

Public Version

Competition Assessment of Public Transport Operating Model

Report
for
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The views expressed in this report are of the author. In this public version, confidential information has been deleted and replaced with square brackets.



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Executive Summary

The Ministry of Transport (MoT) is concerned that the subsidy costs of providing public transport are increasing while patronage growth is slowing. To address these concerns MoT along with other government and industry stakeholders have developed a Public Transport Operating Model (PTOM), which introduces a number of different features to the planning, funding and procurement of urban bus services and ferries in New Zealand.

MoT required a competition assessment to identify how PTOM would influence the procurement and delivery of urban bus and ferry services and what it might mean for the overall welfare of New Zealanders. This report includes a competition assessment of the individual components of PTOM and of PTOM as a whole, based on qualitative evidence. The report also comments on quantifying possible public benefits and detriments.

Background

Development of PTOM first commenced in 2009, following the Minister's intention to review the Public Transport Management Act (2008) due to concerns regarding achieving value for money. Consequently, PTOM introduces procurement processes which involve negotiating urban bus contracts and continuing to tender some contracts, redesigning bus contracts into units, increasing the length of contracts, measuring the performance of bus service providers and benchmarking their costs during negotiations against previously tendered bus contracts.

This report has been produced prior to the completion of PTOM. Some of the features of PTOM that are reviewed in this report are still being developed by MoT and its stakeholders. However, the report does provide a competition assessment of the key concepts being introduced under PTOM.

This competition assessment has been based on desktop research. The analysis is based on the information that was available within the short time period that this report was completed.

Competition assessment

The relevant markets most likely to be affected by PTOM are the:

- Rights to operate scheduled subsidised urban bus services.
- Provision of commercial urban bus services.

Different geographic markets in Auckland, Greater Wellington and Canterbury are also considered.

A competition assessment is conducted by comparing each of the above relevant markets under two scenarios, one with PTOM (the factual) and the other without (counterfactual). The counterfactual scenario is regional councils continue to operate under the legal framework of the Transport Service Licensing Act 1989. The factual scenario includes the introduction of PTOM, which involves councils being able to negotiate exclusive contracts redefined as units, for up to 9-12 years. The factual also includes two procurement processes operating in parallel, namely, tendering and negotiating units. The difference in competition between the factual and counterfactual scenarios represents the competition impact of PTOM.

Findings

Under the factual, compared to the counterfactual, PTOM is likely to have some negative and positive effects on competition in the provision of subsidised and commercial bus services. Further, some components of PTOM are likely to have a greater effect on competition than others. The degree to which competition is promoted under PTOM will depend on the success of transitioning to units, implementing contracts with financial and non-financial incentives to improve performance and creating league tables for units to compare the performance of subsidised and commercial units.

It is unclear, what the overall effect on competition could be, as while it is possible that the positive aspects of PTOM could outweigh the negative, there is still a high degree of scope for the negative aspects, namely negotiating exclusive contracts for long periods of time with incumbents, to have a far greater effect. This means that the Government's desire to achieve value for money could be compromised.

To get a better understanding of the net effect of PTOM, a limited welfare analysis could be feasible. While not all public benefits and detriments could be quantified, it seems possible to quantify some aspects. This could assist in estimating the magnitude of some of the effects of PTOM.

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1. Introduction

The Ministry of Transport (MoT) is concerned that the subsidy costs of providing public transport are increasing while patronage growth is slowing. Between 1990/00 and 2008/09 subsidy payments increased by approximately 260% while bus and ferry trips increased by only 63%.¹ To address these concerns MoT, along with other government and industry stakeholders have developed a Public Transport Operating Model (PTOM). This significant policy development introduces a number of different features to the planning, funding and procurement of urban bus services and ferries in New Zealand.

In assessing the potential effects of the new model, MoT required a competition assessment to identify how PTOM would influence the procurement and delivery of urban bus and ferry services and what it might mean for the overall welfare of New Zealanders.

This report provides a competition assessment of PTOM. It is based on qualitative evidence to assess the impact of each of the individual components of PTOM on existing bus operators, potential bus operators, regional councils and, ultimately, bus passengers. The report also considers the overall competition effects of PTOM. For instance, PTOM has been designed to address the following Government concerns²:

- The need to achieve better value for money from its expenditure on public transport.
- The value operators bring to the delivery of urban bus and ferry services might be undermined by the excessive power regional councils are likely to have under the Public Transport Management Act 2008 (PTMA).

This report:

- Assesses the competition effects of PTOM.
- Assesses, from a competition perspective, whether or not the Government's concerns are valid.
- Comments on how easy it would be to quantify any of the public detriments and public benefits arising from PTOM.

The analysis conducted in this report focuses on urban bus services, as they represent a large part of the public transport services being considered under the PTOM.² However, the same analytical framework would be applied in assessing the competition impact of PTOM on ferries in New Zealand.

Finally, the analysis in this report is based on the information that was available within the short time period that this report was completed. The report has been produced prior to the completion of PTOM. Some of the features of PTOM that are reviewed in this report are still being developed by MoT and its stakeholders. However, the report does provide a competition assessment of the key concepts being introduced under PTOM. The assessment has been based on desktop research.

¹ Data provided by MoT

² In 2008/09, 80% of all trips made on public transport were on urban bus services.

Further, the analysis excludes consideration of school buses tendered through the Ministry of Education as they involve a different business model. However, it does include school bus services procured and tendered by the regional councils.

The outline of this report is as follows:

- Background.
- Competition framework for assessing PTOM.
- Competition assessment of PTOM.
- Welfare analysis of PTOM.
- Conclusion.

2. Background

This section provides some background to the importance of competition assessments in policy making, an explanation of how bus services are provided in New Zealand as well as a summary of the key features of PTOM that are assessed in this report.

2.1 Competition assessments of government policy

A competition assessment of PTOM is an important part of analysing this new proposed policy. When assessing the impact of new policy options and even when assessing the competition impact of mergers, or new agreements between firms, it can be difficult to assess how different industry participants will behave in the future. However, by gathering and analysing historical evidence we can make informed judgements as to what could happen in the future under different scenarios.

Competition is a process of rivalry between firms seeking to win customers' business. This process of rivalry, where it is effective, encourages firms to deliver benefits to customers in terms of prices, quality and choice. Where levels of rivalry are reduced customers have less choice because they have fewer firms from whom they can buy goods or services.

Competition between firms may focus on offering the lowest price. However, most suppliers will try and compete in a number of ways in addition to price, for example by developing new 'improved' products, by offering products of differing quality or characteristics, by branding and advertising the differences in their products relative to their competitors', or by using different sales channels.

In many cases, the government decides to intervene where there is a desire to improve the working of a particular market, perhaps because there are concerns over the market outcomes for consumers of the product or service. In intervening, policy makers need to be clear on the rationale for introducing the policy and what competitive impact, directly and indirectly, it will have on industry participants including the end-customer.³ Where the government has an active role in market design, supervision, and enforcement, it should ensure that the necessary incentives are in place for the goods or services to be provided efficiently, while achieving the same policy goals.⁴

³ Office of Fair Trading, Completing competition assessments in Impact Assessments, Guidelines for Policymakers, Aug 2007.

⁴ Government in markets-Why competition matters, a guide for policy makers, Office of Fair Trading, 2009.

In this report the rationale for PTOM is not considered as this is outside the scope of the work requested. Rather, a competition assessment of PTOM is conducted and consideration is given as to how it will affect different participants in the bus industry including bus passengers, most of which are shown in Figure 1.

As mentioned before the Government has two concerns that have led to the development of PTOM:

- The need to achieve better value for money from its expenditure on public transport.
- The value operators bring to the delivery of urban bus and ferry services might be undermined by the excessive power regional councils are likely to have under the PTMA.

The assessment of whether these concerns are valid requires an understanding of what value for money means and the role of government in procurement.

2.2 Value for money

The concept of value for money and promoting competition is related. Value for money essentially means adopting the option that meets your long-term needs at the desired quality level and within a given budget. In New Zealand, the Auditor-General defines value for money as follows:

*Public entities should use resources effectively, economically, and without waste, with due regard for the total costs and benefits of an arrangement, and its contribution to the outcomes the entity is trying to achieve. Where practical, this may involve considering the costs of alternative supply arrangements.*⁵

New Zealand Transport Agency's (NZTA) procurement manual provides a similar definition of value for money.⁶

Overseas evidence suggests that improvements in procurement processes could deliver savings of up to 40%.⁷ In New Zealand, even a 1% improvement in the value for money of government spending could lead to annual savings of \$300 million of taxpayers' money.⁸

Value for money can be achieved by promoting public procurement processes to take full advantage of competition among providers. More intense competition can deliver lower prices, better quality products and services and innovation. However, sometimes competition is not always considered in procurement processes as the administration

⁵ Public sector purchases, grants, and gifts: Managing funding arrangements with external parties, Office of the Controller and Auditor-General, 2008. Part 2.

⁶ NZ Transport Agency's Procurement Manual, First edition, effective from July 2009. Section 3.3.

⁷ In the United Kingdom, savings generated through better procurement accounted for 40% (NZ\$20 billion) of the wider efficiency programme target of NZ\$50 billion a year savings by April 2008.

http://www.med.govt.nz/templates/Page_____43962.aspx

⁸ The government's procurement spend is approximately \$30 billion per year.

costs of procurements are more visible than the cost savings from more intense competition, or there is a reluctance to switch to new unknown suppliers.

A competition assessment of PTOM is likely to indicate whether or not it would deliver value for money, which would involve increasing patronage but decreasing government subsidy payments.

2.3 Government procurement

A government's role in procurement has increasingly been in the limelight based on the need to promote competition to achieve value for money. Public procurement can have positive and negative effects. It has been considered a few times by the Commerce Commission (Commission), within the context of Wellington and Christchurch bus mergers, as well as mergers between pathology providers. There are also a number of worldwide guidelines on competition and government procurement.⁹ Of particular relevance, the Office of Fair Trading (OFT) guidelines state that:

The public sector, by virtue of its overall demand in certain markets, may be in a position to protect and promote competition, for example by maintaining a competitive market structure through deliberately sourcing its requirements from a range of suppliers, by providing incentives to suppliers to invest and innovate, or by helping firms to overcome barriers to entry. It may, however, also restrict and distort competition e.g. by adopting practices that have the effect of restricting participation in public tenders and that might even discriminate against particular types of firms.¹⁰

While governments have a key role in procurement the extent to which they could exercise their buyer power to promote competition may be diminished. For instance, governments tend to be more risk averse, are not necessarily driven by the need to maximize profits and may try and pursue other policy objectives.

In conducting the competition assessment of PTOM, an assessment of the buyer power of regional councils in the procurement of bus services is considered in greater detail.

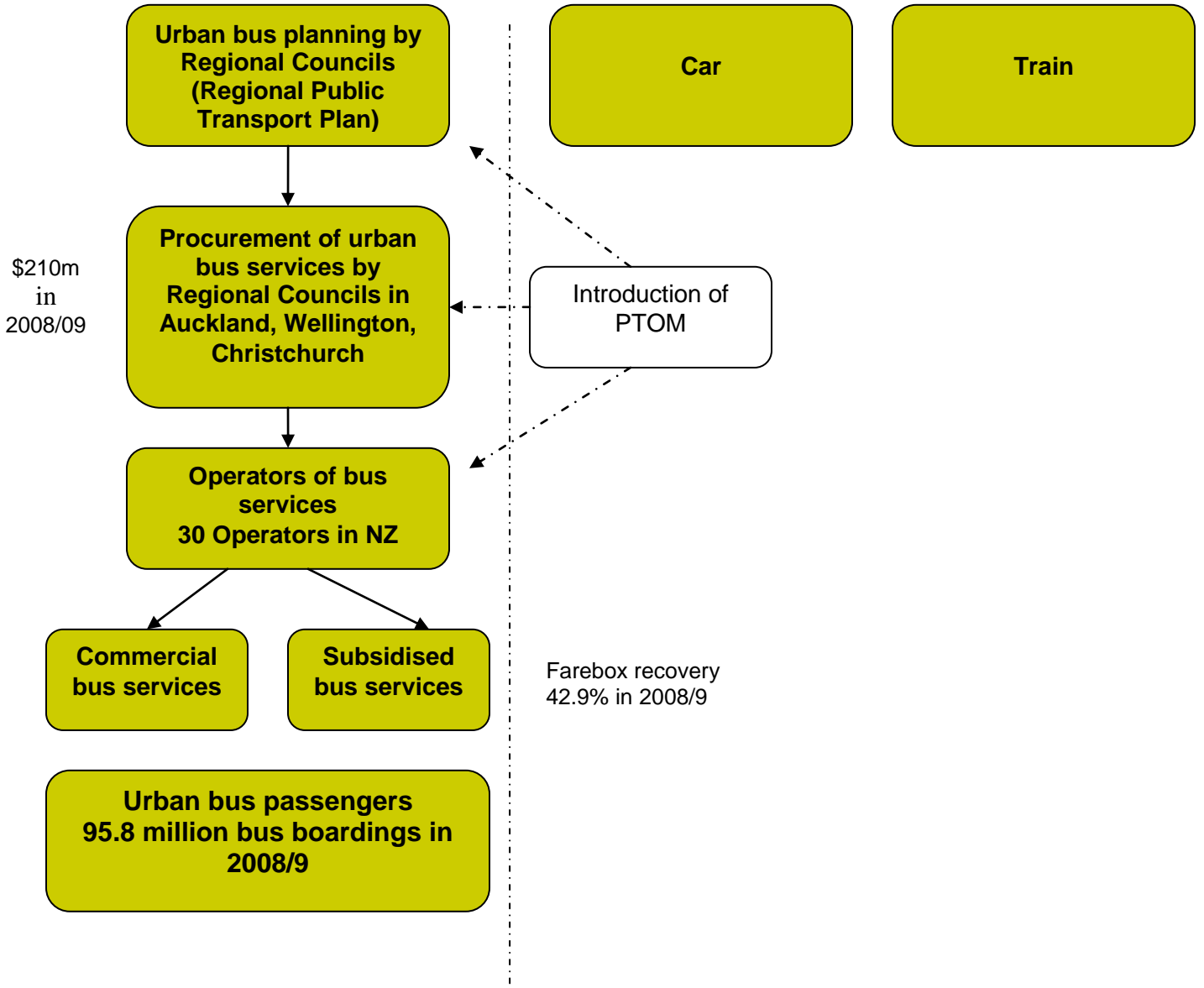
2.4 Bus services in New Zealand

Figure 1 below provides an overview of the industry participants that are most likely to be affected by PTOM. The diagram shows that regional councils are responsible for planning, procuring and monitoring bus services in New Zealand. Bus operators can compete in a tender process to provide subsidised bus services or they can provide commercial bus services which receive no government funding. Consumers have the choice of travelling by bus or choosing an alternative mode of transport to travel from A to B.

⁹ OECD, Competition Policy and Procurement Markets: Best Practise Roundtable (May 1999), www.oecd.org/dataoecd/35/3/1920223.pdf, 16

¹⁰ Assessing the impact of public sector procurement on competition Summary September 2004 Prepared for the Office of Fair Trading by DotEcon, para 1.4.

Figure 1: Industry participants



2.5 Public Transport Operating Model

On 1 January 2009 PTMA came into effect. In April 2009 the Minister of Transport wrote to regional councils and bus and ferry operators advising them of his intention to review the PTMA, including removing contracting requirements.¹¹ He wrote to them again in September 2009 advising that the scope of the review had been widened to consider the whole operating environment for the planning, procurement and delivery of urban bus and ferry services.

PTOM is expected to have dual objectives of growing:

- The commerciality of public transport services and creating incentives for services to become fully commercial.
- Confidence that services are priced efficiently and there is access to public transport markets for competitors.

Key mechanical features of PTOM that represent a break with past practice include:

- The requirement that a regional council segment their network into units for service delivery and contracting purposes.¹²
- All services, whether provided on a 100% commercial basis by an operator or partially funded by a regional council will be subject to a contract between the regional council and operator (fully contracted regime).
- Units will be contracted out either through a tendering process or direct negotiation with an incumbent operator.
- The number of units that will be contracted out through tendering or direct negotiation is correlated with a region's overall 'commerciality ratio' (i.e. the ratio of fare revenue to the total costs incurred to provide services).
- Contract length will be longer, possibly up to 9-12 years for subsidised units compared to between 3 and 6 years now. Fully commercial units will have an indefinite tenure as long as they remain fully commercial and deliver minimum service levels.
- All units performance will be compared using a 'league table' to provide some post tender/negotiation competitive tension between operators.
- Patronage and revenue information will be publicly available regardless of whether a service is fully commercial or not.¹³

¹¹ Includes the Auckland Regional Transport Authority (ARTA), which is not a regional council, but was responsible for the planning and delivery of public transport services in Auckland, at the time. Auckland Transport has now replaced ARTA.

¹² While it is up to the regional council to determine how they want to set up the network into units (e.g. route or area based approach) a unit can be no smaller than a single full route full timetabled service.

¹³ Note at this time, it is assumed that this will occur whether PTOM is implemented or not.

3. Competition framework for assessing PTOM

A competition assessment of PTOM involves understanding the new features of the model, who it affects (like regional councils, bus operators, bus passengers) how it affects them and how does it compare with the current approach for planning, funding and purchasing urban bus services.

The competition assessment of PTOM uses the economic frameworks routinely applied in competition policy. These frameworks are used by the Commission¹⁴ and competition authorities around the world when analysing the competition effects of mergers, acquisitions and complaints on anti-competitive behaviour.

A welfare analysis of PTOM involves assessing the public benefits and detriments of the proposed model. It is concerned with either reductions in, or enhancements to, the welfare of consumers and producers of New Zealand, as measured in money terms. A public benefit is any gain to New Zealand and a detriment is any loss to New Zealand.

A two stage assessment of PTOM is required:

- **Stage one: Conduct competition assessment of PTOM using qualitative evidence.** This would help in identifying the impact of each of the individual components of PTOM and of PTOM as a whole.
- **Stage two: Conduct welfare analysis of PTOM using quantitative evidence.** Once the potential public benefits and detriments of PTOM have been identified, an assessment can be made on how best to quantify those public benefits and detriments.

This report mainly focuses on the competition assessment of PTOM but provides some comments on the how to conduct the second stage, which is the welfare analysis.

