TRANSPORT EDINBURGH LIMITED

Integration between bus and tram operations - Legal Analysis

This note is written as advice to ***tie*** *Limited and is made available as part of the ongoing dialogue among the three signatories to the March 2004 Framework Paper and Transdev Edinburgh Tram Limited. The purpose and existence of this dialogue has already been reported in agreed manner to the OFT. This note is a companion to the paper on commercial and structural issues distributed by* ***tie*** *on October 15th 2004.*

1. INTRODUCTION

The proposed commercial structure to prepare for and enable sustainable long term service integration between bus and tram during the operational phase of the tram network requires the formation at this time of Transport Edinburgh Limited ("TEL").

TEL will have strategic oversight of the integration of both Lothian Buses plc ("LB") and Transdev Edinburgh Tram Limited's ("TETL") network operations as well as other transport operators and modes within Edinburgh. This paper addresses the key legal issues relating to the adoption of the recommended commercial and corporate structure and focuses on how the TEL construct is designed to mitigate the legal risks inherent in integration between Edinburgh bus and tram networks operated and to be operated by LB and TETL.

1. TEL CORPORATE STRUCTURE

The proposal outlined in the October 15th commercial paper is that a new holding company for LB be established under CEC's ownership.

At the agreed appropriate time, this new company, TEL, would also become the counter-party to TETL under the DPOFA and also assume relevant functions under the system procurement and delivery agreements. The TEL corporate structure combines the advantage of a route to compliance with the Competition Act 1998 (Chapter 1), with a transparent advance mechanism to design, implement and ultimately police effective public transportation service integration.

2. THE REGULATORY ENVIRONMENT

The Competition Act 1998 (Chapter 1) ("CA98") creates important restraints on service integration arrangements allowable between independent legal entities. These limitations are inherently in conflict with the practicalities of service integration between transport modes, particularly in the Edinburgh instance between tram and bus. A recognised exemption from these statutory limitations is the doctrine of ***single economic unit*** .

The single economic entity doctrine only applies with certainty where, as well as being owned by a common parent, the co-operating subsidiaries concerned are also "controlled" by that parent entity. Jurisprudence is clear that control means the ability to exercise material influence over business functions such that there is unified conduct in the market by the grouping. It is not necessary that the parent organisation exercise day-to-day management control, but there must be the ability to, for example, veto the business plan or other strategic operational decisions of its subsidiary or set guidelines on pricing strategy. Thus, individual autonomy to decide on matters of service integration would be inconsistent with this doctrine.

A corporate structure exempt from CA98 Chapter 1 restrictions would create proper opportunity for agreements in Edinburgh which, in addition to through-ticketing under the OneTicket system or an alternative, should underpin transport integration: common fares policy, co-ordinated timetables, feeder services and integrated complementary routing. TEL forms the core of the argument for this exemption.

The single economic unit will remain subject to compliance with CA98 Chapter 2 constraints, namely abuse of dominant position, so that the aspirations of the Scottish Executive, the declared LTS objectives and CEC responsibility under the Transport Acts for an open transport market will be important supporting points.

3. TEL, LB AND TETL - TOWARDS A SINGLE ECONOMIC ENTITY

In order that integrated bus and tram operation, under the auspices of TEL, complies with CA98 Chapter 1, the corporate and contractual structure must ensure that the relationships between TEL, LB and TETL as a transport grouping satisfy the tests for the existence of a single economic entity. To achieve this, it must be demonstrable that TEL can exert a sufficient degree of common legal ***ownership*** and management ***control*** over both LB and TETL.

4. LOTHIAN BUS plc - OWNERSHIP AND CONTROL

The model relies upon TEL having the requisite element of both ownership and control of LB. Therefore CEC requires to transfer its shareholding in LB to TEL.

Ownership - Share Transfer

The transfer of CEC's LB shares to TEL must address the following formal limitations on the transfer of these shares:-

"Offer Round" Provision

Article 12 of the LB Articles of Association provides that where a member of the company wishes to sell shares then he must offer them for sale to the other members of the company, at a price agreed with the directors, or in the event that a price cannot be agreed, at the price which the auditor of the company certifies in his opinion be the fair value of the shares. This "offer round" provision means that CEC cannot sell any shares in LB without first offering these to the other three Councils as members of the company, LB may also purchase its own shares out of distributable reserves, unless this right is waived or CEC as 91% shareholder resolves to alter LB's Articles.

Statutory provisions relating to the transfer of LB Shares by CEC

Subject to the consent of the Secretary of State (this authority is now vested in Scottish Ministers), CEC and the other local authority shareholders may dispose of shares in LB in such manner as they think fit (Sections 75 (2) & (3) of the Transport Act 1985).

The only other material statutory provision here relates to the transfer of property by a local authority: Section 69 of the Local Government (Scotland) Act 1973. This grants a local authority power to do anything, (including acquiring or disposing of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions. Acting as the transport authority in Edinburgh is a primary CEC statutory function.

