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Competition Commission Bus Market Investigation

**Response to provisional findings and remedies**

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## 1. Introduction

- 1.1. **pteg** represents the six English Passenger Transport Executives (PTEs) in England which between them serve more than eleven million people in Tyne and Wear, West Yorkshire, South Yorkshire, Greater Manchester, Merseyside and the West Midlands. Leicester City Council, Nottingham City Council, Transport for London (TfL) and Strathclyde Partnership for Transport (SPT) are associate members of **pteg**, though this response does not represent their views.
- 1.2. The PTEs plan, procure, provide and promote public transport in some of Britain's largest city regions, with the aim of delivering integrated public transport networks accessible to all. The PTEs are responsible to Integrated Transport Authorities (ITAs) made up of locally elected representatives from their constituent local authority districts.
- 1.3. **pteg** and the PTEs have endeavoured to produce as complete a joint response as possible in the limited time available. However, there are a number of areas where we have been unable to provide as much detailed evidence as is potentially available. Both **pteg** and the individual PTEs remain very happy to respond to specific requests from the Competition Commission (CC) and we are aiming to produce follow up papers in a number of key areas. We would also refer the CC to individual PTE submissions for additional local details.

## 2. Summary of key points

- 2.1. **Bus networks provide a vital connection to jobs, services and facilities** for the 33% of households in metropolitan areas who do not own a car. They also have a key long term role in minimising the negative externalities of car travel. Our analysis shows that public transport accounts for more than half of all morning peak trips into the largest city centres in England. If all these trips were to be made by car, traffic levels would double and cities would grind to a halt. **Ensuring that public transport networks remain competitive, relative to the private car, is therefore critical** if we are to avoid congestion spiralling out of control in the future.
- 2.2. Hence, we would argue that any proposed remedies need to have the potential both to offer a better outcome for existing bus passengers and to contribute to these policy goals. **Competition should therefore not be seen as an end in itself but rather as one way to help ensure that these wider objectives are achieved by keeping costs and services at their most (socially) efficient levels.**
- 2.3. We share the interim report's view that there is anti-competitive behaviour in the bus market and that this is to the detriment of bus passengers. If the headline figure of £70 million on the cost of this market failure were to be broken down it is likely that the detriment to consumers would very substantially and in some PTE the costs would be significant. **The £70 million headline figure also does not take into account externalities** such as the resulting congestion and environmental impacts
- 2.4. If externalities were applied to the whole of the study area, then it is likely that the detrimental effect per annum would come close to £100 million per year. To put this figure into context:
  - It exceeds the amount PTEs currently spend in supporting non-commercial services.

- It would be enough to install smartcard technology across the entire study area.
  - Over a 10 year period, this would be enough to replace the entire PTE areas' bus fleets with highly fuel efficient hybrid buses.
- 2.5. We share the interim's report's view that **franchising** is a legitimate response to market failure, particularly in conurbations. Franchising is a proven and effective format for the provision of local transport services and Local Transport Authorities are in the best position to determine when, and in what format, it should be deployed (given varied local circumstances). We believe that the provisions for franchising ('quality contracts') in the Local Transport Act 2008 provide an established and viable legal process for LTAs to introduce franchising. However, the fact that no franchises have yet been introduced highlights the intrinsic risks and challenges in moving from a deregulated to a franchised environment, particularly for 'first movers'. We therefore contend that the CC should not seek to tinker, or pursue theoretical perfection, by introducing any additional hurdles or constraints to the franchising process. Instead the existing legislation should be supported and potentially reinforced, and we suggest a number of possible enhancements.
- 2.6. We share the interim report's contention that short-lived, fares reductions and service changes (**'bus wars'**) are not the way forward. The interim report implies that the Traffic Commissioners could take on a competition moderation role to tackle this problem. We would argue that Local Transport Authorities are far better placed to exercise a moderation of competition role as we are closer to local markets, have the economies of scale to take on the task, and have a public interest remit.
- 2.7. The provisions in the LTA 2008 on Voluntary Partnerships and Statutory Quality Partnerships have led to the implementation by PTEs, and other LTAs, of a series of initiatives which have brought substantial benefits to passengers, including higher performing services, newer vehicles and improved frequencies. **pteg** therefore strongly supports the CC's view that, while partnerships between LTAs and operators do not necessarily promote competition, they can have a moderating effect on operators' potential predatory behaviour and may also mitigate some of the detrimental effects from reduced competition by allowing the negotiation and monitoring of service specification. Again the Local Transport Act 2008 offers the basis for the best way forward in developing the scope and effectiveness of partnerships through its provisions on voluntary partnerships and statutory quality partnerships and we suggest ways in which this could be achieved.
- 2.8. The global evidence shows that **simple, unified** (for example through zonal fares) **and integrated ticketing structures** (preferably delivered by smart means) leads to significant passenger benefits and patronage growth. London's Oyster card is the most prominent UK example. This form of ticketing is most easily delivered through franchising, thus providing a further reason why no additional hurdles should be introduced into the franchising process.
- 2.9. In areas where franchising has not been applied there are clear benefits to passengers and small operators of having **multi-operator products** where the premium, when compared with the cost of single operator tickets, is proportionate to the benefits. PTEs are therefore concerned that large operators can - and do - manipulate the availability, promotion and price of multi-operator tickets in order to maximise the market share of

their own discounted products. We suggest that this could be tackled through giving smaller operators and LTAs a stronger role in the governance arrangements for multi operator ticketing schemes; the introduction of capping mechanisms on the premium on multi-operator tickets; and through requiring operators to promote and market such tickets through their own network and retail sales outlets

- 2.10. Due to the wide range of operational, efficiency and passenger benefits, the Government is committed to supporting the rapid introduction of **smart and integrated ticketing**. However, there is a danger that although smart ticketing may be introduced, there will be a proliferation of ticketing products, including separate operator e-purses. This complexity may not only reduce the benefits for passengers of smart ticketing but could also deter new entrants. We therefore recommend regulatory or legislative change that would allow LTAs to require operators to join LTA-led smart ticketing systems. We would also encourage the DfT to commit further resources to the implementation and operation of 'complex capping' systems ie technical and administrative systems which allow passengers to use a single e-purse capable of ensuring the best value option for them no matter what combination of operators' services they use.
- 2.11. **pteg** welcome the CC's emphasis on the need for updated DfT guidance relating to the **tendering of non-commercial services**. We strongly support the proposed 'information remedy' to tackle the asymmetry of information where information isn't available to all bidders for tendered services.

