Notice of acceptance of undertakings varying undertakings given pursuant to section 88 of the Fair Trading Act 1973 following the acquisition by FirstBus plc of SB Holdings Limited

Introduction

1. On 24 January 1997 the Monopolies and Mergers Commission (MMC) published its report into the acquisition by FirstBus plc (FirstBus) of 100 per cent of the issued share capital of SB Holdings Limited (SBH).[1] The MMC found that the acquisition operated or may have been expected to operate against the public interest and in 2002 behavioural undertakings were accepted ('the Undertakings'), capping the fares of FirstBus's operations in Edinburgh and Glasgow and establishing a mileage floor in relation to FirstBus's Edinburgh operations. In 2005 FirstGroup plc (First) applied for release of the Undertakings. Following receipt of a report from the Office of Fair Trading (OFT), the Competition Commission (CC) published its provisional decision not to release the Undertakings, and to consider instead a variation, in November 2007.

2. The CC considered the responses it received to its provisional decision of November 2007, and discussed possible variations with First. In the light of its considerations and these discussions, the CC published a further provisional decision on 20 February 2008 ('the February provisional decision'),[2] stating that it was minded to accept variations that would:

   (a) allow fares to increase so that revenue rises by no more than the lower of the CPT (Scotland) index and the CPT (GB-wide) index;

   (b) allow a 'catch-up' adjustment in revenue for each of First Glasgow and First Edinburgh sufficient to allow First to recover efficiently incurred costs, given that fares have been constrained since 1997 by RPI during a period when bus industry costs have risen at a faster rate than inflation;[3]

   (c) allow First to spread the 'catch-up' adjustment across an indefinite period; and

   (d) rebase the mileage floor (which applies only to First Edinburgh) to 75 per cent of 2002 mileage.

3. In the February provisional decision, the CC also consulted on a set of undertakings offered by First that would have the effect of varying the original Undertakings. These draft undertakings, if accepted, would have implemented the changes outlined in sub paragraphs 2*(b)* to *(d)* above, and would have allowed fares to increase so that revenue rises by no more than the CPT (Scotland) index, which was First's preferred option.

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[1] CC (1997), *FirstBus plc and SB Holdings Limited: a report on the merger situation,* Cm 3531, is available at: www.competition-commission.org.uk/rep_pub/reports/1997/395firstbus.htm#full.

[2] This is available at: http://www.competition-commission.org.uk/rep_pub/notices/notice_decision_vary_undertakings.pdf.

[3] The 'catch-up' adjustment is not intended to compensate First for fare increases foregone in the past, but is rather intended to ensure that the fares to which the varied fare control is applied going forward are at a level sufficient to allow the recovery of efficiently incurred costs. Since there would be no detriment to passengers—and there may be a gain to passengers—from allowing First to spread the 'catch-up' adjustment over time rather than making the whole adjustment upfront, this is provided for in the variation. The rationale for the 'catch-up' adjustment is discussed in more detail in the February provisional decision at paragraph 31 et seq.

4. Having considered the response to the February provisional decision, this notice sets out the CC's decision to accept undertakings varying the original Undertakings. The reasons for this, and the nature of the variation, is set out below.

Response to consultation of 20 February 2008

5. The CC received only one response to its provisional decision of 20 February, from First itself. In its response, First drew the CC's attention to a recent decision of the Scottish Government.[4]

6. This decision means that the Scottish Government has adopted a different approach to the Bus Service Operators' Grant (BSOG—formerly the 'fuel duty rebate') than that used in England and Wales.[5] Broadly, it has decided not to increase the BSOG in line with fuel duty increases from October 2007, which means that bus operators in Scotland will not be compensated for the increase in fuel duty since then. It has since indicated that it will not increase the BSOG in 2008 or 2009.

7. In its response First noted that in England the BSOG was due to increase by 2p per litre from 1 April 2008 and a further 1.84p per litre from 1 April 2009, reflecting corresponding increases in fuel duty. First told the CC that the different approach taken to the BSOG in Scotland would cost it £[✂], £[✂] and £[✂] in each of the relevant years respectively.

8. More generally, First argued that the different approach taken by the Scottish Government with respect to the BSOG—especially when considered alongside its concessionary fares policy—indicated a propensity for the Scottish Government to adopt a different policy towards the bus industry in Scotland to those adopted elsewhere in the UK.

