All change

LESSONS FROM THE FIRSTGROUP UNDERTAKINGS REVIEW

The Competition and Markets Authority (CMA) has identified the continuation of its review of some long-lasting "remedies" - behavioural requirements set as a condition of merger - as a priority for 2016-17. Proof this is not window-dressing came with the CMA's decision in April 2016 to rescind the remedies that had been applied to FirstGroup's acquisition of Scottish Bus Holdings (SBH) back in 1997 – although this required a detailed two-phase investigation. Other firms seeking to free themselves from historic restraints by demonstrating a "relevant change in circumstances" may have much to learn from the CMA's approach to this important decision.

In 1997, the business that is now FirstGroup, a leading UK bus and rail operator, acquired SBH, the former municipal bus operator in Glasgow. The Monopolies and Mergers Commission (MMC), one of the CMA's predecessors, was concerned that this acquisition would lead to competition problems, and so proposed to block the deal. The source of MMC's concerns was that while FirstGroup and SBH did not compete head-to-head with one another, the locations of their respective depots meant that they both had the potential to do so in the future. The MMC was therefore concerned that the merger would remove an important potential competitive constraint across central Scotland.

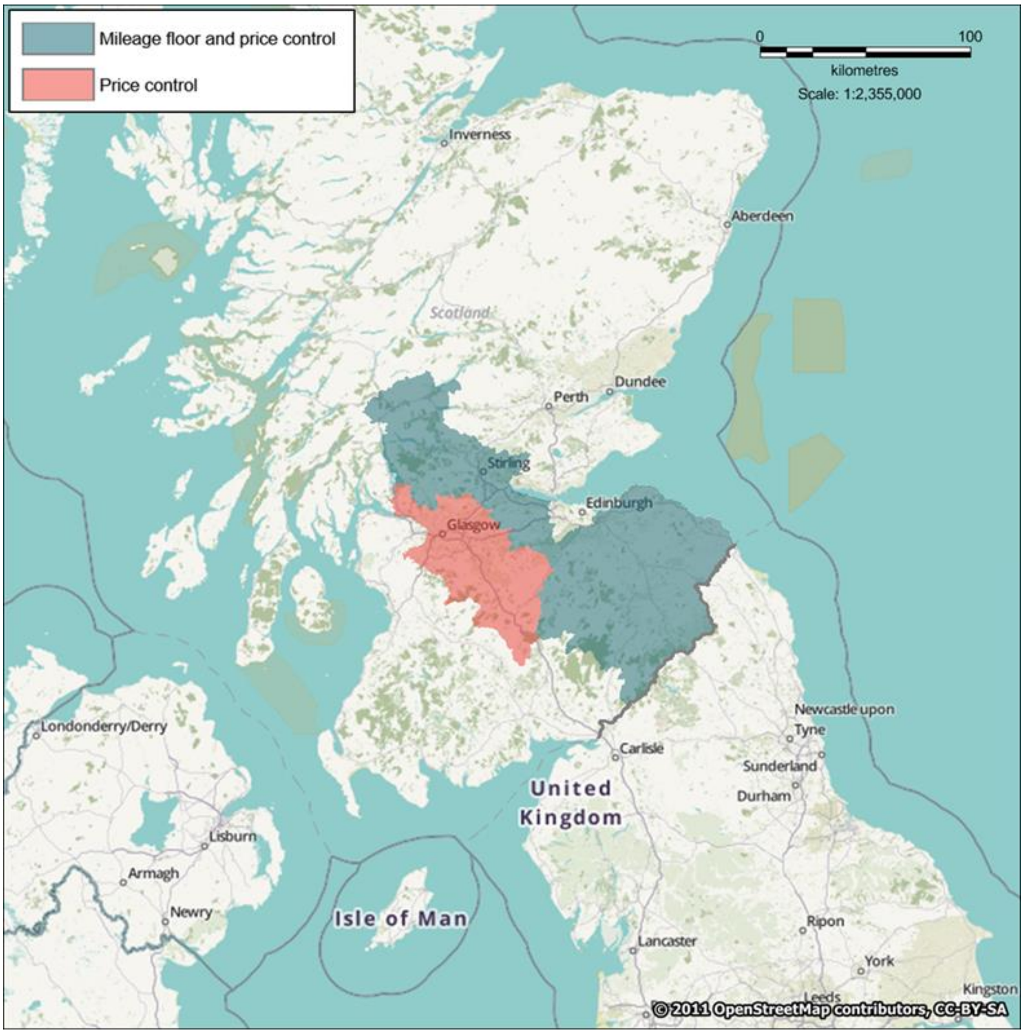
At that time, however, the final decision on merger control cases was taken by the Secretary of State for Trade and Industry (the SoS), not the MMC. Rather than block the deal, the SoS decided instead to introduce a package of behavioural remedies. These consisted primarily of a mileage floor and a price control, as shown in **Figure 1** below. Around 43% of the population of Scotland was covered by the undertaking areas.