### 3. The objectives of local bus networks and the role of competition

- 3.1. Bus networks provide a vital connection to jobs, services and facilities for the 33% of households in metropolitan areas who do not own a car. They also have a key long term role in minimising the negative externalities of car travel. Our analysis shows that public transport accounts for more than half of all morning peak trips into the largest city centres in England. If all these trips were to be made by car, traffic levels would double and cities would grind to a halt. Ensuring that public transport networks remain competitive, relative to the private car, is therefore critical if we are to avoid congestion spiralling out of control in the future.
- 3.2. Given that car users do not pay their full external costs (Sansom et al., 2001) there is also a strong argument for the public sector to be directly involved in promoting, specifying and funding bus services.
- 3.3. Hence, we would argue that any proposed remedies need to have the potential both to offer a better outcome for existing bus passengers and to contribute to these policy goals. Competition should therefore not be seen as an end in itself but rather as one way to help ensure that these wider objectives are achieved by keeping costs and services at their most (socially) efficient levels.
- 3.4. As the CC points out, on-street competition in the local bus market has often been unstable without a guarantee that the most efficient operator is the one who survives. Moreover, evidence from the post-deregulation period suggests (White, 1997; Fairhurst and Edwards, 1996) that the degree of network instability that ensued had a negative and irreversible effect on patronage - this should be avoided in any future regulatory changes.

- 3.5. Integrated ticketing is another useful example to illustrate our point in paragraph 3.3. It has been suggested by a number of authors <sup>1</sup> that there is a non-negligible transaction cost involved in making complex journeys. By removing much of this complexity, integrated tickets can effectively reduce the overall cost (including monetary and non-monetary components) of making a trip. We would argue that, even if integrated ticketing schemes were to lead to higher prices, the reduction in transaction costs is likely to outweigh the change in price for most passengers.
- 3.6. For a review and recent empirical results on the substantial impact of simplified ticketing and other quality (or 'soft') factors on passengers' willingness to pay please see Aecom (2009) and Booz (2009). Our conclusions based on this work are that to compete with alternative modes bus services need to be not only cheap, frequent and fast but also convenient, clean, comfortable, secure and, more critically, easy to use.

## 4. Current legislative framework

- 4.1. Given that the CC proposes a number of remedies which, in some cases, overlap with the existing legislative framework it is useful to succinctly outline what the PTEs consider to be the key existing legal powers set out in the Transport Act 2000 (as amended by the Local Transport Act 2008) which enable them to influence competition in the local bus market.
- Statutory Quality Partnership (SQPs) Schemes: schemes that once made have the potential to require quality standards to be met for operations, can regulate frequencies and timings (subject to the right for operators to object), and can set maximum fares (again subject to the right for operators to object). Any scheme has to pass the competition test.
  - Quality Contracts (QCs): Schemes that allow the LTA to franchise the operation of bus services in a given area.
  - Ticketing Schemes: Schemes which requires operators to make and implement arrangements under which passengers may purchase, in a single transaction, certain types of ticket which cover more than one journey or service. An LTA may not set the price of any tickets and such price setting needs to be undertaken by operators voluntarily and in accordance with the Ticketing Block Exemption.
  - The extension of the bespoke Competition Tests to relevant voluntary partnership agreements between operators and LTAs. The provisions also allow agreements (Qualifying Agreements) between bus operators to be certified by an LTA as meeting the Competition Test.
- 4.2. Also of particular relevance is the Competition Act 1998 (Public Transport Ticketing Schemes Block Exemption) Order 2001. This order means that Schemes or Agreements which meet the conditions set out in the block exemption order are automatically exempt from the chapter one prohibition of agreements that have as their object or effect the prevention of competition.

## 5. Quantifying the detriment to users and non-users

- 5.1. The key provisional conclusion of the CC's investigation is that there are indeed features of local bus markets which "prevent, restrict or distort competition". Moreover

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<sup>1</sup> For a summary, see Bonsall et al. (2007)

these features are found to be present in a large proportion of local bus markets and to have an "adverse effect on competition" (AEC), with a detriment to consumers and taxpayers estimated to be worth in excess of £70million a year.

- 5.2. The CC's estimate of this detriment appears to be based on its calculation of the level of excess profit currently being observed across the industry (~2% of revenue). Although this is a relatively small figure, it is important to note that it excludes any calculation of non-user effects or user externalities (Mohring, 1972).
- 5.3. Furthermore, the degree of concentration and market power is likely to vary across the study area, as demonstrated in research commissioned by the English Department for Transport (LEK, 2010). This work shows excess profits to be higher in PTE areas than elsewhere, and again higher in some PTE areas than others. Hence, the degree of detriment to consumers is likely to be quite substantial in some areas while close to negligible in others. It would be helpful to inform future local discussions if the CC was able to provide more disaggregate indicative figures of its estimates of detrimental effects.
- 5.4. In terms of non-user effects, our analysis suggests that, in a given year, the level of excess profit identified, if directly reflected in higher fares, would lead to an increase in the number of car trips in the six English metropolitan areas of 1.1%<sup>2</sup> (assuming a medium term fare elasticity of -0.55 based on TRL, 2004). Assuming an average bus trip length of 5km, abstraction from car of 38%, average car occupancy of 1.2 and decongestion benefits of 34p/car-km (based on DfT's WebTAG) this is estimated to give rise to £5m p.a. of additional detriment in terms of congestion, accidents and environmental externalities across PTE areas alone.
- 5.5. In terms of the impact on existing users, there would be a second round effect due to the tightening of supply in response to the drop in demand resulting from higher fares. These negative user externalities are known as the Mohring effect (Mohring, 1972). Based on work by Mohring (1972) and Basso and Jara-Diaz (2010), the 1.1% drop in patronage identified above could result in a drop in service mileage of somewhere between 0.5% and 1.1%. Assuming an average waiting time of 5m per trip in PTE areas, this would increase by between 0.025m and 0.05m. Assuming the value of waiting time to be around 10p/m, this would amount to something of the order of £2.5m to £5m p.a. of additional detriment to existing PTE passengers. This would also have a further, albeit smaller, effect on non-users by further reducing bus demand.
- 5.6. In subsequent years, if operators were to continue to apply a similar mark-up above normal profit on further fare increases (as costs go up) this would tend to raise the level of detriment over time. Moreover, to the extent that fixed costs would need to continue to be recouped, but from a dwindling passenger base, this could set in motion a vicious cycle of public transport decline which would further magnify the detriment to users and non-users over time. However, no attempt has been made to estimate this figure.
- 5.7. Additional detrimental effects could arise due to:
  - Wider economic benefits due to agglomeration effects (see DfT's WebTAG), which are typically assumed to amount to around 20% of welfare effects.

