Transport for London Bus service contracting in London

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This paper provides a review of the framework under which London's bus services are procured. It describes the market for the supply of bus services and the consolidation that has taken place in the UK and London market. It describes the development of contract types and incentives since the start of competitive tendering in 1984. It finishes by outlining the current strategy for improving the quality of bus services in London, as part of the Mayor's Transport Strategy.

Throughout this paper, costs and prices are quoted in Euros (€). Values have been converted from pounds sterling at a rate of £1 = €1.60.

Background

In Autumn 1984, the London Regional Transport Act changed the framework under which London Transport (LT) was to provide bus services in the capital. The Act also advocated a tendering regime by empowering LT to invite private operators to submit tenders to carry out services as specified in an 'Invitation to Tender'. In 1985, LT set up London Buses Ltd (LBL) as a separate, wholly owned public sector bus operation and it also set up the Tendered Bus Division of LT, which began the process of competitively tendering bus services. Subsequently in 1988, LBL divided up its bus operations into 12 operating companies in preparation for their future privatisation.

Initially, competition for bus routes was between private bus operators and the LBL operating companies. The initial contracts were developed on a gross cost basis. That is, the operators were paid the full operating cost of the services and LT retained the fares revenue.

The competitive procurement of bus services and use of independent operators gradually increased between 1985 and 1994 and the new LBL operating companies had to adapt to a more commercial environment with the effect that costs were driven down and productivity increased.

Privatisation

In 1994, the subsidiary companies of London Buses Ltd were privatised and by January 1995, 11 London Transport owned companies had been successfully sold; four as management buy-outs and seven sold to private companies. (One had been disbanded.) At the time of privatisation the subsidiary companies held both gross cost contracts won by tender and their remaining routes not yet tendered; the latter were on a net cost basis. (The net difference between the operating cost and the estimated revenue was paid by LT to the company or, where revenue exceeded cost, from the company to LT.)

By 1995, half the London bus network had been tendered and was being operated under contract. Contracts had been won in roughly equal proportions by independent operators and LBL companies. By August 2000, all routes had been successfully tendered and are now operating under contract to London Buses (LB).

London Buses is the subsidiary company of Transport for London responsible for securing bus services following the 1999 Greater London Authority Act. London Buses is responsible for determining the structure and frequencies of the routes together with the level and structure of bus fares. Current contracts are usually 5 years in length, which means that approximately 20% of the bus network is tendered each year. The London Bus network is currently valued at nearly €1,300m.

The Market

Market Consolidation

The merging of operating companies into large groups over recent years has significantly reduced the number of owners of bus companies operating in the London area. Market share data is analysed regularly on a London wide basis and shows a steady market consolidation, from 10 large groups (with 91% of the market) and 13 smaller companies in 1995 to 6

Operator/Group	Market share at 6 Jan 1995 (%)	Cumulative (%)	Group	Market Share at 2 Jan 01 (%)	Cumulative (%)
Stagecoach	17.2	17.2	Arriva	20.3	20.3
Cowie	17.2	34.4	Go-Ahead	16.9	37.2
London General	9.7	44.1	FirstGroup	16.9	54.1
British Bus	9.0	53.1	Stagecoach	16.4	70.5
Go Ahead	7.9	61.0	Metroline (Delgro)	11.8	82.3
CentreWest	7.8	68.8	London United (Transdev)	7.5	**89.8**
London United	7.2	76.0	13 Other Operators	10.2	
Metroline	6.2	82.2	Total	100.0	
MTL Group	5.1	87.3			
Capital Citybus	3.4	90.7			
Thamesway	1.3	92.0			
London Buslines	1.0	93.0			
13 other groups/ companies	7.0	100			
Total	100				

Market share based on LB contracted annual mileage.

Table 1: LB Market Share by Group

groups (with 90% of the market) and 16 smaller companies in January 2001, see Table 1.
It is interesting to note that the following UK companies have interests in the rest of Europe.