The SoS's proposed remedies were finally implemented in 2002. By 2006, it had become clear that they were not working well. The design of the price control meant that FirstGroup was unable to take account of increases in its costs of operation, while the mileage floor resulted in it being forced to operate a number of services at a loss.

FirstGroup applied to the Office of Fair Trading (OFT), another of the CMA's predecessors, to have the remedies removed. The OFT agreed with FirstGroup's assessment and referred the case to the Competition Commission (CC), which by then had succeeded the MMC. The CC did not however fully agree: in 2008, it reduced the mileage floor and (modestly) raised the price cap, rather than removing the remedies entirely.

But FirstGroup continued to find operational performance and profitability challenging. So in 2012 it applied again, to see if - in the light of a reduction in the government grant to bus service operators - the OFT would be able to make immediate changes to the undertakings without a CC review. The OFT did relax the undertakings slightly, but still referred the bulk of FirstGroup's requests to the CC. On that occasion, FirstGroup took things no further. But by 2015, it was back knocking at the doors of what was now the CMA, asking again for the remedies to be removed, and - after a full two-phase review - the CMA agreed.

Figure 1: Scope of SBH undertakings



Source: Frontier Economics.

Testing, testing

For the remedies to be removed, the CMA (and its predecessors) needed evidence of "any change of circumstances" since the imposition of the remedies, such that "the undertaking or order [was] no longer appropriate in detailing with the competition problem and/or adverse effects which it was designed to remedy".[1] Frontier Economics assisted FirstGroup to present evidence that there had been a relevant change of circumstances since the MMC's report, so that the original theories of harm were no longer a concern. Given the lengthy history of the remedies, applying this legal test was challenging.

To begin with, what was the appropriate baseline against which a relevant change in circumstances should be judged? Three options presented themselves:

- 1997, the date of the MMC's original assessment;
- 2002, the date at which the SoS originally introduced the remedies; or
- 2008, the date of the CC's revisions to the remedies.

FirstGroup argued for 1997, for three reasons. First, the 1997 MMC Decision contained the clearest statement of the merger concerns. Second, there was no information available on the reasons for the SoS's decision in 2002. Third, the 2008 CC Decision was based (in FirstGroup's view) on a

1 CMA, Review of FirstGroup Undertakings, paragraphs 1.2 and 1.4

misunderstanding by the CC of the original merger theories of harm. For whatever reason, FirstGroup won the point: the CMA agreed that 1997 was the most appropriate starting-point.

Harm done?

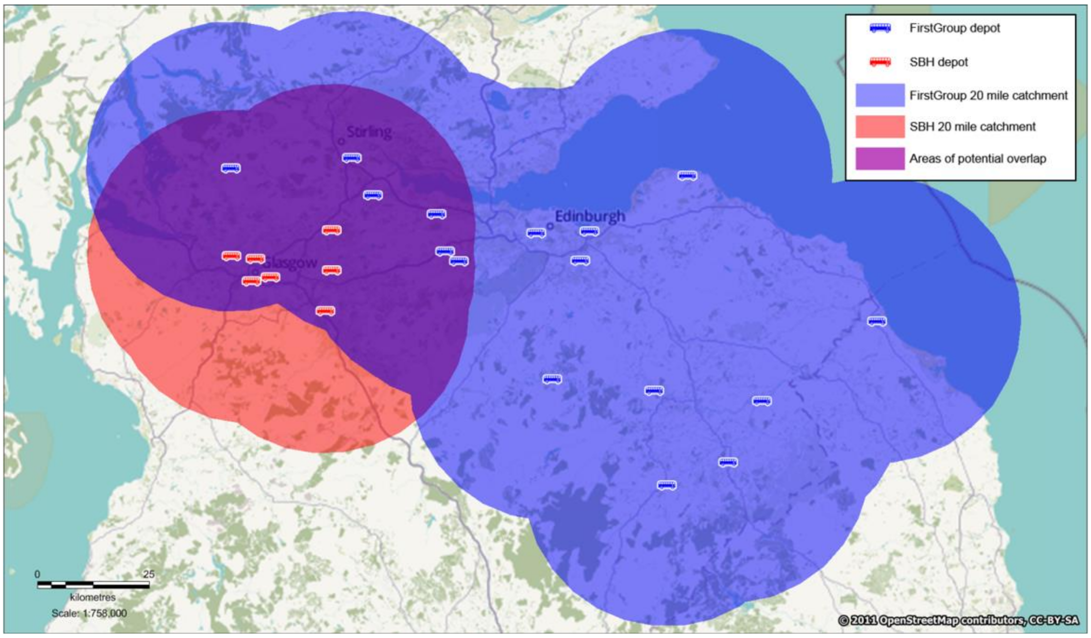
The next question was how to assess whether there had been a “relevant” change of circumstances. FirstGroup argued (and again the CMA agreed) that the key question was whether the 1997 merger theories of harm still applied, or had been overtaken by events.

