COMPETITION COMMISSION

LOCAL BUS SERVICES MARKET INVESTIGATION

Addendum to provisional findings

Geographic market segregation and operator conduct

Published: 1 November 2011

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

Introduction

1. In the Competition Commission's (CC's) Updated Issues Statement, published on 10 September 2010, we set out a theory of harm on geographic market segregation, aimed at assessing whether local bus service operators choose to keep to their own areas of operation and do not encroach on each other's areas because of the reaction this could provoke in generating a sustained or more widespread retaliation.

2. In the provisional findings report published on 6 May 2011, we said that we were unable to provisionally conclude on this theory of harm because we had been unable to complete our assessment of all of the relevant evidence. This was because evidence had been submitted to us at a late stage ahead of publication.[1]

3. Following assessment of this new evidence, we published our provisional findings on tacit coordination on 4 August 2011. We stated that our consideration of tacit coordination concentrated on Large Operators' actions within areas. We found that the conditions for tacit coordination were present and we observed examples of behaviour suggesting attempts to coordinate operator behaviour. Although we did not identify clear examples of tacit coordination being established, or maintained successfully in local markets, we could not dismiss the possibility that operators in some local areas may have achieved, or may in the future achieve a tacit understanding to refrain from head-to-head competition.

4. Since publication, we have continued to uncover evidence from a number of Large Operators which caused us to make further substantial inquiries. This new evidence was complex, involving a range of behaviours. As such, the evidence is relevant not only to our consideration of tacit coordination but also to the wider concept of

[1] See paragraphs 8.185–8.190 of the provisional findings.

geographic market segregation achieved through a variety of means, including communications between operators, signalling and sale/acquisition of rivals' assets.

5. As a result, we have reassessed our interpretation of earlier evidence submitted to us. This addendum should be read in conjunction with our provisional findings of 6 May 2011, and our provisional findings on tacit coordination dated 4 August 2011. It represents a revised provisional view on geographic market segregation. The focus of our investigation since 4 August has centred on evidence relating primarily to competition in the North-East of England and Chester and the Wirral, gathered from three of the Large Operators. The detail of the evidence we have gathered in these areas is set out in the appendices.

6. In the following paragraphs, we begin by setting out the responses we have received to our provisional findings of 4 August and our assessment of them. We then turn to analyse the fresh evidence that has emerged and give our overall provisional conclusion on all of the evidence and the implications for our provisional decision on remedies.[2]

Background

7. In the provisional findings we found that the conditions for tacit coordination in the form of geographic market segregation existed in relation to local bus services within areas (see paragraph 8.188). In the provisional findings on tacit coordination, we stated that

> On the basis of the material assessed for the purposes of evaluating this theory of harm, we have not found evidence which would clearly establish the existence of tacit coordination in the provision of local bus

[2] Our investigations relate only to gaining an understanding over whether any aspects of conduct may have the effect of preventing, restricting or distorting competition within the meaning of a Market Investigation Reference under the Enterprise Act 2002 (the 2002 Act).

> services across the reference area, or clear examples of tacit coordination being established or maintained successfully in local markets. While we therefore provisionally conclude on the basis of this evidence that tacit coordination cannot be said to be a feature of local markets giving rise to an AEC [adverse effect on competition], we have found that the conditions for coordination are met and we have observed that some operators have on occasions tried to coordinate.[3]

8. In their responses to the provisional findings, both Arriva and Stagecoach argued that coordination would not arise. Both operators said that the evidence did not provide a basis for a conclusion that tacit coordination had been established.

9. Stagecoach said that operators would not have an incentive to coordinate because any cost asymmetries between them would mean that they could not easily identify a common, optimal, price, and that any changes in costs would render coordination unstable as the new optimal price would differ for each operator. Coordination on other aspects of service would be extremely difficult. Second, it argued that the threat of punishment may not be credible where cost asymmetries applied, as a lower-cost operator may doubt that a high-cost operator would be willing to incur and sustain the losses that retaliation might imply. Consequently Stagecoach considered that the condition for coordination, that it was costly for firms to deviate from the prevailing behaviour, would not necessarily be met. It also argued that the conditions relating to transparency were unlikely to be met for coordination within an area. It said that segregating services within a region would be difficult because services inevitably overlapped, for example where inter- and intra-urban services coincided. As a consequence, detection of deviation from geographic sharing would be difficult.

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[3] Provisional findings on tacit coordination, paragraph 30.

10. Stagecoach said that a more likely explanation of geographic separation was simply that these areas were already well served by operators such that profitable opportunities for entry were not available. It said that this was because the third condition for coordination, that there were weak external competitive constraints, did not apply.

11. Arriva said in its response to the provisional findings on tacit coordination that there was insufficient evidence to establish that the conditions for coordination applied and that it was difficult to make inferences from observations of competitive behaviour. It stated that coordination as a theory did not provide testable predictions by which its applicability could be assessed.[4] It argued that experiences of the level of entry and expansion against incumbent operators showed that there was no general understanding of geographic market sharing across areas. It said that where entry did not occur, this was generally because there was no viable market opportunity available given that the market was already served by an incumbent operator. Arriva also argued that the threat of new entry and expansion was strong. It pointed to the result that most routes faced at least some significant overlap, which it said showed that operators already tended to face at least some competition, and rivals could easily expand from these overlaps if profitable opportunities were available.