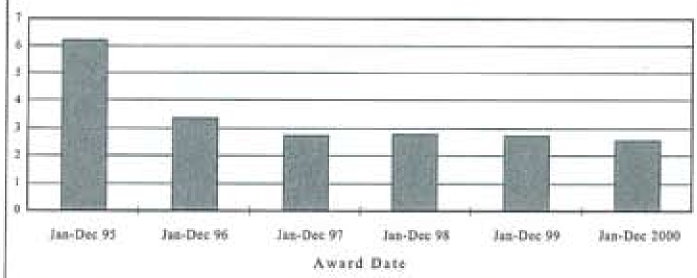
Arriva
Denmark, Spain, Portugal, Sweden and the Netherlands
Go Ahead
Rail joint venture with SNCF. Pulled out of Sweden
Stagecoach
Portugal
Two companies are owned by French companies:
London United
Owned by Transdev – C3D
Connex
Owned by Vivendi

Competition in the market

Markets for bus services are local rather than national. Thus local markets are of greatest concern when reviewing competition. Within London 35 local bus markets have been identified on the basis of passenger perception and local area geography.
The heavy traffic congestion in London, results in relatively slow journey speeds and the need for crew changes and breaks means that it is difficult for operators to operate a route efficiently and reliably if they do not have garages reasonably close to a route. This means that companies based in one area of London cannot easily compete in another area.
Analysis of local market shares, based on scheduled mileage in year 2000, shows that there are 10 areas where a company's share exceeds 60% and another 10 where a company has a share between 50%-60%. Thus over half of the 35 areas have companies with market shares above 50%.
It is interesting to note that the EU competition authorities become concerned if one company controls 40% or more of a market, or two companies control 80% or more. The European Court has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%. The UK does not have market share thresholds for defining dominance, although there is a 25% (combined) share threshold below which anti-competitive agreements would not normally have an appreciable effect and the 25% share threshold used to define a monopoly or complex monopoly under the 1977 Fair Trading Act.
The figures for local market share are also well above the US Department of Justice trigger point for challenging mergers.
The conclusion is drawn that the operating companies do have significant market power and that they have an economic incentive to act in a monopolistic way, particularly by under-providing on quality to save costs.
Another consideration is the size of route being tendered. Larger routes, above 15 peak vehicle requirement (PVR), require a larger input of capital (for buses), larger garage space and management resource to manage the staff and control the route. This, therefore can rule out smaller companies and restricts the number of competitors.

Tender Bids

The number of tender bids per tender has also been declining along with the consolidation of the market (see figure below). In 1995 there was an average of 6 bids per tender. This has reduced to 2.5 bids per tender in 2000. It should also be noted that usually fewer bids are received for larger routes. Those routes requiring a PVR of over 15 vehicles, had on average 2 bids per tender in the first half of 2000 and many only received one bid, although recently the number of tender bids for larger routes has increased. Routes with a PVR of 15 or less had an average of 3.1 bids.



London Bus Routes – Average Number of Bids Per Tender

Barriers to entry

It is recognised that there are barriers to entry to the London market. They are:

- access to appropriate garages;
- the tendering programme – the geographical spread of routes and timescale of five years to tender the whole network;
- management skill and experience of bus/coach operations, (particularly to operate larger routes);
- ability to recruit and retain drivers;
- access to capital.

Access to suitable garages is a major barrier to the London market, particularly in inner London. Land prices are prohibitively high in many locations and planning permission may be difficult to achieve. However, since July 1994, a number of small, new garages have opened to service LB routes. It is recognised that it can be more difficult to open large garages and this may have an impact on the scale of entry into the London market or expansion within it.
Entry to the London market tends to be on a gradual basis over time and the nature of the Tendering Programme, with approximately 20% of the network being tendered each year, (peak vehicle requirement of about 1,200 buses) facilitates incremental growth. This reduces the risk to London Buses but leads to proportionately higher overheads for new operators who may have spare capacity at a garage, that will take time to fill.
Of particular importance is the necessary management

experience to manage large contracts, which require 7 days a week, and sometimes 24 hour service. There is also an administrative requirement to provide London Buses with regular contractual performance data.