3.1 Overview of competition framework

The competition framework applied in assessing PTOM involves:

- **Assessing the relevant markets in which competition would be affected.** Market definition is used as a framework for assessing the extent to which substitution to alternative offerings constrains, in this case, the ability of bus operators to raise prices, reduce frequency and quality. It should be noted that market definition is not an end in itself but serves as tool to conduct a focused competition assessment.
- **Assessing the competitive outcomes of those markets in different scenarios.** This involves comparing the scenario where PTOM does not exist, namely the current situation, to the scenario where PTOM is introduced. The difference in competition under the two scenarios will demonstrate the competition effects of PTOM. The individual components of PTOM will be assessed under the two scenarios, as well as a comparison of PTOM as a whole.
- **Assessing existing competition in the markets defined.** This is an assessment of current bus operators in the region that have frequently provided bus services, either as subsidised or commercial bus services.

¹⁴ Commerce Commission, *Mergers and Acquisition Guidelines*, January 2004.

- **Assessing potential competition in the markets defined.** This includes an assessment of potential bus operators outside the region but still in New Zealand and bus operators outside New Zealand. Different types of potential entrants are likely to face different barriers to entry. Commission guidelines consider an entry or expansion barrier to be anything that amounts to a cost or disadvantage that a business has to face to enter a market that an established incumbent does not face.¹⁵ Potential competition is considered in both the counterfactual and factual scenarios.
- **Assessing the countervailing power of purchasers in the markets defined.** As mentioned before regional councils purchase subsidised bus services as well as approve registrations from bus operators for commercial services. In assessing the effects of PTOM, the extent to which the regional councils countervailing power is affected will be analysed. This involves assessing the regional councils' current powers and its new powers under PTOM. Consideration is given to the short and long-term effects of a regional council's bargaining strength.

4. Competition assessment of PTOM

In this section, the first steps of conducting a competition assessment are carried out. These are defining the relevant markets and assessing the relevant counterfactual and factual scenarios in those markets.

4.1 Defining the relevant market

The first step is to determine the relevant market or markets. The extent of competition a firm faces will depend on the boundary that is drawn around the "market" it operates in. Defining the boundaries of a market is a very useful tool for assessing competitive constraints exerted by existing and potential competitors. It ensures a consistent and explicit analysis of competitive constraints and means that the analysis is focused only on the most relevant areas.

The concept of defining the market is also consistent with NZTA's procurement manual which states that:

*An approved organisation will need to understand how the market for goods and services is structured in its area and the type of activities it is planning to undertake.*¹⁶

Defining the market involves assessing three main dimensions, functional dimension, namely the supply chain, product dimension and the geographic dimension. With these dimensions in mind, the assessment of the relevant markets affected by PTOM takes into account the following issues:

- Bus procurement versus bus planning (functional dimension).
- Bus services versus other modes of transport (product dimension).

¹⁵ Ibid.

¹⁶ NZ Transport Agency's Procurement Manual, First edition, effective from July 2009. Section 4.4

- Subsidised urban bus services versus commercial bus services (product dimension)
- Geographic region in which bus services are provided (geographic dimension).

These issues are explored in greater detail below.

4.1.1 Bus procurement v bus planning

Transportation planning historically has followed the rational planning model of defining goals and objectives, identifying problems, generating alternatives, evaluating alternatives, and developing plans. Under the Land Transport Management Act 2008, regional councils are required to set out their objectives and outcomes in a Regional Land Transport Strategy. These objectives could include delivering public transport for economic, environmental and social reasons. The specific details of how councils will achieve their objectives and implement their public transport plans are currently outlined in a Regional Passenger Transport Plan.¹⁷ This Plan would take into account the demand for public bus services, which is determined by the following factors:

- Direct demand factors (fares, journey times, waiting times, service frequency, and quality).
- Network factors (real time information, information/branding/marketing, coverage, predictability and reliability, interchange and bus lanes).
- External factors (demographics, car ownership and car linkage measures).

The planning of public urban bus services is distinct from the procurement of bus services. For a regional council planning involves co-ordinating the provision of integrated services, routes, timetables, ticketing, fares and minimum service quality and performance standards. Bus procurement, on the other hand, involves designing procurement options, which currently includes tendering, evaluating tenders and monitoring the provision of those bus services.

Therefore, different skills and knowledge is required, although both planning and procurement require an understanding of public transport services, as well as, an understanding of how they are linked. For instance, bus planning could be thought of as the upstream market where the design of the contract is carefully planned by the regional council. The procurement of bus services can be considered to be the downstream market, as it takes the contract designed by the regional council, (in the upstream market) and chooses a procurement method to appoint the best operator to deliver the service at the lowest cost and highest quality.

From an operator's perspective, its main business activity is to provide bus services. However, it can provide a key role in assisting regional councils with their planning activities, although there is a concern that bus operators may have hindered regional councils' planning activities by distorting competition in the provision of bus services.

For the reasons discussed above bus planning and bus procurement are considered to be in separate markets.

¹⁷ Regional Passenger Transport Plans will be replaced with the Regional Public Transport Plan and would be required under the PTMA if certain conditions are met. (Section 9).

4.1.2 Bus v other modes of transport

In the past, the Commission has concluded that specific features of different modes of transport (e.g. cost, route flexibility and coverage) vary enough that it is preferable to define bus markets separately from other modes of transport.

For public transport planning purposes, the market could be defined more broadly, to consider encompassing all bus services (subsidised and commercial bus routes) and even rail and car. It is in this planning role, that a regional council can decide the size of the bus subsidies market and influence the size of commercial bus services market. However, this assessment concerns the competition effects of regional councils *procuring* bus services under PTOM.

Recently, the UK Competition Commission (UKCC) in its current investigation of the local bus market considered that in the longer term, the operation of local bus services may be subject to constraints from other modes of transport. Further, in the Stagecoach/Preston merger it stated that:

Estimates of the price elasticity of demand for bus travel other than in the very long run tend to be low, suggesting that insufficient passengers would switch to alternative modes of travel in the event of a fare increase so as to render the fare increase unprofitable. This would also apply to service reductions.¹⁸

For the purposes of assessing PTOM, there is no evidence to suggest that the relevant market is wider than the provision of bus services.

4.1.3 Subsidised vs commercial bus services

Subsidised bus passenger services are contracted services awarded by a regional council in a 'sealed-bid' competitive tender process. Bus operators submit a tender for a subsidy to run a particular bus service with a pre-set fare schedule. The regional council awards the contract to the bidder with the lowest quality-adjusted bid. The subsidised bus route is identified by the regional council as part of its planning role which considers the network effects of bus services. The majority of bus services in New Zealand are operated on subsidy payments.

Commercial bus passenger services occur when a bus operator decides to operate a route on a stand-alone commercial basis and receives no direct government subsidy in the form of a contract payment.¹⁹ These services must be registered with the regional council, as the authority to license commercial services under the Transport Services Licensing Act 1989 (TSLA) and now under PTMA. Commercial services do not receive a subsidy and rely entirely on fare receipts. Generally, commercial services are identified by bus operators. However, this has been to a lesser extent in Canterbury where 3% of single timetabled bus services are commercially registered compared to Greater Wellington where 25% of the routes are commercial.

¹⁸ UK Competition Commission, StagecoachGroup plc/Preston Bus Limited, Merger Inquiry, Final Decision 2009. para 7.10.

¹⁹ Commercial bus operators may receive a subsidy through concessionary fare payment and in NZ Super Gold Card.

The Commission²⁰ and the High Court²¹ have considered subsidised bus passenger services to be a separate market from commercial bus passenger services. The Commission concluded:

Subsidised regular passenger services differ from commercial ones, mainly on the demand-side. ECan pays for operators to provide subsidised services..... On the other hand, commercial service rights are often granted on the volition of bus operators themselves for commercial reasons. ECan will licence these services if they are compatible with ECan's overall transport and social goals, but their reason for being is primarily commercial.²²

For the bus operator, commercial services are a different kind of asset. The operator of commercial services depends entirely on income from passengers, and does not receive the guaranteed payments earned by the winner of a subsidised contract.²³

Similarly, the UKCC concluded that there were separate markets for tendered services and commercial services.

We also considered whether tendered services were in the same market as commercial services. In most cases, tendered services do not overlap with commercial services, otherwise there would be no reason for Councils to put these services out to tender....²⁴

....The markets for tendered and commercial services are distinct.

However, the UKCC recognises that there may be some interaction between tendered/subsidised services and commercial services. For instance, the UKCC said that winning subsidised bus contracts can be a way of entering or expanding into new areas and highlighted examples of both large and small operators building commercial operations having first gained a foothold in winning a subsidised contract.

In New Zealand the interaction between subsidised and commercial bus services is such that regional councils in Auckland and Greater Wellington have to 'contract around' the commercial services to provide a complete full timetabled service. This is because bus operators in Auckland and Wellington can register single timetables service on a route (7.40 from Smithville to the City), which means that councils have to tender the remaining services on that route.

Despite the strategic interaction between commercial and subsidised services undertaken by incumbent operators, (which is discussed later in this report), there is no strong evidence to suggest that previous Commission market definitions no longer hold.

²⁰ Commerce Commission: NZBL/Mana Investigation Final Report, Public Version, 20 March 2006.

Commerce Commission Decision 551: Red Bus Limited and Leopard Coachlines, 28 June 2005.

²¹ Commerce Commission v New Zealand Bus Limited HC WN CIV 2006-485-585 [29 June 2006] para 124.

²² Commerce Commission Decision 551: Red Bus Limited and Leopard Coachlines, 28 June 2005, para 79.

²³ Commerce Commission Decision 551: Red Bus Limited and Leopard Coachlines, 28 June 2005. para 80.

²⁴ UK Competition Commission, StagecoachGroup plc/Preston Bus Limited, Merger Inquiry, Final Decision 2009. para 7.20f and 7.17.

From the bus operator's perspective, while there is some supply-side substitution between commercial and subsidised services, in that they both provide bus services to the public, the substitution is limited as they operate on different business models with different degrees of flexibility. Operators can switch to supplying commercial services quickly and easily but to switch to subsidised services they would have to wait for a tender to occur, which happens infrequently in New Zealand.

Therefore, based on the above reasons and the bus merger decisions in New Zealand and the UK, separate markets can be considered for:

- Subsidised urban bus passenger services.
- Commercial urban bus passenger services.

A competition assessment of subsidised urban bus services essentially involves assessing bidding markets, where "*competition for the market*" takes place. Therefore, competition occurs infrequently and is for long-term exclusive contracts. This means that competition needs to be considered over a longer period of time rather than the two-year time frame traditionally considered by competition authorities.

A competition assessment for commercial services involves assessing "*competition in the market*".

4.1.4 Geographic region

In terms of the geographic dimension of the provision of subsidised urban bus services, the Commission has generally found the different regions in New Zealand to be in separate markets. Each bus route and each service on that route, could arguably be a separate geographic market, however, supply-side considerations suggest that groupings of routes is appropriate. Moreover, the competition effects are likely to be similar for each route.

Further, each regional council has jurisdiction for a defined region and therefore determines the geographic area of the contracts to be tendered. The councils are also responsible for registering commercial routes within its jurisdiction. Therefore it seems sensible to consider the impact of PTOM within the geographic boundaries of the regional councils, which in this case is:

- Auckland.
- Canterbury (Greater Christchurch).
- Greater Wellington Region.
- Waikato.
- Bay of Plenty (BOP).

These regions are the main procurers of urban bus services. Otago and Queenstown have not been considered in this assessment as they are small regions with unique features.²⁵ The introduction of PTOM is unlikely to have a significant impact in these regions.

Auckland, Greater Wellington and Canterbury are the largest transport markets in New Zealand. Combined the regions represented approximately 90% of bus and ferry boardings made 2008/9 in New Zealand. Therefore, the competition analysis of PTOM

²⁵ Queenstown has tourist bus routes.

has focused on Auckland, Greater Wellington and Canterbury as these are the regions that are most likely to be affected by PTOM.

4.1.5 Conclusion on relevant markets

In conclusion, in order to conduct a competition assessment of PTOM the following relevant markets are considered:

- Rights to operate scheduled subsidised bus services in Auckland.
- Rights to operate scheduled subsidised bus services in Canterbury.
- Rights to operate scheduled subsidised bus services in Greater Wellington.
- Provision of commercial urban bus services in Auckland.
- Provision of commercial urban bus services in Canterbury.
- Provision of commercial urban bus services in Greater Wellington.

Each of the different components of PTOM is assessed with the above markets in mind.

4.2 Scenario analysis

The next step in the competition framework is to assess the extent of competition in each of those markets under two different scenarios. This involves assessing competition in the counterfactual scenario (base case) and the factual scenario. These scenarios are described below.

4.2.1 Counterfactual scenario

The counterfactual scenario is the current situation with no PTOM and the regulatory framework underpinned by the Transport Service Licensing Act 1989 (TSLA). While the PTMA represents the current regulatory status quo, as councils are legally able to exercise the powers granted to it, the PTMA has yet to be tested. The PTMA provides quite wide discretionary powers to regional councils and there is a level of uncertainty about how regional councils would use those powers.²⁶

The operating status quo is broadly:

- Operators can initiate and register any service as a commercial service (single trip to full route full timetable).
- Regional councils can identify any additional services they consider their region requires and procure these through tender rounds.

In the counterfactual, regional councils are likely to have pursued their, own procurement strategies subject to NZTA procurement guidelines and approval of strategy. This means operating under the TSLA regulatory powers, which includes setting fare levels, structuring tenders, cancelling contracts for non-compliance, declining commercial registrations on certain grounds and 'contracting over' existing commercial services if they are unsatisfactory.

Each regional council's procurement strategy, in the counterfactual, is likely to involve evaluating market conditions in their respective regions and where necessary seeking to

²⁶ Nor whether they would successfully utilise those powers, as the PTMA also requires regional councils to meet a number tests before they can implement available powers.

promote competition. For instance, Greater Wellington Regional Council (GWRC) has had an incumbent operator for a long period of time. With this in mind and a High Court Judgement, it is likely that it would continue with its proposed changes to its tender process. For Environment Canterbury, the counterfactual could be that it pursues a strategy to keep three bus operators active in the region. For the purposes of this report, the counterfactual for Auckland is assumed to be [

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However, while regional councils are likely to have sought to promote competition in their regions, there is uncertainty as to how successful that would be and how long it would take for competition in those markets to be strengthened.

On the planning level, in the counterfactual, it is likely that the councils would focus on the critical factors that are necessary to increase the demand for bus services (like service, customer satisfaction), in their regions.

The table below provides a description of the counterfactual scenario.

Table 1: Current situation in each of the three geographic markets for urban bus services

	Geographic Market		
Facts	Auckland	Greater Wellington	Canterbury
Market Characteristics	<ul style="list-style-type: none"> • Estimated that 23% of single timetabled services are registered as commercial • Approx 23.6% of all trips made in Auckland are on commercial services (68% of trip registrations are by NZ Bus, 10% Birkenhead and 10% AIRBUS) • Have not been to tender for almost 5 years due to uncertainty of legislative reviews, contracts have been rolled over 	<ul style="list-style-type: none"> • Estimated that 25% of single timetabled services are registered as (NZ Bus holds 76% of those commercial registrations and Mana Coach Services has 13.6%) • Two fully commercial routes are the City Circular and Airport Flyer both of which are run by NZ Bus • Have not been to tender for almost 5 years due to uncertainty of legislative reviews contracts have been rolled over 	<ul style="list-style-type: none"> • Estimated that 3% of single timetabled services are registered • No individual trip registrations, but some full timetable/full route commercial registrations (e.g Airport service operates as commercial route) • Otago and Canterbury held tenders where up to five or six tenders were received • Tender in Nov 2010, means that each operator has one third of the market.

	Geographic Market		
Facts	Auckland	Greater Wellington	Canterbury
	<ul style="list-style-type: none"> Existing contracts expire in next 3 years 		<ul style="list-style-type: none"> Red Bus lost six routes to its competitors and was unsuccessful bidding for a new route
Current Bus Operators	<ul style="list-style-type: none"> NZ Bus is largest operator Ritchies Transport operates in North and West Auckland, 95% of its public transport services are provided under subsidised contracts. Birkenhead Transport, operates in North Shore Urban Express operates in and around New Lynn. Howick and Eastern (subsidiary of Souter Holdings) operates in East Auckland 	<ul style="list-style-type: none"> NZ Bus operates in Wellington City, Lower Hutt and Upper Hutt city. Mana Coach Services (76% owned by Souter Holdings and 24% by NZ Bus). Operates in Johnsonville North, Porirua and Kapiti. NZ Bus and Mana Coachlines together provide 98% of bus services Madge Transport operates between Waikanae and Otaki Tranzit operates from Wairarapa to Upper Hutt 	<ul style="list-style-type: none"> Red Bus has 6 full routes as commercial but also has subsidised routes Leopard Coachlines, operates the Orbiter-the largest single bus route in Christchurch, carrying 12% of all the city's passengers. Had Orbiter service since 1999 Christchurch Bus Services in receivership in 2010, purchased by Go Bus Hamilton Christchurch Bus Services previously operated in Timaru, South Canterbury contracts now given to Ritchies Transport
Potential Non-incumbent Bidders in New Zealand*	<ul style="list-style-type: none"> [] 	<ul style="list-style-type: none"> [] 	<ul style="list-style-type: none"> []
Potential Bidders Overseas*	<ul style="list-style-type: none"> [] 	<ul style="list-style-type: none"> [] 	<ul style="list-style-type: none"> []

	Geographic Market		
Facts	Auckland	Greater Wellington	Canterbury
Buyer Power of Regional Councils	<ul style="list-style-type: none"> • Able to exercise the legal powers granted to it under the TSLA • Responsible for designing tenders in the region • Council accepts commercial registrations for single timetabled services with all timetabled services being an exception 	<ul style="list-style-type: none"> • Able to exercise the legal powers granted to it under the TSLA • Responsible for designing tenders in the region • Council accepts commercial registrations for single timetabled services with all timetabled services being an exception 	<ul style="list-style-type: none"> • Able to exercise the legal powers granted to it under the TSLA • Responsible for designing tenders in the region • Council accepts commercial registrations only on all timetabled routes

Source: Ministry of Transport briefing to Minister June 2010, Commerce Commission Decision 551 and company websites.

*Some of the data in this section is based on historical information from MoT, Commerce Commission merger decisions. This data is likely to have changed. Nonetheless it provides some possible examples.

4.2.2 Comparison of counterfactual and factual scenario

The table below shows the main differences between the counterfactual and factual scenarios. The factual scenario is the future state where the key features of PTOM are introduced. These features were highlighted in Section 2.5 and are shown in the table below.

