



Monday 20th June 2022

OECD Competition Committee Roundtable Event, Paris France

"Competition and Regulation in the Provision of Local Transportation Services"

Managing Incumbent Advantage

– lessons learned and good practices

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This paper explores the problem of managing incumbent advantage in tendering of local transport

- OECD Competition Committee asked me to consider the following:
 - There is normally an incumbent transport provider
 - Should this provider be restructured (e.g. as in London) before running a tender? or
 - Should the tender go ahead even with a vertically integrated incumbent?
 - What happens to the incumbents assets and workforce if we run a tender?
- This presentation considers approaches to managing **INCUMBENT ADVANTAGE** in competitive tendering of local passenger transport – lessons learned and good practices



Incumbents have significant advantages resulting in a lack of competition for the market – this problem still exists and is growing

The Problem

What is it?

Incumbent Advantages

- ▶ Knowledge and Learning Advantages
 - New entrants bid more aggressively (Utah, Li & Phillips, 2012)
 - New entrants without knowledge don't last long (De Silva et al, 2012)
- ▶ Sunk Costs and Infrastructure
 - Incumbents have readily available resources while new entrants need to obtain them (Depots, Vehicle Fleets, Workforce)
- ▶ Switching Costs
 - Suppliers and contracts established are barriers to competition
 - 99.8% of US Cable TV suppliers were renewed due to switching costs of changing supplier (Zupan, 1989)

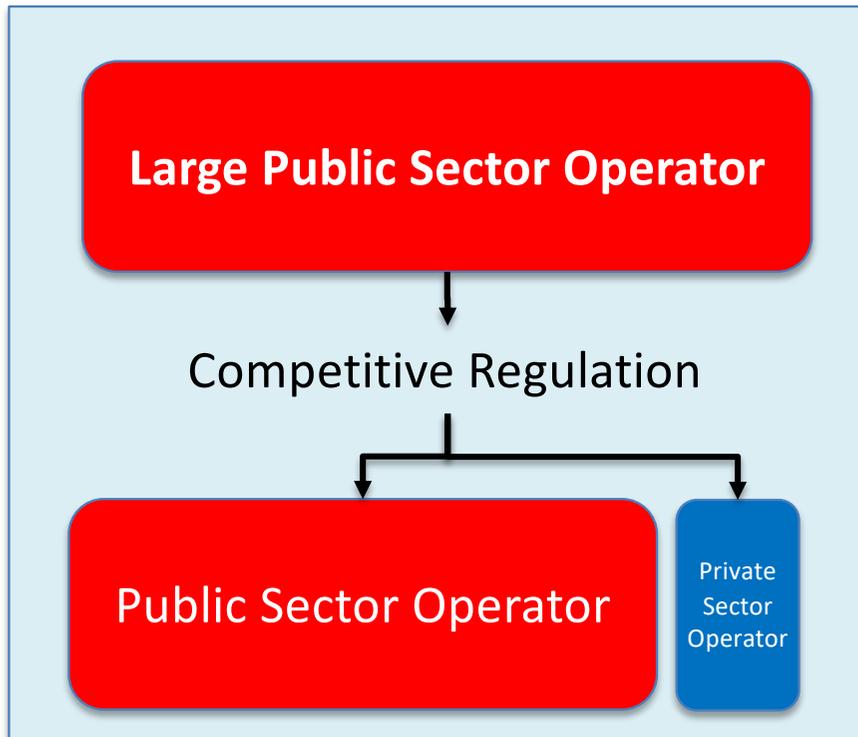
Does it still exist?