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<sup>2</sup> Excess profit equivalent to 2% of revenue in the short term would require.

- Impact on access to jobs and opportunities due to the tightening of supply by operators.
  - The one-off irreversible effect of network instability on demand (see White, 1997 and Fairhurst and Edwards, 1996).
  - The impact of complex fare and ticketing systems on demand (Aecom, 2009 estimates passengers are willing to pay an additional 14p for simpler fares and 46p per trip for a fixed fare structure - this is likely to be greatest for non-users who are least familiar with fare structures and for whom this may pose the greatest barrier to use).
- 5.8. If we attempt to extrapolate our calculations to the whole of the study area, then it is likely that the detrimental effect per annum would come close to £100m per year. To put this figure into context:
- It exceeds the amount PTEs currently spend in supporting non-commercial services.
  - It would be enough to install smartcard technology across the entire study area.
  - Over a 10 year period, this would be enough to replace the entire PTE areas' bus fleets with highly fuel efficient hybrid buses.
- 5.9. We would also argue that the opportunity cost associated with the effect of re-investing this revenue foregone in bus networks should be included in the calculation of detriment, effectively applying a shadow price to this figure over the period in which the detriment has been thought to have taken place.

## 6. Franchising remedy

- 6.1. **pteg** strongly supports the CC's view that the introduction of some form of franchising could effectively inject greater competitive forces into the market. Indeed, this was recognised in the 2000 Transport Act, whose provisions in respect of Quality Contracts were later reinforced in the 2008 Local Transport Act. Amongst developed countries, some form of competitive tendering and local regulation seems to be very much the norm. In the UK it is the norm for provision of rail services and for bus services in London.

### Alternative regulatory/procurement models and their impact on competition under a franchising scenario

- 6.2. There is an extensive evidence base<sup>3</sup> covering the impact of alternative regulatory models on the degree of efficiency and competition in transport markets, which demonstrates that:
- "Competition for the market" can drive similar short term productivity improvements (X-efficiency) as "competition in the market";
  - "Competition for the market" can lead to improved outcomes in terms of allocative efficiency due to better alignment with wider social objectives and the consideration of externalities. Given the significant socio-economic and environmental externalities

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<sup>3</sup> See, for example: Hensher, 2007; Longva et al., 2004; Longva et al., 2005; Amaral et al., 2010; SDG, 2001; SDG, 2002; Alexandersson et al., 1998; Jansson, 2002; Dalen and Gomez-Lobo, 2003; Mathisen and Solvoll, 2005; World Bank and PPIAF, 2006.



that are generated by urban public transport networks, there can be a significant gap between the financial benefits to operators and wider socio-economic benefits;

- There is a range of alternative forms of regulation/procurement within the broader definition of competition "for the market", most of which have been demonstrated to result in sustained and effective competition over time;

6.3. However, the most appropriate regulatory/procurement model is likely to depend on a range of local factors, including<sup>4</sup> :

- the initial degree of concentration;
- the current ownership of existing operators (public/private);
- the size of the market;
- the market structure in adjacent areas;
- the extent to which asymmetries of information exist initially and are likely to persist;
- the amount of resources and skills available within local transport authorities;
- different actors' attitudes to risk;
- the availability of key inputs such as specialised labour, depots and vehicles;
- a range of demand factors, including the degree of complexity of demand patterns, and the sensitivity of passengers to fare, quality and other service attributes.

6.4. We would therefore argue that local transport authorities are in the best position to devise the most appropriate regulatory/procurement model to their local market and individual circumstances. Hence, we would discourage any measures that sought to produce highly prescriptive guidance or constrain existing legislation. In our view any remedies proposed by the CC should reinforce and build upon the existing legislation. A number of proposed enhancements to the existing legislation are suggested in chapter 11.

### **Current PTE franchising plans, evidence and analysis**

6.5. There are a number of reasons why "competition for the market" is likely to be particularly appropriate in PTE areas:

- Presence of mature, privately owned bus operators (with a large number of small operators, despite the high degree of market concentration) ensures that competition would take place at the initial competitive tendering stage;
- Complex demand patterns, with a significant degree of multi-operator and multi-modal trips, highlighting the importance of integrated, easy to use networks;
- High externalities from private car use, implying a significant discrepancy between the outcomes from profit maximising and social welfare maximising behaviour;
- Relatively large networks able to support a substantial number of depots, allowing yardstick competition either at route level or through parallel area based contracts;
- High degree of concentration and excess profits (NERA, 2006; LEK, 2010);
- Potential regulatory framework is already in place (through PTEs);

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<sup>4</sup> For a brief review see, for example World Bank and PPIAF (2006)