12. We acknowledge that substantial cost differences between operators could reduce the incentives to coordinate, as the threat of retaliation may be less credible, and the incentives on efficient operators to coordinate may be reduced. However, the behaviour we are addressing here is geographic market segregation between some

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[4] Arriva stated that all outcomes could be explained both by competitive outcomes and by coordination; in its response it sets out three possibilities:

- if parties do not compete directly, this may be evidence of very efficient 'coordinated effects' leading them not to compete or, alternatively, it may be evidence of the absence of profitable opportunities for competition or some other reason; but
- if they do compete directly, this may be evidence of 'failed' coordination or, competition or alternatively, evidence of effective competition; and finally
- if they compete indirectly(but not 'head to head'), this may be evidence of the theory in action because such competition is designed to discipline errant operators or, alternatively may be evidence of a more effective and profit-maximizing strategy than head to head competition.

Arriva stated that in each of the three situations either explanation may be plausible.

Large Operators. All the Large Operators have substantial resources, and we have not seen any indications of markedly different efficiencies between them (for example, there is little evidence of any of the Large Operators actively seeking to enter against rivals and out-compete them on the basis of superior efficiency as a general policy). The arguments advanced in relation to differing perceptions of an optimal price are not relevant in this case as the focus of coordination is on maintaining separate geographic areas, not maintaining common prices across areas.

13. Some operators' services will overlap with rivals' services, and so there will be areas where multiple operators will be present. We accept that geographic coordination in and around these overlaps may be difficult to establish. However, entry where there has not previously been any overlap should be more visible. We also maintain that the threat of new entry as a constraint is weakened by barriers to entry as set out in the provisional findings.

Further evidence gathering

14. The disclosure of a series of internal notes (received in late July 2011) by Go-Ahead, produced between January 2006 and August 2009, and relating to competition between Go North East (GNE) and Arriva North East (ANE) prompted us to make a series of written information requests to Go-Ahead, and to seek further explanation for the material they had submitted by way of oral evidence at a hearing. As this North-East material described competition with Arriva, and included a range of contacts between senior individuals of the two parties, we subsequently sent written information requests to Arriva, and also asked it to attend an oral hearing to explain how it had been competing with Go-Ahead over that period of time in that area. We also spoke with [OpCo Manager 3, ANE].

15. The North-East evidence led us to consider afresh competition between Arriva and FirstGroup in Chester and the Wirral (which we refer to as the North-West, although our investigation related specifically to these two areas). In particular, we were keen to understand better the rationale behind a proposed swap of vehicles between these parties (although no such deal was undertaken), and the link, if any, between competition in Chester and on the Wirral. To that end, we sent a written information request to FirstGroup, and held a hearing with [Senior Manager 1, FirstGroup UK Bus] [✂].

16. The material uncovered in this request for documents uncovered evidence relating to discussions between FirstGroup and Arriva concerning operations in other parts of the reference area, particularly Leicester and [✂]. Once again, we put this evidence to Arriva at its oral hearing and invited it to submit supporting documentary evidence.

17. This process of written and oral evidence gathering principally over the last three months has been an extensive task. Our work in accumulating relevant evidence from the parties has been significantly hampered by the parties' difficulties in retrieving documentary evidence stored electronically. Delays have also been encountered because the personnel best able to identify relevant documentary evidence and to provide necessary context for it were no longer working for that particular bus operator. We found that recollections of the course of events varied significantly between individuals, although as some of these events took place five years or so ago we recognize that memories do fade, and perceptions of events can differ. Nonetheless, a number of representations to us have had to be corrected.

18. The evidence we have seen and the process undergone to collect it leads us to be concerned on a number of fronts. First, we are concerned that relevant evidence that should have been disclosed to us much earlier in the investigation in response to information requests was withheld. Second, we are assessing whether there are

inconsistencies between evidence provided to us at different stages or our investigation, and between evidence provided to us and to the Office of Fair Trading (OFT).

19. The further evidence we have received in relation to geographic market segregation and operator conduct is set out in two appendices:

(a) Appendix 1: Evidence from the North-East.

(b) Appendix 2: Evidence from the North-West and other areas.

Findings

20. In this section we draw out some key findings from the new evidence we have received, in combination with the evidence of which we were already aware. As relevant we cross refer to the evidence set out in the appendices. Our focus is on evidence relevant to operator conduct contributing to geographic market segregation.

Notion of 'territories'

21. We have found from the evidence relating to the North-East and North-West that the notion of 'territory', 'patch' or 'core network' is understood and recognized by bus operators in these areas. Evidence on use of this notion is set out in Appendix 1, paragraphs 62 to 70 and 116 to 120, and Appendix 2, paragraph 61*(a)*.

22. We found that the term 'territory', referred to more than just a description of where an operator's services are located. Based on the evidence we have considered, this notion implies that in respect of certain core areas the incumbent operator serving that area will not expect to be challenged by other operators offering services within that territory. We have found evidence indicating that certain Large Operators perceive their 'territories' to be their preserve.