Table 2: Comparison of scenarios with and without PTOM

Counterfactual Scenario Without the PTOM	Factual Scenario With PTOM
No clearly defined units exist, Commercialised individual trips can be registered	Introduction of units, units will be exclusive, Units can be no smaller than a single full route/timetabled service. Units can be provided on a fully commercial basis. ²⁷
No contractual relationship exists for commercial routes	Exclusive contracts for commercial and subsidised units

²⁷ Units could be area based and capture a number of routes.

Counterfactual Scenario Without the PTOM	Factual Scenario With PTOM
Contracts for subsidised bus services are awarded through a tender process	Regional councils can tender and negotiate bus services with bus operators
Length of contract for subsidised services varies between 3, 6, 8 years For commercial services, operators have a perpetual right	Length of contract for subsidised services is up to 9 years For commercial services, contracts would be negotiated to transition to units. ²⁸ The length of contract could be up to 12 years. With all contracts there is the possibility of extension subject to good performance
Contracts are awarded based on the lowest quality adjusted price	Performance based contracts are awarded
No benchmarking exists	Benchmarking table is produced assessing the performance of each unit

Source: Ministry of Transport

In comparing the counterfactual and factual, key questions for consideration are:

- Under the counterfactual would a greater degree of competition be promoted by the regional councils and how long would it take to deliver those benefits given that tenders are infrequent. For example, would GWRC attempts to promote competition through its tender design, succeed and when?
- Under the factual, does PTOM promote competition to a greater or lesser extent than the counterfactual? Would it deliver any competition benefits earlier than the counterfactual? On the other hand, does PTOM distort competition to the extent that it would reduce the level of competition compared to the counterfactual?

The current operating environment does not:

- Create a sound platform for operators to invest in their businesses and take a more innovate approach to service delivery.
- Encourage new entrants to seek to enter local markets.
- Enable regional councils to effectively plan and coordinate services to create an attractive network of services.

Therefore, the question is, does the factual address these concerns.

²⁸ It is proposed that one-off 12 year contracts are negotiated with incumbent operators of commercial registrations, as a quid pro quo for deregistering commercial registrations and transiting to units.

5. Assessment of individual components of PTOM

Each of the components of PTOM is analysed by asking, whether compared to the counterfactual, under the factual, does PTOM:²⁹

- Directly limit the number of bus operators?
- Indirectly limit the number of bus operators?
- Limit the ability of bus operators to compete?
- Reduce bus operators' incentives to compete vigorously?
- Affect the regional council's bargaining strength in procuring bus services?

These questions involve applying the framework outlined in Section 3 which is also consistent with UK guidelines on conducting competition assessments of government policy.

In the sections below, the following features of PTOM are considered:

- Introduction of units.
- Exclusive contracts for subsidised and commercial bus routes.
- Tendering versus negotiation of subsidised bus routes.
- Extending the length of contracts.
- Introduction of performance based contracts.
- Introducing of benchmarking of units.

5.1 Introduction of units

Under PTOM, regional councils will be required to segment their public transport networks into units. It is proposed that a unit will consist of all the services on a timetable (24 hours a day, 7 days a week) on a route or group of routes identified in a Regional Public Transport Plan (RPTP). It is proposed that units will support better management of the network as a whole, and will replace the existing 'two tiered' system of commercial and subsidised services being commingled on a route. Under PTOM, units can operate commercially or receive a subsidy but they must relate to a readily identified customer market.

The introduction of units is a formal way of packaging and redefining the rights to operate a bus service, regardless of whether it is a commercial or subsidised bus service. The introduction of units is likely to have a greater impact in Greater Wellington and Auckland where there has been a trend for single timetabled services to be registered as commercial. In Auckland, it is estimated that 23% of single timetabled routes are commercially registered, 25% in Greater Wellington compared to only 3% in Canterbury.

The competition implications of packaging bus services into units are analysed by comparing the counterfactual and factual scenarios.

²⁹Office of Fair Trading, Completing competition assessments in Impact Assessments, Guidelines for Policymakers, Aug 2007.

5.1.1 Counterfactual

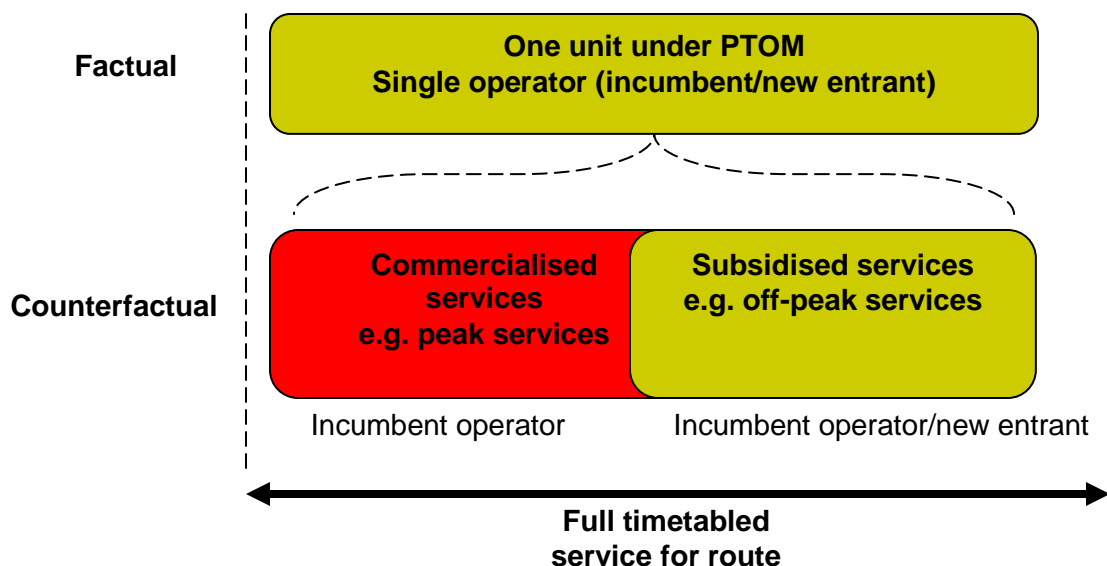
For subsidised services, regional councils generally define the geographic part of the route, the frequency of bus runs on the route, the daily length of the route (e.g. 6.30 am until midnight) and whether the route runs on weekends. For commercial services, bus operators can initiate route design, frequency and length of route, although the vast majority of service developments (excluding airport services) since 2000 have been initiated by the regional council.

In Auckland and Greater Wellington, there is a great degree of interaction between commercial bus services and subsidised bus services. For instance, there has been the following trend:

- **Incumbent bus operators commercially register part of a bus route.** These generally tend to be the profitable parts of the route, such as peak time on weekday mornings, although in Auckland there has been evidence of incumbents commercially registering a block of inter-peak times.
- **Regional councils tender the remaining timetable as subsidised bus services in order to provide a full timetabled service for that route.** In the case of Auckland, the regional council, previously, undertook the procurement process by developing timetables for proposed contracts and then asking operators to confirm their commercial registrations against the proposed timetables. This allowed the council to show the split between commercial and subsidised services and for operators to identify the gaps and inefficiencies of running an incomplete timetable.
- **Incumbents operating the commercial services bid for the remaining subsidised parts of the route when they come up for tender.** However, incumbents will have to compete with any other potential bidder for the subsidised services. The councils only accept the lowest-quality adjusted cost bid.
- **A new entrant may want to provide a full timetabled service for that route.** There is a possibility that if a new entrant is successful in winning the tender for the subsidised services, it may decide to run a commercial service for the remaining part of the route and compete head on with the incumbent already operating a commercial service. To-date this has not occurred.

The counterfactual scenario described above is shown in the figure below:

Figure 2: Interaction between commercial and subsidised services



In the counterfactual, there is a concern that the above situation reduces competition because it:

- **Allows the incumbent to gain advantages in the tendering of subsidised contracts.** Incumbent operators could cross-subsidise profitable services with unprofitable services and benefit from network efficiencies. A study by SAHA found that based on a sample of six Auckland commercial contracts, there was an 8% weighted average financial advantage to holders of commercial services in tenders for subsidised services on the same route.³⁰
- **Deters entry from new operators.** For example, the UK Local Bus Investigation found that tenders relating to part of the timetable or part of a route tend to reduce the likelihood that small operators will bid.³¹ Further, entry could be hindered by not allowing large scale entry via a full timetabled route or by having to tender for a net contract, as the new entrant would have to estimate patronage and revenue. In this respect, the incumbent would have an informational advantage.
- **Affects the regional council's procurement.** For instance, it affects the council's tender design and affects the size of the subsidised contract being offered. For example, GWRC said that if the peak services are taken out by a commercial registration then a 20 bus route might only be a 6 bus route off-peak.

The High Court in the NZ Bus/Mana merger said that “*commercial registrations do inhibit competition*”. The Court concluded that the stability of commercially registered services

³⁰ Analysis of Commercial Registrations in Auckland with Addendums, 30 June 2008, Final Report prepared for the Ministry of Transport, SAHA International.

³¹ Tendered services. Analysis of bidding data. Competition Commission. Local Bus Services Market Investigation.

in Wellington, from 1991-2006, suggest that incumbents have not found it necessary to register more services to achieve their defensive purpose.

In the above scenario, the Auckland and Greater Wellington regional councils' could offset these potential competition concerns by using any of the powers granted to it under the TSLA. For instance:

- While a regional council has limited ability to decline commercial registrations, it does have the ability to completely contract over the commercially registered routes by offering a subsidy to the new entrant for those formally commercially registered routes.
- A regional council could refuse to accept commercially registered single timetabled services and like Canterbury, accept only full timetabled services.

However, neither the Auckland nor Greater Wellington regional council has ever exercised any of the above options to any significant degree. They have threatened to exercise their legal powers but there is doubt as to whether the threat is credible, as the regional councils are reliant on the incumbent operating the vast majority of bus services in those respective regions. For instance in 97% of Greater Wellington's tenders, there has only been one bidder. The High Court concluded:

The Council's countervailing power will remain modest, however, until new entry occurs on a substantial scale. That is so because many tenders attract only one bid.

While the GWRC can decline to contract in such circumstances, it must provide bus services to meet public demand and comply with its own transport strategy by ensuring people may move about by one mode of transport or another. As such, it is presently in a weak bargaining position vis-à-vis NZ Bus and Mana.³²

Recently, Auckland has sought to strengthen its countervailing power not by requesting a full timetable service but by using some of the powers granted to it under the PTMA which includes requesting information from bus operators to evaluate the effect of commercial registrations. In its current RPTP, the Council states that it will process commercial service notifications in line with sections 31 to 40 of the PTMA.³³ This will include an assessment of:

- Whether the service is likely to have a material adverse effect on the financial viability of any contracted public transport service.
- Whether the service is likely to increase the net cost to ARTA of any contracted public transport service.

Under the counterfactual, despite the legal powers granted under the TSLA, Auckland Transport and GWRC are likely to have weak countervailing power.

³² Commerce Commission v New Zealand Bus Limited HC WN CIV 2006-485-585 [29 June 2006] para 197.

³³ Auckland Regional Public Transport Plan 2010. ARTA. Para 11.4b.

In conclusion, in the counterfactual there is some scope for regional councils to exercise their countervailing power if incumbent bus operators attempt to use commercially registered services to deter entry. However, a regional council's countervailing power is reduced if it is reliant on one supplier and so in order to improve competition, and strengthen its negotiating position, it should seek to promote entry in the long-term.

5.1.2 Factual scenario

The introduction of units for full timetabled commercial and subsidised services effectively avoids regional councils having to exercise any countervailing power and gives them the immediate right to award units. As stated before, at present, regional councils in Auckland and Greater Wellington could exercise their buyer power and threaten to contract over commercial routes, although there has been a reluctance to do so as they are reliant on incumbents. In the factual, full timetabled services would be mandatory.

The introduction of units is likely to have a greater impact in Auckland and Greater Wellington. In Canterbury there is likely to be little effect as the Council has already chosen to exercise its countervailing power, as it has three bus operators in the region. For instance, Environment Canterbury's 'anti-cherry-cherry picking' policy has meant that in 2005 it had only three commercially registered routes in Christchurch.³⁴ Further, it has meant that entry has been facilitated because whole routes come up for tender every five years, whereas commercial routes once registered are never available for new operators.

In the factual, the introduction of units may change the nature and type of commercial registrations.

5.1.3 Conclusion on introducing units

The counterfactual scenario suggests that the current strategic interaction between subsidised and commercial services is not producing competitive outcomes. The greater exercise of buyer power from the regional councils could assist in providing a competitive constraint to incumbent operators. This would also make it easier for new entrants to enter, as well as, help improve bus planning so that network efficiencies can be obtained. However, the degree of constraint provided by regional councils in Auckland and Greater Wellington is weak and could be increased if entry into these markets occurs. If this were to be the case, there would be no need to introduce units for full timetabled services.

It could take awhile for entry to occur in Auckland and Greater Wellington or there is a possibility that it may not even happen in the medium to long-term. Therefore while under the counterfactual competition could be promoted long-term if entry is encouraged, in the factual, the introduction of units allows councils to immediately dampen the distortion in competition created by incumbents and increases the scope for potential competition. Therefore, the introduction of units is likely to promote competition in Auckland and Greater Wellington and is likely to be neutral in Environment Canterbury which is not reliant on one bus operator and already exercises its countervailing power.

³⁴Commerce Commission Decision 551: Red Bus Limited and Leopard Coachlines, 28 June 2005. para 216.

5.2 Exclusive contracts

The introduction of PTOM will mean that all units (subsidised or commercial) will be awarded on an exclusive basis.

The use of exclusive contracts is unlikely have an impact in the supply of subsidised bus services as given that the contracts are awarded via a tender, competition takes place *for* the market rather than *in* the market. This means that there is only one operator for the length of the contract. However, the impact of exclusive units for commercial registrations removes the scope for bus operators to compete for bus passengers on a daily basis.

Exclusive commercial units are likely to affect Greater Wellington and Auckland markets, as they serve the largest number of bus passengers and are likely to generate greater commercial opportunities. Auckland and Greater Wellington account for 71% of bus trips made in New Zealand.³⁵ In these markets, there is likely to be a loss of potential competition as there would be no scope for entry on those routes. The threat of entry could act as a constraint on a single bus operator on a route.

It is unclear how significant this loss of competition would be. It is unlikely to be of a concern when the commercial route can only support one operator because there is low demand or there are economies of scale from having one provider. However, if patronage on the commercial routes grows there is scope for more than one operator.

In the Commission's Decision on NZ Bus and Transportation Auckland Corporation, it noted that head-to-head competition was relatively rare, but that where it did exist:

...the benefits commonly associated with competition are clearly evident. On the Great South Round, where TACL, NZ Bus and Howick & Eastern operate competing services, the service frequency is well in excess of the minimum level set down by the ARC.³⁶

The UKCC is currently investigating commercial bus services, but to-date has also found that there are few instances where two bus operators provide identical routes and therefore face head-to-head competition on an entire route.³⁷ Where this did occur there was a high level of demand for that route. The UKCC finds that it is more common for commercial routes to overlap for a proportion of their length.

The loss of potential competition on commercial routes could result in higher bus fares, low quality of service and reliability. On the other hand, price and service standards could be maintained if the exclusive contract contains agreed performance measures with the bus operators. This would involve a more regulated approach and its success would depend on a number of factors. The impact of performance measures is considered later on in this report.

³⁵ Data provided by MoT.

³⁶ New Zealand Bus Limited and Transportation Auckland Corporation Ltd, Commerce Commission Decision 326.

³⁷ Updated Issues Statement, Local Bus Services Market Investigation. Competition Commission, UK. para 11d.

Further evidence is required to assess the impact of exclusive contracts for commercial services. Given the limited nature of information of commercial contracts and the fact there is virtually no head-to-head competition currently occurring, in the factual, there is unlikely to be any immediate effect. However, in the future if the number of commercial registrations increases along with an increase in the demand for bus services (could potentially occur if there is a shock to other modes of transport e.g. rail services breakdown, fuel prices rocket and the number of cars reduces) there is likely to be a dampening effect on competition, as the potential threat of entry on those commercial routes would not exist in the factual. The only source of constraint would be the countervailing power of regional councils and if that is not significant then there would be a loss of competition.

In conclusion, there is a concern that exclusive contracts could reduce potential competition within the market in the long-term in Auckland and Greater Wellington.

5.3 Tendering vs negotiation

PTOM proposes using a mix of competitive tendering and negotiation of units that have not been registered as commercial by operators. It is proposed that a portion of units (either individual or combinations of units) will be subject to competitive tender to provide confidence that prices paid are competitive and support entry of new operators. The remainder of units are proposed to be negotiated with the councils. Under PTOM competitive price tension for negotiated contracts would be applied through performance measures and benchmarking price and performance of other competitively tendered and negotiated units in a region.

The precise nature of competition effects from public procurement can be expected to vary considerably across different procurement settings, reflecting that:

- Procurement covers a wide range of very different goods and services.
- Procurement practices vary considerably with the nature of the goods and services bought, and
- The potential impact of procurement on competition depends on market conditions.

In first instance, the use of tendering and negotiating subsidised bus contracts in Auckland, Greater Wellington and Canterbury and the potential impact on commercial bus services, is considered as two distinct procurement methods. The combination of both procurement processes (tendering and negotiating operating in parallel) is considered in Section 6.

5.3.1 Competitive effects of tendering

Tendering is considered to lead to competitive outcomes. Competitive tendering relies on competition to achieve greater efficiency and better quality service provision. It takes advantage of the competitive marketplace in an attempt to obtain the best value for money. Australian Government guidelines and a review of New South Wales (NSW) bus contracts find that:

Competition is a key element of the Australian Government's procurement policy framework. Effective competition requires non-discrimination in procurement and the use of competitive procurement processes.³⁸

There is a role for competitive tendering in the provision of bus services in metropolitan NSW. This is not simply for the purpose of driving efficiencies (although available evidence is that not all metropolitan operators are operating at efficient costs). Rather, competitive tendering is a means of moving away from the prevailing 'rights' culture and introducing the discipline required to ensure a consistent focus on service and passenger outcomes.³⁹

Further, economic literature states that a well-designed tendering process would:

- Allocate resources efficiently by extracting information like the true cost of providing the service, that is, currently unavailable to the government.
- Avoid favouritism and corruption, and
- Save public finances.