- Existing critical mass within PTEs in terms of knowledge, skills and monitoring capabilities;
  - Substantial experience with tendering of non-commercial services, light and heavy rail networks/services, all of which have attracted a significant degree of sustained competition to date.
- 6.6. A number of PTEs/ITAs (SYLTE, Nexus, Metro) are actively considering the introduction of some form of competitive tendering, following on from the 2008 LTA, and have developed detailed evidence-based proposals on how this could be implemented so as to maximise the degree of competition both initially and in the longer term. SYLTE has gone as far as running a market testing exercise in 2006 which attracted significant interest from both the UK and abroad and provided information on a number of important parameters to inform its proposals.
- 6.7. Both Metro and Nexus have produced estimates of the total social benefits that could be expected from a QC model, and how that would compare with the current scenario and existing partnership proposals. In both cases, a QC model could lead to substantial growth in patronage relative to the alternative scenarios. Part of this would arise from the introduction of improvements such as simplified/integrated ticketing and marketing, partly funded from a more efficient allocation resources.
- 6.8. *pteg*'s own analysis suggests that if all bus passengers were to switch to pre-paid tickets bus operating costs could fall by 3% due to lower journey times and demand would increase by 3.8%<sup>5</sup>. Despite the obvious benefits, few operators are yet to adopt network-wide pre-paid ticketing, discrediting the idea that competition necessarily leads to innovation. In effect, pressure towards innovation has to be balanced against the constraints and risks associated to an open market (for example, leading to a conservative attitude towards fare evasion and revenue leakage).
- 6.9. A PTE [redacted] has done some work which further illustrates the point that competition may not actually lead to socially optimum service levels. They show that a frequency reduction at peak times on 6 existing routes would have the potential to reduce costs by £0.7m and generate £1m of net social benefits. This is largely attributed to the incumbents' current defensive behaviour in response to actual or potential on-street competition, although there may also be other more legitimate reasons why monopolistic commercial operators would choose to oversupply<sup>6</sup>. This illustrates the point that the social optimum may be substantially different from the commercial optimum in a deregulated environment.
- 6.10. It is also important to point out that in developing their proposals, PTEs have benefited from Transport for London's (TfL) accumulated experience of several different regulatory/procurement/ownership models since 1985. Overall, it is reassuring to see that the current approach based on gross cost contracts with quality incentives has led to a substantial improvement in service quality since its implementation, while maintaining a healthy degree of competition at re-tendering<sup>7</sup>. Market structure has also

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<sup>5</sup> PTEG (2010), BSOG Devolution – Funding More Effective and Sustainable Bus Networks, Internal Report.

<sup>6</sup> See Karamychev and van Reeve (2010) for a related discussion.

<sup>7</sup> Amaral et al. (2010); personal communication with Mark O'Donovan, TfL.

become relatively stable over time, without any single operator dominating the market, in part due to explicit rules in the procurement process.

- 6.11. Analysis to date by the PTEs has highlighted a number of challenges and barriers to the implementation of a franchising approach, which go some way towards explaining the relatively slow rate of progress on QCs more generally in other parts of the country:
- Knowledge asymmetries. Effectively, this is likely to discourage LTAs from taking on a substantial degree of risk and may also deter potential bidders, especially smaller operators and those without detailed knowledge of the local market. This is also an important factor when deciding between individual route tendering (essentially, the TfL model) and area-based contracts. Some legislative changes are proposed to address this issue in chapter 11.
  - More generally, the lack of detailed knowledge on some aspects of the commercial network makes it difficult for LTAs to demonstrate with certainty the likely benefits of a franchising model, or, equally important, the likely degree of risk involved.
  - Limited availability of capital to LTAs, in particular PTEs. This effectively limits the degree to which LTAs are able to consider a management contract approach where depots and/or vehicles may remain in public ownership, which would effectively radically reduce barriers to entry. One way to address this issue would be for central government to set up dedicated funding streams aimed at supporting LTAs in this process.
  - First mover disadvantage. The degree of risk and uncertainty is likely to be heightened for the first few franchising areas that may be eventually set up. Again, it would be sensible for central government to support first movers and help absorb some of the potential risks involved.
- 6.12. One important point that has emerged from existing proposals is that the mere threat of QCs appears to have had a moderating role on operator behaviour. In South Yorkshire, for example, this appears to have been the trigger for the two largest operators to agree to come to the table with the PTE and smaller operators to discuss a voluntary partnership agreement requiring substantial changes to timetables and ticketing. We would therefore strongly argue for the existing legislative framework to be maintained and, if anything, strengthened.
- 6.13. Both **pteg** and the PTEs would be very happy to discuss their experience, current proposals and analysis in more detail with the Commission.

## 7. Partnership remedy

- 7.1. The PTEs strongly support the CC's view that, while partnerships between LTAs and operators do not necessarily promote competition, they can have a moderating effect on operators' potential predatory behaviour and may also mitigate some of the detrimental effects from reduced competition by allowing the negotiation and monitoring of service specification. Indeed, all PTEs currently commit substantial resources to the development of partnership arrangements, and have done so for a number of years<sup>8</sup>. Where partnerships have gone ahead the results, in terms of the

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<sup>8</sup> See ([www.buspartnership.com](http://www.buspartnership.com)) for a sample of high profile schemes currently in operation. NERA (2006) provides additional background information.

performance of bus networks (rather than impacts on competition), have been mixed although typically positive.

7.2. Our experience suggests that, at their best, partnerships can have a number of positive effects on the local bus market, including the following:

- Potential market growth and reduced costs can persuade operators of the benefits of integrated ticketing and a jointly planned network, at least in the short term (ie at least, until becoming more exposed to effective competition);
- Partnerships can have a moderating effect on operator conduct as they are based on a sense of trust and commitment between stakeholders;
- Partnerships can help align public and private sector objectives to some extent by allowing LTAs to get involved in service specification and the development of integrated ticketing;
- By protecting incumbent operators from low quality competition and cream skimming partnerships could drive service levels down to their socially optimum level where the incumbent may have artificially increased frequencies to defend itself from new entry. While this is clearly contrary to the CC's objective to lower barriers to entry, it could potentially be in the public interest as demonstrated by the PTE [redacted] work cited in the franchising chapter. NERA (2006) cites the weakening of the SMART quality corridor brand in Merseyside due to low quality vehicles as one of the reasons for Arriva (the largest local operator) to set up its own brand "Le Bus". While some might argue this is a desirable development in terms of product differentiation, it is likely that it would have undermined some of the positive network externalities that the SMART brand was trying to generate.
- Partnerships can help sustain healthy competition where it already exists by preventing or discouraging operators from predatory practices.