9. First therefore argued that the recent decision on the BSOG by the Scottish Government lent further weight to its argument that the CPT (Scotland) index was the most appropriate index for use in restricting fare increases in First Edinburgh and First Glasgow operating areas.

10. In discussion with the CC, First noted the CC's concern (as expressed in the February provisional decision) that the CPT (Scotland) index was sufficiently influenced by First's own cost data that using the CPT (Scotland) index as the basis for the fare control would undermine First's incentive to control its costs. First did not accept this argument. But it suggested that, if the CC continued to have these concerns, it would be possible to address them while still taking account of the BSOG position in Scotland by controlling fares by reference to a hybrid index. A hybrid index could be calculated using the cost increases from the CPT (GB) index in all cost categories except fuel cost, and using the fuel increases from the CPT (Scotland) index. Since the level of fuel costs affects the relative importance of fuel costs in the index, First argued that in calculating the hybrid index the different cost categories should be weighted using the weights in the CPT (Scotland) index.

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[4] On 17 January 2008 Stewart Stevenson the Scottish Minister for Transport, Infrastructure and Climate Change, in a written reply to Alex Johnstone MSP (S3W-8221) announced that 'Unfortunately, given the constraints of the current spending round, it has not been possible to increase Bus Service Operators Grant on this occasion'. The Scottish Budget Spending Review 2007 also indicated that there would be no increase in support for bus services in Scotland from 2007-08 to 2010-2011. See: http://www.scotland.gov.uk/Publications/2007/11/13092240/0

[5] The BSOG came into force on 1 May 2002. Operators who satisfy a range of criteria (which aims to ensure that they offer public transport services) may apply to the Department for Transport (DfT) for a grant which has the effect of in part offsetting the duty imposed on fuel by the Treasury. With the introduction of the fuel duty escalator, it has become increasingly important to bus operators. Responsibility for the BSOG rules has been devolved and now rests with the Scottish Government and the Welsh Assembly Government with the DfT being responsible for England only.

Notice of CC decision to accept undertakings

11. The CC notes that the changes in Scotland will mean that, other things being equal, the costs of bus operators in Scotland will diverge from the costs of bus operators in England and Wales. Given the nature of the BSOG, other things being equal, this divergence will increase over time.

12. The CC remains concerned that the fare cap contained in the Undertakings is distorting competition in the First Glasgow area and in the First Edinburgh area[6] by restricting increases in First's fares below increases in bus industry costs. In order that this underlying concern be addressed, the CC considers it appropriate to take account of the Scottish Government's different approach to the BSOG in deciding what variation to the Undertakings would be appropriate. The CC accepts that this difference in approach provides a compelling argument for the use of Scotland-specific data on fuel costs in the calculation of any index used as the basis for the fare cap in the future.

13. However, the CC does not accept First's argument that the Scottish Government's BSOG decision is indicative of a different approach to bus transport more generally nor that it supports the use of the CPT (Scotland) index as the basis for the fare cap. First, the CC notes that although the Scottish Government has to some extent pursued transport policies different from those elsewhere in the UK (eg in relation to concessionary fares), the only one of those decisions that appears directly to affect the operators' cost bases (thereby making it relevant to the variation of the fare cap) is that in relation to the BSOG. While the CC considers it appropriate to take account of the effects of the BSOG decision in varying the fare cap, it does not accept that the argument supports the use of the CPT (Scotland) index more widely.

14. Second, as set out in the February provisional decision[7] the CC is concerned that the proportion of the CPT (Scotland) index that is accounted for by First's own costs means that its use in setting the fare cap would undermine First's incentives to keep its costs under control. First has not allayed these concerns, and the CC remains of the view that the CPT (Scotland) index would not be the appropriate basis for the fare cap in the future.

15. The CC considers that a hybrid index, using the CPT (Scotland) index figures for fuel and the CPT (GB) index figures for other cost categories, will provide a means of ensuring that the fare cap is set taking into account changes in fuel cost in Scotland while also meeting the CC's concern about the prevalence of First's costs in the CPT (Scotland) index. The CC accepts First's argument that changes in the level of fuel costs will affect the proportion of total costs accounted for by fuel costs, and therefore accepts that the hybrid index should be calculated using the weightings applied to the different cost categories in the CPT (Scotland) index.

16. The CC notes that nothing in the response to the February provisional decision suggests a need to reconsider its approach to other aspects of the variation.

