

Response to the Transport Department's Proposal to Issue New Franchises to Incumbent Bus Operators

Introduction and summary

The Competition Commission (the **Commission**) welcomes the opportunity to respond to the Transport Department's (TD's) consultation on "Franchises of Citybus Limited (**Citybus**) (Franchise for Airport and North Lantau Bus Network), Long Win Bus Company Limited and New World First Bus Services Limited (**NWFB**)" (the **Franchises**) (the **Consultation**).

Our response is set out in four parts.

- In **Part A** - we highlight the benefits of competition in the provision of a high quality, low cost bus service for Hong Kong. In doing so we express concerns about the TD's decision to substitute a competitive process for an assessment of whether the incumbent bus operators are providing a "*proper and efficient service and willing to invest in franchised bus operations*".
- In **Part B** – we propose two measures which would put competitive pressure on bus companies to maximise their efficiency and innovate even in the absence of a tendering process. These are: (A) Introduce more objective quality control metrics and apply them systematically and transparently; and (B) Ensure public tendering of franchises is a credible option.
- In **Part C** – we address the possible reorganisation of bus franchises. We note that such reorganisation may bring about genuine efficiencies. We highlight that consideration needs to be given to ensuring that any such efficiencies are passed on to passengers (or the TD), and not simply retained by the franchise bus operators. We also highlight that the TD should adopt measures so that the retention of a franchise following the merger of two franchise operators is subject to TD's approval and such approval includes consideration of the effects on competition.
- In **Part D** – we address technological changes that may occur during the course of the proposed 10-year franchise. In particular, the possibility of autonomous vehicles. We highlight that the TD should ensure that the current franchise model does not stand in the way of Hong Kong being able to benefit from the potential of technological innovation.

In the interest of brevity, the Commission has set out its views at a high level. We would be very willing to work with the TD to provide clarity or further details on any of the points raised.

Part A - The benefits of competition

1. The Commission notes the TD's proposal to award the Franchises to incumbent bus franchise operators on the basis that they are able to "*provide a proper and efficient service, and [are] willing to further invest in franchised bus operation*".¹

¹ §4 of the Consultation paper

2. Section 5 of the Public Bus Services Ordinance (Cap. 230) (**PBSO**) provides for a public tender process for the award of bus franchises.² Section 6 of the PBSO sets the time limits for such franchises – that is 10 years. This is subject to a possible further 5 year extension period where the Chief Executive in Council is satisfied that the grantee is “*capable of maintaining a proper and efficient service*”.³ The implication is that following any such extension period the franchise would be subject to competitive tendering regardless of the capability of the incumbent to provide a proper and efficient service.
3. Periodic tendering of bus franchises brings several benefits over relying on the incumbent’s capability to provide a proper and efficient service over several decades. In particular, the TD’s reliance on such a test presents the following risks.
 - a. **The TD may not be in a position to objectively evaluate efficiency** – incumbent operators may point to external factors (e.g. increased competition from MTR) to explain reduced performance or profits but TD is unable to evaluate whether a more efficient operator would be able to better address these challenges. It is also difficult for the TD to access whether a different operator would have introduced more innovation and exceeded the TD’s expectations.
 - b. **The TD may be unable to impose measures to address poor performance** – even though the TD uses some metrics to evaluate bus operators’ performance and is in a position to request service improvements the TD may be unlikely to conclude that a bus company has not reached the “proper and efficient” standard or impose (rather than request) improvements that the bus companies would find onerous.
 - c. **Incumbents becoming entrenched** – Becoming entrenched would allow the incumbent bus franchise operators to have a significant say over the terms of the franchise. The absence of periodic retendering also deprives the TD a powerful tool to ensure that franchise operators will continue to provide quality services.
4. In summary, by not relying on the public tendering of franchises at 10 (or even 15) year intervals and applying instead a “proper and efficient service” test, the TD may find it difficult to apply that test objectively. This problem is exacerbated if over a long period of time the TD does not tender its franchises and incumbent bus operators may take advantage of this.
5. In contrast, the use of a competitive tender process means that:
 - a. Higher quality/more efficient operators are rewarded for their efficiency by being given the opportunity to win more franchises and expand their network;
 - b. There is an incentive to innovate and introduce new and better ways of providing the service; and
 - c. Inefficient operators are either forced out or required to increase their efficiency in order to compete with other potential providers.