7.3. However, the fundamental weakness of the partnership approach is that this is ultimately a voluntary agreement characterised by substantial asymmetries of information, and the almost absence of enforcement powers by LTAs (with the exception of the threat of QCs). As pointed out by NERA (2006), this was recognised as far back as 2006:

*"(...) the Parliamentary under Secretary notes that the EQPs [Enhanced Quality Partnerships] would "rely on tough negotiating by local authorities". In order for this 'tough negotiating' to occur, local authorities need to have some degree of leverage within the bargaining process. This suggests to us that an EQP approach will require QCs to be a credible option for local authorities to pursue should partnership approaches fail to deliver the desired outcomes for passengers. But without having an alternative policy tool to fall back on, it is not clear to us how local authorities will be able to engage in 'tough negotiating'."*

7.4. The recognition that for LTAs to persuade operators to voluntarily join SQPs (as EQPs became known) they would need to have some sort of leverage is likely to be one of the reasons that led to the changes to the QC regime introduced in the 2008 LTA. However, we would argue that these have not gone far enough and still provide powerful incumbents with considerable protection, for example by requiring that the

gain to society at large must outweigh the potential loss to individual operators. Please see chapter 11 for some proposed legislative changes intended to address this issue.

- 7.5. An approach similar in some ways to SQPs, often termed Performance Based Contracts (PBCs) or (ironically) Quality Contracts (Hensher, 2007), is currently in place in some parts of Scandinavia with reasonable results in terms of operator performance. This approach is typically used to monitor and steer the performance of reasonably efficient, but near-monopolistic, incumbents in receipt of relatively large sums in public subsidy but without necessarily going through competitive tendering. The key differences between the UK partnership model and PBCs are, firstly, the non-negligible lever associated to the amount of public subsidy in the hand of LTAs and, secondly, the fact that competitive tendering is a much less cumbersome route in the PCB model should the performance of operators fall below expectations.
- 7.6. Effectively, greater devolution of subsidy flows from central to local government and a removal of the legal hurdles currently associated with the introduction of a QC could bring the UK partnership approach closer to a PBC. Please refer to chapter 11 for our thoughts on the introduction of a light touch QC scheme option.

## 8. Ticketing remedy

- 8.1. The PTEs very much share the Competition Commission's concern that incumbent operators' ability to offer attractive discounted tickets can create a significant barrier to entry for smaller operators. Our own experience suggests that large operators can, and often do, manipulate the availability, promotion and price of MTCs (multi-operator tickets) in order to maximise the market share of their own discounted products, hence reducing the ability of smaller operators to compete for significant segments of the market. The greater the proportion of frequent passengers and those requiring multi-leg trips to reach their final destination, the greater will be the degree of market power this will potentially confer on the incumbent. We would therefore suspect the related detrimental effect to be most severe in the largest urban areas.
- 8.2. Although MTC usage in PTE areas is by no means negligible, many PTEs have observed a gradual decline in their market share against sharp increases in the market share of single operator products<sup>9</sup>.
- 8.3. The PTEs have considered the remedies and consultation questions put forward by the CC. In response, we would argue that the following measures, which build on the CC's proposals, could make a positive contribution either to the degree of competition in the market or the amount of detriment to users and non-users

### Governance arrangements

- 8.4. We recommend that the existing legislative framework governing ticketing companies is further developed so as to promote voting arrangements that shift greater power towards LTAs and smaller operators. As part of this reform, no operator should be allowed veto powers, which is effectively the least bureaucratic way to ensure

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<sup>9</sup> In some PTEs, single operator discounted tickets now have a greater market share than either cash fares or MTCs. For example, in [redacted] is used on 50% of all bus trips. In [redacted], sales of operator prepaid tickets have grown by 57% over the past five years, against a background of relatively stable demand. In [redacted] sales of single operator pre-paid tickets have grown by 142% over the period, against a background of decline in overall patronage.

operators are required to take part in any proposed schemes. If one accepts the principle that MTCs cannot undercut comparable single operator products then there should be no need for an appeals or arbitration process.

- 8.5. It should also be borne in mind that PTEs have an overarching incentive to price MTCs at a commercially sustainable level as pricing that undermines the commercial sustainability of services is likely to increase the pressure on tendered budgets.
- 8.6. It's not been possible to summarise PTE evidence on best practice in governance arrangements in the time available. However, we hope to have that information in the coming weeks. and individual PTEs are prepared to share their own experiences with the CC.

### **LTA specification of MTCs**

- 8.7. We recommend that outstanding bureaucratic obstacles to the specification of competing/alternative multi-operator products be removed (in particular in terms of spatial extent, time validity and other terms and conditions) either by LTAs, operators or third parties.
- 8.8. For example, most PTE areas currently offer regional or area-wide multi-operator daily, weekly and season products. However, these are often only attractive for the minority of passengers who travel frequently and across the whole area on multiple operators. Single operators can then easily undercut such tickets by offering discounted products valid within smaller geographic areas where they are the dominant operator.
- 8.9. Anecdotal evidence from several PTEs shows operators to be particularly resistant to the implementation of sub-regional MTCs, which could be expected to attract a substantial proportion of the existing passenger market. This argument could be extended, for example, to return tickets by allowing LTAs, operators or third parties to set up discounted multi-operator return products.
- 8.10. We would also recommend that LTAs' powers are extended to allow the implementation of cross-boundary products. This would be aimed at bringing additional segments of the market into existing or new MTC arrangements.

### **Price regulation of MTC and single operator discounted products**

- 8.11. We recommend that LTAs be allowed to impose a capping mechanism indexing the price of MTCs to single operator products. One possible approach would be to use a formula such that the MTC should be priced at either the average of the relevant single operator products (possibly weighted by demand/mileage) plus a premium, or at the highest single operator product, whichever is greatest. This formula has the advantage that it would reflect the potentially higher cost of providing a more extensive or higher quality network and can be relatively responsive to operators' own evolving pricing strategies with minimal direct LTA intervention. This mechanism assumes only non-negative premia (more on this below).
- 8.12. It has been proposed by some stakeholders that LTAs should have the ability to set MTC prices so as to potentially undercut single operator tickets. Clearly, this would be a legitimate course of action if MTCs were deemed to fall under public service obligations (such as concessionary travel) with associated reimbursement

arrangements, or in a franchising context under negotiated contracts (i.e.: yardstick competition/cost+). However, it is more difficult to see how undercutting single operator prices in a purely deregulated market could deliver best value for passengers both in terms of quality, frequency and price, and not distort competition in some way.

