



**APPLICATION TO THE COMPETITION AND MARKETS AUTHORITY  
FOR THE RELEASE OF UNDERTAKINGS GIVEN IN RELATION TO THE  
ACQUISITION BY FIRSTBUS PLC (NOW FIRSTGROUP PLC) OF SB  
HOLDINGS LIMITED**

**31 August 2015**

**Table of Contents**

I.	EXECUTIVE SUMMARY .....	3
II.	BACKGROUND .....	8
III.	THERE HAVE BEEN CHANGES IN CIRCUMSTANCES SINCE THE UNDERTAKINGS WERE ADOPTED, AND SINCE THEY WERE AMENDED IN 2008 .....	11
IV.	THE FARES CONTROL IS HAVING A DISTORTIVE EFFECT ON FIRSTGROUP'S PRICING.....	40
V.	THE EFFECT OF THE UNDERTAKINGS IS LIKELY TO DETER ENTRY AND EXPANSION, AND TO REQUIRE FIRSTGROUP TO OPERATE PERSISTENTLY UNPROFITABLE ROUTES .....	42
VI.	THESE CHANGES IN CIRCUMSTANCES MAKE IT APPROPRIATE TO RELEASE THE UNDERTAKINGS.....	46
VII.	RELEASE OF THE UNDERTAKINGS WILL HAVE A POSITIVE OR NEUTRAL EFFECT ON CONSUMERS AND BUSINESSES .....	47
VIII.	A REVIEW OF THE UNDERTAKINGS MEETS THE CMA'S PUBLISHED PRIORITISATION PRINCIPLES.....	48
IX.	THE REQUEST IS NOT BEING RAISED IN ORDER TO AVOID A BREACH OF THE UNDERTAKINGS .....	50
X.	CONCLUSION.....	50

## ANNEXES (provided separately):

Annex 1 – 2002 Undertakings

Annex 2 – 2008 Undertakings

Annex 3 – Hybrid CPT Index

Annex 4 – Scotland East Maps

Annex 5 – Dalkeith Maps

Annex 6 – Activity by Competitors

Annex 7 – Glasgow Maps

## I. EXECUTIVE SUMMARY

### A. The application

1. FirstGroup plc (*FirstGroup*) is seeking release of undertakings affecting its bus business across southern and central Scotland that were imposed in 2002<sup>1</sup> following the Monopolies and Mergers Commission's (*MMC*) review of the 1996 acquisition of SB Holdings Limited (*SBH*), a Scottish bus operator.<sup>2</sup> The undertakings were last reviewed by the Competition Commission (*CC*) in 2008.<sup>3</sup>
2. FirstGroup was historically subject to two sets of undertakings affecting its bus business in Scotland: (i) the undertakings that are the subject of this application; and (ii) undertakings that were accepted in 2004 in connection with FirstGroup's acquisition of the Scotrail franchise (the *Scotrail Undertakings*).<sup>4</sup> The Scotrail Undertakings expired earlier this year with the termination of the 2004 Scotrail franchise, and the award of the new franchise to another operator.
3. The undertakings apply to services operated by FirstGroup across what were referred to by the MMC as the Midland Bluebird and Lowland area<sup>5</sup> and the First Glasgow area<sup>6</sup>. The business units affected by the undertakings are First Scotland East, which operates predominantly within the Midland Bluebird and Lowland area and Edinburgh, and First Glasgow, which operates predominantly within the First Glasgow Area (referred to as *Scotland East* area and *Glasgow* area, respectively, in this submission).
4. The undertakings have three principal components:
  - (a) A price control for both the Scotland East (other than Edinburgh) and Glasgow areas;

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<sup>1</sup> MMC, *Report on the merger between FirstBus plc and S B Holdings Ltd - Undertakings given by FirstGroup plc to the Secretary of State for Trade and Industry* (2002). FirstGroup's bus business was formerly known as FirstBus plc.

<sup>2</sup> MMC, *FirstBus plc and SB Holdings Limited: a report on the merger situation*, Cm 3531, January 1997.

<sup>3</sup> CC, *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*, 11 April 2008.

<sup>4</sup> The Scotrail Undertakings included provisions that limited fares and service reductions on certain bus routes that were found to overlap with the Scotrail franchise, required FirstGroup to ensure that other bus operators were invited to participate in multi-modal ticketing schemes on terms that were fair, reasonable and non-discriminatory.

<sup>5</sup> Defined as the unitary authorities of Stirling, Clackmannanshire, Falkirk, West Lothian, Midlothian, East Lothian and the Scottish Borders

<sup>6</sup> Defined as the unitary authorities of City of Glasgow, North Lanarkshire, South Lanarkshire, East Dunbartonshire, West Dunbartonshire, Renfrewshire and East Renfrewshire

- (b) A requirement to maintain a minimum level of services within the Scotland East (other than Edinburgh) area (the *mileage floor*); and
  - (c) A series of behavioural restrictions around how FirstGroup can approach competitive interactions with its rivals.
5. In 2008, the CC varied the fare cap and mileage floor in the original undertakings, after finding evidence that:
- (a) the fare cap had resulted in FirstGroup being forced to set fares below the competitive level, potentially precluding efficient entry; and
  - (b) the mileage floor was potentially distorting the market, by requiring FirstGroup to operate unprofitable services.
6. Since the undertakings were reviewed in 2008, there have been a number of changes of circumstance in the market, the effect of which has been material and far-reaching. These changes in circumstance have rendered the undertakings unnecessary. Moreover, the constraints imposed by the undertakings have prevented FirstGroup from responding to these fundamental market changes, further distorting market outcomes.
7. Having regard to the CMA's current framework for assessing requests for variation or termination of undertakings,<sup>7</sup> FirstGroup considers this is an appropriate case in which undertakings should be released, for the reasons set out below.

**(a) Changes of circumstances since 2008**

8. Undertakings imposed by the CMA, or its predecessor, to address competition concerns arising from a merger may become inappropriate “by reason of *any change of circumstances*”.<sup>8</sup> Since the undertakings were last reviewed by the CC in 2008, there have been a number of *significant* changes of circumstances in the undertaking areas, as discussed below.
9. *Increasing competition*: the undertakings were initially put in place to address concerns about a possible loss of potential competition; however, since 2008 FirstGroup has faced increasing *actual* competition in the areas affected by the undertakings from a number of operators, including major players such as Lothian Buses (**Lothian**), Stagecoach UK Bus (**Stagecoach**) and McGill's Buses (**McGill's**).<sup>9</sup> In addition to increased bus competition, a number of new

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<sup>7</sup> CMA, *Remedies: Guidance on the CMA's approach to the variation and termination of merger, monopoly and market undertakings and orders*, January 2014, paragraph 3.3, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/270251/CMA11\\_Remedies\\_Guidance.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/270251/CMA11_Remedies_Guidance.pdf), and *Enterprise Act 2002* (as amended) (**Enterprise Act**), section 92.

<sup>8</sup> See *Enterprise Act*, section 92 (emphasis added).

<sup>9</sup> McGill's acquired Arriva's Scottish local business in March 2012, which was reviewed and cleared by the CC. See, CC, *McGill's Bus Services Limited/Arriva Scotland West Limited merger inquiry - A report on the completed acquisition by McGill's Bus Services Limited of the business and assets of Arriva Scotland West Limited*, 21 September 2012.

rail and tram lines have been, or shortly will be, introduced across the area covered by the undertakings. These new options for passengers to travel by public transport have had, or are highly likely to have, a significant impact on the level of competition faced by FirstGroup.

10. The original rationale for the undertakings (namely, the possibility of reduced potential competition between the Glasgow and Scotland East operations) is incompatible with the CC's latest analysis of the market<sup>10</sup>, where it found that potential competition and entry are not significant constraints on incumbent operators. Even if potential competition were a significant constraint in this area, other bus operators are stronger actual and potential competitive threats than the Glasgow and Scotland East businesses would be to each other.
11. *Increasing costs that cannot be accounted for under the pricing mechanism.* The pricing mechanism in the undertakings (as modified in 2008) has not accurately reflected the costs of operating bus services within Scotland, such as increasing labour costs and increases in vehicle quality and technical specifications (for example, environmental specifications). Operators within urban areas, such as FirstGroup, have also faced disproportionately higher fuel costs as a result of significant changes to the way the Bus Service Operators Grant (**BSOG**) is allocated in Scotland, which the undertakings pricing mechanism has not reflected. As a result, FirstGroup has been unable to fully recover its costs. This has had a distortive effect on both FirstGroup and the market more generally, and may well lead to barriers to entry, as the CC noted in its 2008 decision to vary the undertakings.<sup>11</sup>
12. This situation is exacerbated by imminent additional cost increases affecting FirstGroup's local bus operations in Scotland that are outside the scope of the pricing mechanism and therefore cannot be recovered through fare adjustments. For example, compliance with public service vehicle accessibility regulations, which have final deadlines for compliance in stages in January 2016 and January 2017<sup>12</sup>, require a substantial portion of FirstGroup's bus fleet in areas affected by the undertakings to be replaced. The cost of financing this expenditure is not reflected within the undertakings pricing mechanism.
13. Finally, following compulsory acquisition of Galashiels bus station by the Scottish Borders Council (**Borders Council**), FirstGroup is facing a significant increase in departure charges if it is to continue operating its services from the

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<sup>10</sup> CC, *Final Report, Local Bus Services Market Investigation*, 20 December 2011 (**Market Investigation**), page 11-12, paragraph 11.54.

<sup>11</sup> CC, *Notice of provisional decision to vary Undertakings given pursuant to section 88 of the Fair Trading Act 1973 following the acquisition by FirstBus plc of SB Holdings Limited*, 20 February 2007, also referring to *Notice of provisional decision to retain Undertakings given pursuant to section 88 of the Fair Trading Act 1973 following the acquisition by FirstBus plc of S B Holdings Limited*, 15 November 2007.

<sup>12</sup> Broadly speaking, 1 January 2016 is the deadline by which all single-decker vehicles must be compliant, and 1 January 2017 is the equivalent deadline for double-decker vehicles.

redeveloped transport interchange in Galashiels. As FirstGroup will be the only commercial operator using the Galashiels transport interchange it will be disproportionately affected by this change. Other operators will be able to pass-on the increased departure charge to the Borders Council through charging higher prices for tendered services. In contrast, FirstGroup would be forced by the undertakings to absorb this increase in cost or to switch its operations away from the new Galashiels interchange, resulting in a significant detriment to passengers and less efficient operations.

14. *The cost pressures are exacerbated by declining demand for bus travel.* The demand for local bus travel in Scotland has declined significantly since 2008, with steadily declining passenger journeys and vehicle miles. At the same time, the proportion of passengers travelling on concessionary fares has increased. This decline in demand has compounded the increasing costs faced by FirstGroup.
15. *Financial challenges for the business:* the Scotland East business, which predominately operates services in the area covered by the mileage floor, ✕. FirstGroup is an efficient operator,<sup>13</sup> and has implemented a number of efforts over the past several years, within the constraints of the undertakings, to improve the performance of its Scotland East business. ✕. The undertakings distort FirstGroup's fare structure (by restricting FirstGroup's ability to set fares at competitive levels and cover its costs) and preclude FirstGroup from being able to rationalise unprofitable routes. FirstGroup hopes to combat declining demand for its services by developing a simpler and more rational network and fare structure, however its ability to do so is currently constrained by the undertakings.

***(b) These changes in circumstances make it appropriate to release the undertakings***

16. The undertakings have become unnecessary as the concern they were originally designed to address, on an updated analysis, can no longer be considered material or relevant. Moreover, not only are they now redundant, they are, in fact, inconsistent with the aim they were designed to achieve.
17. The undertakings are having two distortive effects on competition. First, by failing to allow FirstGroup to reflect fully in its fares the increases in the costs of operating bus service in Scotland, they are likely to be creating a barrier to entry. ✕, the undertakings preclude FirstGroup from operating efficiently, and again are likely to be creating a barrier to entry.
18. FirstGroup considers that there have been significant changes in circumstances since 2008 that have rendered the undertakings unnecessary and inappropriate. In addition, removal of the undertakings would allow FirstGroup to operate an efficient and viable local business.

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<sup>13</sup> The CC has previously concluded that FirstGroup had significantly lower costs than its rivals. Specifically, the CC's detailed econometric analysis of depot cost in the Market Investigation found that FirstGroup's costs were both economically and statistically significantly lower than all but one of the other operators considered in the analysis. See CC, *Final Report, Local Bus Services Market Investigation*, Appendix 9.6, December 2011.

***(c) Release of the undertakings will have a positive or neutral effect on consumers and businesses***

19. Consumers will benefit from the release of the undertakings as this would enable FirstGroup to offer a more rational and simplified fare structure, which customer research indicates is high on the list of priorities for passengers. Moreover, if FirstGroup were able to cover the costs associated with investments in initiatives such as accessibility, smart ticketing and other customer facing technologies, it would then have a greater incentive to engage in these investments.
20. FirstGroup also believes that there will be an indirect benefit for consumers as the removal of the unnecessary burdens imposed by the undertakings will increase the ability for management to focus on serving customers rather than on compliance with the terms of the undertakings.
21. FirstGroup believes that the relevant local bus markets, absent the undertakings, are working effectively and do not require additional intervention. To the extent some degree of intervention were considered desirable in the future, local authorities have considerable oversight powers, for example through developing partnership schemes with local bus operators or introducing quality contracts.
22. Therefore, the undertakings no longer serve a public policy purpose that cannot be better addressed through other better targeted and more effective policy instruments available to local stakeholders in relation to the services in question.

***(d) Review of the undertakings meets the CMA's published prioritisation principles***

23. FirstGroup believes that the request to release the undertakings is consistent with the CMA's current focus on assessing undertakings and considering the removal of measures that are no longer necessary or are now restricting or distorting competition.<sup>14</sup> ✗.
24. FirstGroup does not anticipate an imminent breach of the undertakings. This request is being raised to address a real and growing harm to FirstGroup's business and one that FirstGroup believes is distorting competition and is detrimental to consumers.
25. Release of the undertakings will ✗. It will enable FirstGroup to deliver benefits to consumers including offering a more rational and simplified network and fare structure; to invest in technology, fleet and improved service delivery and reliability; and to deliver value through partnering with procuring authorities, industry partners and communities in the Glasgow and Scotland East areas.

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<sup>14</sup> As published in the CMA's 2015/16 annual plan. FirstGroup notes that the CMA is currently undertaking a review of structural undertakings, and has recently issued a consultation on a review of monopoly undertakings.