Subsidised bus contracts are tendered in the UK, namely London, and in parts of Australia including Adelaide, Perth, Melbourne and Sydney as well as in parts of Europe. For example, competitive tendering for bus contracts takes place in eight suburban districts of the greater metropolitan area of Munich. The contract period is usually 6 to 7 years. The suburban districts tried to realise competition in their area with a sense of proportion. The aim was to encourage small and medium sized bus operators to bid and the result was that the number of operators increased.⁴⁰

Competitive tendering needs to be conducted efficiently and effectively to ensure that it reaps the benefits of competition. It requires a trade-off between costs (e.g. the administrative cost of running a tender with more bidders) and benefits (e.g. the expected reduction in price as a result of more intense competition). Where these decisions are made on the basis of distorted incentives, it may be the case that public procurement fails to promote competition as much as it could, or leads to avoidable restrictions or distortions of competition.

The main problem with tendering is when the number of bidders participating is too low, hence there is little rivalry between bidders to drive prices down, and improve quality. Another problem is collusion, which arises when bidders co-ordinate their bidding strategies in the tender process rather than competing independently. This is considered later on in the report when considering the impact of the design of the tender.

³⁸ Commonwealth Procurement Guidelines, Financial Management Guidance no.1, December 2008, para 5.1

³⁹ Review of Bus Services in NSW, Final Report, February 2004.

⁴⁰ Contracting urban bus routes, 2008.

Low number of bidders

Under the counterfactual scenario, Auckland and Greater Wellington have had few bidders participating in tenders for subsidised bus contracts, whereas in the past Waikato, Canterbury and Otago have had competition for almost all tendered contracts.⁴¹ For example, LEK Consulting reported that in 2004/5 the number of bids per tender was 1.12 in Greater Wellington and 1.33 and 2.39 in Auckland and Canterbury respectively.⁴² A reason for the higher number of bids per tender in Canterbury is likely to be related to a new entrant in 2003. Christchurch Bus Services (CBS) was successful in winning contracts and in the Red Bus/Leopard Coachlines merger, the Commission considered that the new entrant provided a constraint to the two incumbent operators. In 2009, the number of bids per tender in Canterbury increased and was estimated to be 4.93.⁴³

Compared to the UK, the number of bids in Auckland and Greater Wellington are low. For instance, the average bid received per tender, in the UK, was found to be 3.6 (5.62 in Wales and 2.26 in Scotland).⁴⁴

The threat of competition from a number of potential bidders could result in savings in the form of lower tender prices for subsidised bus services. For instance, analysis carried out by external consultants found that in Auckland and Wellington, prices for contracts (by gross costs/km) involving more than one bidder were 15%-20% lower than with a single bidder.⁴⁵ While the study states that it would be simplistic to assume that competition for all contracts would reduce prices to this extent, it does suggest that there is scope for there to be a significant downward pressure on prices.

Economic literature on the number on bidders in auction design varies but seems to agree that two bidders are more competitive than one. For instance, Klemperer states that an auction with too few bidders will both be unprofitable for the auctioneer and potentially inefficient.⁴⁶ McAfee and McMillan find that large gains can be obtained from introducing competition where previously none existed and that the offer price falls as the number of bidders increase.⁴⁷ Bishop and Bishop argue that competition for a contract does not necessarily increase as the number of firms increases “*so long as there are at least two firms capable of making credible bids, competition can be as vigorous with two firms as with three or more.*”⁴⁸

In a merger between pathology providers, the Commission was concerned that the reduction in the choice of providers would weaken the countervailing power of the District Health Boards (DHB), which purchased 96% of the pathology services in New

⁴¹ Procurement Strategy for Bus and Ferry Services, Greater Regional Council, October 2008.

⁴² Procurement Review, NZ Government Department Update, LEK Consulting, March 2006.

⁴³ Wallis, Ian. 11th International Conference on Competition and Ownership in Land Passenger Transport. Delft. Netherlands, 2009.

⁴⁴ Tendered services. Analysis of qualitative evidence from parties. Competition Commission. Local Bus Services Market Investigation, para 18 and Table 2.

⁴⁵ Procurement Strategy for Bus and Ferry Services, Greater Wellington Regional Council, October 2008.

⁴⁶ What really matters in Auction design, Paul Klemplerer Oct 2000 p5.

⁴⁷ McAfee, RP and McMillan, J “Auctions and Bidding” (1987) 25 Journal of Economic Literature 699, 729

⁴⁸ Bishop and Bishop, supra n 4.

Zealand.⁴⁹ The Commission recognised the DHB's desire to move to a single provider model to reduce costs, eliminate duplication of testing and remove operational efficiencies. However, it challenged whether the merger between the two largest private pathology providers was the only way to achieve the savings. The Commission concluded that:

Although the DHBs have indicated that they would achieve short term savings as a result of the proposal, the DHBs may have achieved even greater savings had the parties bid separately for contracts. ...the loss of competition may result in an increase in the costs of pathology services for DHBs in the long run.⁵⁰

Similarly, in the Red Bus/Leopard Coachlines merger, the Commission expressed concern over the number of bidders. The Commission assessed the competition impact of a situation of a monopoly (the merged entity) and a monopsonist, Environment Canterbury and stated the following.

The Commission considers that how many bidders there are, and the expectations of those bidders, are critical to an assessment of countervailing power. In particular, if the market attracts only one bidder, and that bidder can be confident of being the only bidder, its bidding strategy will not be constrained by expectations about rival bids, and ECan's albeit limited, countervailing power would be tested. ...For example, where there is only one bidder, but that bidder expects to face rival bids, the price might be constrained by the bidder's expectations rather than any exercise of countervailing power by ECan.⁵¹

The econometric analysis conducted in the UK's current bus investigation found that the difference between the current winning bid in tenders and the winning bid in the previous tender was lower in tenders with a larger number of bidders.⁵² This suggests that there could be cost savings where there are a larger number of bidders. For example, the econometric analysis found that the bid difference is 13.2 per cent higher in tenders with one bidder than in tenders with more than six bidders. Interestingly, tenders with only one bidder and with two bidders hardly differed. Only for tenders with three or four operators was the increase in the bid difference compared with tenders with six or more operators markedly lower.

Economic theory suggests that, cost savings are most likely to occur when bidders are symmetric. However, if bidders are asymmetric (because they benefit to a different extent from economies of scale) an additional bidder may still lower prices substantially in a sealed-bid auction.

⁴⁹Commerce Commission merger Decision No.559: New Zealand Diagnostic Group Limited and Sonic Healthcare (New Zealand) Ltd. Executive Summary, para 6 and 7.

⁵⁰ Ibid.

⁵¹ Commerce Commission Decision 551: Red Bus Limited and Leopard Coachlines, 28 June 2005, para 227.

⁵²Tendered services. Analysis of bidding data. Competition Commission. Local Bus Services Market Investigation, para 18 and Table 2.

The above evidence indicates that too few bidders' results in lower rivalry between bus operators and is likely to be contributing to poor outcomes for consumers in Auckland, Greater Wellington and Canterbury.

There are a number of reasons why there could be too few bidders. These could be because of:

- Problems with the design of the tender
- Barriers to entry and/or
- Threat of strategic behaviour from the incumbent.

These factors and their relevance to Auckland, Greater Wellington and Canterbury are explored in greater detail below.

Tender design

A poorly designed tender process can affect the number of bidders participating. For example in the UK, current findings on the local bus services market are that:⁵³

- Minimum subsidy contracts (where operators bear the risk and are paid a fixed amount to operate the service but set the fare and take the revenue), appear to attract on average a lower number of bidders than minimum cost contracts.⁵⁴ Further, minimum subsidy contracts increased the likelihood of incumbents winning.
- Points-scoring systems to evaluate tenders appear to reduce the likelihood of small operators bidding.

The above UK example is similar to the scenario found here in New Zealand. Net contracts are generally preferred by incumbents as it allows them greater flexibility to increase profits by increasing patronage. Net contracts, also allows an incumbent to take advantage of their patronage and revenue information as this information is not readily available to new entrants. On the other hand, small operators prefer gross contracts as it removes the requirement to estimate patronage and revenue. Therefore a move to gross contracts (which has occurred in most parts of New Zealand, London, Sydney and Brisbane) could encourage entry. However, the impact of entry in New Zealand is yet to be tested.

From the point of view of incumbents, gross contracts could encourage them to focus on being technically efficient rather than focussing on increasing patronage.⁵⁵ Further, the UK Local Bus Investigation found that if an operator is taking over a bus service that has been run unreliable and there is scope for patronage to increase, it may bid a lower

⁵³ Updated Issues Statement, Local Bus Services Market Investigation. Competition Commission, UK, para 36

⁵⁴ Similar to net contracts in New Zealand.

⁵⁵ Roy, William and Yvrande-Billon. Ownership, Contractual Practices and Technical Efficiency: The Case of Urban Public Transport in France. *Journal of Transport Economics and Policy*, Vol.41, No.2 (May 2007), p 257-282.

price.⁵⁶ However, if the operator thinks the projected revenues from a tender are too low, it may encourage the bidder to bid on cost.

In the NZ Bus/Mana investigation, the Commission found that the structure of tenders appeared to be the greatest problem for potential bidders outside the Wellington region.⁵⁷ Potential entrants said that tenders were too small and needed to be around 50-200 buses, and the length of contracts were too short and needed to be around 5-7 years as that would justify the capital expenditure required to enter on a de novo basis.

Thus, improvements in tender design can encourage more bidders to participate and limit the scope for collusion. For instance, the Commission has published guidelines asking tenderers to ensure they attract the largest number of potential bidders by:

Keeping tender requirements clear and easy to follow, thereby encouraging more companies to bid. The probability of bid rigging increases if you have a small number of potential bidders.

*Thinking carefully about unnecessary restrictions on bidders that may eliminate companies that are in fact qualified for the job, and avoid preferential treatment of certain classes of suppliers, or companies that have contracts up for renewal, which can discourage other suppliers from bidding.*⁵⁸

GWRC has tried to change the design of its tender process in order to reduce its reliance on a large incumbent bus operator and increase the number of bidders. As outlined in GWRC's Procurement Strategy, it plans to introduce:⁵⁹

- Gross contracts. Under this approach GWRC takes the risks and keeps the fare revenues, so bus service operators only have to consider costs in preparing their tenders and not patronage.
- Longer contract duration, initially for 8 years followed by another 4 years depending on performance. NZTA's procurement manual recommended contracts initially for 6 years followed by another 6 years.
- Longer lead times to allow new entrants to establish themselves. There must be a 3 month period between RFP release and contract award and a 9 month period between contract award and commencement of services
- Larger contract sizes, involving at least 50-90 buses.

However, the impact of these changes is untested as GWRC has had no tender rounds under its new procurement model. It is possible that GWRC would try and test its procurement strategy in the future under both the counterfactual and factual, as it recognises the need to promote entry.

⁵⁶ Tendered services. Analysis of qualitative evidence from parties. Competition Commission. Local Bus Services Market Investigation. Para 111

⁵⁷ Commerce Commission: NZBL/Mana Investigation Final Report, Public Version, 20 March 2006. para 7.

⁵⁸ <http://www.comcom.govt.nz/how-to-deter-bid-rigging/>

⁵⁹ Procurement Strategy for Bus and Ferry Services, Greater Wellington Regional Council. October 2008

In Auckland, the council is seeking to ensure that its procurement process provides:⁶⁰

- Appropriate incentives to private sector operators and suppliers by ensuring that rewards are commensurate with the degree of risk taken.
- Introduces economies of scale based upon planned service groups.

Again the impact of these changes in Auckland is untested, as no tenders have been held in the past 5 years due to the uncertainty of the PTMA and PTOM. Instead many contracts in Auckland have been renewed.

Under the counterfactual, as mentioned before, it is assumed that Auckland would [.]
[.]

Under the counterfactual, it is also possible that the Council could have encouraged incumbent operators to expand. For instance, there has been a history of incumbents in Auckland to bid for contracts in their own regions rather than bid for tenders in other parts of Auckland. There could be a number of reasons for this like an implicit market-sharing arrangement between operators, although, there is no evidence of this, or it could be related to the location of their depot and the cost of expanding into other regions requires additional depots, or it could be the result of strategic entry barriers raised by large incumbents.⁶¹ The section below analyses barriers to entry in greater detail.

Barriers to entry

Where there are high barriers to entry this could discourage more bidders to participate in a tender. In June 2006, the High Court examined barriers to entry in the Wellington subsidised bus services market. It found that:

- Potential operators outside of the Wellington region are genuinely interested in entering the market.
- Bus contract sizes are too small and don't last long enough.
- Potential entrants preferred entry by acquisition of existing operators in Wellington, as it exploits existing infrastructure, skills and knowledge.
- Entry risks relate to knowledge of patronage, relationships with Greater Wellington and competitive risks from commercial registrations.
- Potential entrants would consider de novo entry.

Some of the above barriers (e.g. contract size, type and length, local patronage information) identified are related to the design of the tender and could be overcome by

⁶⁰ Auckland Regional Public Transport Plan 2010. ARTA, para 11.4b.

⁶¹ In New Zealand, regional councils operate a sealed bid auction process which means that a contract is awarded to lowest quality adjusted bid. This means that unlike an ascending auction there is no opportunity to signal, or retaliate against a bidder who fails to co-operate and collude. In a sealed bid auction, collusion is most likely to take place in the form of market sharing arrangement.

changes made by the regional council. As discussed above GWRC has reviewed its tendering process. Other barriers that are likely to deter potential entrants either from New Zealand or overseas (including those that have previously expressed an interest in entering) are:

- Accessing buses and hiring bus drivers.
- Access to affordable land for bus depots in larger centres.
- Incumbent response (strategic barriers).

These barriers are explored in greater detail below.

Accessing buses and drivers

In the Red Bus/Leopard Coachlines merger, and in the High Court Judgement of NZ Bus/Mana, accessing buses and hiring bus drivers was generally considered to be a low barrier to entry.⁶² There are two bus manufacturers in New Zealand, DesignLine and Kiwi Bus Builders. DesignLine in Ashburton has been one of the main manufacturers of buses commonly used by operators in New Zealand. However, Kiwi Bus Builders has expanded over the past four years. While they are based in Tauranga, due to increased demand, Kiwi Bus Builders established a facility in Christchurch in 2007. The facility now has 28 staff producing one vehicle every 12 days.

There is no reason to believe that the conclusions made in the previous Commission decision have changed. Further, the evidence of entry from CBS in 2003 suggests that access to buses and staff is not a significant barrier to entry.

Accessing depots

In the Wellington bus merger greater consideration was given to whether access to suitable land for bus depots was a barrier. However, the High Court in 2006 said that:

The evidence confirmed that suitable (and appropriately zoned) sites are available, although establishment of a depot or yard can take up to a year even where it is a permitted use under the District Plan. Provision must be made for security, and a full depot also requires fuelling, cleaning and maintenance facilities.

[]

Alternatively, access to depots was not identified as a barrier to entry for CBS when it entered the subsidised urban bus market in 2003. While its entry was unique in itself (the company was established by an ex-CEO of Red Bus) access to depots was not found to be an issue in the Commission's Red Bus/Leopard Coachlines merger.

The UK is still investigating whether or not access to depots is a barrier to entry in the local bus market. However, its current finding is that:

⁶² Trolley buses are not considered in this report as it mainly affects the Wellington subsidised bus market. They can be considered to be a separate product market. Trolley buses are restricted outside peak times because of the age, condition and frequency of breakdowns.

While depot access is likely to vary across the country, there is evidence to suggest that the ability to access depots on a small to medium scale (up to 50 buses) is likely to be easier than obtaining depot facilities on a more substantial scale. While it may be possible to compete on a small scale through the use of outstation and other parking facilities, to achieve substantial scale a depot is likely to be necessary.⁶³

It appears that access to land for depots is a barrier to entry but not one that is insurmountable. It is also likely to be a barrier to different degrees in each of the regions, for instance, in Auckland city access to land for a depot could be more difficult than in Christchurch.

Incumbent response

Potential bidders in the subsidised urban bus market could be deterred from participating because of strategic barriers raised by an incumbent. In 2004/5, 83% of tenders in Auckland and 88% of tenders were won by the incumbent, compared to 61% in Canterbury.

Incumbent operators can and do react to entry and expansion—although there could be a spectrum of responses. If the incumbent’s response is an aggressive one, and leads to a period of loss-making competition, this will represent a sunk cost of entry or expansion.

In this case, strategic barriers can be considered to be:

- **Use of commercial registrations.** As discussed in Section 5.1.1, in the past, in Auckland and Greater Wellington, incumbent operators have commercially registered single timetable services and then tendered for the remaining subsidised bus timetable. This practice has given incumbents advantages (financial and resource and network efficiencies) in tendering for the subsidised contracts making entry difficult. Even if entrants chose to enter, the scale of the remaining subsidised contracts are likely to be too small. The High Court in the NZ Bus/Mana merger stated that commercial registration of bus services were being “deployed tactfully”.
- **Scale advantages and network efficiencies.** The High Court said that a small entrant would not enter as it would be vulnerable to retaliation and that entry would only occur on a large scale or not at all. In the Red Bus/Leopard Coachlines merger, the Commission considered that there would be some cost advantages to bus operators from operating an integrated network of routes and that this would be a moderate barrier to entry.⁶⁴

It also appears that there are efficiencies in having a single operator on a route rather than one operator for a commercial timetabled service and another for the

⁶³ Barriers to entry and contestability working paper, Local Bus Services Market Investigation. Competition Commission, UK, para 68.

⁶⁴ Commerce Commission Decision 551: Red Bus Limited and Leopard Coachlines, 28 June 2005, para 175.

remaining services on that route. The SAHA study found that the advantages of having a single operator or having routes packages efficiently are:⁶⁵

- Cross utilisation of vehicles between related routes on the corridor.
- Reduced dead running.
- Staff rostering efficiency (reduced layover time).

The report also finds that the cost of running a bus service will increase accordingly with the number of operators servicing a related corridor.

- **Local knowledge and patronage information.** Knowledge of the ways of the regional council and the Ministry, and the community generally, is also useful to any public transport operator and is likely to be barrier to a potential entrant. A lack of important effective local management might make entry more risky, if a new entrant is unsure about the demand on a new route, features of the road and bus network, how to plan and manage services, etc, and hence unsure about how best to set its offering to serve that demand and/or compete with an incumbent operator. In turn, this might make entry more costly. This is likely to apply more to new entry rather than expansion by an existing operator in New Zealand.

The above evidence suggests that barriers to entry are likely to deter bidders participating, particularly in Auckland and Greater Wellington. It is the aggregate effect of the different types of barriers that are likely to have a significant effect rather than any one particular barrier.

5.3.2 Conclusion on competitive effects of tendering

In the past, the competitiveness of tendering subsidised bus contracts has been reduced in Auckland and Greater Wellington as result of a low number of bids. There are a number of reasons for the low number but there is evidence to suggest that tender design, barriers to entry and incumbent response could be the root of the problems.