Evidence of Incumbent Advantage

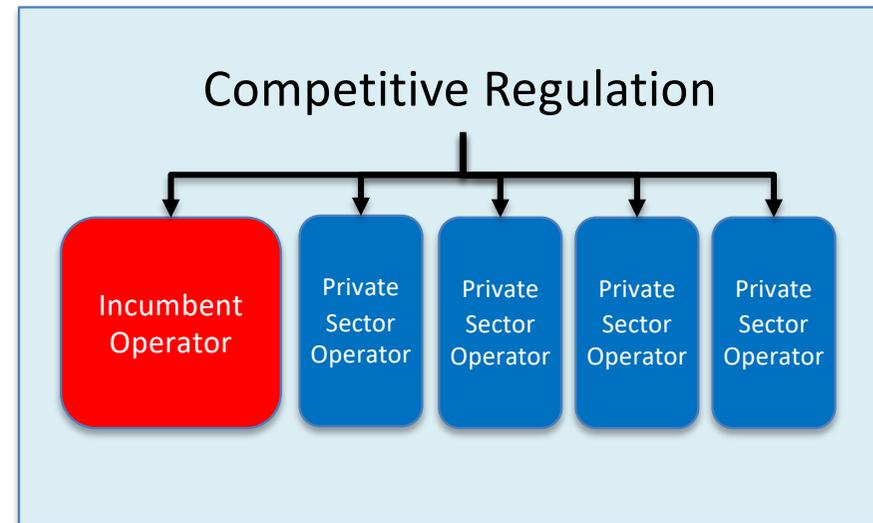
- ▶ Europe (lossa, 2019)
 - between 2006-2016 no. of public tenders with one bid grew from 17% to 30%;
 - average number of offers per tender has fallen from 5 to 3
- ▶ There is evidence that many public tenders are repeatedly won by incumbent companies:
 - Germany ; the former state monopolist (DB Regio3) still operates the majority of the traffic volume (73.6 percent 2015) of short-haul railway passenger services (Weiergraeber and Wolf, 2018)
- ▶ Europe; small and medium enterprises win only 45% of the value of public contracts

There are two types of context for Incumbent Advantage; the public and private sector

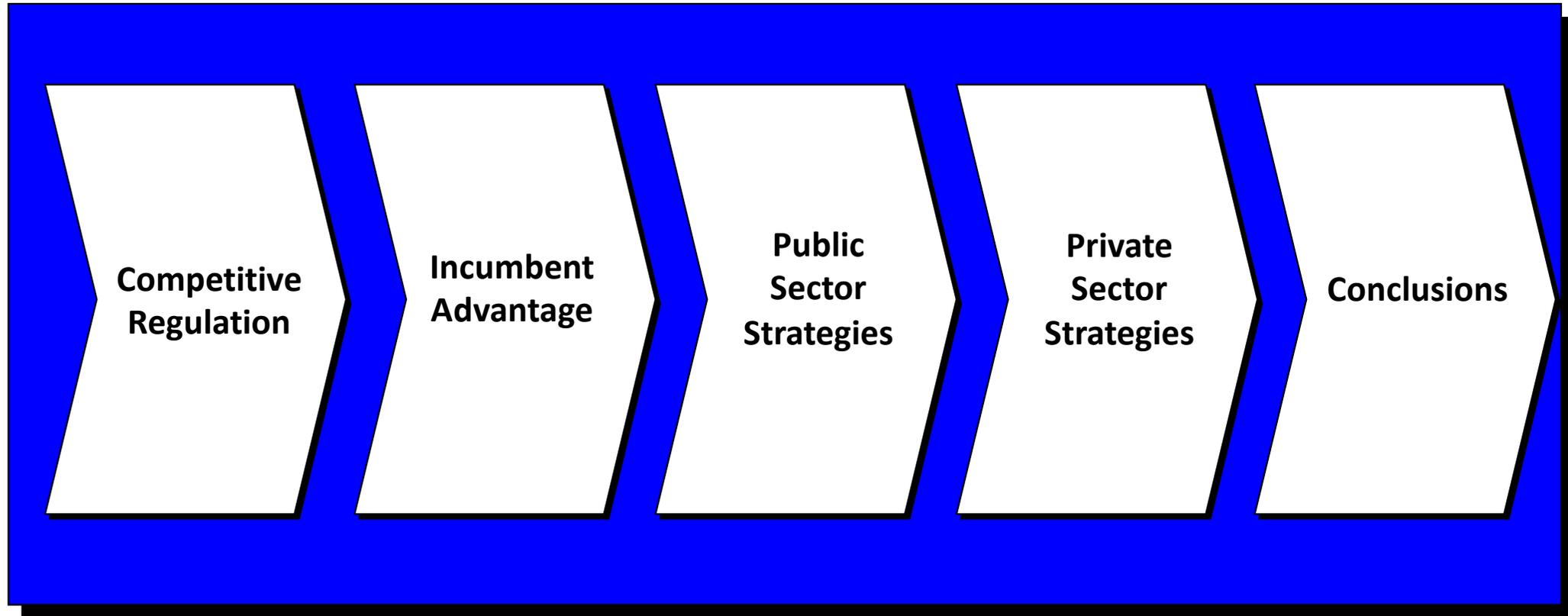
Public Sector Context



Private Sector Context



This presentation is structured as follows:





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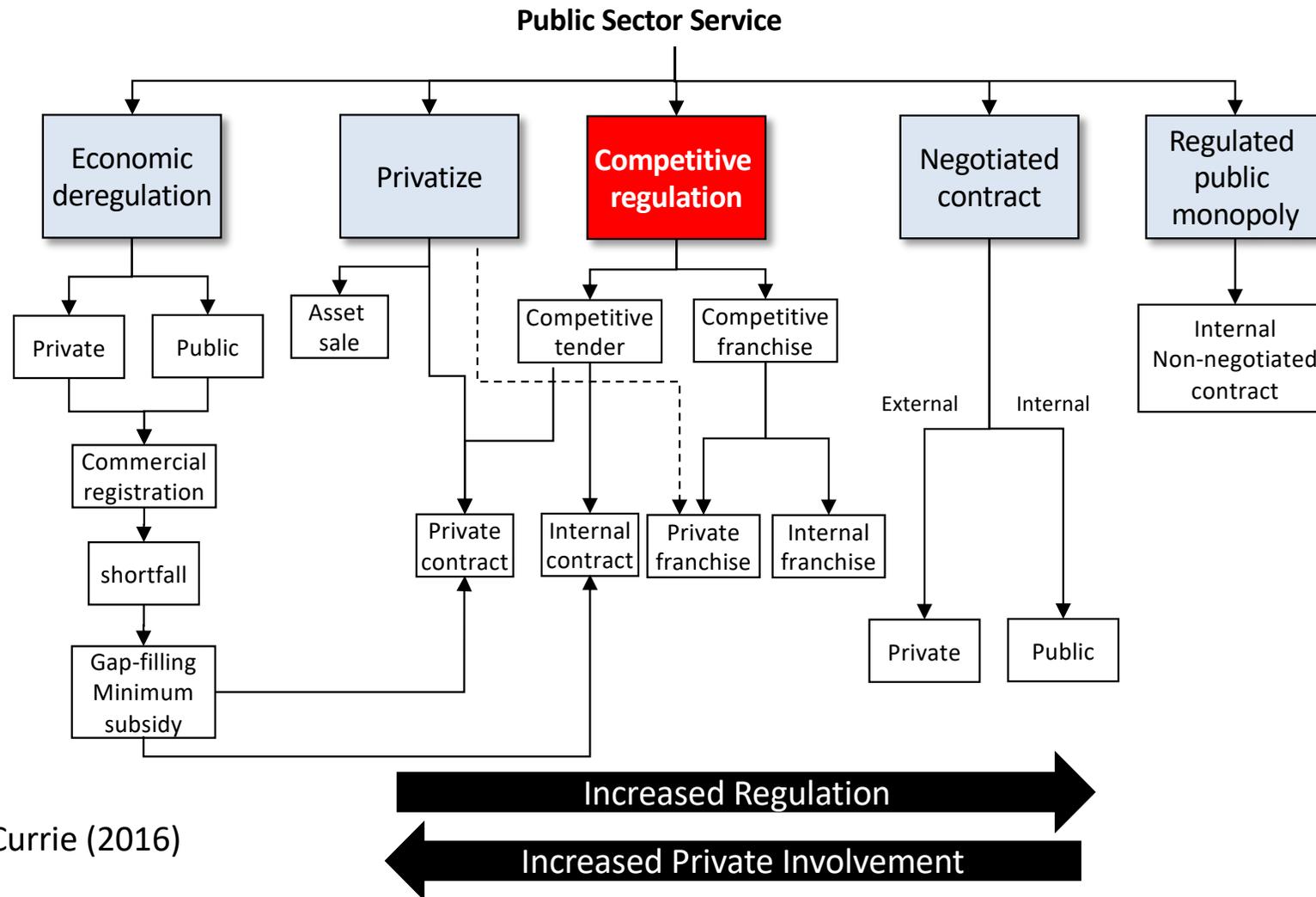
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Competitive regulation is one of many methods to bring competition to public sector operations