23. Further, the evidence shows that in the North-East, the North-West and Leicester, if a rival does encroach on a Large Operator's routes, a retaliatory reaction could be expected. We have also seen reference to consideration of retaliation in some other areas, see for example footnote 6 below and paragraph 21 of the North Devon case study in Appendix 6.4 of the provisional findings. This retaliation is discussed in paragraphs 29 to 36 below, and appears to be different in nature to reactions in 'non-core' or previously contested areas.

24. The evidence indicates that the boundaries of 'territories' are not precisely defined, and there are many overlaps between bus operators' routes. This could mean that operators may not always hold precisely the same understanding of where the boundaries of territories lie. For example, in the North-East they seem to be guided by historical operating areas where there has not been sustained competition with other operators. Because operators enter on routes and compete on overlaps, the notion of territory could be specific to particular routes or sections of those routes, rather than referring to a broader geographic area. Consequently competition might be tolerated on some routes but entry on others could invoke retaliatory responses. Nonetheless we do consider that there could be clarity over the significance of some 'territories', as shown in the use of these terms within the industry, because in many cases historic operating areas have not changed, and because some operators may signal what they see as their 'territory'. The implications of a rival starting new services in these core areas, or on these routes, in competition with an incumbent's services, where they did not exist before, would be clear. A Large Operator may therefore distinguish between its 'core' territory, and other areas where it accepts competition with other operators.

25. If the behaviour identified in the North-East was repeated elsewhere, it might provide an additional explanation for why Large Operators generally refrain from

commencing services in competition with each other.[5] That is they refrain in part because of the notion of core territories and the expectation of a consequential reaction from the incumbent. This reaction is discussed below.

Communications between operators

26. We have found in the North-East and North-West, for example, a high level of contact between two of the Large Operators at various levels of seniority. We have been struck by the sensitivity and specificity of the topics discussed, including in some instances a willingness to disclose what would ordinarily be regarded as commercially sensitive information, not least because Large Operators have competition compliance programmes in place. In our view, the extent of contacts goes beyond what would normally be expected between competitors, and we are concerned that this could serve as a basis for developing a mutual understanding of tactics and objectives which would assist in allowing operators to avoid head-to-head competition and thereby also reducing the threat of potential competition.

27. Specifically, as noted in Appendix 1, paragraphs 144 to 148, in the North-East there were frequent contacts between GNE and Arriva, including the disclosure of financial information in relation to possible route and asset sales, intended competitive moves, and suggestions for options to reduce competition, across routes and operating areas. The extent of discussions about Chester and the Wirral are less certain although contemporaneous written records indicate that conversations about their respective commercial operations took place.

28. Disclosure of information occurred at a variety of levels, including between the managers of the operating companies, but also senior managers of parent companies.

[5] Paragraphs 3–8 of the provisional findings on tacit coordination summarize evidence that market structures are generally stable with few examples of Large Operators entering against each other.

Retaliation and signalling

29. The evidence set out in the appendices indicates that three of the Large Operators are prepared to respond aggressively should entry occur into their core territories. Outside these territories, operators often overlap and compete without retaliation being triggered.

30. Retaliatory responses to entry take a variety of forms. In the North-East we have seen retaliatory entry on to other routes in the area, increases in services on other shared routes, or expansion of operations (through acquiring new depots). In the North-West and Leicester we have seen examples of retaliatory entry on to other routes. The evidence shown in the appendices indicates that these actions were direct responses to other operators' actions following within a short period of time. Rather than responding directly on the route where entry has occurred, responses can occur against the new entrant's core operations elsewhere. Our understanding from the way this behaviour has been used is that this retaliation has the objective of extracting revenue from the entrant's core operations, such that the entrant will be forced to withdraw from its rival's territory. It also has the effect of deterring further entry in anticipation of a similar response. Because entry is likely to lead to significant revenue extraction, possibly on the incumbent's most profitable routes, the incentive to discipline entrants is strong.

31. In order to limit competitive exposure and to avoid periods of retaliation, and to try to end periods of retaliation, operators will seek to signal messages to each other, as an alternative to more explicit discussions. We see signalling taking two forms. First, registration of new services signals that the operator intends to retaliate. This retaliation occurs when geographic market segregation breaks down. Second, deregistration similarly provides a signal that the operator could be seeking to put an end to retaliatory actions and is seeking to return towards some kind of pre-existing

equilibrium. We have not found indications that operators are likely to signal using fare levels or other aspects of the quality of their service. Rather, the focal point for signalling seems to be on what services they run and where they operate.

32. Examples of signalling and retaliation documented in the evidence include:

- A series of retaliatory registrations between Arriva and GNE in the North-East as detailed in Appendix 1, paragraphs 21 and 22. Consideration of the retaliation and signalling element of these actions is set out in Appendix 1, paragraphs 71 to 97.
- Retaliation by FirstGroup by registering services on the Wirral against Arriva because of competition from Arriva in Chester (see Appendix 2, paragraph 12), and by Arriva against FirstGroup (see Appendix 2, paragraph 17).
- Responses by FirstGroup in registering new services against Arriva in Leicester, to which Arriva similarly responded (see Appendix 2, paragraphs 66 to 68).

