

# Agenda

## Advancing economics in business

### In need of a roadmap: local bus markets after the Competition Commission inquiry

The recent market inquiry by the UK Competition Commission raised fundamental questions about how competition in the local bus industry is working and how it should work. What are the key economic issues raised by the inquiry and subsequent developments?

These are challenging times for those involved in the UK local bus industry. Bus operators are grappling with the implications of cuts to tendered bus services and to government subsidies; civil servants are considering how to implement the recommendations arising from the Competition Commission's (CC) market inquiry; and local authorities/Passenger Transport Executives (PTE)<sup>1</sup> are trying to balance reduced funding from central government with the ever-increasing demands on the bus services in their areas.<sup>2</sup>

The CC's recommendations, published in December 2011, combined with other changes announced by the government, have the potential to reshape the bus industry in the UK.<sup>3</sup> The UK Office of Fair Trading (OFT) referred the industry to the CC in early 2010, due to concerns that competition was not functioning properly.<sup>4</sup> What followed was a two-year inquiry. This article reviews some of the issues arising from that inquiry, and subsequent developments.

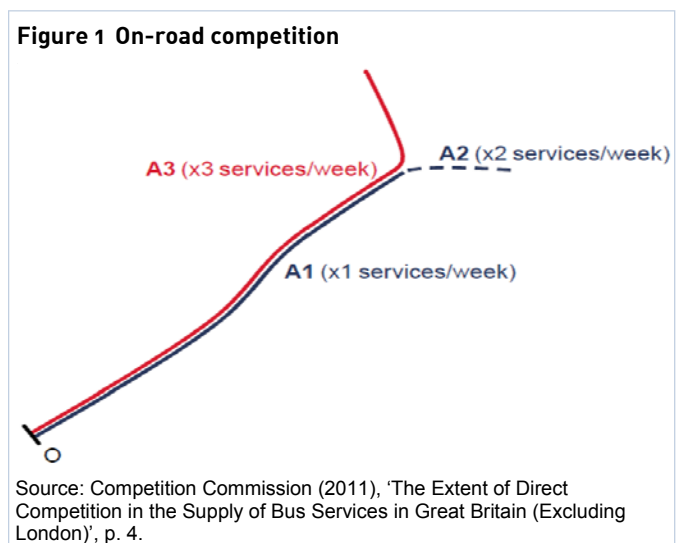
#### Main issues addressed in the market inquiry

A key issue that arises in considering the local bus industry is whether on-road competition, as envisaged when the industry was liberalised in 1986, works to provide bus services that meet the needs of consumers. Competition in the late 1980s and early 1990s was known to many as the 'bus wars', where on-road competition was fierce and, in some cases, chaotic.<sup>5</sup> However, since then there have been trends towards both greater involvement of local authorities in the bus market, and increasing concentration. Outside London (which has a franchise system), bus operators and local authorities in each local area work together with varying degrees of collaboration to provide bus services. Increasing concentration has been driven by the merger of smaller companies and the takeover of smaller companies by larger ones. In its inquiry, the CC considered whether an increased level

of on-road competition was desirable and feasible and, after concluding that it was, designed a package of remedies to strengthen on-road competition.

#### Actual and potential competition on the road

To provide some context, the CC found that 2.5% of routes face an overlap between two or more operators for all or nearly all of their length.<sup>6</sup> At first sight, this might appear to be a low proportion. However, the CC also found that an additional 51.3% of routes faced an overlap between two or more operators for at least 3.2km of the route, with 'a regularly overlapping timetable and a similar or greater frequency', while approximately 75% of routes faced an overlap of at least 10% of the route length from at least one route operated by a competitor with a similar or greater frequency. This substantial difference begs the question: what are the implications for on-road competition of so many routes having a partial overlap?<sup>7</sup> Figure 1 below provides a stylised example of three bus routes.