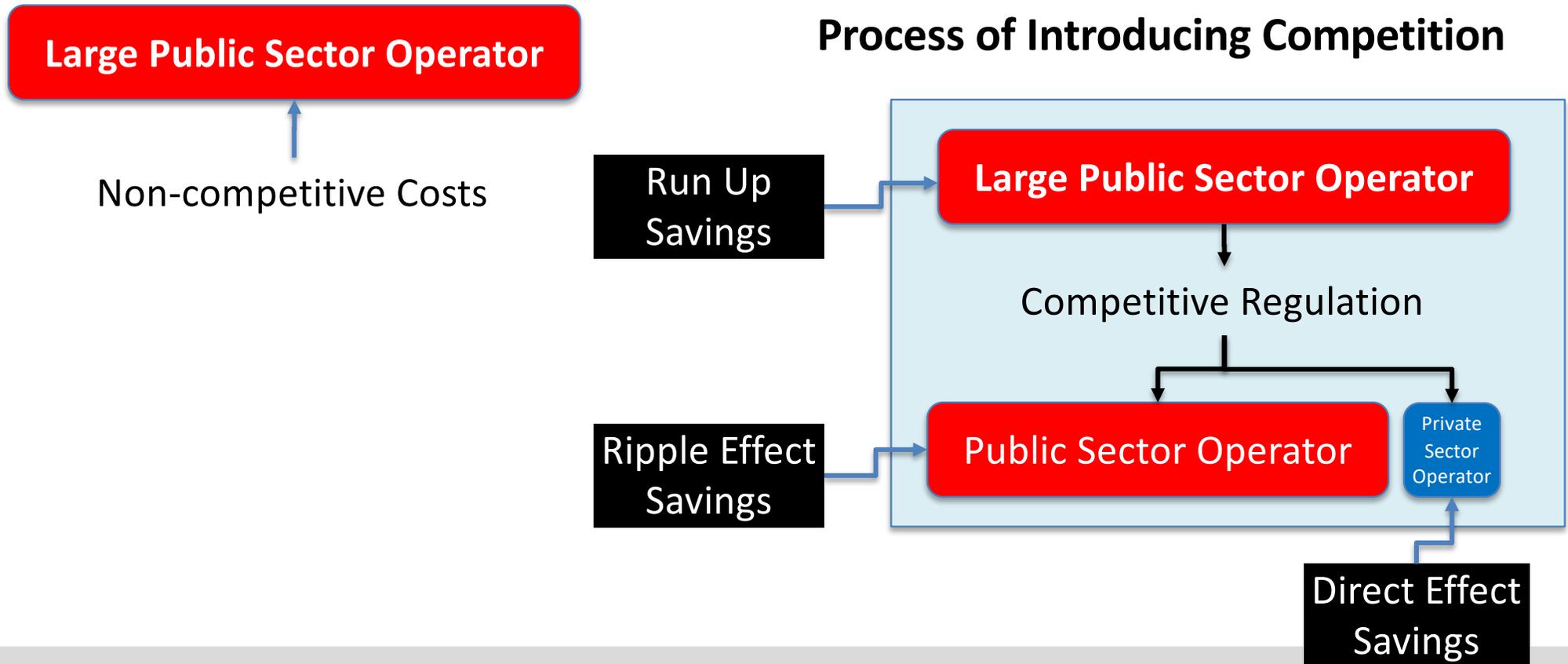
Source: Currie (2016)

Competitive Regulation aims to reduce costs via competition; threat, risk, direct and indirect savings are a major mechanisms to achieve this

Important Mechanisms of Competitive Regulation

- **Threat** is an often quoted rationale for cost competitiveness; 'risk of bankruptcy' (Currie, 2016)
- Direct and Indirect Savings from Competition (Cox et al (1997):
 - **Direct savings:**
 - the difference between the non-competitive cost of operating a service and the market based cost established through competitive tendering.
 - **Indirect savings:**
 - savings occurring in remaining non-competitive services in response to competition or the genuinely perceived threat of competition. There are two broad categories –
 - **"run-up" savings** - Anticipation of competition produces substantial savings in non-competitive services over a short period of time as public transport agencies improve their cost effectiveness during the "run-up" period preceding a short term conversion to competitive tendering. At the end of the "run-up" period, public agency costs must be at market rates for it to successfully compete for contracts. "Run-up" savings typically occur in conversions taking five years or less.
 - **"ripple effect" savings** - produces more moderate savings in more gradual conversions as public transport agencies reduce the cost of their non-competitive services in response to competition.