33. These examples show an intent to punish rivals for entry which, we infer, is meant to persuade rivals to withdraw and/or to desist from further encroachment such as entry on other routes. The documents also show some examples where planned withdrawal from routes is intended to signal to rivals (eg see Appendix 1, paragraph 83). These examples of retaliation have largely been within the same geographic area.[6]

34. It appears that signalling may not always lead to an immediate response. For example, Arriva did not withdraw from services in the Blacon corridor in response to FirstGroup's deregistrations in the Wirral (see Appendix 2, paragraph 23), and [✂].

[6] We have seen one example where an operator indicates in its internal papers when contemplating entry into a new area through acquisition that one consideration is that it would serve as retaliation for a rival which had previously entered a different region in competition with it, and identifying this as its rival's core area. [✂] However, the acquisition appears to have been motivated by the identification of possible market opportunities. We therefore do not treat this as an example of cross-territory retaliation. It does, however, illustrate the understanding of the concepts of territory and retaliation within the industry.

35. Nevertheless, the fact that these retaliatory and signalling actions were taken shows that these operators had some expectation that they would be successful in dissuading rivals from entering their territory. Even in cases where the signals were not fully understood, they are likely to have led to a broader mutual understanding and to have reinforced geographic segregation in the longer term.

36. The distinguishing feature of this retaliation is that it occurs as a timely response to the actions of a rival and would not otherwise occur. This is shown in many of the supporting documents we have seen. If this consequent reaction is an unprofitable entry on to a route, it is an action we would not normally expect to occur. If the entry was expected to be profitable, then the fact that it did not occur until retaliation took place shows that operators are declining to take normal profitable opportunities, and so competitive pressures are reduced. Either way, the linking of entry decisions to entry actions by rivals implies retaliation which is at odds with a normal process of competition.

Sales of depots and assets

37. The evidence in the appendices shows that three of the Large Operators have communicated bilaterally over the possible sale of assets and depots. Asset sales may be no more than normal business practice. They may, for example, increase operating efficiencies or allow more efficient operators to develop a business. The anticompetitive consequences of transactions are subject to legislation on market sharing and the merger regime. However, our concern here is whether the consequence of any sales, particularly linked sales or swaps, is to reduce head-to-head and potential competition, reinforce geographic segregation, and to give effect to a broader understanding among the operators involved about the limits of competition between them (as shown, for example, by the reference to ‘achieving a robust long-term deal’ in Appendix 1, paragraph 132).

38. We have seen a number of such deals considered although only one has come to fruition. We note that the distinguishing characteristic of the proposals is that they usually seem to be bilateral negotiations between Large Operators already present in the area rather than with other operators; there can be reciprocity involved (ie both parties consider the sale and purchase of different assets at the same time); and, the deal may be proposed after a period in which retaliatory conduct between the two operators is observed. These factors together indicate that the objective of the transactions may be driven to a greater or lesser extent by a desire to limit competition.

39. In the case of the one completed depot deal—the Transactions in the North-East—we note that initial discussions and proposals were centred on services on particular routes, rather than consideration of any efficiency or other benefits from depot sales. While this may allow some services to be operated more efficiently or depots to be used more effectively, because these proposals primarily relate to contested routes, it indicates that a reduction in competition is a significant factor. We have also seen proposals for mutual exchange of vehicles, see Appendix 2, paragraphs 41 to 51, and Appendix 1, paragraphs 108 and 109, although these have not been realized. In these cases, our interpretation of this is that the sale of vehicles is intended to act as a signal to withdraw from operations on specific routes and to remain off that service in return for a reciprocal recognition on other routes.

40. We were told that proposals for route and vehicle sales alone were unlikely to be pursued because transactions may not be acceptable to the OFT for assessment under the merger regime unless they relate to businesses.

41. The transactions between Arriva and GNE are described in Appendix 1. As a consequence of these transactions, both operators remained in the North-East area, and

were still in competition on some routes. The parties' rationales for the transactions are set out in Appendix 1. However, we note that a consequence of the transactions was to extend the degree of segregation between these operators. The OFT found that both of these transactions created a realistic prospect of a substantial lessening of competition (SLC) arising through a reduction in actual competition, and in one case, a reduction in potential competition, although the OFT exercised its discretion not to refer the acquisitions on the basis of the de minimis exemption. The parties have not re-entered on the routes they withdrew from.

42. We have also seen proposals to sell businesses where the effect is to remove completely an operator from an area, for example see Appendix 2, paragraphs 73 and 77. The effect of such a sale, where it is made to an existing operator in the area, is to remove both head-to-head and potential competition, and to increase geographic market segregation. It was put to us that it was entirely normal for operators to consider whether poorly performing operations could profitably be sold to a rival which might be better able to improve their results, and that the merger regime existed to monitor and control any anticompetitive consequences of such processes. However, the scope of the work that we have done in the course of this inquiry is likely to be beyond that of a normal review of a merger of the size of the Transactions in the North-East. Our view is that our in-depth investigation of the circumstances surrounding the Transactions has shed considerable further light on their implications for competition.

Extent of this behaviour

43. We have observed geographic market segregation through mutual understanding of areas, signalling and communication, and retaliation in some parts of the North-East between two Large Operators. We have seen retaliatory behaviour in two other areas as well. We have also seen attempted behaviours (where responses have not been

observed) and further examples of active consideration of such behaviours in other areas, also involving another Large Operator. We considered whether this behaviour was likely to apply elsewhere. Obtaining direct evidence of an understanding of market segregation is problematic. The information provided to us by parties in response to our questionnaires and information requests has not provided evidence of such behaviour even where we have subsequently found evidence that they apply.