17. The CC has therefore decided to accept undertakings from First giving effect to the following variations to the Undertakings:

    (a) allow fares to increase so that revenue rises by no more than a hybrid index calculated using fuel costs from the CPT (Scotland) index, other costs from the

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[6] This is discussed in the February provisional decision at paragraph 16 et seq.
[7] At paragraph 29.

CPT (GB) index, and weighting the cost categories using the weightings in the CPT (Scotland) index;

(b) allow a 'catch-up' adjustment in revenue for each of First Glasgow and First Edinburgh that reflects the difference between revenue and cost (including weighted average cost of capital);

(c) allow First to spread the 'catch-up' adjustment across an indefinite period; and

(d) rebase the mileage floor (which applies only to First Edinburgh) to 75 per cent of 2002 mileage.

18. Undertakings giving effect to this variation, are attached at Appendix 1. A complete set of undertakings as varied, which are now in force, is attached for convenience at Appendix 2.

Next steps

19. The CC notes that basing the fare control on the hybrid index represents a halfway house between the two options included in its provisional decision of 20 February 2008 (ie between a fare control based on whichever was the lower of the CPT (GB) index and the CPT (Scotland) index). The CC therefore does not consider that it needs to consult further on its decision. This notice therefore represents the CC's final decision.

(signed) PETER FREEMAN
Chairman
11 April 2008

Appendix 1: Undertakings accepted by the CC giving effect to the variation

UNDERTAKINGS GIVEN TO THE COMPETITION COMMISSION BY FIRSTGROUP PLC TO VARY THE UNDERTAKINGS GIVEN BY FIRSTGROUP PLC TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY FOLLOWING THE MONOPOLIES AND MERGERS COMMISSION REPORT ON THE MERGER BETWEEN FIRSTBUS PLC AND S B HOLDINGS LTD

1. In January 2002 the Secretary of State for Trade and Industry accepted final undertakings ("the Undertakings") from FirstGroup plc ("FirstGroup") in respect of the merger between FirstBus plc and S B Holdings Ltd.

2. On 16 December 2005 FirstGroup submitted an application to the Office of Fair Trading ("OFT") for the release of the Undertakings.

3. On 2006 responsibility for the Undertakings was transferred from the Secretary of State for Trade and Industry to the Competition Commission ("CC") by The Enterprise Act 2002 (Enforcement Undertakings and Orders) Order 2006 (SI 355/2006).

4. On 13 December 2006 the OFT recommended the release of the Undertakings to the CC.

5. On 15 November 2007 the CC provisionally decided not to release the Undertakings, but indicated that it would be sympathetic to an application to vary the Undertakings given their negative effects on the markets in question.

6. On 20 February 2008 the CC published a Notice of a Proposal to accept Further Undertakings varying the Undertakings.

7. FirstGroup now undertakes and agrees with the CC that the Undertakings shall be varied as follows:

Average increase in fares

a. In the heading between clauses 1 and 2 delete the words "not to exceed the rate of retail price inflation".

b. In clause 2(1), after the words "Subject to" insert the words "clause 2(3) below and".

c. Insert the following wording after the end of clause 2(2):

"2(3) FirstGroup shall be entitled to set the average fare increase at a level which exceeds the permitted fare increase where it is entitled to an exceptional fare increase.".

Commercial mileage

d. In the heading between clauses 8 and 9 delete the words "not to be reduced below 95%".

e. In clause 9 delete the figure of "95 per cent" and substitute the figure of "75 per cent".

Interpretation

f. In clause 14, between the definitions of "discounted fare" and "excluded fare" insert

""exceptional fare increase" means the entitlement to increase fares by more than the permitted fare increase, which in respect of the fare year commencing 26 August 2007 is by:

4.47 per cent for journeys within the First Glasgow operating area; and

8.78 per cent for journeys within the Midland Bluebird and Lowland operating area;".

g. In clause 14, at the definition of "fare year"

insert after the word "means" the following: "the period from 26 August 2007 to 30 March 2008 and thereafter";

delete "1 September" and substitute"1 April"; and

delete "that date" and substitute "any of these dates".

h. In clause 14, at the definition of "the index", delete the words "the general index of retail prices (for all items) published by the Office for National Statistics", and substitute the words "the CPT cost index for the 12 months to 31 December published by the Confederation of Passenger Transport UK".