- 8.13. Another related approach would be to replace single operator season tickets with MTCs. This would have a potential financial disadvantage to existing customers in that it would eliminate cheaper existing season tickets, in favour of more expensive products. It is acknowledged, however, that in a more regulated context, it may be deemed socially optimal to replace complex fare structures with simpler ones where the removal of barriers to public transport use from simplification are deemed to outweigh the financial disbenefit to a sub-set of existing users<sup>10</sup>. A review of a number of international examples where simplified ticketing was introduced shows that this can contribute to significant patronage growth (Booz, 2009). This is also supported by recent work for the Department for Transport (Aecom, 2009), which suggests that passengers are willing to pay up to an additional 14p per trip for a simpler fares and 46p per trip for a fixed fare structure.
- 8.14. Some evidence, largely originating from Scandinavia, does exist on how best public subsidy could be targeted at incumbent operators by LTAs through various incentive mechanisms so as to align private (profit maximisation) and public (social welfare maximisation) objectives. However, these have been devised to operate in a near-monopolistic context alongside a competitive tendering or negotiated contract regime. However, there would be a clear opportunity to devolve a greater proportion of existing bus subsidy streams down to LTAs to apportion so as to strengthen their regulatory oversight role.

### MTC marketing by operators

- 8.15. We recommend a change in the regulatory regime (for example through operator licencing conditions) to allow LTAs to require operators to promote and market MTCs through their own network and retail outlets. It may also be necessary to give LTA enforcement powers to ensure compliance. Effectively, the underlying principle is that suppliers should do their best to ensure passengers buy the best value product available to them. At present, there are obvious incentives for operators to promote their own products above MTCs regardless of passenger requirements.

### Implementation of smart ticketing

- 8.16. We recommend regulatory or legislative changes that would allow LTAs to require operators to join LTA-led smart ticketing systems and would also encourage the DfT to commit further resources to the implementation and operation of "complex capping" systems. Recent technological developments, in the form of smartcards, offer further opportunities for reducing the cognitive barriers to passengers in identifying and acquiring the best value product. It has been pointed out by a number of authors<sup>11</sup> that there is a non-negligible **transaction cost** involved in making complex journeys. By removing much of this complexity, integrated tickets can effectively reduce the overall cost (including monetary and non-monetary components) of making a trip. We would

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<sup>10</sup> See Bonsall et al. (2007)

<sup>11</sup> For a summary, see Bonsall et al, (2007)

argue that, even if integrated schemes were to lead to higher prices<sup>12</sup>, the reduction in transaction costs is likely to outweigh the change in price (see reference above to Booz, 2009).

8.17. The latest specification (2.1.4) of the UK's interoperable ITSO standard now allows for "complex capping" systems to be implemented on smartcards. These would, in theory, allow passengers to load money onto their smartcards and for the back-office to select the most appropriate ticket type from the range of available products given their ex-post trip pattern, and deduct the correct amount accordingly. However, three main barriers remain to the delivery of such systems:

- There are at present only weak requirements on operators to join LTA-led ITSO compliant systems and most of the larger operators have been less than willing to join open systems. In response to one of the CC's questions, it is clear to us that an element of compulsion would be critical to enact this.
- The development and testing of "complex capping" systems is technically very challenging, especially in a context where there are multiple suppliers of electronic ticket machines and would therefore require a substantial additional resource commitment from LTAs. In the words of one PTE smart ticketing project manager this would be "impractical but not necessarily impossible". Effectively, this would require appropriate sources of funding to be identified.
- Revenue sharing arrangements would need to be developed and agreed between LTAs and operators. It is also likely that the Ticketing Block Exemption would need to be reviewed so as to allow clarify the legality of alternative revenue sharing mechanisms other than that "revenue should lie where it falls". However, this is perhaps the least problematic of the three barriers, given that LTAs have extensive experience of devising and administering revenue sharing/reimbursement arrangements in the context of concessionary travel, multi-modal travel and tendered services.

8.18. Although there is potential for some of the measures proposed above to lower barriers to entry and mitigate some of the detrimental effects of the existing market structure, we need to emphasise that it is of critical importance to the competitiveness of public transport networks that any proposed remedies do not result in added complexity for customers. As shown by Bonsall et al. (2007b) car users are largely unaware of the true cost of their trips and many would continue to make the same journeys as they do today if charged a small fee just to avoid the transaction costs involved in re-evaluating their travel arrangements. This is an advantage that public transport does not possess so it is important that the transaction costs involved in using the bus are not increased further.

8.19. We appreciate that the measures proposed above provide only a summary of key issues and arguments. Both **pteg** and the PTEs would be very happy to follow up this response with more detailed discussion of the value for money and practical implementation issues relating to these proposals.

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<sup>12</sup> Although the ability to introduce greater price differentiation (Ramsey-Boiteux pricing) would suggest that integrated tickets are likely to lead a more economically efficient outcome and lower prices for those passengers making multi-leg journeys. For a brief discussion of this issue, please see pteg's response to the OFT Ticketing Block Exemption review.



## 9. Regulation remedy

- 9.1. The PTEs share the CC's view that the current structure of the UK's deregulated local bus market is inherently prone to unstable competition, which may not necessarily result in the most efficient long term outcome. We furthermore agree that incumbent operators have a significant degree of market power which they are able to use to ward off new entrants, in some cases through predatory behaviour. But while healthy, sustainable competition is desirable if it promotes efficiency, evidence from the post-deregulation period suggests that the level of instability which on-street competition typically provokes can have a substantial and lasting detrimental impact on bus patronage which may even outweigh some of the potential benefits (White, 1997; Fairhurst and Edwards, 1996). We are therefore concerned that while changes to the regulatory framework could indeed promote some level of competition, there are few reasons to believe this will of the civilised sort the CC advocates.
- 9.2. In addition, and while the PTEs are very willing to work with the CC and other stakeholders in taking forward some of the proposed regulation remedies, there are significant challenges relating to measures seeking to regulate predatory behaviour on fares and frequencies to effectively reduce barriers to new entry/expansion without introducing substantial distortionary effects into the market. That being said, there are likely to be some mitigating effects on the degree of detriment identified by the CC even if sustainable competition is unlikely to ensue.
- 9.3. Critically, predatory behaviour (as opposed to the effects of healthy competitive pressures) can only be safely assessed once the incumbent has gone back to pre-entry levels (Dodgson et al, 1993), by which time the damage will have already been done to the potential new entrant.
- 9.4. Some PTEs operate models with that kind of capability required to assess changes in behaviour in local markets<sup>13</sup>, but we have serious reservations over the ability of other, more centralised bodies, such as the Traffic Commissioners (TCs), or indeed the OFT, to monitor such a complex and fragmented market in a sufficiently timely and effective way. If the CC was minded to take forward these recommendations, then it is our view that, at least in the metropolitan areas, PTEs would be a much more appropriate regulator as they already have the monitoring capability and detailed knowledge of local networks to carry out some of these functions at a low marginal cost, either on their own, or in collaboration with TCs, OFT or some other regulatory body.
- 9.5. In general, we see four main types of governance arrangement for this type of regulatory function. Below, we go through some of the potential advantages and disadvantages of these alternative models.