For the last couple of years, there has been a general shortage of bus drivers in the London area. As the economy has improved, operating companies have found it increasingly difficult to retain drivers. Some operators have put this forward as a reason for not bidding for new work. Significant factors influencing the availability and retention of drivers include wages, driving conditions, employment terms, shift patterns, working practices and company culture. From 31st March 2001 Transport for London has started to pay a bonus to drivers, which will increase their wages by an average of €32 a week. This is expected to improve recruitment and retention.

Normally the operating company needs to secure the buses with which they will run a route. The company therefore needs either access to capital to finance purchase of buses or to have sufficient credit rating to be able to hire them. Smaller companies are usually perceived as a higher credit risk, so finance is more expensive with a resulting impact on their tender price. Smaller companies will also have a smaller credit limit, so it is therefore difficult for them to bid for large routes and/or expand quickly.

In conclusion while it is possible for new entrants to enter the market, constraints on garages, driver availability and other resources and the nature of the Tender Programme make it particularly difficult for large scale entry, other than through the purchase of an existing operator.

Encouraging Competition and New Entrants to the London Market since 1995

London Buses has a policy of encouraging new companies to the market to encourage competition. Since 1995, there have been 15 new entrants to the London Market, two of which are no longer working for London Buses. New companies will continue to be encouraged into the market, but they must be able to demonstrate the ability to deliver the required quality of operation. In addition, London Buses is actively considering increasing the supply of bus garages, through the acquisition of suitable premises for onward leasing to operators.

Contract types and incentives

Gross Cost Contracts

The initial contracts were developed on a gross cost basis. The operators were paid the full operating cost of the services and LT retained the fare revenue. In 1985, the percentage of scheduled bus mileage operated was poor, therefore the contracts allowed for deductions for any scheduled mileage which did not operate and which was within the operator's control (e.g. due to non availability of staff or mechanical breakdown). Contracts could also be terminated on the grounds of poor performance but they did not include any additional financial incentives for good quality of service.

Negotiated Net Cost Contracts

At the time of privatisation, the subsidiary companies were allocated those routes which they ran at the time on a net cost basis. As the price was agreed between LT and the subsidiary company, based on the difference between operating cost and estimated revenue, they were called "Negotiated Net Cost" contracts. Again, these contracts allowed for deductions for mileage not operated which was within the operator's control. The last negotiated net cost contract expired in February 2001. The routes involved have all been tendered and have been let either as Tendered Net Cost contracts or Gross Cost contracts.

Tendered Net Cost Contracts

In 1996, Tendered Net Cost contracts for bus routes were introduced to provide a revenue incentive for operating companies. They were used for the majority of routes. These contracts also allowed for deductions for mileage not operated, which was within the operator's control. The retention of revenue growth was the only financial incentive for operators. By implication this also meant that revenue growth (which was occurring because of economic growth and network and marketing initiatives undertaken by London Buses) was not available for investment in the network.

In the years from 1994/95 to 1999/2000, passenger numbers increased by 12%, but the quality of service as measured by punctuality of buses markedly declined (see below). There is no discernible difference in performance between the net and gross cost contracts, although net cost contracts carry an additional administrative burden. Off bus (Travelcard and Bus Pass) revenue has to be allocated to different operators and changes made to the agreed revenue, where service changes are implemented during the life of a contract. Surveys are expensive to administer and contain a degree of inaccuracies that smaller companies found difficult to manage. In June 1999, London Buses decided not to let any more Tendered Net Cost contracts and reverted to Gross Cost contracts.