While there are some barriers to entry that are likely to exist in the counterfactual and factual, in the counterfactual, GWRC have sought to improve their tender design, but the impact of these changes has been untested. It is possible that these changes could improve the competitive outcomes in Auckland and Greater Wellington and could achieve cost savings if the number of bidders increases.

For example, a report on competitive tendering in NZ bus contracts, suggest that cost savings could potentially be in the region of 15-20%, if there were more bidders participating. In Bay of Plenty, where there are a greater number of bidders participating, the Council feels that it is obtaining acceptably efficient market prices for its contracts and that the market has displayed the capacity and capability to deliver the required outputs.⁶⁶ For instance, in 2008, Bay of Plenty Regional Council (BOPRC) ran a tender in which Hamilton-based Go Bus's bid price was \$3 million less than other bidders

⁶⁵ Analysis of Commercial Registrations in Auckland with Addendums, 30 June 2008, Final Report prepared for the Ministry of Transport, SAHA International.

⁶⁶ Procurement Strategy Activities 2010. Bay of Plenty Regional Council.

including Bayline, which had built up the Tauranga urban bus service over the past seven years.⁶⁷

Other general evidence shows that in the UK, when public authorities moved to outsourcing the provision of goods and services, through competitive tendering, savings of 20%, on average were reported.⁶⁸ However, these estimates have been criticised as being inaccurate.⁶⁹ Actual savings vary according to the degree of efficiency prior to tendering, the intensity of competition, and the way in which council manages the process.

In the UK Local Bus Investigation, it was found that in 49% of cases in the tender sample of over 2,600 bus contracts, the price either stayed the same or reduced compared with the previous tender.⁷⁰ This provides mixed evidence regarding generalised upward cost pressure but shows that UK councils were effective in achieving price reductions.

5.3.3 Competitive effects of negotiated contracts

At present, subsidised contracts in New Zealand are awarded through a competitive tendering process (a sealed bid auction) and negotiations take place when there is only one bidder in the tender round. In addition, under current NZTA procurement guidelines, contracts can be negotiated and awarded by direct appointment if the value of the bus contract is less than or equal to \$100,000 (gross contract price per year).⁷¹

However, there has been some international literature and debate in the bus industry that competitive tendering for bus contracts can lead to negative outcomes and that in some cases it may be preferable to negotiate contracts.⁷² For example, some of this literature finds that over the last five years, in several cases, there have been real price increases, as much as 15%, in re-tendering processes in Adelaide and Perth. In all cases the previous prices were considered to be low relative to the efficient cost benchmark. In addition, in the UK, a consultation paper in 1999 highlighted that tenders could remove decision-making from operators making them less responsive to customers, inflexible and less incentivised to innovate.⁷³

⁶⁷ <http://www.bayofplentytimes.co.nz/local/news/hopper-buses-to-disappear-from-city/3792924/>

⁶⁸ Domberger, S., .Competitive Tendering and Contracting Out: Some Lessons from the UK Experience. in Competitive Tendering and Contracting Out: Towards a Policy Agenda., Graduate School of Business, University of Sydney.

⁶⁹ See Paddon and Thanki (eds), .Australia.s Contracting Public Services: Critical views of Contracting Out by the Public Sector., Public Sector Research Centre Collected Papers No.2, UNSW, 1995.

⁷⁰ Tendered services. Analysis of qualitative evidence from parties. Competition Commission. Local Bus Services Market Investigation.

⁷¹ NZ Transport Agency's Procurement Manual, First edition, effective from July 2009. Section 10.9.

⁷² This literature stems from Wallis, Bray and Webster (2010) which reviewed literature from Norheim (1999), Bray (2002), Auditor General Victoria (2005), Hensher and Wallis (2005), Houghton and Hensher (2005), Kain (2006), Economic and Policy Services Pty Ltd and Ian Wallis Associates Ltd (2007), Myers and Ashmore (2007), Bray and Wallis (2008), Hensher and Stanley (2008), Stanley and van de Velde (2008) and Walters and Cloete (2008).

⁷³ Buses: Quality Partnerships and Quality Contracts. Louise Butcher, July 2010.

Policy makers of PTOM consider that negotiated contracts are likely to be beneficial because they will:

- Provide operators with additional security to invest in public transport assets.
- Provide operators with the opportunity to participate more fully in developing the network.
- Potentially lower transaction costs for both regional councils and operators in negotiating a contract.
- Create a stable core of operators to maintain network integrity.
- Improve incentives to perform as high performance would be rewarded through use of negotiation and tenure.

In a review of bus services in NSW, Australia, the Institute of Transport Studies argued that there is a growing role for negotiated performance based contracts where the financial gains from re-tendering are small, the incumbents are already efficient suppliers, and there is a need to provide longer term incentives to grow patronage, invest in quality assets, and develop effective services in partnership with the government.⁷⁴

Myers and Ashmore (2007) suggest that it is possible to achieve value for money from negotiated contracts.⁷⁵ They state that negotiated contracts may sit alongside the “default” position of competitive tender. There are also substantial relationship benefits in pursuing a partnering approach with the industry. But this depends on trust in both directions; a lack of information (from industry) creates substantial suspicion in government.

One of the concerns with negotiating bus contracts is that it provides no benchmark with which to compare prices, quality and innovation. Negotiated contracts can deter entry from potential entrants in New Zealand or overseas and maintains a situation where there are incumbent advantages. This is particularly a concern, when as discussed in Section 5.3.1 Auckland and Greater Wellington have experienced a low number of bidders. Performance measures and league tables could be introduced into the negotiation process to act as a cost benchmark. This is considered in Section 6.

For the remainder of this section the concept of negotiating contracts is assessed by analysing:

- Examples of where bus contracts have been negotiated overseas and under what circumstances.
- The potential cost savings that could be achieved from negotiating contracts.
- Comments on the potential benefits of negotiated contracts identified under PTOM.

⁷⁴ Review of Bus Services in NSW, Final Report, February 2004.

⁷⁵ Myers, Jonathan and Ashmore, David “When to tender and when to negotiate? Why are we ignoring the elephants in the room?” Papers of the 10th International Conference on Competition and Ownership in Land Transport, Hamilton island 12-17 August, 2007.

International experience of negotiated contracts

There are a number of examples of bus contracts being negotiated overseas. There are examples, in Australia, in particular in Sydney, Perth, Melbourne and Adelaide, Europe and South Africa. Some examples are shown in the table below:

Table 3: Examples of negotiated bus contracts

Country	Examples of negotiated contracts
Australia-Melbourne	Department of Transport examined 18 operators and benchmarked the costs of the previous contracts against interstate contracts and negotiated cost reductions with 11 operators. Contract cost reductions resulting from this process were AUS\$1.3m pa, representing 0.3% of total annual contract costs. ⁷⁶ However, there were implementation problems with its benchmarking exercise.
Australia-Sydney	Until 2004, NSW Metropolitan contracts were negotiated with incumbent operators.
Australia-Adelaide	Contracts were negotiated as a result of increasing prices under tendering processes. Open-book negotiation approach was suggested to satisfy both parties to achieve efficient cost levels for the contract operations plus an allowance for a 'normal' profit margin.
South Africa	<p>Since 2001, no new tendered contracts have been entered into due to a dispute between the Department of Transport and industry participants concerning the tendering system that was allowed under the 1996 White Paper. As a result, a number of negotiated contracts were concluded.</p> <p>Walters and Cloete (2008), find that in South Africa the country is going through a learning phase with negotiated contracts, as each new contract appears to be more complex and the arrangements associated with such contracts, more elaborate.⁷⁷ The main objectives of negotiated contracts were to achieve a faster and more comprehensive transformation of at least the ownership of such companies e.g. there was a lack of capacity of some of the new entrants to operate at senior and executive management levels, as well as internal politics between the shareholders of such companies.</p>

⁷⁶ Victorian Auditor-General, Melbourne's New Bus Contracts, Report to Victorian Parliament, June 2009.

⁷⁷ Walters, Jackie and Cloete, D " The South African Experience with Negotiated Versus Competitive Tendered Bus Contracts, Transportation Research Part A: Policy and Practise, 42(9), 1163-1175.

Country	Examples of negotiated contracts
Nederlands-Amsterdam	<p>The authority awarded a net-cost contract for the management of the urban public transport network of Amsterdam directly to the municipal operator. The contract was awarded for the period 2006-2011 in direct award with a threat of a competitive tendering procedure if the existing municipal operator was not able to deliver a bid under market conformity.</p> <p>Monitoring controls the operation of the agreed number of timetable hours per route, punctuality, the number of realised planned connections, the occupancy rate and passenger satisfaction. A bonus/penalty system is in place, too.</p> <p>The contract was directly contracted to GVB, 100% owned by the Municipality. The awarding authority is the City Region for Amsterdam. The contract was awarded after a procedure where the GVB made a bid that was compared with a 'shadow bid' that had been prepared by the City region and kept secret until GVB issued their bid.</p>
United Kingdom	<p>Negotiated contracts used for de minimis contracts. For authorities with a total spend of less than £600,000, any individual subsidy contracts of less than £30,000 in any one year do not have to be tendered. For authorities with a spend of over £600,000 a year, up to 25% of contracts by value do not have to be tendered. The maximum length of a de minimis contract is 5 years. In Oxford, de minimis contracts are as low as £2,500 per year.</p>

From the above examples it seems that the circumstances in which bus contracts were negotiated differ. Further, in the UK study on public procurement of waste collection,⁷⁸ where 14% of contracts with private operators were negotiated, the OFT said that it is likely to be more appropriate to use restricted or negotiated procedures where bid costs for suppliers were high relative to the value of the contract, the service being procured was quite complex and bids were difficult and time-consuming to evaluate. The OFT also stated that an additional factor to consider was where there is an incumbent supplier, or a firm with a clear advantage, as it may benefit from, and therefore lobby for, a negotiated procedure.⁷⁹

In New Zealand, the Ministry of Economic Development (MED) guidelines produced last year, state that the government can use a direct approach to buy selectively from a specific supplier for higher-value, higher-risk procurements where there are special circumstances, for example:

- The agency needs highly specialist skills, or the contract involves very complex goods or services with a limited number of qualified suppliers.
- There's only one source and this can be verified.
- Only one supplier has the capacity to deliver on time and this can be verified.

⁷⁸ More competition, Less Waste, Office of Fair Trading, May 2006.

⁷⁹ Klemperer, Paul Bidding Markets, June 2005.

- A product or service needs to be compatible with existing equipment or services and the agency must use the same supplier.⁸⁰

In summary, evidence suggests that contracts are more likely to be negotiated if:

- Bids costs for suppliers are high relative to the value of the contract.
- The service being procured is complex.
- Bids are difficult and time-consuming to evaluate.
- Markets are mature and the financial gains from tendering are small.
- Incumbents are already efficient.
- Contracts are de minimis.
- Contracts contain performance measures which are benchmarked.

Each of the above conditions (with the exception of the last point) is assessed in relation to Auckland, Greater Wellington and Canterbury. The use of negotiated contracts with performance measures and benchmarking is considered in Section 6 under the overall assessment of PTOM.

Bid costs for suppliers

Bus operators bidding for bus contracts are likely to invest in time, effort and cost in preparing a bid. However, the costs would vary depending on the size of the tender and the geographic distance between the potential bidder and the incumbent in the region.

Another key feature that would affect the cost of preparing bids would be the type of contract. For example, gross contracts reduce the revenue risk to the bus operator as it does not need to incur the cost of estimating patronage and revenues. Evidence in New Zealand suggests that gross contracts have been a positive move.

The bids costs for suppliers are not necessarily high and are likely to represent a small percentage of the total contract value.⁸¹ For example, the NZ Bus/Mana High Court Judgement said that tendering costs are not particularly significant but they are asymmetric. An incumbent's costs were estimated to be about a third of a new entrant's. This seems plausible as a large incumbent is likely to be significantly experienced in participating in New Zealand tenders.

Complexity of service

The operation of a bus service is not overly complex. The procurement of bus services is based on price, quality of service and quality of vehicles and customer satisfaction. Councils are able to specify the requirements of the public service clearly and easily, with clear and simple performance measures and therefore compare the different offers from operators easily.

Complex purchases involve a number of different dimensions to procurement and the product or services cannot be standardized. This is likely to be the case with new products and services and with new technology. Services are also likely to be complex

⁸⁰ Supply NZ Government. A guide for suppliers on how to bid for government contracts. Ministry of Economic Development, July 2010.

⁸¹ The recent Hutt Valley contracts negotiated by GWRC had an estimated value of \$7.5 - \$10 million.

when information is incomplete and the buyer does not have a complete description of what ought to be done, and how the supplier should proceed in all future contingencies.⁸² Under these circumstances, the buyer cannot compare all the offers from suppliers on a like-for-like basis and may consider negotiating with a few credible suppliers. MED guidelines also suggest that direct approaches can be made where a contract involves very complex goods or services with a limited number of qualified suppliers.⁸³

Assessing bids

As mentioned above, regional councils in New Zealand have been running tenders for bus services for around twenty years. In 1989 the Local Government Reform Act, under which local authorities had to make transport companies into standalone businesses, or sell them, allowed regional councils to decide what public transport services were required and companies would tender to provide them. The Transit New Zealand Act established a requirement for services receiving public funding to be subject to competitive pricing.

Regional councils are likely to be experienced in running and assessing tender bids. Further, the costs of tendering are not significant and are likely to represent a small percentage of the subsidy payments made to bus operators. In 2008/09 regional councils paid an estimated \$203.5 million to bus and ferry operators. In relation to the cost of tendering, [

.] This suggests that regional councils should not be deterred from tendering because of the costs involved. However, it is recognised that under PTOM, the cost of assessing bids and running tenders could increase as the procurement process becomes complex with negotiated contracts and a smaller proportion of tenders taking place.

Maturity of markets

In New Zealand, between 1999/00-2008/9, the number of bus and ferry trips increased by 63% (from 63 million trips to 103 million trips).

At present, GWRC is targeting 50 million public transport trips per annum by 2016/17. The target will require patronage to increase at a rate of 4.7% per annum, which is significantly higher than the 3.3% it tracked in the past. In essence, this means that GWRC is looking to grow bus patronage. Similarly, Auckland has set a target for passenger transport usage in the Auckland region to increase from the current 52.4 million passenger boardings per year to 100 million per year by 2016. In addition, in Canterbury, the regional council in its strategy document stated that the number of people, particularly in Christchurch, using public passenger transport has increased steadily since 2001 and this is reflected with an increase in mode share.⁸⁴

⁸² Tadelis, Stephen and Bajari "Incentives and Award Procedure: Competitive Tendering vs Negotiations in Procurement." January 2006. The authors show a number of possible limitations to the use of competitive tendering. These may perform poorly when projects are complex, contractual design is incomplete and there are few available bidders.

⁸³ Supply NZ Government. A guide for suppliers on how to bid for government contracts. Ministry of Economic Development, July 2010.

⁸⁴ Canterbury Regional Land Transport Strategy. 2008-2018.

The evidence suggests that bus services in New Zealand are not mature, and there is scope for entry and for patronage to grow in the future.

Efficiency of operators

A benchmarking study found that on average, the gross prices paid by GWRC for contracted diesel bus services in Wellington were substantially lower than the equivalent prices in Auckland, but significantly higher than in Canterbury and Otago. This suggests that there are opportunities for modest but significant efficiency savings.

However, there is no clear evidence on the efficiencies of all the bus operators in New Zealand. While a LEK study found that the difference in operating costs between New Zealand and Australia is small, little information is made available to councils to explore this in depth.⁸⁵

De minimis contracts

Although competitive tendering is seen as the most efficient way of choosing between operators, the administration costs could outweigh low value contracts. In such circumstances, it is likely to be more effective to negotiate. De minimis contracts are applied in the UK, although there is a concern in the way in which those contracts are being used. In New Zealand, the NZTA procurement manual states that de minimis contracts are allowed if the value of the contract is less than \$100,000.

Low value contracts may exist for a variety of reasons e.g. low demand that would attract only one bidder, new service, emergency service or minor service alterations. In the UK, de minimis contracts have also been used to successfully patch up networks after commercial de-registrations.

5.3.4 Conclusion on competitive effects of negotiation

International examples of negotiated bus contracts suggest that they have been implemented in different circumstances, which include:

- Bids costs for suppliers are high relative to the value of the contract.
- The services being procured is complex.
- Bids are difficult and time-consuming to evaluate.
- Markets are mature.
- Incumbents are already efficient.
- De minimis contracts.

However, there is some evidence to suggest that none of those conditions hold in New Zealand in the provision of bus services in Auckland, Greater Wellington and Canterbury. While there is evidence to suggest that the gross prices paid by Canterbury are lower suggesting that incumbents could potentially be efficient, given it has more bidders in tenders than Auckland and Greater Wellington, it does present a strong case for negotiating contracts.

⁸⁵ Procurement Review, NZ Government Department Update, LEK Consulting, March 2006.

Therefore, there are doubts as to whether negotiated contracts would be beneficial. Alternatively, if any of the above conditions were to arise, negotiating contracts for a short period of time could be an option.

There is also limited evidence and even mixed evidence on the cost savings that could be achieved in negotiating contracts compared to the cost savings that could be achieved under competitive tendering. A concern could be the desire to achieve short term savings at the expense of long term gains where there is entry in a competitive tendering process.

In Wellington, 97% of GWRC tenders had only one bidder and in these circumstances GRWC had to negotiate the contract with the single bidder. The fact that prices have been lower where there have more bidders compared to one bidder, suggests that not only does the tender design need to be assessed to increase bidder participation but the negotiation of contracts have not been able to achieve the same costs savings as tendered contracts. On the other hand, last year, NZ Bus registered two core Hutt Valley routes (that were previously subsidised) as commercial services. GWRC and the bus operator negotiated the remaining non-registered services in the Hutt valley, as an alternative to going to tender in the face of the two significant registrations. The agreement was for 3-4 years and guaranteed existing service levels, but provided NZ Bus greater flexibility to improve services. As a result of the negotiation, GWRC was able to save around \$2.5 million in subsidy payments.⁸⁶ However, this occurred at the expense of a tender round for those contracts, which was what was originally planned until NZ Bus commercially registered two of the bus routes.

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In Melbourne, the Government negotiated contracts with 11 out of the 18 operators by conducting a benchmarking exercise.⁸⁷ However, the Department of Transport made modest cost reductions. It reduced contract costs by about \$1.3 million, or 0.3% of the typical annual costs of \$400 million. However, it is possible that greater savings could have been achieved had the Department conducted its benchmarking exercise effectively.