## II. BACKGROUND

### A. FirstGroup

26. FirstGroup plc (*FirstGroup*) is a public limited company operating public transport services in the UK, Ireland and North America.<sup>15</sup> It is listed on the London Stock Exchange. FirstGroup has five subsidiaries that are active in the provision of local bus services in Scotland<sup>16</sup>; this application relates to undertakings affecting four of these subsidiaries, two operating in Glasgow and two operating in Scotland East (including in Edinburgh):
27. Glasgow
- (a) First Glasgow (No 1) Limited is a private company limited by shares incorporated in Scotland (registered number SC097299) (First Glasgow (No 1)). Its registered office is at 100 Cathcart Road, Glasgow, G42 7BH. First Glasgow (No 1) operates approximately 40 tendered and commercial bus routes in and around the city of Glasgow. First Glasgow (No 1) had revenue of ₤ for the financial year ended 31 March 2015.
  - (b) First Glasgow (No 2) Limited is a private company limited by shares incorporated in Scotland (registered number SC127012) (First Glasgow (No 2), together with First Glasgow (No 1), First Glasgow). Its registered office is at 100 Cathcart Road, Glasgow, G42 7BH.. First Glasgow (No 2) operates approximately 35 tendered and commercial bus routes in and around the city of Glasgow. First Glasgow (No 2) had revenue of ₤ for the financial year ended 31 March 2015.
28. Scotland East
- (a) First Midland Bluebird Limited is a private company limited by shares incorporated in Scotland (registered number SC016923) (*FMBL*). Its registered office is at Carmuir House, 300 Stirling Road, Larbert, Stirlingshire FK5 3NJ. FMBL operates approximately 140 tendered and commercial bus routes in and around Edinburgh, Stirling, Alloa, Falkirk, Galashiels, Hawick and Peebles. FMBL had revenue of ₤ for the financial year ended 31 March 2015.
  - (b) First Scotland East Limited is a private company limited by shares incorporated in Scotland (registered number SC091923) (FSEL and, together with FMBL, First Scotland East). Its registered office is at

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<sup>15</sup> FirstGroup also has a 30% holding in DSBFirst, a joint venture with Danish State Railways which operates some passenger rail services in the Oresund region of Denmark.

<sup>16</sup> The other subsidiary operating in Scotland is First Aberdeen Limited (*First Aberdeen*). First Aberdeen is a private company limited by shares incorporated in Scotland (registered number SC97420). Its registered office is at 395 King Street, Aberdeen AB24 5RP. First Aberdeen operates 22 commercial bus routes in and around the city of Aberdeen. First Aberdeen had revenue of ₤ for the financial year ended 31 March 2015. First Aberdeen's operations are not affected by the undertakings.

Carmuir House, 300 Stirling Road, Larbert, Stirlingshire FK5 3NJ. FSEL operates approximately 40 tendered and commercial bus routes in and around Edinburgh, Bathgate, Livingston, Musselburgh and North Berwick. FSEL had revenue of ₤ for the financial year ended 31 March 2015.

## **B. Background to the undertakings**

29. FirstGroup entered into undertakings with the MMC in 2002 in connection with its 1996 acquisition of the Scottish bus operator SBH.<sup>17</sup>
30. As is described in further detail below, these undertakings apply to services operated by FirstGroup across what were referred to by the MMC as the Midland Bluebird and Lowland area<sup>18</sup> and the First Glasgow Area.<sup>19</sup> The undertakings imposed a fare cap on FirstGroup's bus operations in the Midland Bluebird and Lowland area and the First Glasgow area, and established a mileage floor for FirstGroup's bus operations in the Midland Bluebird and Lowland area.
31. In April 2008, the CC varied the fare cap and mileage floor after finding evidence that the fare cap had resulted in FirstGroup being forced to set fares below the competitive level and at a level that would preclude efficient entry, and that it was likely that the mileage floor was distorting the market.

## **C. 2002 SBH undertakings**

32. The original undertakings were given by FirstGroup to the Secretary of State for Trade and Industry on 17 January 2002. A copy of the 2002 undertakings is set out in **Annex 1 – 2002 Undertakings**.
33. The undertakings included a price control mechanism: there was an initial period during which FirstGroup could not increase fares; once that period expired, the undertakings imposed a cap on price increases that was pegged to the rate of retail price inflation (*RPI*). The price control mechanism applied to most fares in existence in 2002, although tendered fares, concessionary fares and multi-operator fares (and fares outside the controlled area) were excluded.

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<sup>17</sup> The Secretary of State referred the merger to the MMC under the Fair Trading Act 1973. The MMC recommended that FirstGroup be ordered to divest one subsidiary and the Glasgow depots and routes previously operated by SB Holdings. FirstGroup asked for a review of the decision based on developments in the Glasgow bus market that cast doubt on the MMC's conclusion and made the divestment unnecessary. The Secretary of State then asked the OFT to conduct a review of the Scottish bus market. Following this review, the Secretary of State concluded divestment was not required, and instead sought behavioural undertakings.

<sup>18</sup> Defined as the unitary authorities of Stirling, Clackmannanshire, Falkirk, West Lothian, Midlothian, East Lothian and the Scottish Borders

<sup>19</sup> Defined as the unitary authorities of City of Glasgow, North Lanarkshire, South Lanarkshire, East Dunbartonshire, West Dunbartonshire, Renfrewshire and East Renfrewshire

34. The undertakings also prevented FirstGroup from reducing its commercial mileage in the Midland Bluebird and Lowland operating area (i.e. the majority of the area covered by First Scotland East) below 95% of its commercial mileage in that area (i.e. its registered bus miles in respect of its commercial services) on 17 January 2002.
35. Finally the undertakings imposed certain additional behavioural constraints on FirstGroup in the relevant areas. These included:
- (a) Prohibitions on altering the terms and conditions relating to bus services and fares, including changing the location of any fare stage, changing the boundary of any fare zone, extending or introducing a peak fare for the ‘rush hour’;
  - (b) Bus services in Midland Bluebird and Lowland were to be evenly spaced between competitors’ bus services; and
  - (c) Where FirstGroup had unsuccessfully bid to run a tendered contract in Midland Bluebird and Lowland, it was constrained in its ability to compete with the winning contractor’s services.

**D. 2008 amended undertakings**

36. In 2005, FirstGroup applied for the release of the undertakings, and the Office of Fair Trading (*OFT*) recommended their full release.<sup>20</sup> The CC did not follow the *OFT*’s recommendation, but did accept amendments to the undertakings reflecting changes in the local market conditions. A copy of the amended undertakings is set out in **Annex 2 – 2008 Undertakings**.
37. The CC found that the fare cap in its original form was likely to result in distortive effects as a consequence of having constrained increases in FirstGroup’s fares to below increases in bus industry costs. The fare cap was tied to RPI, but bus industry costs appeared to have risen at a faster rate than RPI over the relevant period.<sup>21</sup> Given the distortive effects of the undertakings, the CC decided to vary the fare cap to use an index, the hybrid CPT index (*H-CPT*) that, it was expected, would allow fares in the future to rise in line with changes in bus industry costs. The CC stated that using such an index as the basis for the fare control “*would permit First to increase fares so as to recover (efficiently-incurred) costs*”.<sup>22</sup>
38. The H-CPT is calculated from the components of a cost index published by the Confederation of Passenger Transport UK (the *CPT Index*) bi-annually. The H-CPT is 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. In addition, the different cost categories are weighted using

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<sup>20</sup> *OFT, Monopolies and Mergers Commission report on the merger between FirstBus plc and S B Holdings Ltd – Request for release from undertakings given by FirstBus plc (now FirstGroup plc) pursuant to section 88 of the Fair Trading Act 1973, 13 December 2006.*

<sup>21</sup> *CC Notice of acceptance of undertakings, 11 April 2008.*

<sup>22</sup> *CC Notice of provisional decision, 20 February 2008.*

the weights in the CPT (Scotland) Index.<sup>23</sup> Further details on the CPT Index and the H-CPT are set out in **Annex 3 – H-CPT**.

39. The CC also found that it was likely the mileage floor was resulting in additional distortive effects in the First Scotland East area to the extent it required FirstGroup to continue to operate persistently unprofitable services. Given the distortive effect of the undertakings, the CC decided to reduce the mileage floor.
40. As a result of these findings, the CC accepted the following amendments to the undertakings:
  - (a) Fares would be allowed to increase so that the average prices rose by no more than the H-CPT;
  - (b) A catch-up adjustment in revenue was allowed reflecting the difference between revenue and cost (including the cost of capital), which the CC allowed FirstGroup to spread across an indefinite period; and
  - (c) The mileage floor (which affects First Scotland East) was rebased to 75% of 2002 commercial mileage within the Midland Bluebird and Lowland area.

**III. THERE HAVE BEEN CHANGES IN CIRCUMSTANCES SINCE THE UNDERTAKINGS WERE ADOPTED, AND SINCE THEY WERE AMENDED IN 2008**

41. FirstGroup believes that the relevant reference point for the current review is the last time the undertakings were amended in 2008. Whether the CMA looks at the development of the market since the undertakings were adopted in 2002, or since they were amended in 2008, it remains the case that there have been a number of significant changes in circumstances that render the undertakings both unnecessary and distortive.
  - (a) Local market conditions have changed dramatically imposing new constraints on FirstGroup’s Scottish bus business, in particular through:
    - (i) growing bus competition;
    - (ii) the introduction of new transport modes; and
    - (iii) the increasing appetite for using the existing regulatory mechanisms affecting bus businesses and the markets generally, coupled with the proposed introduction of new

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<sup>23</sup> The H-CPT was designed to address two concerns: (i) the CC was concerned that the size of FirstGroup’s Scottish operations meant that its own costs would inevitably form a large part of any Scotland-only cost index. As such, if the annual price increase allowed as part of the undertakings was set with reference to the change in the costs of Scottish operators, FirstGroup’s incentives to control its own costs might be muted; and (ii) the Scottish Government approach to the BSOG is different to that used by the Government in England and Wales meaning that both the level and trend of net fuel costs is likely to differ between Scottish and non-Scottish bus operators.

regulatory mechanisms and ongoing moves towards greater devolution and local authority autonomy.

- (b) The H-CPT used in the pricing mechanism has not accurately reflected rising costs in Scotland and, as a result, FirstGroup has not been able to reflect its increasing costs in its fares. As the CC found when it varied the undertakings in 2008, restrictions that prevent recovery of efficiently incurred costs are likely to distort competition by creating barriers to entry.
  - (c) In addition, FirstGroup is facing future unavoidable cost increases that are outside the scope of the pricing mechanism. FirstGroup will not be able to reflect these cost increases within its pricing.
  - (d) The cost pressures have been exacerbated by declining revenues. As a result, First Scotland East in particular has faced significant financial challenges over the past four years – see below.
42. As FirstGroup has already reached the mileage floor and increased its fares to the full extent of the allowances granted to it by the undertakings,<sup>24</sup> the undertakings prevent FirstGroup from responding efficiently to these changes, either by fully recovering costs or, in Scotland East, by reducing mileage where routes cannot be run profitably.

**A. FirstGroup is facing increased bus competition**

43. The competitive landscape in Scotland East and Glasgow has changed dramatically over the last seven years. There has been significant expansion by large competing operators, particularly McGill's in the Glasgow area and Lothian in the Scotland East area. At the same time, FirstGroup has retrenched its bus services in the area, particularly in Scotland East.

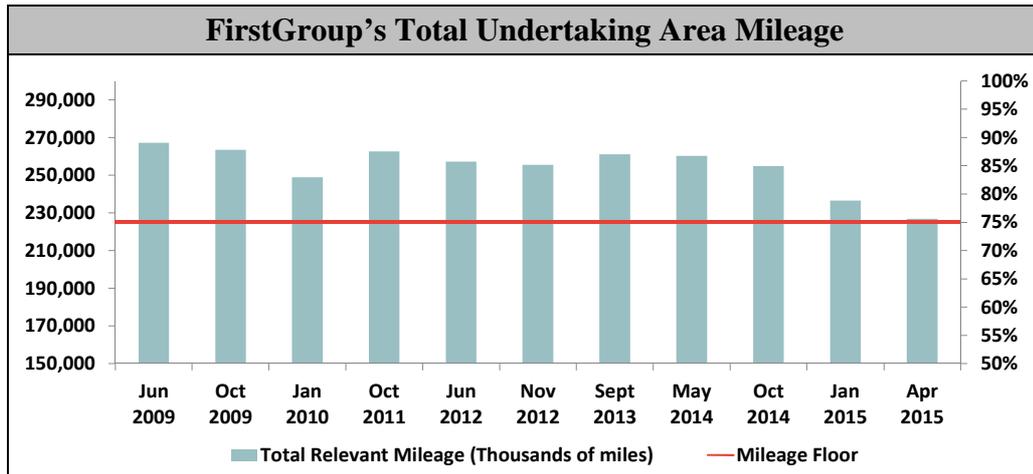
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<sup>24</sup> Please refer to paragraphs IV.144 to IV.148 below, for a more detailed discussion of the impact of the fare cap on FirstGroup's business in the undertaking areas.

**FirstGroup retrenchment in Scotland East**

44. **Figure 1** shows FirstGroup’s total undertaking compliant (commercial) mileage from 2009 to 2015 within the Midland Bluebird and Lowland operating area (the areas in Scotland East to which the mileage floor applies). **Figure 1** shows that FirstGroup has reduced mileage over this period and is now prevented from doing so further by the undertakings.

**Figure 1 - FirstGroup’s Total Undertaking Compliant Mileage from 2009 to 2015**



Source: FirstGroup

45. **Figure 1** and the maps set out in **Annex 4 – Scotland East Maps** show that the geographic coverage of FirstGroup’s business across the area has shrunk over the last seven years. This reflects  $\asymp$  and the strong rivalry from key competitors such as Lothian.<sup>25</sup>
46. The key areas of decline are:
- (a) Edinburgh, due to strong competition from Lothian;
  - (b) The area along the south side of the Firth of Forth between Falkirk and Edinburgh;
  - (c) Livingston; and
  - (d) Dalkeith, where FirstGroup closed its depot in 2012, following strong competition from Lothian.
47. FirstGroup is constrained in Scotland East by strong rivalry from Lothian, which is the largest publicly-owned bus company in Britain. Moreover, as Lothian is majority owned by a public authority – the City of Edinburgh Council – it has a greater ability to absorb costs compared to FirstGroup,

<sup>25</sup> FirstGroup would note that market shares do not provide a useful tool for assessing bus competition in Scotland East because shares are typically assessed based on mileage. Shares based on mileage would be distorted because FirstGroup’s mileage is fixed.

which allows it to sustain lower fares and higher operating losses than a commercial rival.

48. An example of Lothian's approach can be seen from market developments around the Dalkeith depot, leading up to FirstGroup withdrawing from operations there in April 2012. Maps set out in **Annex 5 – Dalkeith** show FirstGroup's operations and the network of its key competitor Lothian in and around Dalkeith in October 2010 and in April 2015. A simple comparison clearly shows that following the exit of FirstGroup, Lothian moved quickly to cover the services that FirstGroup no longer ran.
49. Further evidence on key competitor activity in the last 5 years, highlighting the extent of Lothian's activity in particular, is included in a table at **Annex 6 – Activity by competitors**.