Service Quality

Delivering a good quality service is as important as providing it at an efficient cost. The Mayor for London has a policy of improving public transport, particularly bus services, in order to attract more people from cars to public transport.

The percentage of scheduled bus mileage operated improved under the tendering regime and with better management rose to 98.2% in 1995/96. Since then, the percentage of scheduled mileage operated has declined, (although total operated mileage has increased.) By 2000, only around 96% of scheduled mileage was being operated. Service reliability – buses turning up on time - is also an important indicator of quality for the customer. High frequency routes are measured by Excess Waiting Time (which is additional to scheduled waiting time). This indicator has declined from a high of 1.7 minutes in 1995/6 to 2.1 minutes in 1999/00. For low frequency routes the percentage of buses departing on time has declined from 71% in 1995/96 to 67% in 1999/00.

The drop in mileage operated and reliability is partially caused by staff shortages, which is being addressed by the recently introduced TfL Bonus. In addition a new form of contract has recently been developed to provide a direct link between performance and contract payments in order to encourage better performance. These new contracts are known as Quality Incentive Contracts.
LB has the power to terminate contracts for poor performance, but it is a difficult option to pursue, as it requires an alternative operator, vehicles and staff to be provided at relatively short notice. It is therefore a power used sparingly.

Quality Incentive Contracts (QIC)

In order to provide greater incentives for operators to provide better quality services, London Buses has developed Quality Incentive Contracts (QIC). Operators will be paid for the quality of service they deliver as well as volume. The main features are as follows:

- Bonus payments will be made for performance above target, deductions will be made if targets are not achieved.
- Contract extensions of 2 years will also be available if performance is above the set standard.
- The current system of deductions for lost mileage is retained.
- Fare revenue will be retained by London Buses to fund incentive payments and for investment in the network.
- The major measure of quality will be reliability as this is of most importance to passengers. 'Softer' customer satisfaction measures reflecting the passengers' whole experience of the journey will also be taken into account, and will affect the contract extension provision.

Targets are set by route category, according to operational difficulty (traffic conditions) and whether they are high frequency or low frequency routes. The target for high frequency routes is based upon Excess Wait Time (EWT) and this will vary between 1.9 minutes to 1.1 minutes. The target for low frequency routes is based on percentage on-time and this will vary between 65% and 82%. Overall if all targets were met, the network average for high frequency routes would be 1.5 minutes EWT and 77% on time for low frequency routes.

Payments

High frequency routes:

- For every 0.1 minute (6 seconds) improvement in EWT an extra 1.5% of the annual contract price will be paid.
- For every 0.1 minute (6 seconds) below the EWT target, deductions of 1% of the annual contract price will be made.

Low frequency routes:

- For every 2 percentage points on time above target, an extra 1.5% of the annual contract price will be paid.
- For every 2 percentage points on time below target, a deduction of 1.0% of the annual contract price will be made.

Routes are currently being tendered on the basis of QICs and it is too early to say what affect they will have. Their impact will be monitored and they will continue to be developed to ensure that the contractual regime delivers quality services.

Trends in London buses' costs and subsidy

The Gross Margin for the Bus Network and for London Buses as a whole (including infrastructure and operating services) is shown in Table 2 below.

	Actual										
	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	2000/01
Bus Network Gross Margin				-44	-32	-11	49	53	46	6	-32
LTB Gross Margin/ (Loss) :	**-179**	**-187**	**-173**	**-105**	**-98**	**-54**	**-19**	**0.0**	**-19**	**-65**	**-105**
Subsidy: € / Km	**0.64**	**0.66**	**0.58**	**0.34**	**0.32**	**0.17**	**0.06**	**0**	**0.05**	**0.18**	**0.29**

LB Gross margin includes all revenue and vehicle costs but excludes capital investment.