44. We also note that where geographic market segregation is established and respected by the operators involved, there would not be evidence of retaliation or other actions to observe. In such a static environment, operators may just accept that entry against an incumbent operator, unless it was particularly weak or unable to provide an adequate service, would be likely to be unprofitable because of the threat of retaliation. In such cases we would observe a stable market structure with operators tending not to enter in direct competition with one another.

45. Such an outcome would also be consistent with restrictions on competition from barriers to entry, or a competitive market where the threat of entry was an effective constraint. Operators have stressed a lack of commercial opportunities to us as explaining why there is not more entry into territories principally served by their rivals, but the evidence set out above indicates that this can also be shaped by the understanding of areas and likely retaliatory actions. We have also determined the existence of barriers to entry.

46. The examples we have observed involve certain Large Operators in particular parts of the UK. We have not investigated this conduct outside the set of Large Operators. We would expect Large Operators to have a greater incentive to engage in this conduct when facing another Large Operator because they are more likely to face

multi-market contact, which provides an incentive to engage in geographic segregation and the means to engage in retaliation on other routes.

47. We have only seen evidence of this type of behaviour in relation to three of the five Large Operators and only in limited areas. In the case of Stagecoach, we have no evidence of it considering or engaging in such behaviour. Similarly we have no evidence of National Express being involved in such behaviour but we note that it has little direct market contact with the other Large Operators and has not itself sought to enter against any of them.

Effects of these findings on competition

48. We have found that operators understand that encroachment on core territories can produce strategic retaliation from the incumbent. We have in some areas seen examples of signalling and retaliation which have been internally described as such by operators. Competition can still arise outside these core areas. We found previously in relation to our consideration of tacit coordination that the conditions to facilitate tacit coordination are in place. We now find a broad range of behaviours has occurred and these behaviours contribute to geographic segregation.

49. In the North-East there is evidence of a preparedness to incur the costs of retaliation to deter entry and to reinforce a territory. There is also evidence of retaliation in the North-West and Leicester. This creates a barrier to entry and expansion, at least to other Large Operators. The way in which it does this is different from, but additional to the barrier to entry created by the uncertainty about the competitive response of incumbent operators on a route identified in the provisional findings (see paragraph 9.167). This differs in that incumbents may choose to undertake a strategic response away from the route in question.

50. Because we have found retaliatory conduct in several areas, it is likely that operators in general may perceive, in advance of entry, a risk that incumbent operators might retaliate on other routes, whether or not this then occurs ex post. We note that retaliatory conduct is only a worthwhile strategy where there are barriers to entry to protect the incumbent from continuous competitive pressures from entry.

51. In the North-East we have seen Arriva and Go-Ahead engage in frequent bilateral contacts and discussion. In the North-West we have observed similar behaviour between Arriva and FirstGroup. We would not expect such extensive bilateral contacts and discussion to occur. These contacts have the effect of sharing information which will help to develop an understanding of each other's operations, tactics and interests, for example where what would ordinarily be regarded as commercially sensitive information is discussed. We consider that such discussions will help operators to develop a mutual understanding of where the boundaries of acceptable competition are believed to lie, whether actions are intended to breach these boundaries or not, and to signal whether retaliatory action might be taken.

52. We understand that communication between competitors is sometimes necessary and appropriate. In the case of local bus services, there is a considerable political and social dimension given the role of public transport as an instrument of social and environmental policy, and public funding of some aspects of operations. There are also instances where operators are required to cooperate, such as on delivering integrated public transport, and multi-operator ticketing schemes. Operators may also have legitimate interests in the sale and purchase of assets. However, as stated above, the extent of contacts we have seen is more widespread than we would expect and sometimes covers commercially sensitive information.

53. We also observe that operators discuss opportunities for the sale of assets. Only one instance in the events we have examined was completed, and hence has had the effect of enhancing local concentration. However, we observe in the areas we have examined a number of unusual aspects to these negotiations:

(a) In the case of the North-East Transactions, we note that there was a theme in the negotiations that the sale of assets to each party should be of similar value. We would expect that if there were reasons to sell assets because they were under-performing or fitted poorly with a portfolio of operations, an operator would identify these and then seek offers from a variety of operators. In these Transactions there was a target of a mutual balancing of operations which is not explained by the desire to dispose of underperforming assets or acquire new assets.

(b) We also note that these negotiations are usually held between operators already present in an area. We infer from this that competition between the operators is a significant consideration within the negotiations, given that in the provisional findings we found little evidence of regional economies of scale.

(c) The sale of routes or vehicles, as discussed in the North-West, is also difficult to explain without an associated understanding that operators will refrain from competing on the routes where vehicles were used.

54. We conclude that the effect of communications between operators can be to facilitate conduct that leads to geographic market segregation. In determining that these sales and acquisitions are part of the same process of geographic market segregation, we note that consideration of sales can follow on from a period of competition.