The City Code on Takeovers and Mergers

The City Code on Takeovers and Mergers (the "Code") applies to offers for all listed and unlisted public companies. LB is an unlisted plc. The Code applies to takeover and merger transactions (policed by a panel) however effected for all relevant companies. That includes partial offers, offers by a parent for shares in a subsidiary and certain other transactions where control of a company is to be obtained, but not to intergroup transfers. The basic principle is that all shareholders of the offeree company must be treated in a similar way by the offeror.

The statutory status of LB

A final review of the documentation generated by the Secretary of State orders on corporatisation under the Transport Act 1985 remains advisable to ensure no secondary but enduring requirements were placed on how and for how long LB retained its public transport company status. As a matter of fact, this status (the Act intended to be interim) has no continuing relevance to LB's successful commercial activity, its financial capacity or its relationship with CEC and the ministerial permission mentioned above could be expressly worded to remove any residual uncertainty.

Subject to the above, we do not see any legal impediment to the transfer of the LB shares to TEL arising out of either the Transport Act 1985, the Transport (Scotland) Act 2001 or CEC's statutory responsibilities.

Previous advice has highlighted the desirability of an amendment to LB's Articles to align the company's formal primary objectives with the achievement of public transport integration.

Control

LB's majority shareholder, CEC, has chosen not to exercise (and does currently not exercise) management control over LB. Consequently, the current CEC-LB relationship is more likely than not to fail the *ownership and control* tests for the relevant CA98 Chapter 1 exemption described at Section 3 above. Therefore in transferring its LB shares to TEL, CEC should also agree to allow TEL sufficient control over LB to facilitate public transport integration and specifically LB service and routing integration with the Edinburgh tram network.

Transport Act 1985

On its face, the Transport Act 1985 ("TA 85") does not prevent CEC from directing LB to operate in accordance with the LTS and CEC stated evolving transport policies generally, nor does it prevent CEC from transferring this ability to another wholly owned CEC subsidiary. Indeed, the Act specifically restates the local authority's power to manage public transport matters in its area. The fundamental purpose of the TA 85 was devolve local authority bus operations into a separate corporate vehicle distinct from in-house transport function) but not to abrogate the legal capacity to direct or the responsibility for control of a local authority company operating within the transport jurisdiction confirmed by the TA 85.

5. TETL - OWNERSHIP AND CONTROL

As indicated, TEL requires a recognisable element of both ownership and control of TETL to create the strongest argument on single economic entity. One element of control in the case of TETL is based on the eventual novation of the DPOFA Contract from **tie** to TEL. The issue of ownership can be resolved through TEL obtaining a "golden share" in TETL. TETL has been appointed under the DPOFA and it should be recognised that arrangements which could undermine or fetter TETL's commercial discretion to perform obligations and exercise rights set out in the DPOFA would require careful attention. However, The DPOFA is a partnering contract and the purpose of the "golden share" would be in essence to create a legally compliant environment supporting TETL's efforts to comply with and derive direct economic benefit from sustained performance of its service integration responsibilities under DPOFA.

Ownership - Golden Share

A minority shareholding in TETL held by TEL conferring a focussed material influence over TETL (a "golden share") provides the necessary element of ownership to TEL. The exact rights attaching to the shareholding would require discussion, and should focus on the main business decision related to achievement of tram service integration with LB operations and other transport operators. This construct will require attention to ensure that it does not take on the substance of a deemed merger for the purposes of the Enterprise Act 2002 and the UK merger control regime. Best practice in this situation will be to describe and explain the rationale behind the arrangements to the OFT. The operation of the rights attaching to the shareholding would not necessarily require TEL representation on the TETL Board, in view of the contractual obligation owed to **tie** (and later to TEL) by TETL under DPOFA to deliver progressively on service integration plans and actuality, not only with LB but also with other public transport modes. The question of a requirement for economic interest to accompany the shareholding is not answered directly by the jurisprudence, but here the ultimate objective is not in fact profit, but public transport integration and ,through it, ridership growth.

7. DPOFA Migration to TEL

Transfer of the DPOFA to TEL and TEL's "golden share" in TETL form the basis of the argument for control and ownership for the purposes of competition law. The DPOFA entered into by **tie** and TETL on 14 May 2004 contains assignation and novation provisions. Express provision is made for novation of the DPOFA to an entity established by CEC for the purposes of achieving tram-bus service integration or any party acceptable to TETL. Contractually, novation of the DPOFA to TEL does not require TETL consent.

8. TEL - tie relationship

During phases 1, 2 and 3 outlined in the October 15th commercial paper, it is envisaged that there will be a contractual link between TEL and **tie** which will formalise co ordination between TEL and **tie** relating to integration issues. This will be important within the context of explaining to the system procurement funders how their borrower's counterparty (under system availability and maintenance interface arrangements) is supported and incentivised by its client to grow patronage. This agreement, creating an additional connection between TETL service integration plan development pre-system operation and TEL's oversight function, should also house (i) agreement on TEL's role during the system procurement process and its delivery and (ii) precise provisions covering the novation of DPOFA and the high value, long term system operation contracts.

8. State Aid

TEL's clear participation in system procurement assists in raising the presumption that market prices will apply for operating and infrastructure services, which is one of the main practical tests in satisfying exemption from Article 81 of the Treaty.

DLA

October 16th 2004