Comments on possible benefits of negotiation

Policymakers of PTOM identified some possible benefits of negotiating bus contracts. Those benefits are shown in the table below along with some comments as to whether they could be achieved.

⁸⁶ <http://www.valleyflyer.co.nz/news-and-events/media-release.php?id=72>

⁸⁷ Victorian Auditor-General, Melbourne's New Bus Contracts, Report to Victorian Parliament, June 2009.

Table 4: Comments on negotiated contracts under PTOM

Possible benefit of PTOM	Comments
Provide operators with additional security to invest in public transport assets	Not an argument for a negotiated contracts as it should be addressed in the length of contract
Provide operators with the opportunity to participate more fully in developing the network	<p>Negotiated contracts may not necessarily help with improving the network. The introduction of units should help in the first instance in improving the network.</p> <p>The operation of delivering bus services is distinct from bus planning and so it would be better to promote partnerships in bus planning. This could be achieved by:</p> <ul style="list-style-type: none"> • Consulting bus operators • Setting up local forums • Establishing a code of conduct <p>One option is to have tendered contracts for networks</p>
Potentially lower transaction costs for both regional councils and operators in negotiating a contract	<p>Debatable as it depends on how long negotiations could take. The council could end up tendering if no agreement is made.</p> <p>The cost of negotiating contracts will depend on the ability and knowledge of the council. The more experienced it is, the more likely that it will be able to complete the negotiation process easily and successfully. However the less experienced it is the less likely it will be able to handle tough negotiations. It is possible that lengthy disputes could occur, creating a period of uncertainty.</p>
Stable core of operators to maintain network integrity.	Should require all operators to this make it part of their contractual requirement. De minimis contracts could be used to appoint an emergency operator until a tender is arranged.
Improve incentive to perform (high performance rewarded through use of negotiation and tenure)	<p>Performance measures can be used in tendered contracts and in negotiated contracts, therefore it is unclear why negotiated contracts will provide stronger incentives-assuming the same incentives apply. The extent to which performance is increased will depend on the incentives. Examples of incentives are:</p> <ul style="list-style-type: none"> • Financial incentives • Extending contract length • Negotiating contract for a short period of time

5.3.5 Conclusion on tendering versus negotiation

The table below provides a summary comparison of the competition effects of tendering versus the competition effects of negotiation.

Table 5: Comparison of tenders vs negotiation

Potential competition effects	Tenders	Negotiated Contracts
Impact on current operators	<ul style="list-style-type: none"> Unlikely to be any immediate impact but means that they will need to tender for future contracts 	<ul style="list-style-type: none"> Where there are incumbents opportunity for gaming based on incumbency advantages
Impact on potential operators	<ul style="list-style-type: none"> Cost of participating in tender Accountable to delivering low cost, high quality services 	<ul style="list-style-type: none"> Cost of negotiating a contract Opportunity to be creative on contract design-have a more complex offering Less transparent process, could lead to uncertainty
Impact on regional councils buyer power	<ul style="list-style-type: none"> Can change tender design to promote more competition in the bidding process Exercise buyer power on price and non-price competition Cost of running tender and evaluating bids Cost of monitoring the contract 	<ul style="list-style-type: none"> Needs capability to be effective negotiator-this will determine the cost of negotiations e.g. inexperienced council could increase cost of negotiating Needs to be well informed purchaser to be an effective negotiator-need benchmark comparison Effective if contract is complex and incomplete, markets are mature, bus operators are efficient Cost of monitoring the contract

Competitive tendering processes can deliver value for money, as they allow for qualified bidders to participate to, offer high quality bus services at the lowest cost. In order to reap the benefits of a competitive processes, they be must be designed so as not to create artificial barriers to entry to potential bidders. The competitive tensions will deliver better outcomes. Bulow and Klemplerer (1996) show that under certain conditions, allocating products through a bidding process will yield a seller greater revenue than if they were allocated through a negotiation process.⁸⁸

⁸⁸ Bulow, Jeremy and Klemperer, Paul Auctions Versus Negotiation The American Economic Review, Vol. 86, No. 1. (Mar., 1996), pp. 180-194.

In short, in the Auckland, Canterbury and Greater Wellington subsidised bus markets, under the counterfactual there would continue to be two sources of competitive constraints, one from the regional council and the second from other potential bidders. In the counterfactual, some changes to the tendering processes have been made by regional councils but their impact on competition is untested. It is possible that they could have positive effects on competition, although this could take some time. Further, past merger decisions have found regional councils not to maximise their bargaining strength which suggests that their competitive constraint could be stronger in the counterfactual.

Under the factual, negotiating bus contracts means that there is only one source of constraint which is the regional councils. But this is not currently strong, mainly as a result of its reliance on an incumbent operator. In Auckland, it was noted that the value from contract negotiation was questionable following single bids. This was evident in 4 of 10 tenders in the North Shore held five years ago and on 80% of tenders held in 2003.⁸⁹

In conclusion, there is a concern that negotiated contracts in the factual are likely to reduce competition compared to the counterfactual. The interaction of negotiated contracts, tendered contracts combined with exclusivity and length of a contract are considered in Section 6.1.

5.4 Length of the contract

PTOM proposes to extend the length of future bus contracts. Longer contracts are being proposed because it is important for operators, both incumbents and new entrants, to recoup their investment over a reasonable time period. Under PTOM initial contracts are yet to be decided but could be in the order of 9-12 years with opportunities for tenure to be extended if performance targets are met. Negotiated contracts awarded as a transition from commercial registrations to units are expected to be for 12 years.

A balance is needed in having the timeframe of a bus contract which allows the operator to invest for a sufficient period of time but also allows the opportunity for new entry to occur as incumbents can become slack over a long period of time. OFT guidelines state that an overly strong focus on price in public tenders may discourage innovation because bidders might not be able to recoup their investments. At the same time, significant public sector demand can be used to provide incentives for investment and innovation, not least to ensure that capacity in the long-term meets the public's demand.

Smith and Merrett (2007) state that while too short a contract may confer an incumbency advantage, so too may a contract that is excessively long.⁹⁰ The period of exclusivity justifies investment in the specialised assets necessary to supply the market, however, over a long term contract, unsuccessful bidders may exit adjacent geographic markets and so there will be little or no competition for the contract in the future. Whether this happens depends on the height of barriers to entry or re-entry into the subject market and whether the unsuccessful firms operate in other adjacent markets and can easily

⁸⁹ Public Transport Procurement Legislation Review, Consultation Document-May 2006. Auckland Sustainable Cities Programme, p21.

⁹⁰ Smith, Rhonda and Merrett, Alexandra, "Auctions, Exclusive contracts and competition for the market", European Competition Journal, June 2007 p180.

expand from these. Their paper finds that the longer the contract period the greater the degree of uncertainty about the market in light of possible future developments in technology and changes in demand. Such uncertainty may also deter bidders and confer incumbency advantages in subsequent tenders.

A European study found the following factors to influence the length of a public transport contract:⁹¹

- The amortisation period of the investment (in vehicles and/or infrastructures) made by the transport operator under contract to reduce the investment risk.
- The extent to which the operator has service design freedom and is submitted to revenue risk. A longer contractual period may be needed to allow the operator to develop market actions that will influence patronage.

The subsequent sections analyse the length of bus contracts in New Zealand and overseas.

5.4.1 Current length of contracts in NZ

At present, commercial registrations do not have a fixed period of time. Subsidised contracts have ranged from 3, 6 or 9 years. For instance, in the Red Bus/Leopard Coachlines merger, Environment Canterbury's subsidised contracts ranged from 18 months to 5 years. The High Court Judgement found that in Greater Wellington contracts were for a maximum term of 5 years, or up to 8 years if rolled over. Contracts were less than 5 years when GWRC was unsure of service viability or when they were trying to align contract expiry dates. The High Court Judgement states that:

*Potential entrants generally preferred contracts that ranged variously between five and 10 years, but I do not find that this is a significant constraint... the present maximum term seems to be adequate to address the preferences of most potential tenderers.*⁹²

GWRC planned to introduce 8 year contracts plus provision for an additional 4 year term based on satisfactory performance against agreed renewal benchmarks. GWRC states that based on research conducted on behalf of NZTA and the findings of the High Court it chose to extend the contract length to encourage entry.

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In December 2009, Environment Waikato tendered bus contracts for 8 years (4 plus 4). In 2008, BOPRC issued a contract for a five-and-a-half year contract, which was worth nearly \$7.5 million.

⁹¹ Contracting in urban public transport, 2008.

⁹² Commerce Commission v New Zealand Bus Limited HC WN CIV 2006-485-585 [29 June 2006] para 164.

5.4.2 International experience

In Europe, contracts for the provision of public transport services often have a duration of (roughly) 4 to 10 years for those contracts requiring no investments from the operators or only investments in vehicles that have a relatively short amortisation period or are easier to trade (such as buses).⁹³ Other specific examples of contract length are highlighted in the table below.

Table 6: Examples on the length of contracts

Country	Example of length of contract
Australia-NSW	<p>Suggestions in respect of a suitable contract term were generally around the 10 year mark. The Review acknowledged that there is a case for a contract period of longer than 5 years, particularly where operators continue to own the assets. However, it was important to ensure that performance and contract terms are able to be reviewed at a suitable midway point, so that there is opportunity to terminate should this be necessary, or to extend on the basis of satisfactory or good performance.</p> <p>5 year contracts, and the opportunity to extend for 2 to 5 years (subject to satisfactory performance),</p>
South Africa	<p>In South Africa contracts were initially for five years, but extended to seven years in later amendments to the NLTTA.</p>
United Kingdom	<p>In the UK, TfL, awards tenders for contracts that are normally 5 years, with a potential 2 year performance related extension available to the operator.</p>

5.4.3 Conclusion on length of contracts

The table below provides an assessment of the potential competition impact of extending the length of bus contracts to a worst case scenario of 12 years.

Table 7: Competition impact of extended contract length

Potential competition effects	Impact of extended length of contract
Impact on current operators	<ul style="list-style-type: none"> • Benefit from additional time to invest in assets e.g. bus depots, buses • Benefit from additional time to innovate e.g. ticketing system

⁹³ Contracting in urban public transport, 2008.

Potential competition effects	Impact of extended length of contract
	<ul style="list-style-type: none"> • Longer period to reap benefits of economies of scale and scope • Benefit from incumbency advantages e.g. local knowledge
Impact on potential operators	<ul style="list-style-type: none"> • Could deter entry of new entrants-depends on the ease at which they can expand into other markets, and the frequency of tenders • Could encourage large scale entry
Impact on regional councils buyer power	<ul style="list-style-type: none"> • Could create incumbency advantages and regional councils will have to use its buyer power to facilitate new entry • Long contracts could create uncertainty for it to respond to any short to medium term changes in the market

There is a possibility that a long length of the contract could deter potential entrants in the long-term. This is particularly important in Auckland and Greater Wellington where there is a need for entry and where potential entrants have expressed an interest. While there is a need to have a contract length of sufficient time to allow investment in buses and possibly land for depots, as discussed before, these individually do not seem to be significant barriers to entry and could be addressed in tender lead times.

It appears that the maximum length of 5 plus 2 years could be more than sufficient to allow for this investment to take place. For example, compared to overseas experience, standards contract are around 7 years maximum. Further, the bus fleets in Canterbury average 7.7 years of age while buses in Auckland and Greater Wellington average 9 years of age.⁹⁴

Finally, it should be noted that good performance can be rewarded in different ways. This should be explored further rather than extending the length of the contract to 12 years, at the expense of future entry.

5.5 Performance based contracts

Under PTOM, all units will be subject to a performance-based contract. It is proposed that with commercial units, the delivery of those services will be subject to minimum quality requirements (such as vehicle standards, on-time running) to ensure a consistent service is provided across the region's network. With subsidised units, it is proposed that the contract will contain additional performance requirements linked to growing commerciality and patronage, reducing subsidies and providing meaningful incentives and penalties.

⁹⁴ Public Transport Procurement Legislation Review, Consultation Document-May 2006. Auckland Sustainable Cities Programme, p48.

In economics, the principal–agent problem treats the difficulties that arise when a principal, (the regional council) hires an agent (the bus operator), but there is incomplete or asymmetric information, in aligning their interests. Various mechanisms may be used to try to align the interests of the agent in solidarity with those of the principal, one of which is performance measurement.

Performance measures can be used to:

- Strengthen the countervailing power of the purchaser awarding the contract. For instance, by monitoring the terms and conditions of the contract, the purchaser can ensure that throughout the life of the contract, price and quality of service could be improved.
- Encourage entry from potential operators. In a tender process, bidders that are able to perform to high standards will be incentivised to take part in a procurement process.

However, if performance measures are not introduced and applied appropriately, it can affect their ability to improve competition. Successful performance measures should follow the SMART criteria. That is:

- Each measure has a **S**pecific purpose for the business.
- It is **M**easurable to really get a value of the performance indicator. It should also be easy to collect the relevant data.
- The defined norms have to be **A**chievable. The awarded contract must be monitored to ensure that the supplier meets its targets.
- The improvement of the performance has to be **R**elevant.
- It must be **T**ime phased, which means the value or outcomes are shown for a predefined and relevant period.

In this section, the following is assessed:

- Benefits of contracts with performance measures.
- What lessons can be learnt if they are not implemented successfully.
- What is required to effectively monitor performance measures.
- Rewarding and punishing performance.

5.5.1 Benefits of performance measures

Using performance measures in bus contracts can help improve competition as it allows the regional council to provide bus operators with incentives to improve services and reach desired outcomes, which under PTOM, is lower bus subsidy payments and increased patronage. For example, a UK study evaluating merger decisions concluded that buyers can seek to exert buyer power through providing suppliers with incentives to deliver low prices and a high quality of service.⁹⁵ This can be achieved by:

⁹⁵ Ex post evaluation of mergers, A report prepared for the Office of Fair Trading, Department of Trade and Industry and the Competition Commission by PricewaterhouseCoopers LLP. March 2005.

- Designing contracts that force suppliers to reveal information about their costs.
- Rewarding good performance and penalising poor performance.
- Designing tenders that minimise the scope for collusion.

The report analysed various case studies and found that buyer power remained strong when incentives were included into the contract, despite a shortage of credible bidders. For instance, in a rail catering case,⁹⁶ a series of incentives were built into the contracts to reward the provision of good service. This was backed with open-book accounting and rail passenger surveys to monitor compliance.⁹⁷ In another example⁹⁸, TfL redesigned contracts so that bus companies no longer had to take any revenue risk but were instead rewarded for meeting a number of quality standards. Bids were based on quality, reliability of service and price. This meant that few bus companies were capable of bidding for the new quality incentive contract, although it helped improve the benefits to TfL and, ultimately, the customer.

In New Zealand, stronger performance measures are being introduced in subsidised bus contracts, although these have been in conjunction with a certain type of contract, namely gross cost plus contracts.⁹⁹ However in the factual, under PTOM minimum performance measures will also apply to commercial routes.

With the exception of Otago, most of the regional councils in New Zealand have phased in subsidised gross cost plus contracts that contain performance measures. In Auckland and Greater Wellington the introduction of gross contracts with performance incentives has yet to be tested. However, evidence from regional councils in Canterbury, Waikato and Bay of Plenty suggest that there have been some positive effects.

- GWRC in its 2009 Procurement Strategy aims to progressively introduce gross contracts with performance incentives and contract payment deduction mechanisms related to reliability and other input measures for service quality. It also states that patronage based incentives will also be used.
- Auckland's RTP states that, in terms of procurement, it will aim to have appropriate incentives to private sector operators by ensuring that rewards are commensurate with the degree of risk taken.
- Canterbury moved to gross contracts in 2009 and has considered it to be successful.

⁹⁶ Compass/Rail Gourmet (2002).

⁹⁷ There are positive and negative effects of using open book accounting. While it can provide a useful comparison of costs, there are a number of different ways in which costs can be accounted and there is also the issue of sharing commercially sensitive information.

⁹⁸ Cowie/British Bus Group merger in 1997.

⁹⁹ Gross cost plus are contracts with performance incentives. It is when the bus operator is incentivised to increase patronage by improving service and being rewarded for it. The operator does not keep any of the fare receipts. Such contracts are favoured by new entrants as this eliminates the need to have patronage and revenue information. Net contracts, on the other hand, means that the bus operator keeps the fare receipts and so has an incentive to increase patronage to increase its revenue. Net contracts tend to be favoured by incumbents.

- BOPRC recent tenders have included performance measures based on service reliability, service punctuality, patronage, reporting timeliness, service inputs, farebox revenue, customer satisfaction, passenger facilities (on bus), safety and security, contract conformance with fleet composition, and complaints.
- In Waikato, gross contracts were introduced in 2005/06 and the Council considered it to be a successful move. Now contracts are being awarded with incentive payments for service reliability, quality control, driver quality and customer service. Gross contracts have meant that the Council had a direct hand in achieving their targets and objectives.

Gross cost plus contracts have also been used internationally and in the rail sector. For example, in Germany, in the state of Berlin and Brandenburg, prior to 2004, there were three net contracts that awarded by negotiation.¹⁰⁰ After 2004, the Government moved to gross contracts that included customer satisfaction incentives. The result was significant cost reductions (10-40%), increased performance and better monitor on quality.

5.5.2 Implementation problems

If performance measures are not successfully implemented into the design of a contract, then the chances of achieving a competitive outcome are reduced. Australia introduced performance based contracts, although in some cases, they were not introduced effectively and have not delivered the desired results.

Case Study: NSW Metropolitan Bus Services

In Sydney, following a review, Metropolitan Bus Service Contracts were introduced in 2005 worth AUS\$5.6 billion over 7 years. The contracts included performance measures. Last year, the Audit Office of New South Wales assessed how effectively New South Wales Transport and Infrastructure (NSWTI) was managing the performance of those contracts. In particular, it investigated whether:

- There were clear performance objectives
- Operator's performance was closely monitored
- Performance information was accurate and timely
- Action was taken to address any deficiencies

The Audit Office found that:

- Performance measures were still being developed four years after the bus contracts came into effect and that it remained unproven as a basis for ensuring value for money.
- Bus services were not always reliable
- There were wide variations in service levels, with services in privately operated areas likely to be less frequent and less accessible
- New bus contracts were directly negotiated with existing operators, using a cost and profit benchmarking process, in the absence of an open competitive tender.