***Edinburgh and Midland Bluebird and Lowlands Area***

50. Bus markets are local and interconnected. This means that developments within the Edinburgh area are important for the performance of FirstGroup's services within the Midland Bluebird and Lowland area, particularly for services that either operate between the Edinburgh area and the Midland Bluebird and Lowland area, or operate close to the boundary of the two areas.
51. The experience of Scotland East over recent years helps to demonstrate this point:
  - (a) The Dalkeith depot, which was located close to Edinburgh, closed in 2012 after posting heavy losses for a number of years in the face of significant competition from Lothian;
  - (b) ✂;
  - (c) The introduction of the Edinburgh tram has both increased the costs of operating services into that city (as a result of slower journey speeds), and decreased the attractiveness of FirstGroup's services due to direct competition from the tram itself and, more significantly, the network benefits that Lothian is able to offer through its intermodal ticketing arrangements (please refer to discussion of the Edinburgh tram at paragraphs B.67 to B.70 below).
52. FirstGroup therefore considers that assessing developments within the Midland Bluebird and Lowland area without reference to developments within Edinburgh would produce a misleading picture of market developments since the undertakings were varied in 2008.

***Glasgow Market Developments***

53. There have been several examples of material entry and expansion in the Glasgow area over the past seven years, increasing the competitive pressure on FirstGroup in the area. In particular:
  - (a) McGill's Bus Services is a bus operator based in Greenock, Inverclyde, Scotland. McGill's was formed in 2001 from the sale of Arriva Scotland West's operations in the Inverclyde region. The company has

grown from an initial fleet of 33 vehicles to operate a network of routes covering much of Inverclyde, Renfrewshire and Glasgow. A second depot in Barrhead was opened in 2008, and four independent operators were taken over by McGill's in the following three years. McGill's took over the surviving operations of Arriva Scotland West in a £10 million deal in 2012 (this deal was subject to a phase two review). Further expansion followed in 2012 and 2013.

In late 2014, the tendered bus service operator, Henderson Travel, went into liquidation. McGill's stepped in to operate what was an entirely tendered service business on emergency contracts to Strathclyde Partnership for Transport (*SPT*) using the Henderson yard, Henderson/SPT buses and Henderson drivers.

In due course, long-term contracts were advertised, worth approximately £10 million over five years, for which both FirstGroup and McGill's bid. FirstGroup expected to acquire a portion of this work, but, McGill's was the successful bidder for all contracts. The business has moved to new premises in the Hamilton area and current peak vehicle requirement for this operation is approximately 35 buses, all operating on SPT contracts.

McGill's has the potential to use its existing depots as operating bases from which to initiate further competition with FirstGroup in areas where it has previously been absent. McGill's has recently announced record profits and significant capital investment in new vehicles. It now operates over 400 buses across 110 routes.<sup>26</sup>

- (b) Fastlink is a bus rapid transit system linking Glasgow City Centre with the new Queen Elizabeth University Hospital complex. Originally intended to be provided via an exclusive operating contract, SPT and Glasgow City Council have instead provided the necessary infrastructure, leaving it open to any commercial operator to provide services on some or all of the Fastlink corridor via a statutory quality partnership (see further paragraph 82 below).

The corridor that Fastlink covers was already well served by various services, with McGill's 23/26 providing almost identical end-to-end links, and other services operating for shorter sections.

Other than the new hospital development, the corridor itself has relatively poor bus travel demand having suffered from significant industrial and population decline. As such, First Glasgow chose not to operate a city to hospital Fastlink service, instead focusing on serving the hospital via a more established alternative route.

FirstGroup expected that McGill's would simply convert their existing 23/26 services, which together provide eight to ten buses per hour, to the Fastlink standard. However, instead McGill's chose to divert all

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<sup>26</sup> See <http://www.mcgillsbuses.co.uk/mcgills.aspx>

their services in the area via the hospital and also to include a new dedicated Fastlink service, the F1, between the hospital and city centre. Moreover, Stagecoach, which previously operated no services in the area, has also introduced a new dedicated Fastlink service, the X1, in direct competition with McGill's.

As a result, in addition to the existing eight to ten buses per hour that the McGill's 23/26 routes provide between the hospital and city centre, the F1 and X1 provide an additional six buses each per hour.

- (c) Stagecoach has become increasingly competitive in the Cumbernauld area. Following a four year period of sustained head to head competition between Stagecoach and FirstGroup, FirstGroup's losses at its Cumbernauld depot were so heavy the decision was taken to close it in May 2013 and it has recently been sold to Stagecoach. At the same time, FirstGroup significantly reduced its remaining services in the area to just the X3 and the X5. Stagecoach then increased the frequency of its existing services and introduced new routes to compete with the X5, and the X5 has become heavily loss-making. With the lapse of the ScotRail undertakings, which required FirstGroup to run the X5, this service has now been withdrawn from 19 October 2015.
  - (d) As well as their involvement in Fastlink Stagecoach have recently started two new services in the city, each running every 10 minutes and requiring 13 vehicles in total to operate.
54. Maps set out in Annex 7 – Glasgow show the changes to FirstGroup's network, and significant changes to competitors' networks, in particular that of McGill's.
55. *In conclusion*, FirstGroup faces increasing *actual* bus competition from major bus operators, particularly McGill's, Stagecoach and Lothian. These developments clearly constitute relevant changes of circumstances for the purposes of section 92 of the Enterprise Act. In fact, these changes in the market are highly significant and the undertakings materially restrict FirstGroup's ability to respond.

## **B. Constraints from new modes of transport**

56. Since the undertakings were revised in 2008, two new rail lines and a new tram have been introduced in the area covered by the undertakings. A further new rail line is also due to open imminently and increased incentives to encourage inter-modal competition have been introduced by the new Scotrail franchise. The introduction of these new modes of transport has significantly altered transportation patterns and demand for bus services.

### ***Alloa Railway***

57. In March 2008, 13 miles of disused track was reopened linking Stirling to Alloa and introducing an alternative to the bus for passengers making the trip

not only between Alloa and Stirling, but also between Alloa and places further afield such as Falkirk.

58. Usage for the line was predicted to be 155,000 passengers per year. In its first two four-week periods, the line carried 64,000 passengers, and carried an annual total of around 400,000 passengers.<sup>27</sup>

### ***Bathgate-Airdrie Railway***

59. The Bathgate-Airdrie route opened in December 2010. It involved a combination of new track laid, some improvements to existing track and three new stations. This provided a fourth route connecting Glasgow and Edinburgh.
60. The improvements largely consisted of heavily upgrading this route between Edinburgh and Glasgow to operate on electrified double track. These improvements were largely aimed at commuters, as shown by the 1,100 new station car parking spaces built along the route. The increased competition represented by this service resulted in FirstGroup subsequently cancelling its X14 Livingston to Glasgow service once it was permitted to do so with the ending of the ScotRail undertakings.

### ***Borders Railway***

61. The Borders Railway is scheduled to open in September 2015. It includes four new stations built in Midlothian and three in the Scottish Borders. Trains will run every half hour Monday to Saturday in daytime and journey times between Tweedbank and Edinburgh will take less than one hour, considerably faster than FirstGroup's X95 bus service, which covers a similar route in approximately 1 hour and 40 minutes at peak times.
62. ✕.

### ***The 2015 ScotRail franchise***

63. FirstGroup was unsuccessful in its bid to operate the new ScotRail franchise. Therefore, as of April 2015, FirstGroup no longer has any significant rail operations within Scotland.<sup>28</sup>
64. FirstGroup notes that the CC has previously concluded that rail services can be a competitive constraint on local bus services in certain cases.<sup>29</sup> Moreover, previous CC decisions indicate that this constraint is likely to be significantly stronger within Glasgow than other parts of Great Britain, as a result of Glasgow's dense urban rail network.<sup>30,31</sup> In particular, FirstGroup notes that

<sup>27</sup> See: <http://www.transportscotland.gov.uk/news/minister-unveils-%C2A%330-million-investment-rail-stations> Accessed 4 June 2015: <http://www.theyworkforyou.com/sp/?id=2008-10-02.11540.0>

<sup>28</sup> FirstGroup continues to operate a very limited number of rail services within Scotland as part of the TransPennine Express franchise. None of these services are relevant for the purposes of considering the undertakings.

<sup>29</sup> See for example Paragraph 22, Market Investigation, Final Report.

<sup>30</sup> See for example Table 5, Appendix 11.2, Market Investigation, Final Report.

the remedies imposed upon it following its successful bid for the previous ScotRail franchise were at the time, and indeed remain so today, the most extensive imposed in any rail franchising merger inquiry.

65. FirstGroup considers that a number of unique features associated with the new ScotRail franchise have the potential to significantly alter transport patterns across Scotland, leading to fewer passengers travelling by bus. These are set out below:
- (a) *Stricter fares regulation, with real terms reduction in off-peak tickets.*<sup>32</sup> In summary, the increase in regulated peak fares may not exceed RPI + 0% per annum and the increase in off-peak tickets may not exceed RPI – 1% per annum. There is no greater individual fare increase permitted unlike the situation applying to the regulated fares regime in England. This means that, in those areas where bus and rail do compete (such as central Glasgow), travelling by bus is likely to become less attractive over time due to increasingly attractive rail fares.
  - (b) *Off-peak patronage growth targets.*<sup>33</sup> Failure to meet this target can lead to the franchise operator being required by Transport Scotland to implement improvement plans. Contravention of the Franchise Agreement (where this occurs in two successive years) or an Event of Default (where failures occur in three successive years), lead to possible termination of the operator's contract to run the ScotRail franchise. Moreover, falls in off-peak patronage in absolute terms across the franchise can count as a contravention of the Franchise Agreement (where this occurs in two successive years) or an Event of Default (where failures occur in three successive years), leading to possible termination of the operator's contract to run the ScotRail franchise. Therefore, the rail operator is heavily incentivised to seek to divert passengers from other modes, including bus, wherever possible.
66. FirstGroup notes that the views set out above are consistent with those it expressed to the CMA during pre-notification discussions on the ScotRail franchise last year (namely, that the award of the ScotRail franchise to FirstGroup would not result in a substantial lessening of competition). This is because the changes set out above were mandated within the ScotRail Franchise Agreement, and as such would have taken place regardless of the identity of the successful bidder for the franchise.<sup>34</sup>

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<sup>31</sup> See for example the CC's Final Report in the *Firstgroup plc / Scotrail rail franchise merger inquiry*.

<sup>32</sup> See Schedule 5.3 of the ScotRail Franchise Agreement.

<sup>33</sup> See Schedule 7.2 of the ScotRail Franchise Agreement.

<sup>34</sup> Specifically, these changes would have formed part of the counterfactual against which FirstGroup's bid for the ScotRail franchise was assessed, given that the standard counterfactual for rail franchising cases is the award of the franchise to a bidder who poses no competition issues.

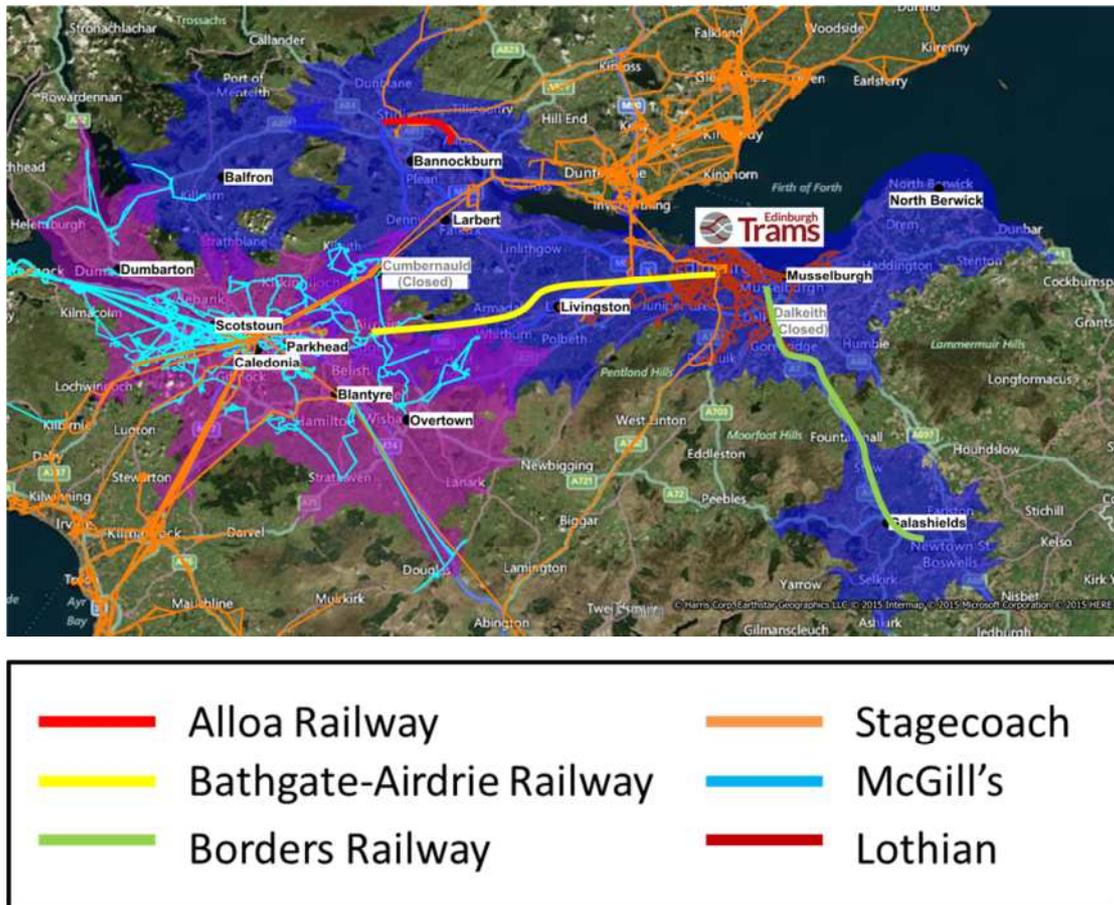
***Edinburgh Tram***

67. A new tram service was introduced in Edinburgh on 31 May 2014 and is having, and is expected to have further, significant disruptive effects on existing patterns of bus travel in and around the city. It provides a competitive alternative to bus travel for customers on many routes in the city. The Edinburgh tram service is operated by Edinburgh Trams Limited (“**Edinburgh Trams**”), a company owned by the City of Edinburgh Council, in partnership with Lothian (also majority owned by the City of Edinburgh Council), for Transport for Edinburgh. Lothian has expanded its service to provide an increasingly “integrated” service with the tram, for example by opening routes to Kirkliston.
68. Trams have automatic priority at traffic lights, which Edinburgh Trams notes makes “*for more consistent journey times than other road traffic*”.<sup>35</sup> For passengers, Edinburgh Trams and Lothian work as one and the Ridacard and on-bus day/week tickets can be used on both services. Other operators, including FirstGroup, are not permitted to participate in the Ridacard scheme.
69. FirstGroup has lost business as a result of passengers switching to Lothian services that allow them to transfer to the trams in Edinburgh. In addition, the introduction of the tram has increased the costs to FirstGroup of operating within Edinburgh due to delays being encountered by buses and other traffic with traffic light signals being altered to give the tram priority.
70. *In conclusion*, in addition to *actual* competition from major bus operators described in section III(A) above, FirstGroup faces increasing competition from new modes of transport, namely rail and tram services (as illustrated in **Map 1** below). These developments clearly constitute relevant changes of circumstances for the purposes of section 92 of the Enterprise Act. In fact, these changes are highly significant and the undertakings materially restrict FirstGroup’s ability to respond.