Incumbent management needs to both reduce incumbent costs to be competitive – as well as reducing incumbent advantage





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Incumbent advantage is a key reason for lack of competition

- Incumbent advantage
 - An important obstacle to the functioning of competition (Iossa, 2019)
 - A key reason for lack of competition (Hensher, 1991) :
 - Incumbent seeks to deter new entrants (subsidises high quality alternative); making competition very expensive
 - Fear of predatory practices ; large ops have more resources to discourage smaller operators

The key elements of Incumbent Advantage are Learning Effects (knowledge), Sunk Costs/Infrastructure and Switching Costs

Key Components of Incumbent Advantage

Learning Effects (Knowledge)	Sunk Costs/Infrastructure	Switching Costs
<ul style="list-style-type: none">▶ The 'experience-competition trade-off'▶ Incumbent suppliers acquires experience which may help it to reduce its operating costs. – Good news for the authority but it may make subsequent procurement less competitive and more costly as this knowledge isn't shared▶ Creates 'lock-in' of suppliers as they don't share knowledge (Lewis and Yildirim, 2011)▶ Key Points:<ul style="list-style-type: none">– Better information and more shared information removes advantage– Experience Decay; all losing bidders will lose learning advantages over time	<ul style="list-style-type: none">▶ 'Privileged' access to existing infrastructure other bidders don't have access to▶ E.g,<ul style="list-style-type: none">– Depots– Vehicles– Workforce– Other Infrastructure▶ Key Points:<ul style="list-style-type: none">– Need to be 'unbundled' from the competitive process	<ul style="list-style-type: none">▶ Additional costs (and time) incurred if the incumbent loses and a new entrant wins▶ E.g. IT contracts; many existing contractual obligations already in place▶ Key Points:<ul style="list-style-type: none">– Need to be identified and managed; ideally 'unbundled'

Source: after Iossa and Waterson (2019)



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Preparing public sector for competition maximises indirect savings while also removing incumbency advantages

Managing Incumbent Advantage – Public Sector Strategies

Prepare the Market

- ▶ create conditions for a level playing field
- ▶ remove technology /info barriers to entry
- ▶ tackle the incumbency advantage that past experience/knowledge of the market creates
- ▶ provide benchmarking/ performance data for ex post evaluations
- ▶ in general prepare the market for competition

Reduce Incumbency Advantage

- ▶ Breaking up (and possibly privatize) the incumbent into smaller lots - initially awarding different contracts to different companies (even if at the cost of short term efficiencies)
- ▶ Ideally procurers should coordinate contract awards in different cities; timing of tenders depend on likelihood of monopolization
- ▶ When monopolization is likely; have synchronous tenders (increases pressure on incumbents); when less likely stagger it..

Other Priorities

- ▶ In general while removing incumbency advantage is important; encouraging and keeping competition is also important.
- ▶ Shorter and more frequency contract offers or unbundled contracts help in encouraging competition

Maximises Run Up Indirect Savings

Source: after Iossa and Waterson (2019)



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Good information, removal of barriers to entry and frequent tender offers remove incumbent advantage in more developed tendering contexts

Managing Incumbent Advantage – Private Sector Strategies

Reduce Incumbency Advantage

- ▶ Reduce/remove barriers to entry
- ▶ Provide good information on the market conditions
- ▶ Ideally procurers should coordinate contract awards in different cities; timing of tenders depend on likelihood of monopolization
- ▶ Have more gross contract tenders than net (with demand risk). Demand risk is always the biggest problem for non-incumbents; removing the risk removes the incumbent advantage. BUT this should be balanced against the problem of service quality buy in for having this risk.
- ▶ Shorter, more frequent contract offers on unbundled contracts encourage competition

Source: after Iossa and Waterson (2019)

The current (1998-present) London bus contracting system is a worthwhile example to consider...