### The Traffic Commissioners

- 9.6. The TCs are an existing body which exercises a quasi-judicial function. However, the expertise of the TCs lies mainly in operational issues in relation to safety and performance. There is no expertise in relation to economic regulation.

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<sup>13</sup> For example, the SimBus model, which has been used by Nexus, Metro and SYPTE in their work on Quality Contracts.

- 9.7. The TCs are also very lightly resourced and have recently seen further functions transferred to VOSA (on service performance monitoring). They cover large regions (some TCs covering more than one region) and, given their lack of resources, are relatively remote from local markets.
- 9.8. To expand the role of the TCs to take on a regulatory function of this nature would require a major change in the culture, expertise and scale of the TCs. In our view, therefore, they are not an appropriate body to take on this role.

### **OfBus**

- 9.9. There is the option of creating a new regulatory body for bus - or expanding the OFT's role within the bus sector. The advantage of this would be the creation of a body with specific expertise and knowledge of the bus sector able to enter into a long term dialogue with the industry, as well as exercise a quasi-judicial function (as is the case with ORR for the rail sector).
- 9.10. The disadvantage would be the costs of creating a new body, especially at a time when the Government wants to abolish quangos rather than create new ones.
- 9.11. In addition, given the very local and fragmented nature of the bus market (compared, say, to the UK rail market) it could be difficult for a national body to carry out its functions effectively when it would necessarily be relatively remote from those local markets. Indeed, we are not aware of any developed countries where this centralised regulatory function is currently in place, with the exclusion of federal states which are much closer in geographical scope to UK regions.

### **LTAs**

- 9.12. A much more common approach is for local or regional transport authorities to take on this regulatory role. The advantages of giving the regulatory function to LTAs are that they:
- Are existing bodies who could take on this role at low marginal cost;
  - Have knowledge of the local market, and;
  - Already monitor the local market.
- 9.13. LTAs are also in a position to identify and recognise more subtle forms of anti-competitive behaviour that would not be apparent to more remote national entities. LTAs reflect the public interest in that they wish to see bus networks that best meet the needs of local people in a sustainable way. Ultimately LTAs will also be held responsible by voters if their actions (or inaction) leads to market failure, not to mention the fact that it is their responsibility to fund services no longer deemed commercial by operators.
- 9.14. LTAs could carry out this role, for example, by taking responsibility for registrations of services and fares (the latter not currently part of the registration process). This role could range from becoming the registration authority through to being a statutory consultee on registrations. Through this role the LTAs could seek to prevent changes in services and fares which introduced unsustainable and disruptive changes to fares and frequencies.

- 9.15. A variation on this theme would be for the LTA to send automatic requests to operators asking to explain changes above/below a certain threshold from what were deemed to be commercially sustainable fares and frequencies. Future changes would continue to be monitored and operators informed that reversal of fares/frequency changes following exit would be automatically referred to OFT.
- 9.16. A further variation would be for LTAs to be given a duty to consider complaints about anti-competitive behaviour and powers to investigate anti-competitive behaviour, together with a duty to issue a reasoned opinion that would be published. There would be an obligation on operators to either comply or to formally respond. The LTA's reasoned opinion could ultimately be submitted to the OFT or CC. Such a process would act as a disincentive to short term anti-competitive responses to new entrants.

### **Arms-length LTA-appointed regulator**

- 9.17. If it was not considered appropriate for LTAs to directly take on a regulatory function it would be entirely feasible for an independent regulator to be nominated, who would rely on the LTA for monitoring and data analysis.
- 9.18. There are some significant challenges around all these options for the moderation of competition. First of all, on what basis should an authority determine that an operator is acting in a way that is detrimental to competition rather than in the public interest, especially if the aim is to prevent this action from causing damage, rather than retrospectively assessing it sometime later when the damage can't be repaired? Work by Dodgson et al. (1993) shows that, while this is possible in theory, it cannot be easily done on the basis of simple rules of thumb.
- 9.19. There are also questions around the costs, timescales and basis of any appeals process against the decision by the authority (and how a balance is struck between any fair appeals process and not creating an incentive to appeal on the basis that there is nothing to be lost by appealing).
- 9.20. Finally there are questions around how a process designed to moderate competition could be fair both to a new entrant to the market and the incumbent. It would be unreasonable not to allow for an incumbent to react to a new entrant in terms of the service it provides (which includes fares and frequencies).
- 9.21. Guidance from the DfT could potentially help to provide the basis for decision-makers to address some of these questions. It should also be recognised that whatever the difficulties with any of the proposed solutions, the status quo is unsatisfactory (i.e.: the retrospective investigation and punishment of anti-competitive behaviour).

## **10. Tendered market**

- 10.1. The PTEs welcome the CC's emphasis on the need for updated DfT guidance relating to the tendering of non-commercial services. We also accept that current tendering practice is not always necessarily conducive to the greatest degree of competition. That being said, there are significant structural obstacles to the use of, for example, net cost contracts, not least the asymmetry of information between incumbents and LTAs and the barrier to entry posed by single operator tickets.
- 10.2. We therefore strongly support the proposed 'information remedy' and make some related suggestions in chapter 11 on legislative changes.