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<sup>35</sup> See: [edinburghtrams.com/customer-services/frequently-asked-questions](http://edinburghtrams.com/customer-services/frequently-asked-questions).

**Map 1 - Glasgow's and Scotland East's depots and their catchment areas,<sup>36</sup> and Competitors' operations in 2015**



**C. The changes in local competitive conditions remove the concerns that were the basis for the undertakings**

71. The MMC had four reasons for its finding in relation to the SBH merger. As explained below, none of the four reasons identified by the MMC remains relevant:

- (a) First, the merger caused a loss of potential competition between FirstBus and SBH;
- (b) Second, the merger was likely to deter competition from two other large adjacent operators, Stagecoach and Cowie;
- (c) Third, as a result of the scale and dominance of a merged FirstBus/SBH in central and south-east Scotland, the merger was likely to deter entry by other operators; and
- (d) Finally, the merger caused some loss of direct competition between FirstBus and SBH, although the MMC also noted that direct

<sup>36</sup> See paragraph 73 below for details on the definition of catchment areas.

competition between FirstBus and SBH was limited (“... *there was little actual competition between FirstBus and SBH before the merger either in commercial services or tenders...*”).<sup>37</sup>

72. The focus of the MMC decision was on a loss of *potential* competition.<sup>38</sup> In general, potential competition is likely to be strongest when an operator’s existing depots are sufficiently close to the areas served by a rival operator that it can easily expand its services into that area at a minimal cost. This is because having a nearby depot minimises the costs associated with having to run a vehicle to and from the start of a route (“dead mileage”).
73. **Maps 2 and 3** below show the depots of both the First Glasgow (in pink) and First Scotland East (in blue) businesses in 2011 (i.e. prior to the closure of Dalkeith and Cumbernauld depots) and 2015 (i.e. after the closure of Dalkeith and Cumbernauld). The maps show for each depot the isochrones associated with 20 (full fill) and 30 (translucent fill) minute drive times around each depot location, which provide an indication of its operating range.<sup>39</sup>

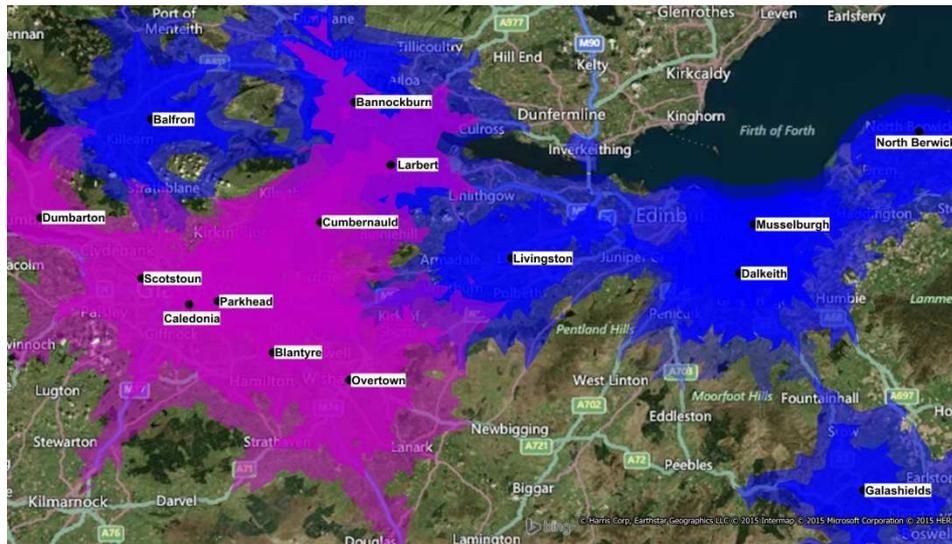
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<sup>37</sup> Paragraph 1.5, Page 3, 1997 MMC Decision. FirstBus and SBH approximately mirror FirstGroup’s current First Glasgow and First Scotland East businesses, respectively.

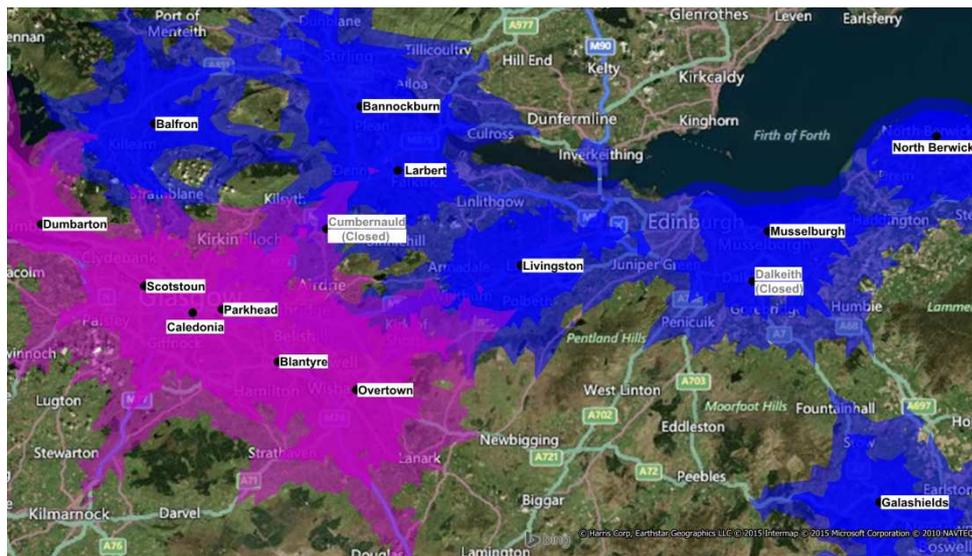
<sup>38</sup> FirstGroup notes that this view is superseded by the CC in the Market Investigation. While the CC recognised that potential competition could in principle provide a constraint on the behaviour of bus operators, the CC ultimately concluded that: “... *we have identified a number of barriers to entry and expansion .... The effect of these barriers is to reduce the probability that entry or expansion will be attracted by a market opportunity. This, in turn, will reduce incumbents’ perception of the constraint posed by the threat of entry or expansion, but this does not guarantee entry will definitely not occur... We also find that some of these barriers impede the constraint from potential competition.*” (Competition Commission, *Local bus services market investigation: A report on the supply of local bus services in the UK (excluding Northern Ireland and London)* (20 December 2011) at para 9.226)

<sup>39</sup> The CC stated that “[it] is unlikely that operators without existing services and facilities within approximately a 30-minute drive-time from a flow (i.e. new entrants) would substitute into the supply of services on that flow in response to a small increase in fares above competitive levels”. Paragraph 7.99, Market Investigation, Final Report.

**Map 2 - Glasgow's and Scotland East's depots and their catchment areas of 20 and 30 minutes' drive time in 2011**



**Map 3 - Glasgow's and Scotland East's depots and their catchment areas of 20 and 30 minutes' drive time in 2015**



74. As is apparent from **Maps 2 and 3**, there would be limited opportunities for First Glasgow or First Scotland East to expand into each other's territory using their existing depots. The main area of overlap between the two operations was around Cumbernauld (which is apparent from **Maps 2 and 3**, above), a depot which FirstGroup closed following significant competition from Stagecoach and has now sold to Stagecoach. The overlap today between Scotland East and Glasgow is minimal, with Stagecoach now strongly located in the key area of potential overlap. Stagecoach provides an actual and potential constraint on the operations of FirstGroup in both Glasgow and Scotland East.

75. The basis for reimbursement under BSOG changed in April 2012, from a rebate paid in proportion to the number of litres of fuel consumed by an operator operating eligible services, to the number of (eligible) kilometres an operator runs, excluding dead mileage.<sup>40</sup> The decision to end the payment of BSOG for dead mileage has reduced the range at which services can be profitably operated from a given depot. This suggests that the relevant drive time isochrones for an analysis of the scope for potential competition between two bus operators based on the locations of their respective depots is likely to be closer to 20 minutes, rather than the 30 minutes the CC had cited in earlier decisions. On this basis, the scope for Glasgow to be a material potential competitor to Scotland East (and vice versa) has been eradicated.
76. FirstGroup also notes that even as an independent operator, First Glasgow would have no incentive to enter into First Scotland East's territory. ✕ the local markets do not pose an attractive opportunity for expansion for the Glasgow business.
77. Moreover, recent reviews of bus mergers have focused on effects on head-to-head competition as opposed to potential competition. The CC's views following the Market Investigation, based on the then current market data and more extensive and sophisticated analysis than was available to the MMC at the time of the SBH merger, were inconsistent with the competitive assessment that led to the SBH undertakings being imposed. As such, the original rationale for the SBH undertakings no longer appears supported on the more up-to-date methodology. FirstGroup therefore considers that if, hypothetically, the companies had remained separate, but a merger were to be considered by the CMA today, in light of recent precedent, a substantial lessening of competition finding would be highly unlikely. For example, the Market Investigation route classification methodology estimated the consumer detriment resulting in each area due to an insufficient level of head-to-head competition. The CC did not consider that there were any routes (including those in the Undertaking Areas) in which this detriment was alleviated by the existence of potential competition. FirstGroup therefore believes that there has been a change in circumstances in relation to the extent of potential competition between First Glasgow and First Scotland East which it now considers to have been eradicated.
78. Further, the concerns expressed in the SBH merger decision about the potential for the merger to deter entry have not been borne out in practice. As explained in further detail above, there have been significant instances of entry or expansion by competitors in the last several years. These include expansion by Lothian, which is a very significant operator in Edinburgh, and expansion by other competitors such as McGill's and Stagecoach. These operators each have a significant market position and would be well placed to expand further. There are also a large number of smaller bus operators active in the undertaking areas.

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<sup>40</sup> Please refer to paragraphs III.E.102 to III.E.107 below for further discussion of changes to BSOG.

79. Finally, while the MMC argued that the merger could result in a small loss of direct competition between FirstBus and SBH it accepted that this direct competition was “*not significant*” prior to the merger<sup>41</sup>. Moreover, any hypothetical direct competition between FirstGroup’s operations in Glasgow and Scotland East has clearly been further reduced by the expansion of Stagecoach in the Cumbernauld area (the main area of possible overlap), and the subsequent closure of FirstGroup’s Cumbernauld depot (see **Maps 2 and 3** above) and disposal of the depot to Stagecoach. Therefore, to the very limited extent the undertakings were designed to address merger-related issues affecting actual competition, this is no longer necessary.
80. *In conclusion*, the concerns about loss of potential competition underlying the original undertakings imposed by the MMC in 2002, and underpinning the CC’s decision to vary the undertakings in 2008, have not been borne out. On the contrary, since 2008 FirstGroup has been subject to increasing *actual* competition from major bus operators, as well as from other modes of transport, while the extent of overlap between FirstGroup’s operations in the Scotland East and Glasgow areas has contracted. These developments clearly constitute relevant changes of circumstances for the purposes of section 92 of the Enterprise Act. In fact, these changes are highly significant individually and in aggregate, and the undertakings materially restrict FirstGroup’s ability to respond.

#### **D. Regulatory changes to Scottish bus services**

81. There has been a significant increase in the oversight of bus services by local transport authorities over the past several years. Some of these changes have imposed additional costs on bus operators.
82. First, the Transport (Scotland) Act 2001 provides a framework for local transport authorities to enhance the provision of local bus services. The Act allows local authorities to introduce Quality Partnerships, Quality Contracts, provision of information about local bus services and joint ticketing schemes. The Act also provides local authorities in the SPT area with concurrent powers to introduce Quality Partnerships and Quality Contracts. Although such powers have existed since the adoption of the Act in 2001, and similar powers have existed in England under the Transport Act 2000, there have been a number of recent efforts by local authorities to take on an enhanced oversight role.
- (a) *Quality Partnership*: a Quality Partnership is a scheme in which the local authority specifies factors such as the quality of buses, and minimum frequencies that must be provided by bus operators using specific infrastructure provided by the authority (e.g. bus stops or bus priority measures). Operators can use that infrastructure only if they meet the requirements of the Quality Partnership scheme.

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<sup>41</sup> Paragraph 1.5, Page 3, 1997 MMC Decision. FirstBus and SBH approximately mirror FirstGroup’s current First Glasgow and First Scotland East businesses, respectively.

- (b) *Quality Contract*: a Quality Contract is a scheme similar to franchising. Under a quality contract, a local authority can stipulate which local services should be provided, bus routes, the standard and quality of service, and the level of fares. A local authority can introduce a Quality Contract where five public interest criteria are met: (i) the scheme will result in increased bus use; (ii) it will improve the quality of the local services; (iii) it will contribute to the implementation of the policies of the LTA; (iv) it will contribute to implementation in a way which is economic, efficient and effective; and (v) any adverse effects on operators will be proportionate to the improvement in well-being of local persons.
83. A number of Quality Partnerships have recently been introduced in Scotland. For example, the Fastlink statutory Quality Partnership Scheme came into effect in June 2015. This scheme requires bus operators providing local bus services on the Fastlink route corridor in Glasgow to operate within designated areas and in accordance with specific standards. These standards include minimum operating hours and frequencies<sup>42</sup> (see paragraph A.53 (b) above). The ability to impose Quality Partnerships and Quality Contracts gives local transport authorities significant power to direct local bus services and represents a significant constraint on bus operators.
84. Second, the proposed devolution of additional powers, both to Scotland generally and to cities across the UK more specifically, will increase the constraints that local authorities can impose on bus operators. Cities, including Glasgow, are actively seeking greater devolution from Westminster.<sup>43</sup> It is not yet clear whether the Buses Bill proposed in the Queen's Speech extends to Scotland, however, equivalent devolutionary measures are under active consideration.
85. A Private Members' Bill was proposed to the Scottish Parliament recently and consulted on, which contemplated giving transport authorities greater control over bus services by allowing regulation through Quality Contract schemes, Quality Partnership schemes, and ticketing schemes; and to extend the powers of the Traffic Commissioner in relation to the registration of bus services. Although the bill has now been withdrawn, FirstGroup understands that there is ongoing discussion about implementing elements of the bill through a partnership or alliance arrangement.<sup>44</sup>

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<sup>42</sup> See: *The Statutory Quality Partnership Scheme for Fastlink*, available online at: [http://www.spt.co.uk/wmslib/Documents\\_Bus/fastlink-sqp.pdf?3](http://www.spt.co.uk/wmslib/Documents_Bus/fastlink-sqp.pdf?3).