The MMC’s original concerns with the merger were that:

- while the two firms did not directly compete to a material extent, either could - at least in theory - have launched services into the areas served by the other; and
- the merged entity’s dominance in central and south-eastern Scotland would deter entry from rivals.

The MMC spent most time on the first of these concerns, calculating a 20-mile catchment around each firm’s depots. It found that there was a considerable area of potential overlap in the centre of southern Scotland around Cumbernauld, shown as the purple shaded area in **Figure 2**. In this area, the two merging parties could launch services into each other’s territory, while no other operator would be able to launch services from their existing infrastructure.

Figure 2. Potential overlaps between FirstGroup and SBH depot catchments, 1997



Source: Frontier Economics.

For its second concern - that the expanded group’s dominance might deter entry - the MMC did not provide specific evidence. This simply appeared to reflect a general worry about the size of FirstGroup and its wide coverage across central and southern Scotland. The mid-1990s were marked by successive “bus wars”, in which firms often competed extremely fiercely to drive out rivals, and this may have been in the MMC’s mind at the time.

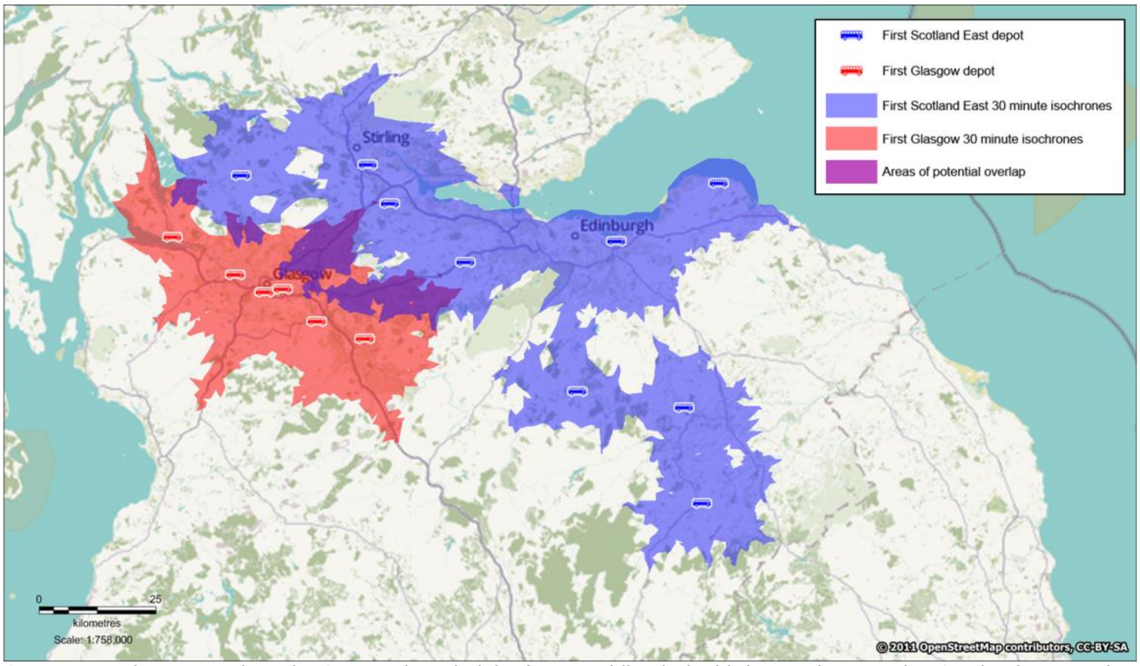
A sufficient change?

Fast forwarding to 2015, there were several reasons to believe that any loss of potential competition from the merger of SBH and FirstGroup was much reduced. For a start, far from exploiting the advantage of merging with its rival in areas where they had been potential competitors, FirstGroup had actually shut or sold a number of depots in these areas altogether.

Next, more recent work on catchment areas (in the CC Local Bus Services Market Investigation) suggested that a 30-minute isochrone was more appropriate than a 20-mile radius. These two factors together reduced the areas of overlap very substantially, as shown in **Figure 3**. Moreover, the sale of

FirstGroup's Cumbernauld depot to Stagecoach, plus the expansion of other significant operators such as McGill's in Glasgow and Lothian Buses in Edinburgh, had meant that rivals were now better placed to compete in these areas.