The Audit Office recommended that NSWTI specifies a range of performance objectives for each contract region (e.g. cost per passenger kilometre, service quality and accessibility) with a clear

¹⁰⁰ Dr Alexander West "Gross-cost incentive contracts-an innovative instrument for financing local and regional railways", Centre of Public Transport and Quality Management, Dresden, VBB Verkehrsverbund Berlin-Brandenburg GmbH, 26 November 2010.

5.5.3 Monitoring and enforcement of contract

In the factual and in the counterfactual, when awarding contracts with performance measures, during the contract period the regional council will have to verify, whether the operator respects the conditions of the contract it has agreed upon. This involves the regional council monitoring those conditions and gathering data on a regular basis.

In case the operator does not fulfill the obligations of the contract it will be necessary to prove where and to what extent the service agreed upon was delivered or not. Regional councils should collect at least the most essential information from independent sources. Alternatively, they will have to monitor the supply of information by the operator and if necessary, force the operator to provide the requested information. The regional council needs to be competent enough to interpret the relevant data. As some of the gathered data will form the basis of rewarding good performance, the operator has an interest in ensuring the regional council has the correct data to make its assessment.

In the factual, it is possible that NZTA could assist councils in establishing performance measures and league tables as well as assist in monitoring and enforcing performance incentives. NZTA is quite active in this area but in a broader scope. For example NZTA's current performance measurement and monitoring framework is used to:

- Provide evidence of value for money in procurement.
- Provide measures other than price to support procurement decisions.
- Monitor the competitiveness of the supplier markets.
- Benchmark and monitor the effectiveness of procurement across the sector.
- Bring continuous improvement through:
 - improving capability and capacity in approved organizations.
 - providing a health check as part of a continuous improvement programme.
 - sharing best practice information across the sector.

Smith and Merrett (2007) state that once the exclusive contract is awarded there are issues relating to the enforcement of the conditions outlined in the contract.¹⁰¹ There are:

- Monitoring compliance costs.
- Costs in terminating a contract and engaging in another tender process
- The political embarrassment of voiding or renegotiating a contract for non-performance
- The risk of non-supply during a period of dispute over supply conditions.

GWRC in its move to gross contracts with performance incentives recognised that they would need to develop the capability to carry out contracting, understand performance management and implement administration processes. GWRC stated that the required changes to cope with this approach should not be underestimated.

¹⁰¹ Smith, Rhonda and Merrett, Alexandra, "Auctions, Exclusive contracts and competition for the market", European Competition Journal, June 2007 p180.

In the UK, in 2001, TfL introduced Quality Incentive Contracts to replace gross and net contracts. The contracts include direct financial incentives for improving the quality of the service. TfL monitors these contracts in the following manner:

- The “Quality Incentive” contract payments are based on a monitoring regime that primarily measures the reliability of the buses. The contract dedicates a whole section to reliability. It states for example at which location and what frequency monitoring will take place.
- Customer Satisfaction Surveys are carried out, measuring waiting time and riding, driving standard, cleanliness, information at bus stops, etc.
- Other monitoring mechanisms include: Mystery Travellers, driving standards reporting, accident & incident reporting, environmental reporting etc.
- Operator league tables are published for reliability and excess wait time. Other quality indicators are reported at network level only.
- Presently monitoring is undertaken manually, with a hand held device. However, TfL is in the process of introducing GPS in the future. This tracking system would have additional benefits, such as passenger information.

The number of bus services in London, provided under the Quality Incentive Contracts scheme has increased.¹⁰² These contracts, combined with improved route control, bus priority and enforcement and the effects of congestion charging, led to a marked improvement in service reliability. Consequently, in 2004/05 the number of passenger journeys increased by 40% since 1999/2000, the highest since 1965. More bus kilometres were run and services were more frequent. Further, 95% of the network now runs accessible buses. All these factors have led to greater passenger satisfaction in London.

5.5.4 Rewarding and punishing performance

So far in this section, we assessed the benefits of performance measures, how to implement them successfully and how to monitor them. In the remainder of this section, we discuss the different ways in which good performance can be rewarded and how poor performance can be punished. Such incentives need to be carefully structured so that they achieve the outcomes required and are strong enough to encourage operators to improve the operation of their bus service.

Under PTOM, it is proposed that good performance would be rewarded by a contract extension. This could act as a positive incentive, however, this could be offset if the contract extension is too long. Under PTOM contracts could be extended for a long period of time. In London, under the terms of the contract, a bus operator is entitled to an automatic 2 year extension of the contract if it meets or exceeds the reliability “Extension Threshold” criteria. Where a route qualifies for an extension, it is offered on the basis of the current contract provisions.

¹⁰² <http://www.tfl.gov.uk/corporate/about-tfl/investorrelations/4444.aspx>

There are other ways of rewarding and punishing performance. These can include financial incentives. Under PTOM, a revenue sharing mechanism between the council and the operator is being considered. Although, it is noted that the Minister of Transport has effectively capped the Government's contribution to public transport for the next three years. Therefore, financial incentives could be funded from increases in revenue from patronage growth e.g. allow bus operators to take a percentage of the revenue growth in patronage, namely, if they achieve a certain commerciality ratio. For instance, in Melbourne, bus operators are rewarded with a payment of 50¢ per additional passenger if the annual growth in route patronage exceeds 2 per cent. There are no penalties if patronage falls.

Other examples of financial incentive payments used in bus contracts are shown in the box below.

Case Study: Financial Performance incentives

- In London, the TfL awards performance payments based on the reliability of the service. Bonus payments are paid at a rate of 1.5% of the contract price for each step above the standard. Deductions are made at a rate of 1% of the contract price for each step below the standard. Bonus and deduction payments are capped at 15% and 10% respectively of the contract price. This financial incentive appears to be attractive to operators, for instance, Go-Ahead Bus Group states that its London bus operations rank consistently high in the TfL performance league tables, resulting in bonus payments of £14.2m in 2009 and £13.7m in 2008.
- A tender held in 2009 by Environment Waikato included incentive payments based on the annual customer satisfaction rating obtained by quarterly survey's undertaken by a contractor engaged by the council to undertake a professional Mystery Shopper independent review of the services. Incentives were paid for exceeding service standards, based on a % payment of total gross contract value. A total combined incentive payment of 5% of the gross contract value was available. The incentive was designed so customers experience high levels of customer satisfaction via service reliability, quality and comfort and driver quality.
- In India, Indore City Transport Services Limited (ICTSL) was set up in 2005 to operate and manage the public transport system. ICTSL entered into public private partnership with private bus operators. Each private operator entered into a common framework of revenue sharing and other specified terms and conditions. Besides getting a share of the revenue from the passes and advertising, the private operators keep their daily fare collection.

5.5.5 Conclusion on performance measures

The table below provides a competition assessment of introducing performance measures into bus contracts. It shows the impact that it could have on existing operators, potential operators and regional councils.

Table 8: Competition impact of performance based contract

Potential competition effects	Performance based contract
Impact on current operators	<ul style="list-style-type: none"> • Must improve performance • Scope to be rewarded/punished for good/poor performance • Cost of collecting and storing performance data e.g. cost of conducting regular customer satisfaction surveys • Cost of reporting performance information to regional council
Impact on potential operators	<ul style="list-style-type: none"> • Maybe few credible operators that are qualified to bid • Will need to have resources in place to meet performance targets
Impact on regional councils buyer power	<ul style="list-style-type: none"> • Buyer power increases if performance measures are SMART. The council is able to exercise buyer power if quality/reliability of service is reduced • If implementation is unsuccessful it can reduce the regional council's buyer power e.g. if no data is available or it is incorrect the council's ability to reward/punish would be affected • Cost of developing capability in monitoring and enforcements • Cost of collecting and analysing data • Cost of dealing with poor performance e.g. service disruptions, disputes

Performance measures can help improve competition by increasing the buyer power of the regional council and or encouraging entry through gross contracts with incentives. However if the incentives in the contract are not designed effectively they will not achieve the desired outcomes, which in this case is to improve bus services levels, reduce costs and increase patronage. In order for performance measures to be pro-competitive, they must fulfil the following requirements:

- Clear performance objectives.
- Operator's performance must be closely monitored.
- Performance information must be accurate and timely.
- Action must be taken to address any deficiencies in performance or to reward improvements in performance.

Performance measures are likely to exist in the counterfactual but to a greater degree in the factual, where it is likely to be included in negotiated commercial units. Performance measures will also play a vital role in developing a benchmarking scheme for negotiated

contracts. The impact of performance measures in negotiated contracts is considered on greater detail in Section 6.

5.6 Benchmarking of units

Under PTOM all units performance will be compared using a 'league table' to provide some post tender/negotiation competitive tension between operators. Units will be compared according to the performance measures outlined in contracts.

Under PTOM, it is proposed that a benchmarking system would be introduced. This would include a league table with both cost comparisons which would assist in negotiating price with incumbent operators, as well as service performance comparisons.

In assessing the competition impact of benchmarking the devil will be in the detail. That is, what financial and non-financial performance measures will be included, as they need to be credible comparators that will incentivise bus operators. It will be necessary to have performance measures that measure the outcomes regional councils want to achieve.

More importantly, the type of reward and punishment strategy for good and poor performance will affect the success of benchmarking and its ability to provide a competitive constraint to bus operators. For example, rewarding good performance by extending the length of the contract may result in hindering new entry but strong financial incentives may encourage operators to perform well and participate in the benchmarking process.

Comparative performance assessments, are often undertaken by regulators of utilities, and are designed to emulate a competitive market. If one market leader innovates using advances in technology, competitors attempt to catch up. Theory suggests that any target (relating to yardstick competition or otherwise) that is credible and achievable should be sufficient to incentivise firms to meet or outperform it, if the company retains a positive share of savings made beyond the target.

This section assesses:

- Examples of benchmarking bus services and the impact they have had.
- The potential costs and benefits of benchmarking.

5.6.1 Examples of benchmarking bus services

In Australia, the benchmarking of NSW Metropolitan bus services was found to be poorly implemented. The Audit Office which reviewed the contracts found that a lack of performance information prevented New South Wales Transport and Infrastructure (NSWTI) from undertaking any comprehensive analysis of the performance of bus services. It stated that NSWTI relied on the bus operators self-reporting using their own existing systems to collect and report on operational and performance data. This carried a risk of unreliability and inaccuracy. The Audit Office recommended that NSWTI:

- Comprehensively benchmark performance to hold bus operators accountable, with penalties for poor performance strengthening controls on operator self reporting to ensure that performance information is accurate publicly reporting operator performance by route and by region.
- Conducting more frequent bus customer satisfaction and usage surveys, including the use of Mystery Shoppers.

In India, the Government has advised all cities covered by the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) to benchmark public transport in a city.¹⁰³ Detailed indicators have been developed to assess the level of service which involves indicators like presence of organised public transport system, its availability, bus route network density, service frequency, level of comfort and percentage fleet as per urban specifications. The indicators are used to indicate how good or poor, the public transport system of a city is, and is monitored by urban local bodies or the development authority.

The challenges the authority faces are the need to develop enormous capacity to implement the benchmarking process, which involves having the processes and systems to gather and evaluate the information and training staff in every aspect starting from data formats, survey and collection of data.

In the UK, TfL has bus operator league tables.¹⁰⁴ The league tables show how operators have been performing against a number of measures (e.g. frequency, mileage). There's also a network average for further comparisons. Quarterly reports are distributed internally, as well as to operators. The reports give operators the data to measure performance against their own track record and that of other bus companies. The data comes from electronic systems that hold bus mileage by day and route.

A 2006 report on the international bus benchmarking system found that:¹⁰⁵

- Almost all organisations measure the degree to which the actual service they operated conforms to the scheduled service, both in terms of the vehicle km operated (reliability) and the on-time performance (punctuality).
- Common indicators included reliability and availability of the fleet as well as the proportion of the fleet used in the peak hour.
- Some bus organisations recorded a high number of financial performance measures, while others have comparatively few, in one case measuring only revenue performance and not measuring internal cost performance at all.

¹⁰³ Benchmarking Urban Transport in Cities, Fact Sheet, Centre for Science and Environment.

¹⁰⁴ <http://www.tfl.gov.uk/businessandpartners/busoperators/1232.aspx>

¹⁰⁵ Randall, E., Condry, B., Trompet, M. (2006), International Bus System Benchmarking: Performance Measurement Development, Challenges, and Lessons Learned, Transportation Research Board 86th Annual Meeting, January 2007, Washington.

5.6.2 Costs and benefits of benchmarking

The development of a league table of bus units under PTOM is likely to have the following costs and benefits.

Table 9: Benefits associated with benchmarking (yardstick competition)

Possible benefits and opportunities of benchmarking	
Benefits and opportunities	Limiting factor
Price reductions	Past gains might not be sustainable
Incentives to adjust to changing operating conditions	Uncertainty regarding future operating conditions
Identify leading firms	Are they leading due to performance or favourable operating conditions?
Focus on all areas of output	How much do consumers value other aspects of output?

Table 10: Costs associated with benchmarking

Possible costs and risks of benchmarking	
Costs and risks	Mitigation
Data collection burden management	Integration with existing management information systems Consistency of regulator's requirements
Distinguish noise from inefficiency	Use of techniques that identify inefficiency noise or establish confidence in results
Small number of comparators	New technology in data comparators recording to model at a disaggregated level

The above tables provide a cost benefit assessment of the concept of benchmarking. At this stage it is difficult to assess the extent to which these costs and benefits will apply in the factual. This is because further evidence of performance issues in Auckland, Greater Wellington and Canterbury is required, as well as, further consideration of how a benchmarking regime will be implemented. The introduction of units will assist the

benchmarking process, as it will enable the performance of units to be compared on a like-for-like basis. However the strength of the competitive constraint will depend on how operators are rewarded and the proportion of units that are tendered and negotiated.

5.6.3 Conclusion on benchmarking

The impact of a league table of bus routes in New Zealand if implemented correctly could be a useful tool for yardstick competition as it can help regional councils in monitoring and enforcing compliance with contractual regulations. The establishment costs of benchmarking could be high and so it could take a while before the benefits of the system kick-in. There is scope for NZTA to assist in designing and implementing the leagues table.

However, it should be noted that in regulated industries benchmarking is used as a substitute for competition. In each of the markets identified, there could be a role for benchmarking but it may not necessarily be an effective substitute for competitive tendering.

As mentioned before, under PTOM, it is proposed that the league table would also play a key role in providing a price benchmark when negotiating contracts with incumbent operators. The price benchmark would be obtained from previous and future tender prices. This aspect of PTOM is considered in more detail in Section 6.

5.7 Summary of individual components of PTOM

Section 5 has assessed each of the individual components of PTOM under the counterfactual and factual scenarios in each of the bus markets identified in Auckland, Canterbury and Greater Wellington. The impact of each component was considered in terms of its ability to:

- Directly limit the number of bus operators?
- Indirectly limit the number of bus operators?
- Limit the ability of bus operators to compete?
- Reduce bus operators' incentives to compete vigorously?
- Affect the regional council's bargaining strength in procuring bus services?

In some cases there is limited evidence on the overall effect of the individual component of PTOM. Nonetheless an assessment is made on the possible competition effects that could occur. These are shown in the table below. However, it should be noted that the competition impact of each component of PTOM will vary in each geographic market. In some cases there is likely to be a greater impact in Auckland and Greater Wellington.

Table 11: Assessment of individual components of PTOM

Component of PTOM	Possible impact on competition	Possible negative or positive competition effect
Introduction of units. Units are issued for single full route/timetabled trips	Low Greater impact in Auckland and Greater Wellington	Positive
Exclusive contracts for commercial and subsidised routes	Low in the short-run could be moderate in long run Greater impact in Auckland and Greater Wellington	Negative for commercial contracts
Regional councils can negotiate as well as tender bus services with bus operators	Likely to be high	Negative for negotiated contracts and could also affect competition for tendered services
Length of contract for bus operators could be extended for up to 9-12 years	Possibly moderate	Possibly negative
Performance based contracts are awarded	Possibly moderate	Positive
Benchmarking table is produced assessing the performance of each unit	Moderate	Possibly positive

To summarise:

- Under PTOM the introduction of units is likely to have a positive impact on competition in Auckland and Greater Wellington, as it would reduce the strategic use of commercial registrations by incumbent bus operators. However, the introduction of units is unlikely to be significant in Canterbury, as the Council is able to exercise its countervailing power with the three bus operators.
- Under PTOM exclusive units are likely to have a greater effect on commercial services. In the short-term there is unlikely to be any impact but in the long term this could change if patronage on commercial routes increases.
- Tendering units is likely to deliver the greatest benefits compared to negotiated units. The conditions most beneficial to negotiated units do not appear to be present in New Zealand. However, in the counterfactual, councils need to encourage more bidders to participate and need to continue with those strategies.

- Contracts with incentives will help improve performance of bus services to the benefit of the passenger. These incentives can be included in contracts awarded by tender (even when there is only one bidder) or by negotiation.
- Benchmarking/league tables could improve competition but its success depends on its implementation of useful financial and non-financial cost comparators. The introduction of units will assist in establishing the league table. However, benchmarking is often used in regulated industries and should not be considered to be a substitute of competitive tendering. Benchmarking is more attractive when comparing identical firms that are natural monopolies in their regions.
- Good performance should be rewarded but extending the length of the contracts may have a negative effect on long-term competition and discourage entry. Other ways of rewarding performance could be considered e.g. financial incentives for improving performance and patronage.