Table 2: LB Financial Performance (€ million)

In 1997/98 LB broke even, after several years of competitive prices and a reducing loss. Since then costs have been increasing above the rate of the inflation and the loss has started to increase and in 2000/01 the Gross Margin loss was €105 million. The change to a Gross Margin loss from 1989/99 was in part caused by the growth in the bus network, (additional miles,) the introduction of new vehicles and additional vehicles to improve reliability, increased traffic congestion, as well as increased expenditure on improved passenger information, eg. Countdown, increased maintenance volumes in respect of Advanced Vehicle Location system and increased Revenue Protection.

Tender prices started to increase significantly faster than inflation at the end of 1996. Further increases became apparent following the switch from Gross cost to Net cost contracts in 1997. The main reasons for the increases in unit prices are considered to be the following:-

- Net cost tendering transfers revenue risk to bus operators and it is apparent that an element of this is being built into tender prices.
- The volume of tendering has doubled since 1995 and quadrupled since 1994, in line with the programme set out during the privatisation process. The increasing volume of tendering has meant the opportunity to bid on a marginal cost basis is reduced and operators are bidding on a full or average cost basis.
- The introduction of a significant number of new, more accessible vehicles, incorporating new features.

- Knock-on effect of increased operators' costs (for example labour costs have risen to attract more drivers and overcome staff shortage problems.)
- Uncertainties concerning fuel prices, including possible taxation changes.
- Reduction in the number of operators bidding as a result of merger activity.
- A general reflection of the increasing pressure on bus contractors to improve overhead recovery and profit and or the need to counter-balance earlier loss making contracts.

One reason for the big increases in recent contract prices is the existing low price of some contracts. Early on in the tendering process (1990 – 1996) operators bid relatively low prices to gain a foothold in London and achieve a significant market share. As contracts with low prices are re-tendered, there is an increase in cost, as tenders are priced to cover costs as well as provide a return on investment and resource.

In addition the public companies, quoted on the stock exchange, are under pressure to produce returns for their shareholders and investors. Previously Arriva, Go-Ahead and Stagecoach had stated that their targets were 18% operating profit. This is a higher level of operating profit than has previously been generally achieved and puts pressure on contract costs. Currently the larger operating companies achieve a pre-tax profit margin of around 9%.

Farebox ratio

The London network is valued at nearly €1,300 million. In the year to March 2001, it received a subsidy of only €135 million. The passenger revenue accounts for 88% of income, if concessionary fare payments by London local authorities are counted as revenue. If concessionary fare payments are considered as subsidy, then the paying customer accounts for 71% of income received.

The mayor's transport strategy

The Mayor has put improvement in public transport at the top of his agenda. This has the following implications for the contracting process:

- He initiated a review of the contracting regime for bus services in last summer.
- The Mayor appointed a new Managing Director of London Buses at the end of 2000.
- A new Performance Task Force has been set up to address failing routes and operators.
- Stricter standards for company premises and training and better staff conditions of work and remuneration including pensions will be followed up.
- There will be encouragement to operators to pay high enough wages to attract sufficient staff of the necessary quality, by London Buses paying the appropriate contract rates.
- London Buses will also require operating companies to take steps to encourage more women to enter the workforce, by the use of appropriate practices and facilities.
- Competition will continue to be encouraged, but the pre-qualification process will set higher standards for new entrants and existing operators who fall below these standards will have to take steps to meet the new standards.

Conclusion

In London since 1985, there has been a significant reduction in costs and subsidy, and increased service provision. Passenger numbers have grown by 18% since then, which is in contrast to a general decline in the rest of Great Britain.

Since 1995, there has been significant consolidation within the London (and British) market, to which London Buses has responded by encouraging competition and entry of new operators to the market. Since 1996, a variety of factors has caused tender prices to increase and service quality to decline. LB has responded by testing alternative contract arrangements and developing incentives to encourage operators to provide a consistently better quality of service. Given the dynamic nature of the economic, social and political environment in which bus services are provided, it is important that London Buses responds flexibly to market conditions and promotes competition and new initiatives in order to secure bus services offering the best quality and value for money.