<sup>43</sup> See The Independent, "UK's biggest cities demand devolution 'at same speed as Scotland'" (24 September 2014). Available online at: <http://www.independent.co.uk/news/uk/politics/uks-biggest-cities-demand-devolution-at-same-speed-as-scotland-9753752.html>.

<sup>44</sup> See [http://www.heraldscotland.com/news/13211714.Supreme\\_Court\\_orders\\_action\\_on\\_illegal\\_air\\_pollution\\_in\\_cities\\_including\\_Glasgow/](http://www.heraldscotland.com/news/13211714.Supreme_Court_orders_action_on_illegal_air_pollution_in_cities_including_Glasgow/)

86. Effective local oversight is visible in places such as South Yorkshire. The South Yorkshire PTE has entered into a voluntary partnership with bus operators in Sheffield. Although all cities have their own unique characteristics, Sheffield may be a useful comparator because it is similar in size to Glasgow (and slightly larger than Edinburgh). There are two major operators (FirstGroup and Stagecoach) and a number of smaller operators in Sheffield. The partnership has delivered substantial benefits to consumers with requirements for, among other things, network stability, reliability, fleet standards and driver standards. The partnership has evolved and been enhanced over time, and the PTE is currently in discussion with operators about further enhancements including a simplified and consistent single ticket range.
87. The enhanced ability and growing willingness of local authorities to exercise oversight over bus services in local areas is a relevant change in circumstances. Further, local authorities may have enhanced powers to regulate local bus services in the future following the devolution of further powers to cities. Quality Partnerships have worked successfully in the interest of customers in places such as Sheffield and Glasgow. The availability of the more onerous Quality Contracts regime may provide additional motivation for operators to enter into a Quality Partnership Scheme. A mechanism such as a Quality Partnership Scheme is more targeted than the undertakings and would arguably be the preferable mechanism for addressing concerns about the provision of local bus services in the relevant areas. The undertakings no longer serve a public policy purpose that cannot be better addressed through other, better targeted and more effective, policy instruments available to local stakeholders in relation to the services in question.
88. *In conclusion*, the increasing willingness of local authorities, since 2008, to control bus services in local areas constitutes a relevant change of circumstance for the purposes of section 92 of the Enterprise Act. Moreover, this significant development mitigates any possible concerns (and FirstGroup believes no such concerns would arise in any event, for the reasons set out in this submission) about potential risks to consumers or market outcomes resulting from release of the undertakings.
- E. The H-CPT has not accurately reflected rising costs in Scotland and prevents FirstGroup from raising prices in line with costs**
89. As part of the undertakings, FirstGroup is allowed to increase its prices annually to take account of increases in the costs of providing local bus services as measured by the H-CPT.
90. Since the undertakings were amended in 2008, however, there has been a persistent divergence between the cost increases FirstGroup, and other operators within Scotland, have faced and cost increases as measured by the

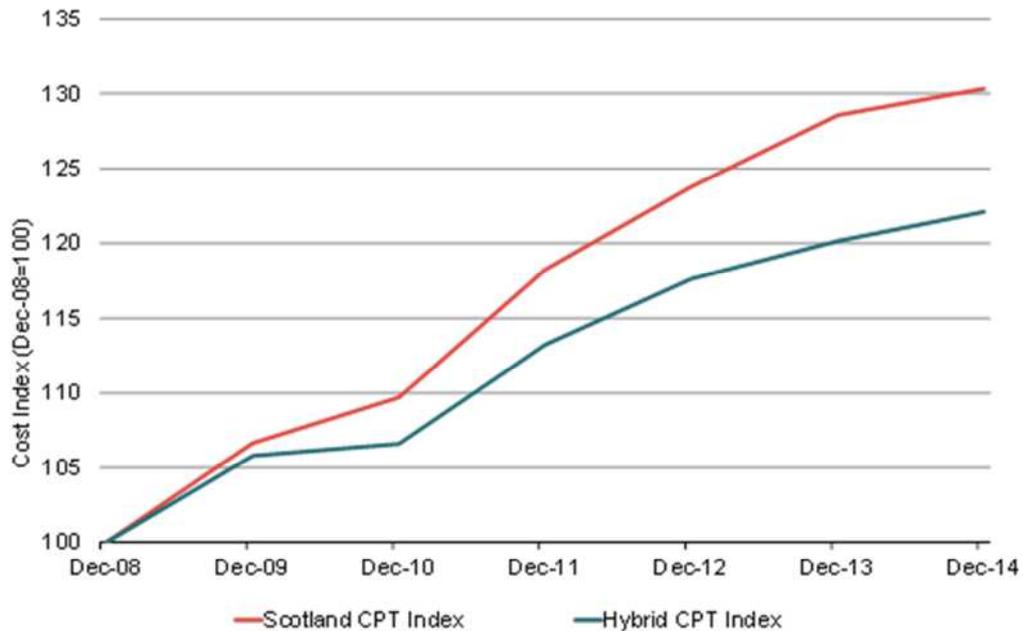
H-CPT. This divergence has prevented FirstGroup from fully recovering its costs.<sup>45</sup>

- 91. The divergence between allowed price increases (as measured by the H-CPT) and the actual cost of providing bus services in Scotland has the potential to distort competition by requiring FirstGroup to charge fares that are below the competitive level.

***The relationship between the H-CPT and the CPT Index for Scotland***

- 92. **Figure 2** shows that in December 2014 the CPT Scotland Index (rebased to 2008) stood at 130.32, while the H-CPT stood at 122.12. In other words, since 2008, bus operators’ costs in Scotland have increased by 8.21% more than FirstGroup has been allowed to recover under the fares control.

**Figure 2 - Hybrid CPT index and Scottish CPT Index**



Source: FirstGroup for CPT Scotland weights and CPT for cost increases

- 93. The conclusion of the analysis presented above is not sensitive to the base year used to compare the evolution of the two indexes. If the analysis presented above was replicated using December 2006 or December 2007 as the base year, the cumulative divergence between the H-CPT and the CPT Index for

<sup>45</sup> This divergence is due to external factors. The design of the H-CPT means that FirstGroup has every incentive to control its own costs. At the time it incurs costs, FirstGroup has no guarantee that those costs will be reflected within the H-CPT. Moreover, FirstGroup has not been able to cover costs through “exceptional” fare increases. The OFT turned down an application for an exceptional fare increase in 2011. In 2012, First Group was allowed to reflect the changes in BSOG reimbursement a year ahead of their reflection within the H-CPT, but its allowed increase in the following year was reduced accordingly, so that overall it was in no better position.

Scotland would be 10.94% and 9.39% respectively. Based on this, FirstGroup concludes that the H-CPT has systematically failed to reflect the evolution of bus operator costs within Scotland.

94. This divergence is also seen in other indexes of bus industry costs. For example, over the period 2007/08 to 2013/14, the Department for Transport (*DfT*) estimated that operating costs per mile for local bus services increased by 26% (in real terms) in Scotland compared to 10% (again in real terms) in Great Britain outside of London.<sup>46</sup>
95. Finally, FirstGroup's own costs in the areas affected by the undertakings have increased by more than the H-CPT over the period. Between 2008/09 and 2014/15  $\times$ .
96. This data provides strong evidence to suggest that the H-CPT has not reflected the development of the cost of operating a bus service in Scotland since 2008.

***Reasons for the divergence***

97. Mathematically, divergences between the H-CPT and the Scottish CPT index can only arise if the trends for the non-fuel cost items included within the CPT indexes have differed between Scotland and the rest of Great Britain. This is because both the H-CPT and the Scottish CPT weight changes in each cost item identically, and use the same figures for changes in fuel costs.
98. In practice, this means that differences between the H-CPT and the Scottish CPT would be driven by:
  - (a) Larger increases in labour costs in Scotland compared to Great Britain as a whole; and/or
  - (b) Higher investment in new vehicles, leading to higher increases in depreciation charges and potentially maintenance and insurance costs, in Scotland compared to Great Britain as a whole; and/or
  - (c) Larger increases in non-bus costs (e.g. depot rents, utilities, etc.) in Scotland compared to Great Britain as a whole.
99. FirstGroup's analysis of the data underlying CPT indexes suggests that over the period December 2008 to December 2014 all of the non-fuel cost items contained in the indexes have increased at a faster rate in Scotland than in Great Britain as a whole.
100. FirstGroup believes that there are a number of objective factors that explain the differential rates of increases between Great Britain as a whole and Scotland.
  - (a) First, according to data from the Annual Survey of Hours and Earnings (the source for national statistics on earnings), median hourly wages for full time employees have risen at a faster rate in Scotland since

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<sup>46</sup> DfT Annual Bus Statistics, Table BUS0408b.

2008 than in all but one region of the UK.<sup>47</sup> Over the period 2008 to 2014 median hourly wages for full time employees in Scotland increased by 13.2% compared to 9.3% across the UK as a whole. Given that labour costs make up around 55% to 60% of the CPT indexes, this differential trend in wage rates is likely to be an important underlying driver for the difference between the H-CPT and Scottish CPT index.

A similar picture emerges for the wages of bus and coach drivers. Since 2008, median hourly wages for full time bus and coach drivers have risen at a faster rate in Scotland than in all but two regions of the UK. Specifically, over the period median hourly wages for full time bus and coach drivers in Scotland increased by 16.9% compared to 12.9% across the UK as a whole. Given that driver costs make up around 40% to 45% of the CPT indexes,<sup>48</sup> this differential trend in wage rates is likely to be an important underlying driver for the difference between the H-CPT and Scottish CPT index.

- (b) Second, there has been a reduction in average bus speeds  $\times$  between 2008/09 and 2014/15 for First Glasgow and First Scotland East respectively. This means that for the same operated frequency of service more driver hours and more vehicles are needed. FirstGroup believes that there are a number of reasons for this reduction in bus speeds, including:
- (i) Increased traffic congestion.
  - (ii) Priority given to trams within Edinburgh.
  - (iii) The introduction during this period of a new smart card system for the Scottish concessionary fare scheme. Previously concessionary passengers were issued a simple nil value ticket. In contrast, these passengers now have to place their card on a reader and state their destination, and the driver has to issue a destination specific ticket. This change has led to an increase in boarding times, and consequently an increase in the trip time for services. This has further reinforced the need for an increase in operated hours in Scotland even as the operated miles have reduced. The biggest impact has been seen within Glasgow City where bus speeds were declining overall, a decline exacerbated by the concessionary fare scheme.

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<sup>47</sup> There are likely to be a number of factors behind this differential, including differences in the industrial make-up of Scotland versus the UK, differences in proportion of public sector employees in Scotland versus the UK and differences in regional economic performance. However, FirstGroup is not aware of any analysis that decomposes the differential wage growth between Scotland and the rest of the UK into its different components.

<sup>48</sup> Other labour and staff costs make up the remainder of the labour costs in the CPT index.

- (c) Finally, data from the DfT suggests that there has been a higher level of investment in public service vehicles (*PSVs*) within Scotland compared to the rest of Great Britain over the period. Specifically:
- (i) Between 2007-08 and 2013-14 the proportion of PSVs which either had accessibility certificates or low floor access increased by 33 percentage points in Scotland compared to 24 percentage points in Great Britain; and
  - (ii) Between 2007-08 and 2013-14 the proportion of PSVs with automatic vehicle location devices increased by 55 percentage points in Scotland compared to an increase of 46 percentage points in Great Britain.

101. Based on the evidence set out above, FirstGroup believes that there are objective reasons why the costs of operating a bus service have increased at a faster rate in Scotland compared to the rest of Great Britain since 2008.

### *Rising fuel costs*

102. Although the H-CPT uses fuel increases from the CPT (Scotland) index, as a result of significant changes in the allocation methodology for BSOG announced by Transport Scotland in December 2011, it has understated FirstGroup's, and other predominantly urban operators', fuel costs in recent years notwithstanding recent decreases in wholesale fuel prices.
103. Previously, BSOG was paid in proportion to the number of litres of fuel consumed by an operator operating eligible services. However, from 1 April 2012, the basis for reimbursement was changed to the number of (eligible) kilometres an operator runs, excluding dead mileage.
104. In practice, this change resulted in the level of support received by operators with predominately urban operations falling relative to the level of support received by operators with predominately rural operations. This is for two reasons:
- (a) urban operators are more likely to use heavier double decker vehicles which are less fuel efficient than lighter single decker vehicles; and
  - (b) urban driving is typically less fuel efficient than rural driving as a result of its stop-start nature.
105. In addition to this change, the 1% uplift for positioning was also removed (this previously increased BSOG payments to account for engineering movements and training mileage), compounding the effect of the change set out above.
106. As these changes (in and of themselves) did not reduce the overall "pot" of BSOG funding received by operators, they were not reflected within the H-CPT.<sup>49</sup> This is because the higher fuel costs for operators within

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<sup>49</sup> At the same time as these changes to the allocation methodology were implemented the overall level of BSOG support was also reduced. Changes in the overall level of BSOG funding are reflected in the H-CPT as they result in all operators' fuels costs increasing.

(predominately) urban areas would have been exactly offset by lower fuel costs for operators in (predominately) rural areas.

107. As FirstGroup's operations in the undertaking areas are more urban than its competitors', for the reasons mentioned above the changes to BSOG disproportionately increase FirstGroup's fuel costs compared to other operators. This is exacerbated by the undertakings, which limit the rate of increase in FirstGroup's fares to the change in the H-CPT, and prevent FirstGroup from fully recovering its increasing costs.

***Effect of increased costs***

108. The factors set out above have had a significant cumulative effect on the costs of FirstGroup's operations within Scotland (and likely those of other Scottish operators). However, the H-CPT pricing mechanism has not reflected this market reality because it relies predominately on data from Great Britain as a whole, where the costs of running a bus service have increased at a lower rate. As a result, the pricing mechanism prevents FirstGroup from pricing efficiently to cover its costs.
109. *In conclusion*, the H-CPT has systematically failed to reflect the development of the cost of operating bus services in Scotland since 2008, and failed accurately to capture changes in FirstGroup's fuel costs since 2008. As a result, despite applying the maximum fare increases permitted by the undertakings each year, FirstGroup is unable to fully recover its costs, while developments not fully accounted for in the H-CPT (such as changes to BSOG) ✕. These developments constitute relevant changes of circumstance for the purposes of section 92 of the Enterprise Act.