The figure illustrates a common scenario in the local bus industry, where services begin in different places, such as different housing estates, before converging and running along a common corridor to a single destination, such as a city centre. This raises important issues about how actual and potential competition works in local bus markets. Service A3, for example, faces actual competition from two other services (A1 and A2) on part of its route. In principle, potential competition from the operators of A1 and A2 extending their services to cover more of the A3 route may discipline the behaviour of the operator of route A3 on the uncompleted section. In practice, whether this is the case will depend on whether the operators of route A1 or A2 have the capacity to expand their operations, and whether there are any other barriers to entry onto the uncompleted section of route.

### Sustainable competition

If an operator enters a route in direct competition with another operator, it does not mean that the long-term result will be the two operators remaining in competition with each other. Instead, there may be insufficient demand on the route to support both operators. This suggests that the extent to which entry is sustainable depends on both the level of demand on a route and the extent to which increased competition and additional supply of services generate additional demand. During the CC's market inquiry Oxera carried out analysis to examine whether routes can support additional competitors.<sup>8</sup> The results are discussed further below.

Operators can compete on a number of aspects in relation to local bus services, including price, quality of service (including frequency and quality of the vehicles), and providing services to different places. The CC believed that all three aspects of competition were relevant. Although it did not find firm evidence to support the hypothesis that prices depended on the number of competitors on a route, it did conclude that frequency of service was related to the number of competitors.<sup>9</sup> However, the CC did not quantify the extra demand that would be expected from additional competition, and hence under what conditions competition would be expected to be sustainable. The CC found that the more similar the competing services are, the fiercer the competition is likely to be, and the more likely the result will be 'winner takes all', with the loser exiting.<sup>10</sup> Thus, for any given level of demand, undifferentiated competition is more likely to be inherently unstable than competition where the service offering is differentiated in some way.

Oxera's analysis during the market inquiry suggested that the majority of routes could not profitably sustain an additional competitor, and that a sustainable increase in on-road competition could be brought about

only by increasing the level of demand on a route, not by facilitating easier entry by additional competitors.

### Franchising

An alternative market structure—which the CC also considered—is a market where the operators compete to win franchises to operate in particular areas—ie, where competition is 'for the market', rather than the current structure, in which competition occurs 'in the market' (where operators compete with each other on the road). Franchising is currently used for local bus services in London and Northern Ireland but not in the rest of the UK. The CC concluded that introducing franchising more widely would address only indirectly the competition problems the CC had identified and that its preference was for a remedies package that led to greater competition 'in the market' rather than 'for the market'.

In its final report in December 2011, the CC concluded that there were four features of the market for local bus services which 'mean that effective head-to-head competition is uncommon and which limit the effectiveness of potential competition and new entry'.<sup>11</sup> These features are:

- the high level of concentration and lack of effective head-to-head competition in the local bus market;
- the existence of barriers to entry and expansion;
- the way in which customers conduct themselves by either committing to a particular operator through the purchase of multi-journey tickets or catching the first bus that arrives; and
- operator conduct, with operators sticking to their core territories.

The CC estimated that the removal of these features would result in an increase in consumer welfare of at least £70m per year. To address these four features, the CC suggested a number of remedies. These can be split into several categories: increasing the availability and desirability of multi-operator tickets (MOTs); improving access to bus stations; implementing an industry code of conduct; increasing the effectiveness of competition enforcement; reforming the Bus Service Operator Grant (BSOG);<sup>12</sup> providing a forum for local authorities to discuss partnerships with operators and the OFT; and improving local authority practice when tendering for bus services.<sup>13</sup>

### Subsequent developments

Since the conclusion of the CC's inquiry, there have been several developments with a bearing on the industry, including an inquiry by the House of Commons Transport Select Committee;<sup>14</sup> the publication of a White Paper by the Department

for Transport (DfT);<sup>15</sup> and the government's response to the CC inquiry, which was published by the Department for Business, Innovation and Skills (BIS).<sup>16</sup>

The ongoing House of Commons Transport Select Committee inquiry has gathered evidence on a number of questions, including whether the CC addressed the issues of most importance to passengers; the effectiveness of the CC's remedies; and what action local and central government should take.