Buses in London Case Study

London Bus Contracting System

- ▶ Big network; 675 bus routes, 8,000 buses
- ▶ Gross cost contracts with quality contracts for incentives
- ▶ Tender competitions by route every two weeks on a rotating basis.
- ▶ Tend to put out routes for tender in spatially contiguous areas to prove opportunities for operational efficiencies (interworking/depots etc) called 'bundling'
- ▶ Routes largely unchanged over time; planning kept with TFL; operators just manage the routes
- ▶ Contract period varies; up to 7 years (5 plus 2) and continuous performance review



Source: Currie and Fournier (2019), Iossa and Waterson (2019)

...transparent data, gross cost tenders, performance incentives and contract award lag help remove incumbent advantages

Buses in London Case Study

Measures to Reduce Incumbent Advantage

- ▶ Open and transparent data, performance management and tendering system
- ▶ Gross cost (simpler) tender management (reduces demand information advantages)
- ▶ Frequent tenders
- ▶ Performance incentive via information (and retender period length; 5 to 7 years +2 years extensions)
- ▶ Garages a major concern – but no real problem as sites in London available
- ▶ Vehicles; all contracts have tended to mandate new vehicles for longer contracts (7 years)
- ▶ **IMPORTANT**; Contract Award Lag; period between contract award and commencing operations; enables new entrants to procure infrastructure



Source: Currie and Fournier (2019), Iossa and Waterson (2019)

Researchers have monitored London incumbent advantage related issues – maintaining competition is a challenge even in London...

- lossa and Waterson (2019)
 - Out of 402 routes analysed between 2003-2015
 - Same company won 48% of the time
 - Average number of competitors per contract decreased over time; 3.03 tenders/rte initially to 2.85 at retender
 - 16 instances of only 1 tender
 - At retender; 120 routes have more competitors on retender; 150 have less

Source: lossa, E. & Waterson, M. (2019) Maintaining competition in recurrent procurement contracts: A case study on the London bus market. Transport Policy, 75, 141-149

...adjusted bid prices increase over time (av. 3.8% each bid); no evidence that prices are lower for new entrants; if incumbents win; prices are higher

- Iossa and Waterson (2019)

- Award cost increases over time:

- of 402 cases, 253 (63%) show a rise in cost/mile above what might be based on price based formula
 - average sample price increase was 3.8% above formula in rebids; see graphic; excluding outliers the 10% increase most common group

- Thought to be led by increases in mandated vehicle quality as well as other factors:

- Price increase and new entry
 - Highest price observed with new entrants (4.2% vs 3.41% for incumbent); this against previous evidence. No evidence new entrants win due to lower price.
 - Package bidding associated with lower price increases
 - 2.1% increase when awarded as package; 6.7% when allocated to individual companies; suggesting economies of scale
 - Price change and contract length
 - Found price increase slightly lower for 7 years and linked this to incumbent and new entrants both needing to buy new buses
 - Modelling suggests cheaper prices based on 1. more competitors, 2. longer contracts, package bids; **if incumbent wins; price is higher other things being equal**

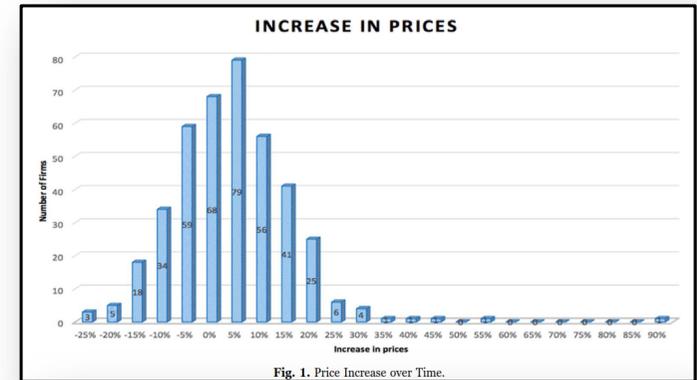


Fig. 1. Price Increase over Time.



Fig. 2. Price Ratio and Contract Duration.

Source: Iossa, E. & Waterson, M. (2019) Maintaining competition in recurrent procurement contracts: A case study on the London bus market. Transport Policy, 75, 141-149



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Simple answer to the original OECD questions

- OECD Competition Committee questions:
 - There is normally an incumbent transport provider

- Should this provider be restructured (e.g. as in London) before running a tender? or

YES – smaller groups, unbundle advantages, improve information to all bidders

- Should the tender go ahead even with a vertically integrated incumbent?