**F. FirstGroup is facing cost increases that are outside the scope of the pricing mechanism and could not be recovered**

110. FirstGroup is facing a number of imminent cost increases that will not be reflected in the H-CPT and, therefore, that cannot be recovered through price increases. The cost increases below are current examples of externally imposed cost increases that FirstGroup cannot recover. These examples are not atypical occurrences in the business. FirstGroup has experienced similar cost increases in many other parts of the business where investments were required to respond to local changes, or to participate in quality partnership schemes. Such cost changes have also arisen previously in Scotland leading, for instance, to the variation of the undertakings in 2008. The indeterminate length and broad scope of the undertakings deprive FirstGroup of the flexibility to respond to changes in the bus market in Scotland in a timely manner.

***Compliance with vehicle accessibility regulations***

111. The Public Service Vehicles Accessibility Regulations 2000 (***PSVAR***) require substantial changes to FirstGroup's Scottish bus fleet. The PSVAR require that all single decker buses be fully accessible by 1 January 2016 and that all double decker buses be fully accessible by 1 January 2017. The accessibility requirements include:

- (a) space for a wheelchair, with suitable safety provisions depending on whether the wheelchair is carried facing forwards or backwards;
  - (b) a boarding device to enable wheelchair users to get on and off vehicles;
  - (c) criteria for steps;
  - (d) handrails to assist disabled people;
  - (e) visual contrast of features such as handrails and steps to help partially sighted people; and
  - (f) audible and visible signals to stop a vehicle or to request a boarding device.
112. Complying with the PSVAR requires the replacement of a substantial proportion of FirstGroup's Scottish bus fleet. Many existing vehicles cannot be modified to meet the requirements (or the modifications are not cost effective). Many of these vehicles would not otherwise have been replaced on this schedule and the replacements will result in very significant capital costs for the business.
113. Some of these costs will be reflected within the H-CPT through the CPT cost items for maintenance parts expenditure, other labour costs and PSV depreciation. However, as the H-CPT explicitly excludes interest costs, the cost of financing this capital expenditure will not be reflected within the undertakings pricing mechanism in its entirety.
114. As compliance with PSVAR is a mandatory requirement for all bus operators, it would typically be expected to result in either higher prices or the withdrawal of services where the return on investment was insufficient to warrant the necessary capital expenditure. The undertakings limit FirstGroup's ability to reflect the cost of complying with PSVAR. Within Scotland East, the undertakings prohibit it from withdrawing services where the capital expenditure necessary to comply with PSVAR is unlikely to yield an economic return; ✕.

***Galashiels bus station closure***

115. Galashiels bus station was owned by FirstGroup until it was made the subject of a compulsory purchase order (**CPO**) by the Borders Council in May 2013.<sup>50</sup> Following the opening of the re-developed transport interchange, FirstGroup will face a very significant increase in departure charges in Galashiels. This increase will not be reflected in the H-CPT, as it is limited to operators within Galashiels.

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<sup>50</sup> The original CPO was issued by the Borders Council in May 2011 and subsequently objected to by FirstGroup. Following a public inquiry the CPO was confirmed by the Scottish Government in May 2013. The land was transferred to the Borders Council in October 2013.

### ***Background to the CPO***

116. The Borders Council issued a CPO for the bus station as part of its plans to create an integrated transport hub. The Borders Council plans to significantly redevelop the site with an investment of £5.2 million, financed in part by the European Regional Development Fund. The redevelopment includes:
- (a) the complete rebuilding of the bus station;
  - (b) the addition of new facilities such as showers and lockers to encourage cycling; and
  - (c) the addition of retail and business space to the bus station.
117. As part of this redevelopment, services ceased operating out of the old bus station in October 2013 and temporary on-street stands were used instead. The new integrated Galashiels transport interchange opened in August 2015.
118. **Figure 3** provides further detail on the location of the old bus station, the new railway station and the site of the Border Council’s new integrated transport interchange.

**Figure 3 - Location of Galashiels bus station**



### ***Impact on FirstGroup***

119. The old bus station had a limited selection of facilities<sup>51</sup> and so was a relatively low cost operation. The departure charge for using the bus station in its final year of operation was £0.35.<sup>52</sup>

<sup>51</sup> The old station did not have a ticket booth, it provided only toilets and a heated waiting area.

120. In contrast, the new integrated transport interchange has a wider range of facilities, and consequently a higher cost base. The Borders Council's plan is that these higher running costs should be financed, in part at least, through higher departure charges. The departure charge is still under discussion, but it appears that there will be a near five-fold increase in departure charges to £1.75 (exclusive of VAT).
121. The introduction of this new integrated transport interchange is therefore likely to have an ongoing financial impact on FirstGroup's operations. This impact is the result of either:
- (a) the higher costs of operating from the integrated transport interchange;  
or
  - (b) ✕.
122. ✕. FirstGroup is the only commercial operator in the Galashiels area; other operators would be able to pass the increased charges back to the Council through increased tender service costs. As a result, FirstGroup is disproportionately affected by this cost increase. In addition, since this cost is specific to FirstGroup in Scotland, it will not be reflected in the H-CPT. ✕.
123. The alternative to operating from the redeveloped bus station would be to alter the route of FirstGroup's services so that they did not call at the transport interchange. This would reduce the attractiveness of FirstGroup's services as they would no longer stop close to a number of key trip generators such as the railway station and B&M (the department store). In addition, services would become less convenient for passengers who could otherwise access these services directly from the bus station car park, and for passengers wishing to transfer between bus and rail services. Further, in such circumstances, the FirstGroup bus services would potentially be less efficient to operate because of increases in the time to change over drivers. This decision remains under discussion at FirstGroup.
124. *In conclusion*, the H-CPT does not reflect several imminent cost increases faced by FirstGroup, including costs related to compliance with vehicle accessibility regulations and the closure of the Galashiels bus station. These developments constitute relevant changes of circumstance for the purposes of section 92 of the Enterprise Act. The undertakings restrict FirstGroup's ability to respond to these developments, ✕.

**G. The cost pressures have been exacerbated by declining revenues resulting from reduced demand for bus travel**

125. The demand for bus travel in Scotland has declined significantly since 2008. This decline has been concentrated in urban areas, and amongst fare-paying non-concessionary passengers. Coupled with the rising costs of providing bus services in Scotland (which have not been fully reflected within the undertakings fare control), and increasing competition, this decline in demand

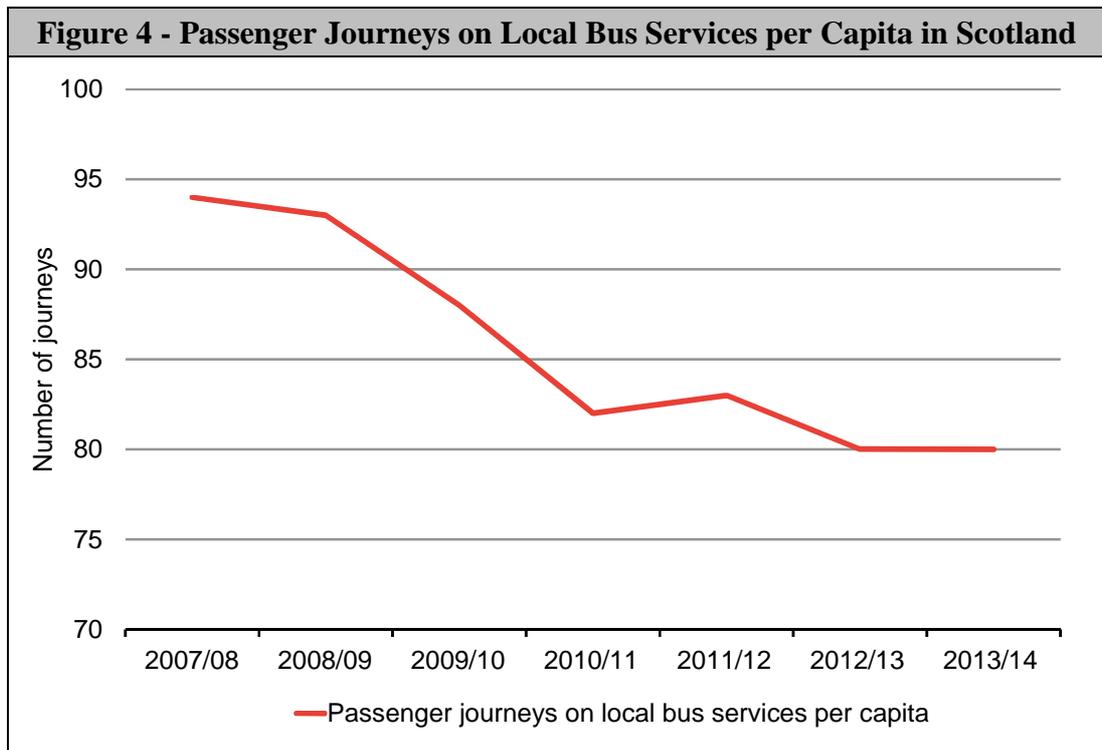
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<sup>52</sup> This departure charge was calculated in accordance with the CC's Access to Bus Station Order 2012.

✂. The undertakings have prevented FirstGroup from responding to this decline in demand.

***Declining number of passenger journeys and growing proportion of concessionary passenger journeys***

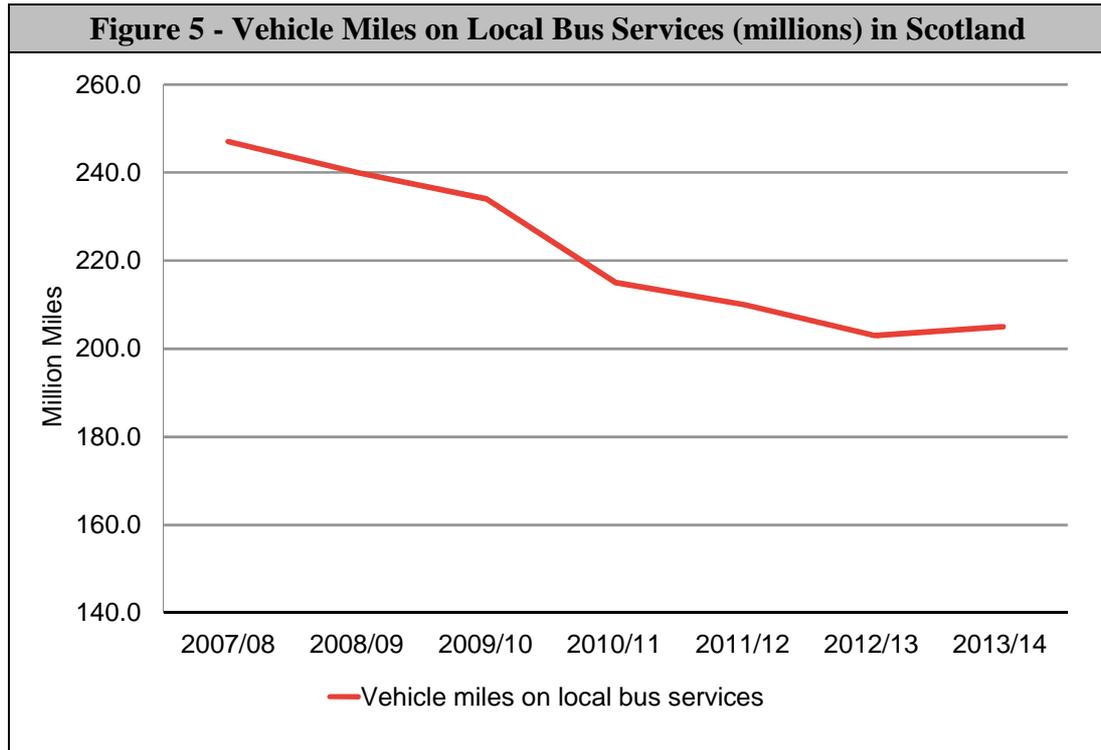
126. The number of passenger journeys on local bus services per head of population in Scotland has decreased by 14.9% over the period 2007/08 to 2013/14 see **Figure 4** below.<sup>53</sup>



Source: DfT annual bus statistics

127. Furthermore, vehicle miles – a measure of the provision of local bus services closely related to passenger demand – have fallen by 17% over the same period see **Figure 5** below.

<sup>53</sup> Figures 4, 5 and 6 are based on data from the DfT 2014 publication “Annual Bus Statistics”.

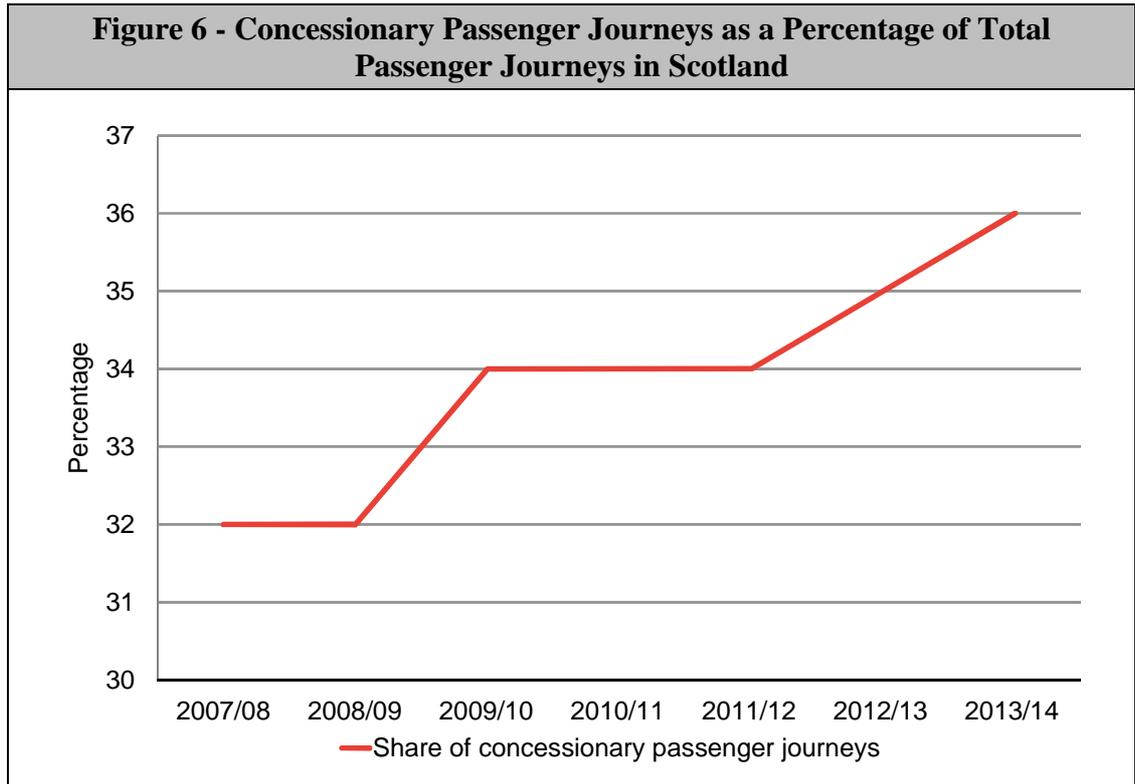


Source: DfT annual bus statistics

128. Taken together, the data in **Figures 4 and 5**, above, demonstrate that there has been a significant reduction in demand for local bus services within Scotland since the undertakings were last reviewed.
129. In addition to the overall decline in the level of demand for bus services, as illustrated in **Figure 6** below, the composition of that demand has also changed over time. Although the number of total concessionary passenger journeys has slightly decreased by 2% between 2007/08 and 2013/14, the share of concessionary passenger journeys out of total passenger journeys has actually increased from 32% to 36%.
- (a) Local bus operators do not charge concessionary passengers for their travel directly. Instead, operators are reimbursed by the relevant local authority for the foregone revenue and higher costs associated with transporting these passengers. Over the last five years this reimbursement rate has fallen, negatively impacting on operators' revenues.
  - (b) The reimbursement rate was initially set at 73.6% in 2006-07. After a number of years at this level, it was then revised downwards to 67.0% in 2010-11.
  - (c) Following agreements reached between Transport Scotland and the CPT, the Scottish Government was allowed to limit total payments to specific reimbursement "caps" within each financial year, based on forecast changes in the main factors that should influence payments. This change meant that if total claims exceeded the cap for the year, the reimbursement rate would be reduced until the overall value of claims came within the cap. This change effectively transferred a

significant portion of the financial risk associated with the scheme from the Scottish Government to operators.