Figure 3. Overlap between FirstGroup's Glasgow and Scotland East operations



Source: Frontier Economics. FirstGroup rebranded the former Midland Bluebird operations as First Scotland East and the SBH operations as First Glasgow.

What about the concern that the merger would deter entry? There had, in fact, been several examples of rivals entering these areas. Stagecoach entered Glasgow almost immediately after the merger review was completed in 1997 (contrary to the MMC's view that its entry was unlikely). Lothian had expanded substantially from its original basis in the City of Edinburgh since 1997. McGill's was originally based to the west of Glasgow, but had expanded across Glasgow, largely through acquisition. Moreover, there was no evidence of firms being deterred from entry in the manner envisaged by the MMC.

With respect to both concerns, the CMA found the MMC's theories of harm no longer held – and so there had been a relevant change of circumstances. This led to their recommending that the remedies be lifted in their entirety.

Changing merger fashions

This decision, historic in two senses, illustrates the extent to which merger analysis has changed in a couple of decades. This is hardly surprising: competition authorities have learnt by experience, and have better analytical frameworks and empirical tools today. But it leads to one intriguing reflection: that there certainly appears to have been a "change of circumstances" in relation to the nature of the UK competition authorities' approach to assessing mergers. For it is questionable whether the same merger, considered under today's criteria, would have led to the same outcome.

The current approach to local bus mergers[2], which focuses primarily on overlapping bus routes (i.e., where passengers have different journey options), was not applicable to the FirstGroup merger since there was no material overlap. But the issue of potential competition on which the MMC relied in 1997 has played a much more limited role in recent bus merger cases. However, perhaps fashion is changing again: the issue of potential or "pipeline" competition has increasingly been explored in recent retail merger cases.[3]

[2] See for instance Stagecoach/First Devon & Cornwall; Greater Manchester Buses Ltd/JP Executive Travel; Stagecoach/Norfolk Green.

[3] See for instance Pure Gym/The Gym, Poundland/99p Stores.

More controversial, by contemporary standards, is the MMC's concern about the "deterrence of the entry of competitors as a result of a dominant position in central and southern Scotland". Today it is generally agreed that here is nothing, in principle, about firm size that would of itself deter rivals.

Of course, if a firm is large because it is very efficient, this might deter less efficient rivals – but this would not be merger concern. Equally, if a large firm had responded fiercely to entry threats, its aggressive reputation might be an issue - but only a merger concern if the merger would extend its "reign of terror" into new areas. But the MMC did not explore such specific theories of harm, relying instead on vague assertions about the low likelihood of rivals seeking to challenge "the largest bus operator in the UK".

However, this reflection is itself an illustration of a difficulty in remedy reviews. This change in merger control fashions did not lead to the CMA's decision in April. The CMA is conducting its remedy reviews within the context of the concerns found previously, by itself or more likely by its predecessors. The CMA sees its task as not to refight past battles with modern weapons, but to take previous results at their face value, and see if the circumstances determining them have changed.

The 2008 Review

The approach taken by the CC in the 2008 Review was, however, rather different. Instead of focussing on whether the MMC's 1997 theories of harm still held, it looked at whether the relevant markets had since become sufficiently competitive. The CC decided that market shares had not fallen by enough to give it confidence that each market was now competitive enough.

In our view, this was the wrong approach. The impact of the merger was to put together two contiguous and non-overlapping businesses. Market shares had, indeed, not fallen dramatically since the merger. But there was no expectation that they would have fallen absent the merger – the parties were not seeking to enter each other's territory. The 2008 approach seems odd, because it did not properly focus on the original concerns found by the MMC (nor, for that matter, did it appear to be consistent with the approach that would have been taken to a bus merger of this type in 2008).

In its 2016 decision, the CMA touched on the market share point, taking the view that the fall from 90% to 76% in Glasgow did amount to a change in circumstances relative to the expectation of no change in the counterfactual. But the CMA's overall approach was to focus on the original theories of harm, and simply test whether they still held - a more disciplined approach, which more clearly relates to the test it has set out.

Conclusion

The outcome of the review of the FirstGroup undertakings (and of other recent merger remedy reviews) suggests that the CMA is open to reconsideration of other long-standing constraints on merged firms. Indeed, the strategic prompting from government to do what it can in this area to reduce the burden of regulation gives force to the announcement that remedy reviews are a priority. But firms thinking of knocking on the CMA's door should also understand the key lesson from the FirstGroup review: that it is critical to understand the original theories of harm the remedies sought to address, in order to put forward the right evidence to demonstrate that relevant circumstances have changed.

David Parker
+44 (0)20 7031 7000
david.parker@frontier-economics.com

Iain Boa
+44 (0)20 7031 7000
iain.boa@frontier-economics.com