YES – because indirect run up and trickle down savings will occur in the incumbent and are significant

- What happens to the incumbents assets and workforce if we run a tender?

Most separate from tender; those in tender can compete or be sold off

Please reach out for more information

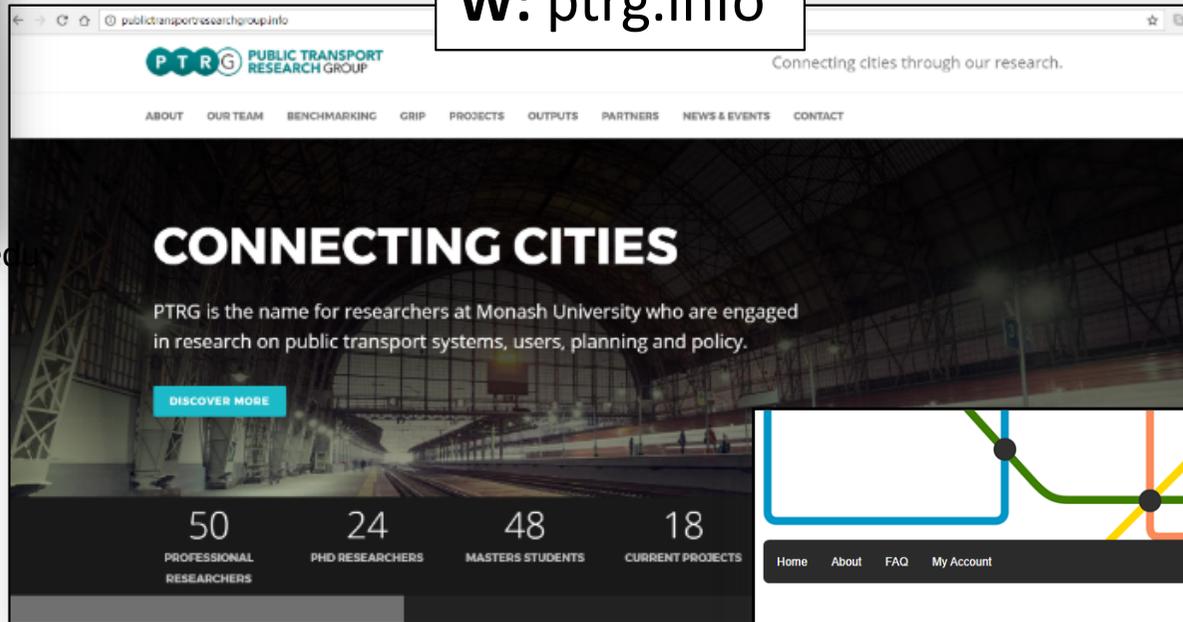


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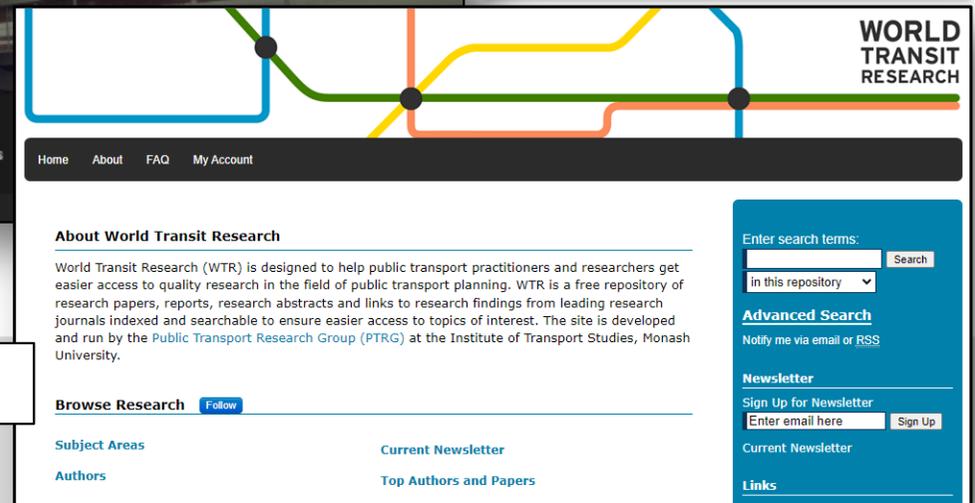
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