Meanwhile, the DfT's policy paper has set out several key reforms, including a reform of the BSOG (although this is not part of the package recommended by the CC); an increase in the partnership working between operators and local authorities; improved competition between operators; encouragement to enable local authorities and operators to work together to offer a wider range of MOTs; and support for local authorities in delivering innovative solutions to local transport requirements.

It is interesting to note that the tenor of the DfT's policy is in terms of partnership to deliver high-quality, stable bus services that serve the needs of the local community, as well as implementing many of the CC's recommendations.

Both the DfT and BIS documents suggest that the government will implement many of the recommendations from the CC, particularly the requirements for operators to give longer notice periods before altering their bus routes. However, there is a caveat that other regulatory costs will need to be reduced before these changes are brought in. There

is also a commitment to introduce primary legislation in a number of areas before the end of the current Parliament, in order to implement the CC's recommendations on additional powers for the Traffic Commissioners, and, perhaps, to provide local authorities with the powers to mandate the introduction of MOTs should voluntary discussions between operators and local authorities prove unsuccessful.

While the government has accepted most of the CC's recommendations, the Transport Select Committee is continuing to gather evidence on the fundamental issues, such as whether the CC asked the right questions and whether it has arrived at the right conclusions. All these developments following the CC's inquiry illustrate the continuing uncertainty around the future of local bus industry regulation.

## Conclusions

To return to where we started, there are currently substantial challenges in a number of areas for those involved in the UK local bus industry. Measures aimed at boosting demand for bus services should therefore be welcomed, because increased demand is likely both to support the provision of a local bus network with less government funding, and to result in more sustainable competition. However, there are many different (and sometimes conflicting) objectives within the local bus industry, arising from the range of stakeholder interests involved. If there is one thing that the CC's market inquiry has demonstrated, it is that the bus industry is one where the issues are complex and, quite often, dependent on specific local circumstances.

<sup>1</sup> PTEs aim to deliver single, integrated public transport networks accessible to all. The six PTEs provide, plan, procure and promote public transport in six of England's largest conurbations: Greater Manchester, Merseyside, South Yorkshire, Tyne and Wear, West Midlands and West Yorkshire.

<sup>2</sup> Two separate Oxera teams provided economic advice to Arriva and Stagecoach respectively throughout the CC's inquiry.

<sup>3</sup> Competition Commission (2011), 'Local Bus Services Market Investigation: A Report on the Supply of Local Bus Services in the UK (Excluding Northern Ireland and London)', December 20th, p. 1.

<sup>4</sup> Office of Fair Trading (2010), 'Terms of Reference', January 7th.

<sup>5</sup> Bradley, M. (2006), 'Bus deregulation: driving a third phase?', *Agenda*, October.

<sup>6</sup> Competition Commission (2011), *op. cit.*, para 8.16.

<sup>7</sup> Competition Commission (2011), *op. cit.*, Appendix 8.1, Tables 1 and 2, p. 1–13.

<sup>8</sup> Competition Commission (2011), *op. cit.*, para 8.20 (footnote 4).

<sup>9</sup> Owing to data limitations, the CC's definition of service frequency was based on the number of buses in a particular local area per week. This is a potential weakness of the analysis, since an area may be deemed to have a high frequency of services even in situations where services are tightly clustered around certain times or days, leaving other times or days with a low service frequency.

<sup>10</sup> Competition Commission (2011), *op. cit.*, para 31.

<sup>11</sup> Competition Commission (2011), *op. cit.*, p. 1.

<sup>12</sup> BSOG is a payment from the DfT to operators of local bus services to partially offset the fuel duty paid by those operators.

<sup>13</sup> Competition Commission (2011), *op. cit.*, p. 15–2.

<sup>14</sup> House of Commons Transport Select Committee (2012), 'Call for Evidence: Competition in the Local Bus Market', January 24th.

<sup>15</sup> Department for Transport (2012), 'Green Light for Better Buses', March.

<sup>16</sup> Department for Business, Innovation and Skills (2012), 'Government Response to the Competition Commission's Report "Local Bus Services Market Investigation"', March.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email [l\\_mautino@oxera.com](mailto:l_mautino@oxera.com)

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