- (d) The current reimbursement rate for 2014/15 is 58.1% with a budget of £192m. The new rates will be 57.1% in 2015/16 and 56.9% in 2016/17. The budgets for each year will be £202 million and £212 million, respectively.
130. The increasing proportion of concessionary passengers, and changes in concessionary remuneration set out above, have acted to heighten the negative impact of falling demand on operators’ revenue and profitability.



Source: DfT annual bus statistics

***Declining number of bus trips per person in Glasgow metropolitan area***

131. FirstGroup has used additional DfT data, published in the DfT’s National Travel Survey (NTS),<sup>54</sup> to identify for the years 2007 to 2010 how journey

<sup>54</sup> The NTS is a nationally representative survey, carried out by DfT since 1972 (continuously since 1988). Respondents to the NTS complete a travel diary providing details of all the trips made within the survey week, as well as completing a household questionnaire. Survey fieldwork is carried out over the course of the year.

All of FirstGroup’s analysis of the NTS follows the same weighting methodology as that used by DfT to produce statistical releases based on NTS data. Moreover, FirstGroup has followed the same approach as DfT to analysing data on a two yearly basis.

The NTS defines a journey as travel via a mode (or number of different modes) with a specific purpose. Within each journey, respondents record each of the different stages involved. The main mode of travel for the journey is recorded as the mode of transport that makes up the largest part of

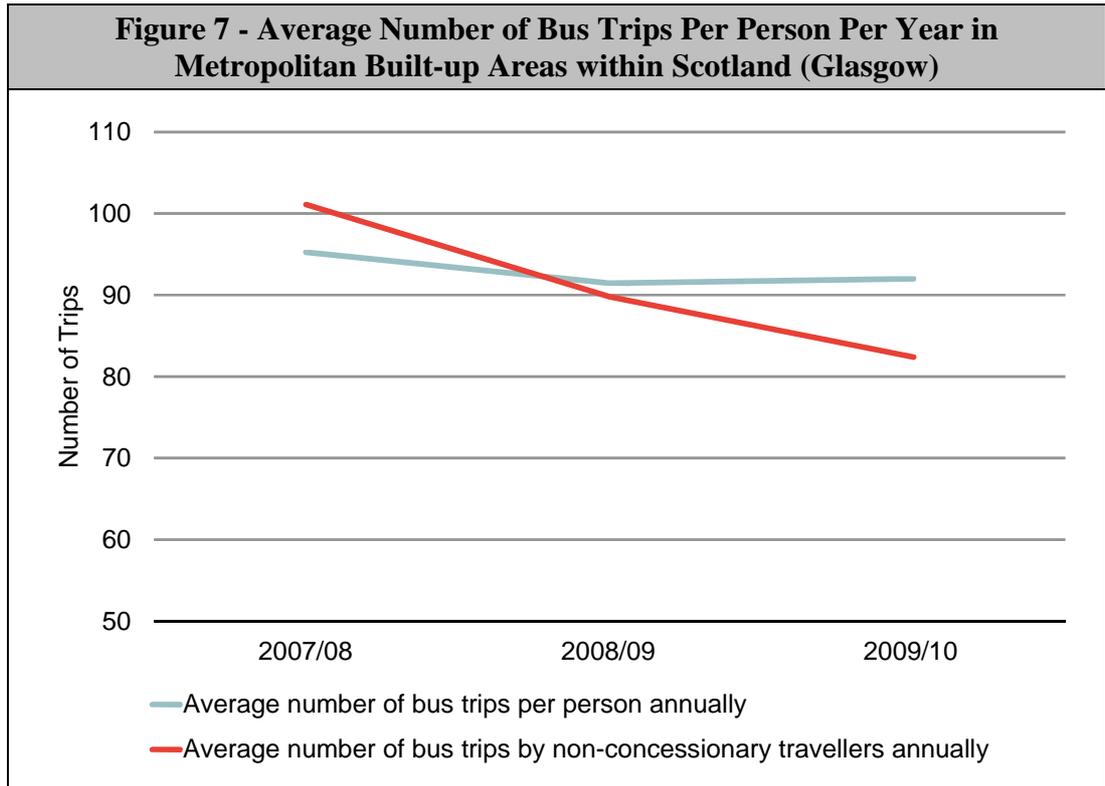
patterns for residents of large cities (referred to as metropolitan built-up areas within the NTS) in Scotland have developed over this period separately from individuals who live in less built up areas. FirstGroup's operations within Scotland are heavily centred on Glasgow, the principal urban area within Scotland. FirstGroup therefore believes that focusing the analysis in this way allows for a more accurate estimate of how the demand for FirstGroup's services has evolved since the undertakings were last revised in 2008.

132. In addition, as well as breaking down the NTS data by the type of area respondents lived in, it is also possible to analyse it according to the demographic characteristics of the respondents. FirstGroup has therefore analysed separately how the demand for bus travel within Scotland has developed for passengers between the ages of 16 and 60 (which provides a good proxy for non-concessionary journeys) since the undertakings were last revised in 2008.
133. **Figures 7 and 8** below illustrate the trends in bus travel for metropolitan built-up areas in Scotland (i.e. Glasgow)<sup>55</sup> over the period 2007/08 to 2009/10. **Figure 7** shows that the number of bus trips per person per year has decreased both for all passengers (in blue) and non-concessionary passengers (in red), with a larger decline in demand for non-concessionary passengers. Specifically, since 2007/08, the average number of bus journeys per year for this group has decreased  $\times$ .

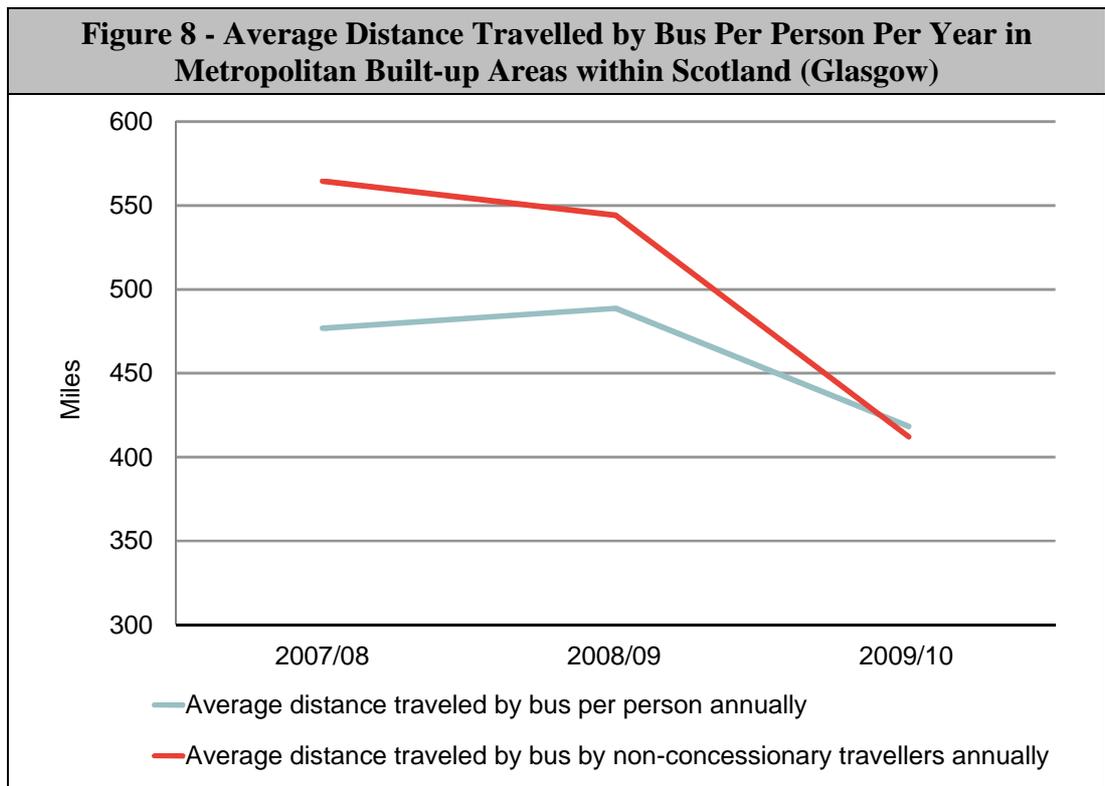
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the journey. The analysis presented below on the average number of bus trips per person focuses on those journeys where bus was the main mode of transport, while the analysis of the average distance travelled includes all journeys on bus regardless of whether bus was or was not the main mode of travel for the overall journey.

<sup>55</sup> According to the 2001 Census, the population of Greater Glasgow was 1,168,270. Since Glasgow is unique in Scotland in terms of its large population, we concluded that majority of respondents to the NTS within a Scottish metropolitan built-up area are very likely to come from Glasgow. However, it is possible that some of the respondents also come from Edinburgh, the next largest city in Scotland with a population of just half the size of Greater Glasgow.



Source: DfT National Travel Survey



Source: ✂

- 134. ✂ passengers the average annual distance travelled by bus decreased by 27% over the period, from 564 miles in 2007/08 to 412 miles in 2009/10.

135. Based on the above analysis, FirstGroup considers that there has been a significant and persistent fall in demand for bus services within the major urban areas where the majority of the services it offers within the undertakings areas are located.

***Effect on FirstGroup***

136. The data above show that demand for bus travel has declined across Scotland. FirstGroup has not been immune to these changes:
- (a) ✕
  - (b) ✕.
137. ✕.
138. *In conclusion*, the declining demand for bus travel and consequent negative impact on FirstGroup’s revenue constitute relevant changes of circumstances for the purposes of section 92 of the Enterprise Act. In fact, these changes are highly significant, for the reasons discussed in this submission.

**IV. THE FARES CONTROL IS HAVING A DISTORTIVE EFFECT ON FIRSTGROUP’S PRICING**

139. The fares control within the undertakings limits the rate at which the volume weighted average price of the fares within the fares basket can increase each year.<sup>56</sup> This means that individual fares can rise at a faster rate than the H-CPT provided that these higher increases are offset by other fares within the fares basket increasing at a rate below the H-CPT.
140. Not all fares are contained with the fares basket. Multi-operator tickets, concessionary fares and fares that FirstGroup is required to charge on tendered services are expressly excluded from the fares control for example.<sup>57</sup>
141. **Table 1** and **Table 2** below show the principal fares included within the fares control in Glasgow and Scotland East respectively. The data in these tables indicates that:
- (a) ✕;
  - (b) ✕;

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<sup>56</sup> The undertakings allow for unused fare increase allowances to be carried forward. As such if the fare increases in a given year are below the allowed increase, the residual amount can be added to the allowed increases for the subsequent year.

<sup>57</sup> Clause 5 of the undertakings states that tendered fares, multi-operator fares and concessionary fares are expressly excluded from the fares control. Moreover, Schedule 1 of the undertakings makes clear that only those fares within the “Standard Fare Scheme” (defined as all fares listed in Schedule 5 of the undertakings) are included within the calculation of the average fare increase. This means that fares not listed within Schedule 5 of the undertakings are not subject to the fares control.

- (c) concessions are the main ticket type not covered by the fares control.

**Table 1 - Scotland East sales by ticket type (2014/15)**

Fare	Revenue	
	£ (000s)	%
<b>Controlled fares</b>	✂	✂
<i>Adult Singles</i>	✂	✂
<i>Child Singles</i>	✂	✂
<i>Adult Returns</i>	✂	✂
<i>Child Returns</i>	✂	✂
<b>Non-controlled fares</b>	✂	✂
<i>Concessions</i>	✂	✂
<i>Other</i>	✂	✂

✂

Source: FirstGroup

**Table 2 - Glasgow sales by ticket type (2014/15)**

Fare	Revenue	
	£ (000s)	%
<b>Controlled fares</b>	✂	✂
<i>Adult Singles</i>	✂	✂
<i>Child Singles</i>	✂	✂
<i>FirstCard</i>	✂	✂
<b>Non-controlled fares</b>	✂	✂
<i>Concessions</i>	✂	✂
<i>Other</i>	✂	✂

✂

Source: FirstGroup

142. ✂.

143. Moreover in some cases, such as for concessions, there is a direct mechanical link between non-controlled revenue and the level of controlled fares. Specifically, Scotland operates a single concessions scheme with reimbursement directly linked to the price of an operator's adult single fare. As adult single fares are included within the fares basket this means that FirstGroup's concessionary income is directly constrained by the undertaking's fares control. As a result, the vast majority of revenue of both First Glasgow and First Scotland East is directly controlled by the undertakings fare control.

*Evidence of distortion*

144. **Figure 2** above (see paragraph III.E.92) demonstrated that the use of the H-CPT has resulted in FirstGroup's not being able to increase its fares to match market wide increases in costs, as would be expected to be the case in a competitive market.
145. As would be expected in such a situation, FirstGroup has increased its fares according to the full extent of the allowances granted to it and the constraints of having practical prices.<sup>58</sup> ✕.
146. FirstGroup has therefore faced difficult commercial decisions about how to manage its fare structure given the insufficient fare allowance generated by the H-CPT. The trade-off faced by FirstGroup has been whether to:
- (a) ✕;
  - (b) ✕.
147. ✕.
148. This is clearly far from the choice a bus operator would be faced with making within a competitive market, and indicates the real distortive effects that the undertakings are having upon how FirstGroup manages its business on a day-to-day basis.