55. What we have seen is that geographic market segregation can be strengthened through a variety of mechanisms, which each serve to moderate or avoid competitive behaviour, or allow the resolution of periods of retaliatory conduct. In the case of the

North-East, see Appendix 1, paragraphs 121 to 126, there was also discussion of a partnership scheme. Arriva told us 'the effect of the Quality Bus Network Partnership as proposed by [OpCo Manager 1, GNE], if endorsed by the appropriate Local Authorities, would have been to abate competition between the rival companies in the area covered'. While this was not pursued, it raises a concern that operators could more generally perceive partnerships as an opportunity to diminish competition between them.

Conclusions

56. We first note our overall findings and then set out the feature we have identified. We provisionally find that competition among operators of local bus services has been diminished by operator conduct in so far as this facilitates a degree of geographic segregation of their respective operations, particularly with regard to their perceived 'core' territories. This may come about as a result of tacit coordination but may also result from a range of behaviours that we have observed. We have observed a complex set of behaviours that can differ significantly in the degree of interaction between operators and in their effects. It is notable that on occasions the interaction between Large Operators is undertaken by them with mutually different objectives and that at times it is an adjunct of legitimate activity. We note that proposals for asset sales and acquisitions have been discussed in relation to other areas which, had they been implemented, would have led to a similar outcome.

57. We provisionally conclude that competition has been restricted by the conduct of two Large Operators in the North-East. We provisionally find that operator conduct leading to market segregation is a feature that gives rise to an AEC in the North-East or that contributes to the AEC in the North-East arising from other features provisionally identified. This conduct consists in extensive communication between operators, retaliation and signalling and the sale/acquisition of rivals' assets.

58. We have already provisionally found in our provisional findings on tacit coordination that the conditions to facilitate tacit coordination are present across the UK. We are concerned that coordination or the sort of conduct that we have described in the appendices and that exacerbates geographic segregation may occur elsewhere and could do so in the future.

59. This new feature reflects a lack of head-to-head competition, as well as indicating that constraints from potential competition and new entry are weak. While operators might reasonably wish to serve their core territories well, these behaviours will have the effect of reducing or eliminating competitive pressures from rivals within these areas. The new feature is consistent with our earlier provisional findings on features giving rise to an AEC. The significance of what we now see lies particularly in its demonstration of additional ways in which competition may be avoided by operators.

60. We have seen retaliatory conduct in the North-East, the North-West and Leicester. Retaliation may in the short term bring benefits to consumers. However, the point of retaliation is that in the longer term competition is deterred, and if it is successful the overall effect of retaliation is to diminish head-to-head competition across multiple routes and markets and to reduce the likelihood of entry. That is the intention of those operators who pursue retaliatory strategies. Moreover, as we have noted above, the conduct that we have observed reduces the pressure of potential competition from nearby operators because they are less likely to enter against each other in response to market opportunities. In the long run consumers are denied the benefits of competition.

61. We also provisionally conclude that the possibility of retaliatory conduct arising can form a barrier to entry and expansion which can apply across other areas. This is because a potential entrant will not know in advance whether or not retaliation will

occur, and it is this uncertainty which could make operators less likely to enter than they otherwise would. This barrier to entry and expansion forms an additional aspect of the barrier to entry feature identified in our provisional findings.

Implications for remedies

62. The CC published its provisional decision on remedies on 6 October 2011. We now address possible implications for remedies of the findings set out in this addendum to the provisional findings.

63. In preparation of the provisional decision on remedies, we were mindful of the need to ensure that we would not be introducing or recommending measures that would increase the likelihood of geographic market segregation, or other forms of coordination between operators that would adversely affect competition and/or harm the interests of bus passengers.[7]

64. This consideration has shaped the design of our proposed remedies. For example, we have recommended that, in introducing partnerships and applying the relevant competition test, Local Transport Authorities (LTAs) are careful to take account of the risks associated with facilitating coordination between competitors that goes beyond what is acceptable under competition law and what is necessary to deliver passenger benefits. To help LTAs do this, we have provisionally decided to recommend the establishment of a forum, whereby the OFT and LTAs can discuss competition issues arising from specific partnership proposals.[8] Likewise, in relation to our ticketing remedies,[9] we provisionally decided not to recommend that price setting be permitted on route-based ticketing schemes because of the risk that agreement on

[7] See paragraph 23 of the provisional decision on remedies.
[8] See Figure 6 in paragraph 342 of the provisional decision on remedies.
[9] See Figure 1 in paragraph 42 of the provisional decision on remedies.

the price of a multi-operator ticket could result in the removal of price competition on the route.[10]

65. In light of our further findings on coordination, we set out below how we expect our proposed remedy package to affect operators' incentives and ability to engage in harmful forms of coordination. In particular, we consider the likely impact of our proposed remedies on the three conditions for coordination set out in our guidelines. These conditions are:[11]

(a) first, the market has to be sufficiently concentrated for *firms to be aware of the behaviour of their competitors*, and for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market;

(b) second, it must be clear that it will be *costly for firms to deviate from the prevailing behaviour*, so costly that it will be in a firm's interests to go along with the prevailing behaviour rather than seek to deviate from it; and

(c) third, this type of parallelism can only be sustained in markets where there are *relatively weak competitive constraints*.