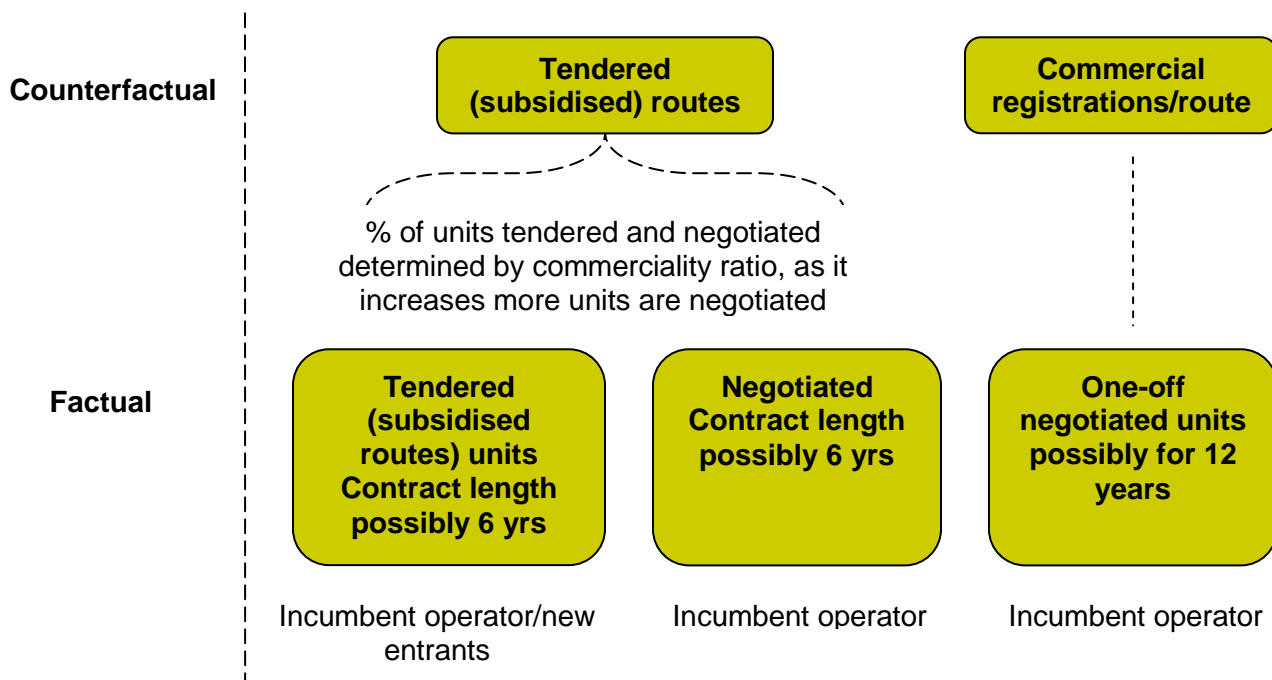
6. Assessment of PTOM as a whole

Under the factual, compared to the counterfactual, PTOM is likely to have some negative effects on competition in the provision of subsidised and commercial bus services. While some components of PTOM are likely to have a greater effect on competition than others, it is the overall effect of these different elements working together that needs to be considered.

6.1 Tendered units, negotiated units, exclusivity and contract tenure

In the factual, it is proposed that there will be exclusive tendered units and exclusive negotiated units. The interaction of such units are summarised in the diagram below.

Figure 3: Proposed interaction between tendered and negotiated contracts



Under PTOM it is proposed there would be the following three tier system:

- One-off 12 year like-for-like contract as a pure quid pro quo for operators deregistering commercial registrations and transitioning to PTOM units. These units are likely to represent 25% of the current bus network.
- Remaining units are awarded through direct negotiation with the incumbent. The length of the contract is yet to be determined but could be up to 9 years.
- A proportion of the networks units are tendered, and the contract length is possibly up to 9 years. It is proposed that 50% of the network on a service kilometre basis would be tendered. The proportion of units to be tendered would be determined by the commerciality ratio.¹⁰⁶ As it increases, less units would be tendered as less funding is required as patronage revenue would cover the costs of the service.

Comments on the first tier

With regards to the first tier, it is possible that there is little impact on the actual transition from commercially registered routes to contractual units. Negotiating contracts for transition purposes occurs as a way of getting the provider to 'buy-in' to new terms and conditions, which allows the councils greater oversight of the commercial services. This type of transition sometimes occurs internationally with regards to airport slots, carbon emissions trading and radio spectrum.

In the counterfactual, bus operators have a greater degree of flexibility with commercial registrations. However, it is unclear the extent to which this flexibility particularly in relation to innovation is valued.

What is likely to have a greater impact, is the length of the negotiated contract in the factual and the exclusivity provision post-transition. As discussed under Section 5.4, the length of the negotiated contract is a concern. The longer the tenure of the contract, the less scope there is to increase potential competition. The same can be said for the exclusivity clause, as in the future if patronage increases there is no scope for entry.

In Auckland, contracts (either gross or net) and commercial registrations transitioned to amended contractual arrangements via negotiation with the regional council. In this example, [

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[

.] Therefore, under PTOM, the current proposal to transition commercial registrations to a 12 year contract seems long and it could be more beneficial to have a shorter time period, which can be reviewed by both the operator and the council on expiry. This review could take into account changing demand and could

¹⁰⁶

$$\frac{\text{Total annual farebox revenue + SGC + CFS}}{\text{Total annual subsidy payment + (Total annual farebox revenue + SGC + CFS)}} \times 100 = \text{Commerciality Ratio}$$

include assessing the design of the unit, the commercial success of the unit and whether it should be subsidised.

Comments on the second and third tiers

In relation to the second and third tiers, two procurement processes would operate in parallel. This raises the following concerns.

- The conditions identified that could make negotiated contracts beneficial do not hold in any of the bus markets identified in New Zealand. Therefore as a procurement method there are doubts as to whether it could deliver value for money in the future.
- Using a mix of tendered and negotiated contracts introduces an unnecessary complexity. It involves ensuring that the correct proportion of units are tendered and negotiated. It would also involve councils having the relevant skill, knowledge, systems and processes in place to determine the appropriate proportion of tendered and negotiated units. The development of the benchmarking systems would assist in this task, although the cost and time of establishing the systems would in the first instance would be high.
- Under, the second tier and third tier, it is envisaged that less units are tendered if they are able to cover their costs in patronage revenues. A possible example of this proposal is when NZ Bus registered two commercial routes, which were originally planned to be tendered. GWRC subsequently negotiated the remaining non-commercial contracts with the bus operator rather than tender them. However, the contracts are for only 3-4 years. While the Council achieved cost savings there is a concern that entry in future tenders could be deterred.
- The mix of tendering and negotiated contacts would affect the bidding and negotiating strategies of the incumbent operators and could distort competition by denying new bidders the opportunity to enter or expand into new regions. For example, incumbents will have the opportunity to negotiate units say A, B, C but will have to tender for D and E. There is no scope for a new entrant to bid for A, B, C and they only have the option of bidding for D and E. Therefore, the new entrant does not have the opportunity to benefit from any scale advantages from running A, B, C, D and E. On the other hand, incumbents could have a greater advantage as it could potentially operate all five units if it is aggressive in bidding for D and E. The incumbent could offer a lower value per km for D and E and apply it to A, B, C, if it can benefit from economies of scale and scope and hence keep its ranking in the league tables. The extent to which this a problem for entry could be dependent on the size and value of the units that are negotiated or tendered.

An incumbent's strategy to bid for D and E is likely to depend on:

- Its costs and possibly some estimate of its competitors' costs.
- Whether there are any network efficiencies from operating all five units.
- Size and value of each of the units.
- Whether the threat from potential entrants in a tender process is credible.

Without having analysed any past bidding behaviour, it is difficult to assess future bidding strategies of new and existing bus operators. Even with the analysis it can be difficult to draw any conclusions with certainty. What can be said that bidding strategies could be distorted which could deter entry in the first place (new entrants faced with strategic barriers opt not to bid) or hampering entry (reducing the chances of a new bidder winning.) This could be even more problematic in Greater Wellington and Auckland where there is a greater need to encourage entry and expansion.

6.2 Negotiated contracts, performance measures and league tables

It is possible that there is scope to introduce negotiations into the procurement process, if any of the situations identified in Section 5.3 arise. However, rather than negotiate the contract directly with the incumbent, negotiations could take place with a small number of potential suppliers that could meet the outcomes required by the council. This could be in line with MED procurement guidelines, which suggest that direct approaches can be made where a contract involves very complex goods or services with a limited number of qualified suppliers.¹⁰⁷ Alternatively, there could be scope for negotiations to take place for contracts of short periods of time that involve major service amendments [], emergency services, trialling of new routes, or any other one-off occasions where a partnership approach is required, namely, investment from both the regional council and the operator.

Introducing negotiated contracts as a standard procurement practise raises concerns. Negotiating contracts for transition purposes could occur as a way of getting the provider to 'buy-in' to new terms and conditions. However, negotiating contracts with incumbents as a way of awarding contracts after expiry, reduces the scope for entry. While it is recognised that performance measures and league tables could assist in ensuring service levels are maximised the same constraint could be applied to tendered contracts which could also include strong incentives to improve services. Even though, it is proposed that some proportion of units would always be subject to tendering within a specified time period, potential entry could be hindered. For instance, there are no new entrants in the water industry and the performance of UK water companies are benchmarked against each other. It is questionable though as to whether the bus operators should be treated as natural monopolies.¹⁰⁸

Negotiated contracts with performance measures compared to tendered contracts with performance measures may yield the same results in terms of improvements in service (assuming the same performance measures, rewards and punishment are applied). However, under the former procurement option a higher cost of service could be achieved, although the use of league tables could provide some cost benchmark. The question is whether league tables are a sufficient constraint compared to competitive tendering as it is reliant of there being up-to-date and suitable cost benchmarks. League tables are likely to be more effective when operators have similar costs.

¹⁰⁷Supply NZ Government. A guide for suppliers on how to bid for government contracts. Ministry of Economic Development, July 2010.

¹⁰⁸Natural monopolies usually arise where there are significant economies of scale or where there are demand factors such as network effects.

7. Welfare analysis of PTOM

A welfare analysis of PTOM involves assessing the public benefits and detriments of the proposed model. It is concerned with either reductions in, or enhancements to, the welfare of consumers and producers of New Zealand, as measured in money terms. A public benefit is any gain to New Zealand and a detriment is any loss to New Zealand.

A lessening of competition would be expected to result in economic detriments to the public of New Zealand in terms of a loss of economic efficiency. Attempts to quantify public detriments would involve quantifying:

- **Allocative inefficiency:** measures the economic effect of the price increases which are expected to result from PTOM. They reflect the 'cost' to society of an increase in price which leads either to an unsatisfied demand or the purchase of a less preferred substitute
- **Productive inefficiency:** measures the extent to which costs exceed the minimum amount necessary to produce a given output. The excess represents a public detriment because resources which could be deployed productively elsewhere in the economy are being used unnecessarily by the inefficient firm.
- **Dynamic inefficiency:** measures the losses that arise when a business is less innovative than it would be in a fully competitive market. A substantial decrease in competition in a market reduces the incentive for firms to innovate (new products or services or technologies) to match or keep ahead of rivals.

The quantification of public benefits requires an assessment of efficiency gains. These include economies of scale and scope, better utilisation of capacity and costs savings. Public benefits can involve social and intangible benefits. However, only net benefits can be considered. Transfers of wealth are not generally considered and benefits must accrue to the public of New Zealand and not to foreigners.

7.1 Feasibility of conducting welfare analysis

MoT required comment on the feasibility of a welfare analysis of PTOM and how robust the analysis would be.

The overall effect of PTOM is unclear as it depends on how successful performance measures and league tables are and whether this offsets the negative effects of negotiating exclusive contracts for a long period of time. By attempting to quantify the total impact of PTOM, the magnitude of the different effects could be assessed. It follows standard cost benefit analysis, which involves collecting data to estimate the net effect of different policy options. Further, Australia's Best Practise Regulation Handbook states that quantification:¹⁰⁹

¹⁰⁹ <http://www.finance.gov.au/obpr/proposal/gov-requirements.html#handbook>.

- Provides comprehensive and comparable information to decision makers.
- Encourages close examination of the nature and impact of costs and benefits.
- Encourages reduction in the costs associated with regulation.
- Clarifies the essential assumptions and judgements that underpin the decision about the preferred option, and can provide a basis for consultation with stakeholders.

A suggested approach to conducting the welfare analysis of PTOM is to use quantitative data from any examples in NZ or overseas that provide a natural experiment of before and after effects of the individual components of PTOM. While it may not be possible to accurately say a change occurred as a result of a particular intervention, it might be possible to assess the extent of its contribution.

The tables below show the possible public benefits and detriments of PTOM. The competition assessment of PTOM using qualitative evidence guides us in identifying the potential public benefits and detriments, namely, what are the possible outcomes of PTOM as a whole. The tables also show what qualitative evidence there currently exists on the possible magnitude of the detriment or benefit or what further evidence could be obtained. With some further research and quantitative modelling, it could be possible to obtain more accurate estimates of the public detriments and benefits than those demonstrated below.

Table 12: Possible public detriments of PTOM

Possible public detriments	Comments	Some evidence of possible magnitude
Increased cost of subsidy payments	<p>These are costs that are not passed on through higher fares as these would welfare transfers from the government to consumer.</p> <p>These could be costs from the procurement method chosen (negotiation and tendering) and its impact on discouraging entry</p>	Subsidy payments could potentially be up to 15-20% higher if they are negotiated.
Reduced bus service levels	Could occur as a result of incorrect performance measures included in the contract, or other implementation problems in measuring or rewarding good performance	Melbourne negotiated contracts with performance measures only delivered 0.3% of contract value in savings. Problems with the benchmarking reduced the scope of savings

Possible public detriments	Comments	Some evidence of possible magnitude
Fares on commercial and subsidised units could increase	<p>Fares on commercial units could increase if no constraint on prices</p> <p>Fares on subsidised units could increase. However, if savings from subsidy reductions lead to an equal fare increase, social welfare is unchanged although the financing burden has been transferred from the public purse to the passengers.</p> <p>Therefore, a welfare loss is if fares increase as a result of increasing operating costs.</p>	<p>Obtain evidence of fare levels in Auckland and Greater Wellington and compare with Canterbury.</p> <p>Auckland showed comparatively high average fares of around \$1.50 per boarding expressed in 2005 dollars, while Christchurch had average fare at or below \$1.00</p> <p>Might be difficult to get data on operating costs, gross cost/km are available</p>
Less innovation in providing bus services	Lack of entry in providing either subsidised or commercial services could mean less scope to innovate e.g. introduce new vehicles, less innovate to find new commercial services	Need more evidence of what innovations would be hampered, or what benefits new vehicles have delivered

Table 13: Possible public benefits of PTOM

Possible public benefits	Comments	Some evidence of possible magnitude
Improved bus services	<p>Successful implementation of performance measures and league tables could improved bus services by increasing reliability and customer satisfaction</p> <p>Entry of efficient operator for full timetabled units could improve bus planning and improve service levels</p>	<p>Could potentially deliver 10-40% savings based on evidence of gross contracts in the rail sector in Germany</p> <p>Could be measured by waiting times, frequency and customer satisfaction data. Could look at impact of gross plus contracts in Waikato and Bay of Plenty</p>
Improved bus planning	Introduction of units could lead to improved bus scheduling for full timetabled units	Difficult to quantify but improvements in bus services could be a result of better bus planning

Possible public benefits	Comments	Some evidence of possible magnitude
Increase in patronage	Introduction of performance measures, leagues tables and units could improve service levels to the extent that patronage increases	<p>Could potentially increase by up to 6% in a year. TfL research shows that only 18% of Londoners do not use buses compared to 24% last year.</p> <p>Could look at other research on the link between performance measures and patronage</p>
Increase in patronage revenue	Patronage revenue could increase as a result of increased patronage or a reduction in costs or both. Costs could fall from improved performance.	<p>Evidence suggests that the proportion of costs recovered from the farebox in New Zealand is higher than in Australia. Therefore any increases in costs are likely to affect patronage revenue</p> <p>Farebox recovery ratio has fallen to 42.9% in 2008/9 from 60% in 1990/00</p>
Environmental benefits e.g. less cars, less land use, better vehicles	<p>Intangible benefit from any increases in patronage or from:</p> <ul style="list-style-type: none"> • Making environmental performance a factor in competitive tendering • Imposing minimum environmental performance requirements on operators • Providing financial incentives for environmental performance 	Likely to be difficult to quantify

It would be feasible to conduct a welfare analysis on a limited scale. A full scale welfare analysis would not be possible but it would be possible to quantify some of the effects of PTOM. The data available is fragmented, but by using realistic assumptions and some sensitivity analysis, it may be possible to establish a wide range for which the actual value of a particular benefit or detriment, and the totality of detriments and benefits could occur.

Possible data sources are the regional councils, as well as, studies referenced in this report, which include a SAHA International study, a LEK study, a Public Transport Procurement Legislation Review and several working papers from a UK Local Bus Investigation.

However, as with all cost benefit analyses, the accuracy of quantified estimates may be uncertain, and a number of assumptions would be made in order to generate quantified estimates. Appropriately qualifying and explaining the approach is important, including why better estimates are not achievable.

Some of the public detriments and costs are difficult to quantify because of the uncertainty about how PTOM would affect bus operator behaviour and new entry. Typically in cost-benefit analysis, the costs are more certain than the benefits which, may seem to defy quantification and monetary valuation because of the lack of close analogies from which to draw inferences of value. Therefore, a welfare analysis could proceed by quantifying what it can, and seeing how large the unquantifiable benefits would have to be to deliver a positive impact of PTOM.

Alternatively, it could be possible to assess the net effect of the quantified impacts and compare this to a qualitative assessment of the remaining unquantified benefits.

8. Conclusion

PTOM will affect the way in which public transport is procured and planned in New Zealand. There is concern that to-date councils have not been able to conduct their planning activities effectively, as a result of limited competition in the bus procurement level, as incumbent operators have been registering commercial services prior to them being subsidised. While PTOM is seeking to gain a partnership approach at the bus planning level, this could be at the expense of distorting competition at the bus procurement level. For example incumbents want to help plan the bus routes but also want to deliver those routes. There is a need to ensure there is a competitive process for using operators that deliver specified bus services at the highest quality and lowest price.

A competition analysis of PTOM based on desktop research suggests that some components of PTOM are likely to have a positive impact on competition in the markets for subsidised bus services in Auckland, Greater Wellington and Canterbury and for commercialised bus services in those regions. On the other hand, other components of PTOM could have a negative impact on competition in those markets.

The degree to which competition is promoted under PTOM will depend on the success of transitioning to units, implementing contracts with financial and non-financial incentives to improve performance and creating league tables for units to compare the costs and service performance of subsidised and commercial units.

It is unclear, what the overall effect on competition could be, as while it is possible that the positive aspects of PTOM could outweigh the negative effects, there is still a high degree of scope for the negative aspects, namely negotiating contracts with incumbent operators, which removes the scope for entry, to have a far greater effect. This means that the Government's desire to achieve value for money could be compromised.

With regards to the regional council's buyer power in the counterfactual, their negotiating strength is limited and could be improved if entry occurs. Therefore attempts to encourage entry would improve their bargaining position. However in the factual, additional regulatory powers are awarded to the councils and this makes it easier and quicker for councils to exercise immediate regulatory power and puts less pressure to promote entry in the short-term. Whether this is at the expense of innovation is unclear as this depends on what innovations would be facilitated under the factual and counterfactual.

To get a better understanding of the net effect of PTOM, a limited welfare analysis could be feasible. While not all public benefits and detriments could be quantified, it seems

possible to quantify some aspects. This could assist in estimating the magnitude of some of the effects of PTOM.