**V. THE EFFECT OF THE UNDERTAKINGS IS LIKELY TO DETER ENTRY AND EXPANSION, AND TO REQUIRE FIRSTGROUP TO OPERATE UNPROFITABLE ROUTES**

149. In varying the undertakings in 2008, the CC noted that, if FirstGroup were in a position where fares in the two areas did not allow it to recover its costs, assuming FirstGroup was an efficient operator, that could have a negative effect on entry and expansion. The CC also considered that, at that time and absent any change to the undertakings, increases in bus industry costs might require FirstGroup to operate services that had been persistently unprofitable and were likely to remain so. These same concerns are relevant to the present review of the undertakings:
- (a) All the evidence suggests that FirstGroup is an efficient operator;
  - (b) Despite this, as set out above, the undertakings prevent FirstGroup from recovering its costs, a situation that could deter entry and expansion;
  - (c) As a result, the undertakings require FirstGroup to operate services that have been persistently unprofitable and are likely to remain so.

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<sup>58</sup> Bus fares are usually set at levels which mean that they can be quickly paid for in cash when boarding the bus and minimise the need to provide change. In practice this means that there can be a small amount of the annual allowance that goes unclaimed as it is not possible to increase fares to the full extent whilst maintaining an operationally practical set of fares.

**A. All the evidence suggests that FirstGroup is an efficient operator**

150. The CC has previously concluded that FirstGroup had significantly lower costs than its rivals. Specifically, the CC's detailed econometric analysis of depot costs in the Market Investigation found that FirstGroup's costs were both economically and statistically significantly lower than all or all but one of the other operators considered in the analysis.<sup>59</sup> This thorough and sophisticated analysis was based on data from six major operators (FirstGroup, Arriva, Stagecoach, Go-Ahead, National Express and Transdev) over the period 2007 to 2009 and so is directly relevant to relative cost efficiency of FirstGroup's operations during the period immediately before and after the introduction of the H-CPT.

***Actions and their impact***

151. FirstGroup has made extensive efforts to operate efficiently within the constraints of the undertakings. These efforts include extensive efforts to rectify the performance of its Scotland East business within the constraints of the undertakings,  $\times$ . These efforts have, however, been unsuccessful  $\times$ .
- (a) FirstGroup applied to the OFT for an exceptional fare increase in 2012 to compensate for the divergence between the H-CPT and its own costs. This was not granted by the OFT on the basis that doing so would mean the OFT would be taking a different view from the one expressed by the CC in its 2008 report (the CC had identified the H-CPT as the most appropriate index). The OFT suggested that FirstGroup would need to submit a request to vary the undertakings in order to vary the index. The OFT did allow an exceptional fare increase to offset the loss of the BSOG umbrella payment for the 2013-14 fare year.
  - (b) In 2012, FirstGroup closed its Dalkeith depot, which was heavily loss making. The site of the depot was sold to Morrisons.
  - (c) FirstGroup has implemented a number of changes to its routes following the ending of the ScotRail undertakings in April 2015. Similar changes were made following the modification of the ScotRail undertakings in 2011. FirstGroup is, however, constrained in its ability to make further changes to its routes in Scotland East because it is at the mileage floor.
  - (d) FirstGroup has undertaken a number of management actions to improve performance. **Table 3** below provides a summary of those which have been implemented over the last five years.

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<sup>59</sup> Market Investigation, Final Report, Appendix 9.6. FirstGroup was informed in a Putback dated 15 November 2010 that the CC had referred to FirstGroup as "Operator 5" throughout the Appendix. There is a discrepancy between the final report, which suggested that First Group had lower costs than all other operators, and the working papers which suggested that First Group had lower costs than all but one other operator. FirstGroup does not know which version of the analysis is correct, but either result demonstrates FirstGroup's cost efficiency.



156. ✕.

✕

157. ✕:

(a) ✕.

(b) ✕.

(c) ✕.

(d) ✕.

(e) ✕.

(f) ✕.

(g) ✕

✕

158. ✕.<sup>60</sup>

159. ✕.

✕

160. ✕.

161. ✕. For example:

(a) In 2006/07:

(i) ✕;

(ii) ✕;

(iii) ✕.

(b) In 2014/15:

(i) ✕;

(ii) ✕;

(iii) ✕.

✕

162. ✕.

163. ✕.

✕

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<sup>60</sup> ✕. A route is “lossmaking” if its apportioned revenue is lower than its apportioned direct costs, semi-direct costs, and overheads.

**D. Return on capital employed**

164. FirstGroup has ~~not~~ looked at the Return on Capital Employed (**ROCE**) made by its Scotland East business over the period.
165. FirstGroup's analysis is based on the statutory accounts for the relevant legal entities that make up the Scotland East business over the period between 2006 and 2014.<sup>61</sup> FirstGroup notes that this is a considerably longer period of time than the five years that is normally considered adequate by the CMA when conducting profitability analysis.
166. Conducting a full assessment of the economic profitability of a business is a difficult and time consuming task which involves re-valuing assets to reflect their current cost, rather than the historic costs (which is the basis used to compile a business' balance sheet within their statutory accounts).
167. FirstGroup's ROCE analysis therefore has been carried out on an accounting rather than an economic basis. FirstGroup considers that this will lead to a conservative estimate of Scotland East's economic profitability. This is for two main reasons:
- (a) First, the revaluing process would increase the relevant value of the passenger carrying vehicles, raising the capital employed of the business. FirstGroup was required to model the economic profitability as part of the Market Investigation. ~~not~~ (depending on the year).<sup>62</sup> While these figures date from 2011, FirstGroup consider that they are likely to be representative of the uplift that would be necessary to apply today to Scotland East's capital base to estimate the economic profitability of the business.
  - (b) Second, any increase in the capital base of a business would also increase the depreciation charges it faced, reducing operating profit and thus further reducing its ROCE.
168. **Table 4** below sets out the results of FirstGroup's analysis. As this is unadjusted accounting data, taking an average over several years is a better guide to economic profitability than focusing on any one year in isolation. **Table 4** ~~is~~.

~~is~~

**VI. THESE CHANGES IN CIRCUMSTANCES MAKE IT APPROPRIATE TO RELEASE THE UNDERTAKINGS**

169. The undertakings have become unnecessary as the competition concern they were originally designed to address could no longer arise. Any concern

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<sup>61</sup> The adoption of FRS 17 had a significant impact on how retirement benefits were recorded within the statutory accounts for the relevant legal entities that make up the Scotland East business, and as such FirstGroup does not consider that the data pre and post 2006 can be easily compared. The fiscal 2015 audited accounts are not yet available.

<sup>62</sup> Table 8, Appendix 10, Market Investigation, Final Report.

around potential competition has disappeared with the retrenchment of the two operations and the increase in actual competition from rivals such as McGill's, Stagecoach and Lothian. The significant expansion of each of these competing operators also demonstrates that the theoretical concern expressed around the ability of other operators, such as Lothian, to compete with FirstGroup did not arise in practice.

170. It would also be appropriate to release the undertakings because they are having a distortive effect by preventing FirstGroup from recovering its costs today, and will prevent FirstGroup from covering the costs of required future investments. FirstGroup has made significant efforts to recover the profitability of the First Scotland East business within the constraints of the undertakings ✕.
171. As the undertakings prevent FirstGroup from covering its costs, there is a risk that the undertakings are creating a barrier to entry by driving FirstGroup's prices down below the competitive level. The original intent of the undertakings was to encourage potential competition, but their effect today is to risk deterring potential entrants.
172. FirstGroup is seeking a release, rather than a variation, of the undertakings in part because the business is subject to frequent changes and developments. As the CMA is aware, FirstGroup has made previous applications to vary the undertakings to allow the business to respond to change in the market. Changes that have a substantial effect on the cost base of the business, such as the PSVAR accessibility requirements or the changes at Galashiels, are not unusual in the bus business and the undertakings prevent FirstGroup from responding to such changes in a timely manner or without seeking a variation. This lack of flexibility has a particularly significant effect on the business because the undertakings are not time limited: unlike the undertakings imposed in connection with ScotRail, these undertakings are not tied to particular routes and do not have a time limit (the ScotRail undertakings were for the duration of the franchise).

**VII. RELEASE OF THE UNDERTAKINGS WILL HAVE A POSITIVE OR NEUTRAL EFFECT ON CONSUMERS AND BUSINESSES**

173. FirstGroup anticipates that consumers will benefit if it has the flexibility to make changes to its business to meet demand. For example, in Glasgow where (unlike Scotland East) there is no mileage floor, FirstGroup has made significant changes to its network to better serve key corridors. These changes, called SimpliCity, have benefitted consumers (which can be seen through the increased ridership), and the business which is operating more efficiently. ✕.
174. Consumers will also benefit if FirstGroup is able to cover the costs associated with investments in initiatives such as accessibility, smart ticketing and other customer facing technologies.
175. In connection with its current review of structural merger undertakings, the CMA has noted that there can be indirect benefits for consumers as a result of the removal of unnecessary burdens imposed on businesses by remedies.

These benefits would be equally applicable in the present case as the release of the undertakings would allow FirstGroup to operate more efficiently in the market, resulting in benefits for consumers.

176. As noted above, by preventing FirstGroup from covering its costs, the undertakings risk creating a barrier to entry. The release of the undertakings would, therefore, create an opportunity for new competitors to enter the market or existing competitors to expand.
177. Release of the undertakings will remove the constraints that have eroded the financial viability of FirstGroup's bus operations in Scotland, and will allow FirstGroup to focus on achieving a simplified network and fare structure; investing in technology, fleet and improved service reliability; and, importantly, pursuing a partnership approach with stakeholders, resulting in substantial consumer benefits. Partnership is a key driver of success across FirstGroup's UK businesses, and release of the undertakings will enable FirstGroup to extend this approach to the Glasgow and Scotland East areas. FirstGroup works closely with procuring authorities, industry partners and communities, to understand and respond to their specific needs and deliver solutions to congestion, helping stimulate the local economy and deliver good value for customers.
178. FirstGroup has an established track record of building successful voluntary partnerships in the UK that result in positive consumer and market outcomes. For instance, FirstGroup is the lead operator partner in three of the five ground-breaking Better Bus Areas (*BBA*) announced by the DfT – in South Yorkshire, York and the West of England. In South Yorkshire, the first BBA, FirstGroup's successful voluntary partnership with local authorities and other operators has reduced congestion and duplication on key bus routes; seen over 35% of adult fare-paying customers benefitting from cheaper fares; reduced complaints by 30%; and has resulted in 14% more adult fare-paying passengers travelling on Sheffield's buses since 2012. FirstGroup believes that release of the undertakings will enable it to replicate this success in the Glasgow and Scotland East areas.

#### **VIII. A REVIEW OF THE UNDERTAKINGS MEETS THE CMA'S PUBLISHED PRIORITISATION PRINCIPLES**

179. In its 2015/2016 Annual Plan, the CMA indicated that it intended to "*commence a programme of work to systematically review our existing remedies, which may lead to the removal of measures that are no longer necessary or are now restricting or distorting competition.*" FirstGroup is aware that the CMA has begun this programme with a review of structural merger undertakings given before 1 January 2005. The CMA applied its prioritisation principles to its decision to implement that programme and a number of similar considerations apply with respect to a review of FirstGroup's undertakings:
  - (a) **Strategic significance:** the CMA indicated that the review project was a good fit with its objectives and strategy on the basis that it reflects the CMA's statutory duty to keep under review undertakings made

under the Fair Trading Act 1973 and the Enterprise Act 2002 and, from time to time, to consider whether as a result of a change in circumstance, those undertakings are no longer appropriate. The CMA also noted the proposed commitment in the annual plan to review existing undertakings. A review of the FirstGroup undertakings would similarly meet all of these objectives.

- (b) **Impact:** the CMA indicated that the review project was likely to result in indirect benefits for consumer welfare by varying or releasing, where appropriate, constraints on the business community some of which might be of limited relevance or may impose unnecessary burdens on business. The CMA also noted that the release of undertakings that are no longer needed would enable the CMA to focus its monitoring and enforcement resources more effectively on remedies that continue to benefit UK consumers.

The release of the undertakings will also provide FirstGroup with an opportunity to improve its efficiency and  $\times$ . Further, FirstGroup will be required to make substantial investments in the business in early 2016 to acquire buses that will meet PSVAR requirements. This investment will include acquiring new buses to run on persistently unprofitable routes: FirstGroup cannot reduce services on these routes based on demand due to the undertakings, and all buses must meet PSVAR requirements by 1 January 2017. A release of the undertakings would allow FirstGroup to run a more efficient business, which would support FirstGroup's ability to invest in planned or required consumer-facing improvements to its services such as accessibility and smart ticketing.

- (c) **Risk:** the CMA suggested that, given the length of time the undertakings had been in place, and the nature of the associated remedies, its initial view was that there may be a realistic prospect of finding a change of circumstance concerning some or all of the undertakings identified as part of the review process. Given the length of time the FirstGroup undertakings have been in place (thirteen years for the original undertakings, and seven years for the amended undertakings), and the effect of those undertakings in the market, there is similarly a realistic prospect of finding a change of circumstance regarding the FirstGroup undertakings. As explained above, the concerns about the effect of FirstGroup's 1996 acquisition of SBH on potential competition could no longer be considered relevant for a number of reasons including more recent assessments of the market which suggest that potential competition does not provide a significant constraint.

Further, the current and anticipated regulatory framework which gives local transport authorities significant powers over the provision of local bus services, mitigates possible concerns about risks to consumers or market outcomes that could result from the termination of the undertakings.

- (d) **Resources:** although FirstGroup recognises that some degree of CMA resources would be required to review the undertakings, FirstGroup does not believe the use of resources would be excessive or disproportionate. First, the FirstGroup undertakings affect FirstGroup's provision of transport services to consumers across the two largest population centres in Scotland; given the risk of distortions and consumer detriment resulting from the undertakings, dedicating resources to this review would not be disproportionate. Second, the CMA has considered transport in Scotland quite recently in connection with the ScotRail franchising process, including reviewing material provided by FirstGroup regarding its Scottish bus and rail activities (the rail activities have been significantly reduced following lapse of the ScotRail franchise). It therefore has a reasonably recent assessment of prevailing market conditions. Third, public consultation in this case would be a focused task given clearly identifiable consumer representative groups and other stakeholders.

**IX. THE REQUEST IS NOT BEING RAISED IN ORDER TO AVOID A BREACH OF THE UNDERTAKINGS**

180. FirstGroup does not anticipate an imminent breach of the undertakings. This request is being raised to address a real and growing harm to FirstGroup's business, and one that FirstGroup believes is distorting competition and is detrimental to consumers.

**X. CONCLUSION**

181. Changes in the market have resulted in significant new constraints on, and challenges to, FirstGroup's Scottish bus business and, as a result, the undertakings are no longer necessary to preserve competition in these markets. Moreover, the undertakings themselves are likely to have a materially distortive effect in the relevant area.
182. Given these relevant changes in circumstances, FirstGroup would submit that releasing the undertakings would now be appropriate.
183. FirstGroup is at the CMA's disposal to deal with any matters arising from this submission and its application to release the undertakings.