Condition 1: Firms are aware of the behaviour of their competitors

66. In our provisional findings, we concluded that this condition for coordination is already met: the behaviour of local bus operators is highly visible such that operators can easily determine the competitive behaviour of their rivals.[12] In addition to the inherent transparency of the bus industry, the evidence set out in paragraphs 26 to 28 above shows that there are a large number of contacts between competitors in the bus industry, in particular between Large Operators. The large number of such contacts and the nature of these contacts further increases the awareness of the operators concerned of each other's behaviour and likely competitive intentions.

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[10] See paragraph 104 of the provisional decision on remedies.
[11] *Market Investigation References: Competition Commission Guidelines, June 2003, CC3*, paragraphs 3.62–3.64.
[12] See paragraph 8.157 of the provisional findings.

67. Against this background of a relatively high degree of transparency between operators, the remedy package includes a number of measures aimed at improving the quality of information provided to bus passengers and to LTAs, while not increasing the information that is available to other operators.[13] Such increases in market transparency are likely to enhance competition, by helping passengers and LTAs to make well-informed choices, without increasing the likelihood of harmful coordination between operators.

68. There are also some ways in which the remedy package is likely to result in a limited increase in the information available to operators about their rivals' activities. In particular:

(a) We have provisionally decided to recommend changes to the registration of frequent services.[14] Material changes to the frequency of such services would need to be registered with the Traffic Commissioner and, as a consequence, would be published in Notices and Proceedings.[15]

(b) We have provisionally decided to make recommendations that we expect to result in the development of new multi-operator ticketing schemes[16] and which may also result in new partnerships being agreed between operators and LTAs.[17] These new schemes and partnerships may provide an additional point of contact between the operators concerned.

(c) We have provisionally decided to recommend that LTAs be given the power to obtain and include information about the passenger and revenue performance of newly deregistered services in subsequent tender documents.[18]

[13] See paragraph 470 of the provisional decision on remedies.
[14] See Figure 2 in paragraph 135 of the provisional decision on remedies,
[15] See the provisional findings, Appendix 12.1, paragraph 49.
[16] See Figure 6 in paragraph 342 of the provisional decision on remedies.
[17] See Figure 1 in paragraph 42 of the provisional decision on remedies.
[18] See Figure 4 in paragraph 266 of the provisional decision on remedies.

69. We considered each of these potential increases in transparency between operators. We noted first that the changes to the registration of frequent services would simply bring the level of transparency surrounding such changes into line with changes to the registration of less frequent services. We did not consider that this modest increase in market transparency would materially increase the likelihood that bus operators would be able to achieve or sustain a coordinated outcome.

70. We acknowledge that the development of a new multi-operator ticketing scheme, or the development of new partnerships, is likely to involve some additional contacts between the operators involved. We fully accept that such contacts between operators can be both legitimate and desirable, where these are necessary to develop convenient ticketing products and deliver other initiatives that are clearly in the benefit of passengers. Competition policy frameworks are in place in relation to both partnerships and ticketing schemes that, if followed correctly, will ensure that harmful coordination does not take place.

71. Moreover, we have been careful in the specification of the partnership and ticketing remedies to minimize the scope for the disclosure of confidential information between operators.[19] There is nothing in either remedy that would require the levels of information exchange between competitors that we have described in the appendices to this document. Likewise, we have taken care to strike an appropriate balance in relation to the disclosure of information about newly deregistered services between enabling LTAs to run a competitive tender process on the one hand and safeguarding confidential information and preventing coordination on the other.[20]

[19] For example, we have proposed that sensitive information relevant to the pricing of multi-operator travelcards is only seen by the LTA and is not shared among operators in a non-aggregated form. See paragraph 94 of the provisional decision on remedies.
[20] See paragraph 296 of the provisional decision on remedies.

72. Certain forms of information exchange between competitors are illegal under the Chapter I prohibition of the Competition Act 1998 (the 1998 Act) and/or the cartel provisions under the 2002 Act. Our proposed recommendations in relation to effective competition enforcement and the Code of Conduct are likely to decrease the risk of these particularly harmful forms of 'transparency'. The development of revised Frequently Asked Questions would provide an opportunity for the OFT to set out the types of information exchange between operators that are not acceptable under competition law.[21] The inclusion of compliance with the 1998 Act in the proposed Code of Conduct would provide an additional incentive to comply with this Act.[22] These effects would be further reinforced if the Bus Service Operators Grant were to incentivize adherence to the Code of Conduct.[23]

73. In summary, we have found that the level of transparency of bus markets is inherently high. We expect the increases in transparency of information to passengers and LTAs that result from our remedies to be unambiguously pro-competitive. Certain remedies are likely to result in an increase in the information available to operators about their rivals' activities. However, such effects are likely to be modest and we have designed these remedies to minimize the scope for the exchange of confidential information between operators. Other remedies are likely to reduce the risk of harmful and illegal exchanges of information between competitors.

74. Overall, we concluded that it was highly unlikely that any increases in market transparency resulting from our remedies would increase the extent or likelihood of harmful coordination between operators.

[21] See Figure 5 in paragraph 312 of the provisional decision on remedies.
[22] See Figure 2 in paragraph 135 of the provisional decision on remedies.
[23] See Figure 7 in paragraph 391 of the provisional decision on remedies.

Costly to deviate from prevailing behaviour

75. Next we considered how our remedies would affect the balance of incentives for an operator between coordinating with a rival and competing against it.

76. We identified three important ways in which our proposed remedy package is likely to result in an increased incentive to deviate from a coordinated outcome.