i. In clause 14, at the definition of "the permitted fare increase", delete the entirety of the current wording in sub-paragraph (a) (including, for the avoidance of doubt, the wording in sub-paragraphs (a)(i) and (a)(ii)) and substitute:

"the overall percentage change in:

the non-fuel operating costs figure for Great Britain (comprising drivers wages and on costs, other labour and staff costs, insurance and claims, maintenance materials, vehicle depreciation and other operating costs); and

the fuel operating costs figure for Scotland

as set out in the index relating to the 12 months to 31 December immediately preceding the fare year in which the increase is to be made. The overall percentage change shall be calculated by reference to Schedule 7;".

j. In clause 14, at the definition of "the permitted fare increase", at the end of (b)(ii) delete the "," and substitute:

"; and

(c) any part of any exceptional fare increase

applicable in any year or fare years preceding the fare year in which the increase is to be made, but

not applied by FirstGroup in that or any subsequent year,

such fare increases shall be applied in accordance with Schedule 1 and Schedule 6".

Schedule 6

k. After the end of Schedule 5 insert the following:

"**Schedule 6**

1. This Schedule sets out the methodology to be used for applying fare increases, in particular, where the whole or any part of any fare increases need to be carried forward between fare years where they are not applied in full in the fare year in which they become available.

Where the following applies, a fare increase that may be carried forwards from the relevant fare year to one or more future fare years may be generated:

$$(\sum_{i=1}^{n} P_i^y Q_i^{y-1}) < (\sum_{i=1}^{n} P_i^{y-1} Q_i^{y-1})(1 + f^y)$$

Where:

i and n are used in the same way as in Schedule 1;

P_i^y = the price in the relevant fare year of fare category or fare value i;

' P_i^{y-1} = the price in the previous fare year of fare category or fare value i;

Q_i^{y-1} = the number of passengers purchasing tickets of fare category or fare value i in the previous fare year;

f^y = the percentage potential fare increase in the relevant fare year - being the sum of:

(i) the applicable change in operating costs in the index (see definition of "permitted fare increase", sub-paragraph (a)); and

(ii) any exceptional fare increase.

2. The following formulae should be used as appropriate to determine the fare increase available:

(a) Assuming that there is no fare increase to be carried over from the previous fare year into the current fare year, let:

$$PI^y = \sum_{i=1}^{n} P_i^{y-1} Q_i^{y-1})(1 + f^y)$$

$$AI^y = (\sum_{i=1}^{n} P_i^y Q_i^{y-1})$$

Where:

PI^y = the potential fare increase value in any fare year; and

AI^y = the actual fare increase value utilised in any fare year.

(b) Such that:

$$PI^y - AI^y = RV^y$$

Where:

RV^y = the residual value of allowable fare increase not used.

(c) Then:

$$TUI^{y+1} = PI^{y+1} + (RV^y * (1 + f^{y+1}))$$

Where:

TUI^{y+1} = the total useable fare increase in the year following the year in which First did not use the entirety of the fare increase that it could have used.

(d) Should:

$$TUI^{y+1} - RI^{y+1} > 0$$

Then:

$$TUI^{y+1} - RI^{y+1} = RV^{y+1}$$

Such that the unused residual value from the useable fare increase (RV^{y+1}) can be carried forward into the following fare year in the same way as described above in paragraph (c).

Schedule 7

1. This Schedule sets out the methodology to be used for calculating the overall percentage change in (i) the non-fuel operating costs figure for Great Britain (comprising drivers wages and on costs, other labour and staff costs, insurance and claims, maintenance materials, vehicle depreciation and other operating costs); and (ii) the fuel operating costs figure for Scotland as set out in the index relating to the 12 months to 31 December immediately preceding the fare year in which the increase is to be made.

To calculate the overall percentage change the Great Britain operating costs figures for:

a. drivers wages and on costs;

b. other labour and staff costs;

c. insurance and claims;

d. maintenance materials;

e. vehicle depreciation;

f. other operating costs; and

the Scotland operating cost figure for:

g. fuel;

shall be multiplied by the percentage figure that each cost category represents in Scotland as set out in the index. The sum of these weighted percentages shall then equal the overall percentage figure."

For and on behalf of FirstGroup plc:

Signed: ……………………………………… (Director)

Name:

Signed: ……………………………………… (Director)

Name:

Date: