marketing expenditure and contracts ensure a secure minimum revenue stream from the outset. Moreover, entry can occur on a small scale, for example one or two buses per route, or through leasing vehicles.

29. The parties also submitted that it is easy for an incumbent provider to expand onto a new route or flow. Existing operators already have the necessary depot facilities and a vehicle fleet. The parties submitted that the process of registering a new route is straightforward, requiring only 56 days notice to the Traffic Commissioner. There is no significant marketing expenditure for small and expanding local bus operators of commercial services, as they tend to operate a near identical version of the route of

one or more established competitors (aiming to run just in front to pick up waiting passengers first).

30. Overall, third parties confirmed that barriers to entry and expansion into the market for local bus services in Cornwall are low and expressed the view that other operators might enter the market or expand their services. Third parties did, however, mention difficulties in finding trained drivers, and in building or expanding depot facilities. However, third parties did not see any of these barriers as impossible to overcome within a maximum period of four to five months.

31. Overall, the OFT found no evidence that the availability, utilisation, or specific location of depot facilities in Cornwall or the availability of drivers currently represents a substantial barrier to entry or expansion. The OFT also found no evidence that expenditure on new buses or on advertising and promotion currently represents a substantial barrier to entry or expansion into the market for local bus services in Cornwall.

Recent entry, expansion and exit

32. The OFT has found evidence that the de-registration of routes by First over the past 10 years has provided the opportunity for independent operators to enter the market and/or expand their position. The OFT also found that some competitors had increased the frequency of services in competition with First on certain routes.

33. Third parties mentioned other operators which are either new entrants or have moved or expanded from the school bus segment into commercial or tendered services in the last five years.

Potential entry

34. The parties also brought to the attention of the OFT the existence of a bus operator planning to start operations in Cornwall in March 2009, with two depots located in Redruth and Launceston. On the basis of the evidence available, the OFT took the view that this operator has firm intentions to enter the market for local bus services in Cornwall.

Threat of predation or retaliation

35. The OFT also considered whether after the merger First might engage in predatory or retaliatory practices (e.g. fare reductions, increases in bus frequency and changes of schedule) in order to deter entry (or expansion) into local bus services in Cornwall. The OFT found no evidence that the operators would be deterred from entering the market for bus services in Cornwall for fear of predatory or retaliatory practices by First.

Conclusion on barriers to entry and expansion

36. In this case, the evidence before the OFT showed that there are no substantial barriers to entry and expansion into the market for local bus services in Cornwall. This is supported by recent entry and expansion and the prospect of further new entry in the near future. Accordingly, the OFT considers that the prospect and incentives for entry or expansion in tendered bus services would be sufficient to address any potential competition concerns arising from the transaction.

THIRD PARTY VIEWS

37. The OFT received three written responses to its questionnaires on the transaction, one from Cornwall CC and two from associations of bus users. The OFT also contacted Cornwall CC and a number of the parties' competitors by telephone. The majority of third parties expressed little or no concerns with the proposed transaction. In relation to tendered services in particular, Cornwall CC did not consider that the transaction raised any major issues. Any concerns that were expressed by third parties have been addressed above.

ASSESSMENT

38. First and Truronian overlap in the operation of commercial and tendered bus services in Cornwall. In addition, First also runs the Great Western passenger rail franchise. In line with previous cases, the OFT has in its examination of the merger distinguished between tendered bus services in Cornwall and individual flows in commercial services.

39. In relation to tendered services, there are currently 20 bus operators active in this area, in addition to First and Truronian. A total of 10 different operators (including First and Truronian) won at least one contract in the four rounds of tenders organised by Cornwall CC between 2005 and 2007. Data relating to these tenders show that the parties competed against each other in only [ ] out of 48 tenders. In [ ] of these [ ] tenders, the parties faced competition from at least one other operator. Their combined success rate in tenders where they both participated was high, [ ]. In the other [ ] tenders, the parties were the only bidders. On the basis of this bidding data, the OFT cannot exclude that the transaction raises competition concerns in relation to tendered bus services.

40. The parties overlap in the provision of commercial services on six flows. On four of the six flows the parties face no competition from other operators at present. On all four of these flows, the OFT found that the overlap is limited to short sections of a route or involves only a small proportion of the total number of passengers on the entire route (less than 10 per cent of the total number of passengers on the route in each case). On two of the

four flows, the OFT also found evidence that the parties are not particularly close substitutes, because of the differences in frequencies between their respective services. On the two remaining overlap flows (where the parties face competition from Western Greyhound, Hopleys Coaches and Summercourt), the evidence before the OFT showed that the parties may be only competing against each other to a limited extent, because of differences in the frequency of the services provided. However, the fact that the parties may be close competitors on some flows, including some flows where they face no alternative operator, means that the OFT cannot confidently rule out completely the possibility of competition concerns arising.

41. In relation to the overlaps between First's commercial and Truronian's tendered services, the OFT received robust evidence that the parties are not effective competitors on most of the flows and that the overlap in each case represents only a short section of a longer route. However, there remains a residual number of overlaps where the parties may be close competitors and therefore the OFT has not been able to exclude completely the possibility of potential competition concerns arising.

42. The OFT considered whether the prospects and incentives for entry or expansion are sufficient to address any residual concerns relating to the overlaps between the parties' commercial services and certain overlaps between First's commercial and Truronian's tendered services.

43. The evidence before the OFT showed that there are no major barriers to entry and expansion in relation to the provision of local bus services in Cornwall. The OFT found evidence of several instances of entry and expansion of services in the recent past, some in direct competition with First, as well as evidence of likely potential entry in the near future. Moreover, the OFT found no credible evidence of First deterring entry or expansion in Cornwall through predatory or retaliatory practice in the past. The OFT considers that these findings on ease of entry and expansion are sufficient to address any competition concerns arising from the reduction in the number of bidders for tendered services, from the two-to-one commercial service overlaps and from the overlaps between First's commercial and Truronian's tendered services.

44. In relation to the overlaps between First's rail and Truronian's local bus services, the OFT was able to conclude on the basis of the evidence available that no competition concerns arise. Customers would not regard these modes of transport as being effective competition in relation to the overlaps identified.

45. The vast majority of third parties expressed little or no concerns about the proposed merger.

46. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

47. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.