## 11. Proposed legislative changes

### Making existing franchising powers work better

11.1. LTAs have Quality Contract franchising powers under the Transport Act 2000 (as amended by the 2008 Act), improving the ability for LTAs to use these by removing some of the barriers would assist in improving competition when 'for the market' competition is deemed appropriate and will generally improve standards of service operation in non QC locations as the threat that a QC could be used would be increased. As it remains uncertain whether any other changes to assist in the market competition will succeed, the availability of an implementable franchising alternative is vitally important

11.2. Legislative changes:

- Remove express requirements in section 124(e) for adverse effects on operators to be proportionate to the improvement in wellbeing of persons living or working in the area. Apart from the fact that these effects are both subjective and difficult to quantify with any degree of accuracy prior to the introduction of a franchising arrangement, it is also easy to see how, for a highly inefficient operator or in the context of over-bussing, the detriment to operators would be potentially greater than the benefits to local passengers, at least in the short term. Taking into account the impact on incumbent operators (in a sense, attributing grandfather rights) adds to their market power. Should an incumbent be replaced by a more efficient operator through a franchising process then that's effectively the outcome that a truly competitive open market should have delivered in the first place. There is therefore no benefit to consumers in maintaining this requirement. Adequate protection to incumbent operators is given by the impact of the European Convention on Human Rights.
- Allow greater flexibility in terms of the LTAs' franchising approach. It should be ultimately up to the commissioning authority to devise the most effective procurement/contract monitoring and enforcement approaches so it makes little sense for primary legislation to fix this a priori. That being said, a review of evidence on existing bus franchising practice by the DfT would be welcome.
- Reduce the risks during the transition period and beyond, e.g., by extending de-registration periods prior to franchising and allowing access to operator data on demand and revenue.
- Light touch QCs. One PTE has looked at the concept of a 'light touch Quality Contract Scheme' which seeks to combine the benefits of elements of regulation and competition for the market with the more advantageous aspects of free market operation of bus services by commercially adept private operators. In essence the proposition is that aspects such as network over-bussing to deter competitors would be restricted using QCS powers, but that operators would be encouraged to innovate and compete responsibly. The management of the free market elements would be by a combination of service exclusions (with some light touch minimum standards) as permitted by s.127(4) of the 2000 Local Transport Act and clearance certificates issued by the LTA under s.6B of the 1985 Transport Act as amended. The legislative limitation at present is that the LTA can only refuse to issue

clearance certificates if the proposed service has an adverse effect on services provided under quality contracts in the QCS area. To facilitate this s.6B could be amended so that it can also add other conditions to the issue of clearance certificates and for these conditions to be treated as prescribed particulars of the service registration.

- Improve the legislation to allow more flexibility in terms of making variations during the contract term. At present the legislation is cumbersome in terms of allowing variations to be made during the lifetime of a QC (up to ten years).

### **Making partnerships work better**

11.3. The use of partnerships is the main power LTAs have in order to work with commercial operators to improve the quality of bus services and secure influence. It is agreed that head to head competition is often unstable and in addition there is often little in the market competition to regulate the activities of commercial operators. In both circumstances it is through such Partnerships that LTAs can exert some pressure to make quality improvements. Improvements to the powers LTAs have at their disposal to implement. Partnerships are important in the absence of in the market competition driving up standards.

11.4. There is also the option of building on existing SQP legislation to introduce what could be termed 'super SQPs' which could be introduced across wider areas and with fewer legal burdens restricting their implementation. These changes could include:

- Removing the requirement for an LTA to provide facilities in order to implement SQPs. There is only limited, and possibly flawed, economic rationale underlying this requirement. Public funds are scarce and it should be up to LTAs to devise how these should be deployed most effectively in the public interest. In some cases this may be through infrastructure enhancements but in others it could well be through increased subsidy levels, for example. This requirement effectively introduces an entirely arbitrary distortionary effect into the market. By removing the facilities requirement it would also make it easy to extend the boundaries of SQPs so that they covered more cohesive networks
- Limit the ability to make admissible objections. The ability of operators to make admissible objections to standards in an SQP relating to maximum fares and frequencies are unnecessary. The ability to exert an element of control on maximum fares in near monopoly situations is important as is the ability to coordinate frequencies and timings. The requirement for an SQP to meet the Competition Test is sufficient safeguard. In reality the provisions on maximum fares do not go far enough to effectively control fares in monopoly situations and the use of extended multi-operator ticketing powers/controls may assist in this area.

### **Preventing predatory behaviour**

11.5. As set out above **pteg** would like to see legislative changes to give LTAs a role in monitoring and preventing predatory behaviour and we would welcome the opportunity to consider with you the most appropriate model and legislative changes required to deliver this.

### Protecting newly awarded tendered services

11.6. One way into the market for new operators is to secure a contract for the provision of tendered services. If such a right to operate has been won in open competition then there is an argument for preventing 'in the market' competition being established that undermines that tendered service. Registration restrictions (similar to SQPs) could be allowed to restrict new registrations that may be seen as competing with the tendered service awarded. At present there is limited risk to incumbents in de-registering non-commercial departures at the margins of commercial services as they are likely to hold a competitive advantage once this service is tendered by the LTA. But should the service be awarded to a competitor the incumbent operator is allowed to re-register the commercial service and entirely undermine the new entrant. This is effectively predatory behaviour but which should be much easier to monitor than in the case of commercial services. There is anecdotal evidence relating to this type of behaviour from several PTEs but we believe Metro should be able to provide some recent examples.

### Ticketing schemes

11.7. Extend LTA powers (section 135, LTA 2000) to introduce a ticketing scheme, greater flexibility in the definition of products (including geographic scope) and a price setting mechanism (see ticketing section), even where MTCs already exist (but may be sub-optimal).

11.8. Introduce powers relating to smartcards which require operators to install ITSO compatible readers and load their products onto e-purse portfolios.

### Access to data

11.9. Introduce powers to allow LTAs to access commercial data from recently de-registered services (some powers already in place in the context of CT reimbursement), building on the CC's proposed information remedy relating to tendered services.

### Competition tests/ticketing block exemption.

11.10. **pteg** would like the opportunity to review how the competition tests and ticketing block exemption operate to ensure they are not unnecessarily restricting the use of SQPs and voluntary agreements. In particular we would like to explore whether a competition test is actually needed for LTA functions such as SQPs.

### Preventing predatory behaviour

11.11. As set out above **pteg** would like to see legislative changes to give LTAs a role in monitoring and preventing predatory behaviour and we would welcome the opportunity to consider with you the most appropriate model and legislative changes required to deliver this.

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