77. First, our proposed measures in relation to operator behaviour[24] are likely to make it more difficult for operators to retaliate as quickly, in response to a rival's competitive actions. The requirement to give 14 days' notice to LTAs combined with the longer notice period for changes to service registrations increases the amount of time that will elapse before an operator can respond to a rival's service changes. They also have the effect of requiring any such changes to be sustained for longer. The requirement to register frequent services means that an operator of such services cannot respond immediately to a service change by 'flooding a route'. These measures make it more difficult and costly for operators to enforce a cooperative outcome through rapid 'tit for tat' responses to deviations. They thereby also increase the incentive on operators to deviate from a cooperative outcome.

78. Second, for the reasons set out in paragraph 72, we expect our remedy package to increase the incentives on operators to comply with the 1998 and 2002 Acts and to refrain from illegal forms of coordination. Our remedies are also likely to increase the likelihood of illegal coordination being detected promptly. The obligation to notify LTAs of changes to registrations 14 days in advance of submission to the Traffic Commissioner will provide LTAs with greater visibility of planned changes and an enhanced opportunity to raise concerns about breaches of competition law[25] with the

[24] See Figure 2 in paragraph 135 of the provisional decision on remedies.
[25] For example, concerns about coordination of service registrations and/or deregistrations.

OFT.[26] Similarly, our proposed recommendations in relation to merger control are likely to increase the risks of detection, if operators seek to 'pass off' an agreement to coordinate as a qualifying merger.[27] More generally, the risk of geographic market segregation, highlighted by the evidence set out in the appendices to this document, reinforces the case for vigilant enforcement of competition law in this sector.[28]

79. Third, we expect our remedies to promote entry and expansion into local bus markets (see paragraphs 81 to 84). Lower barriers to entry and expansion are likely to reduce the incentives to coordinate, as the future benefits of coordination are more likely to be undermined by entry or expansion.

80. We therefore concluded that introduction of our proposed remedies package is expected to decrease the incentives on operators to engage in harmful coordination.

Relatively weak competitive constraints

81. Harmful coordination will not generally persist if there are other operators, outside the coordinating group, which could disrupt any attempt to form or maintain a coordinated equilibrium. For example, if barriers to entry or expansion are low, any attempt by existing operators to increase fares or cut services might present a profitable opportunity for entry by another operator, thus undermining the incentives to engage in coordination.

82. The main focus of our remedy package is on three market-opening measures aimed at reducing barriers to entry and expansion in markets for commercial bus services and providing an environment in which competition is likely to be sustained. As a result of these measures:

[26] See paragraph 162 of the provisional decision on remedies.
[27] See paragraph 329 of the provisional decision on remedies.
[28] See paragraph 332 of the provisional decision on remedies.

(a) the development of effective multi-operator ticketing schemes that we envisage to result from our ticketing remedies is expected to reduce the barriers to entry arising from network effects;[29]

(b) our proposed recommendations in relation to operator behaviour are expected to reduce the barriers to entry and expansion associated with sunk costs of entry, cheap exclusion and the expected intensity of post-entry competition;[30] and

(c) our proposed fair access framework is expected to reduce barriers to entry associated with obtaining access to bus stations.[31]

83. We expect the other measures in the remedy package to reinforce the beneficial effects of these measures on competition in markets for local bus services, by providing a supportive regulatory and policy environment and through greater competition for supported services.[32]

84. We therefore expect that the introduction of our proposed remedy package would increase substantially the competitive constraint posed by entry and expansion. We further expect that this would, in turn, make it significantly less likely that operators would be able to maintain a coordinated outcome.

Conclusion on implications for remedies

85. As set out in paragraphs 63 and 64 above we have been mindful, throughout the remedies process to avoid introducing remedies that would increase the likelihood of harmful coordination being introduced or sustained. This has influenced the design of our proposed remedies package.

[29] See Figure 1 in paragraph 42 of the provisional decision on remedies.
[30] See Figure 2 in paragraph 135 of the provisional decision on remedies.
[31] See Figure 3 in paragraph 208 of the provisional decision on remedies.
[32] See paragraphs 470 & 471 of the provisional decision on remedies.

86. Furthermore, we expect our proposed remedies package to reduce barriers to entry and expansion (see paragraph 84 above). This will make it considerably harder to sustain a coordinated outcome and, as a result, the incentive to coordinate will also reduce. Our proposed remedy package will directly reduce the incentives to coordinate by weakening operators' ability to enforce a coordinated outcome and by strengthening the deterrent effect of competition law (see paragraph 80 above).

87. We acknowledge that certain elements of the proposed remedies package require cooperation between operators and LTAs while other elements are likely to increase some aspects of market transparency. However, in light of the design of our remedies, we do not expect that such cooperation or increases in market transparency would increase the extent or likelihood of harmful coordination between bus operators (see paragraph 74).

88. As a result of these considerations, we concluded that our proposed remedy package is expected to reduce substantially operators' incentives and ability to engage in forms of coordination that would adversely affect competition and/or harm the interests of bus passengers. We therefore expect our proposed remedies package to reduce the likelihood of harmful coordination being introduced or sustained in future. As a consequence we have provisionally decided not to amend our proposed remedy package in light of these further findings.