² See section 5(3)(a). While the PBSO provides the Chief Executive in Council the discretion to depart from it, a public tender process remains the default mechanism for the award of bus franchises in the PBSO.

³ Section 6(2) PBSO.

6. Ultimately, the absence of a competitive tender process risks bus franchise operators adopting what Adam Smith referred to as “*the quiet life of the monopolist*”.⁴

Part B - Increasing performance and efficiency through the potential of future competition

7. The Commission acknowledges that returning to the practice of periodic tendering of bus franchises would present significant challenges for the TD in the short term. Doing so may be unfeasible before the current franchises expire. There are, however, other preparatory steps that would be straightforward for the TD to take which would place the incumbent franchise bus operators under a certain degree of competitive pressure.
8. The Commission recommends that if the TD decides not to engage in a public tender exercise, they adopt the following measures to apply increased competitive pressure on franchise bus operators for the benefit of their customers.

A. Introduce more objective quality control metrics and apply them systematically and transparently

9. The Consultation paper identifies several service performance indicators, such as lost trip rate, number of complaints and accident per million passengers. Given technological innovation in tracking technology the TD could, in addition, monitor buses’ actual arrival times and deviation from schedule. The TD could also gather real-time safety related measures such as speeding or harsh deceleration. Environmental performance could also be closely monitored and evaluated based on emission testing. These additional objective measures could be used to supplement more subjective measures such as customer satisfaction surveys.
10. The Commission notes, however, that the Consultation paper does not set out what threshold franchise bus operators are required to meet in order to satisfy the TD that they are operating a proper and efficient service.
11. It is evident that the performance of the franchise bus operators varies. For example, Citybus’s lost trip rate in H1 2020 was 2.2%⁵ in comparison NWFb’s was 11.1%⁶ i.e. approximately 5 times more. Even the pre-Covid lost trip rate was twice as high for NWFb compared to Citybus. It is not clear how many lost trips there would need to be to raise questions as to whether a service is being operated efficiently.
12. The Commission recommends that the TD sets out in clear terms what the standard is for a franchise bus operator to be providing a sufficiently good service that there is no need to conduct a public tendering exercise. In the Commission’s view a high threshold should be set given the “punishment” is simply being required to tender for the subsequent franchise. Falling below such a high threshold should not preclude a franchisee from participating in future tenders.
13. Transparency on this point, alongside high but realistic targets, would put pressure on franchisees to demonstrably improve performance and understand the risk if they fail to do so. TD could also consider tying some of the metrics to other franchisee’s performance so that, for

⁴ Albeit there may be a degree of competition from other forms of transport.

⁵ Consultation paper paragraph 8.

⁶ Ibid paragraph 16

example, improved performance by one franchisee would put pressure on others to replicate their success.

B. Ensure public tendering is a credible option

14. Regardless of the introduction of more objective quality metrics and/or transparent thresholds, franchisees are unlikely to improve performance if they anticipate that the TD will not in practice implement a public tender process. The cornerstone of a public tender process is the possibility that the incumbent operator may be replaced. This change in operators may present significant challenges particularly around whether the new operator can gain access to its predecessor's assets and even employees.
15. These issues, however, are best addressed early on and in particular at the start of a new franchise. This allows the terms of any new franchise to set out clearly what happens in the event the franchise is retendered and an incumbent replaced. These may include pre-emption rights, handover periods, staff transfer arrangements etc. In the absence of such provisions incumbent franchisee's may consider the TD would not, in practice, put future franchises up for tender on the grounds that they would be unable to manage the transition to a new operator.
16. Adopting this approach has benefits outside that of competition. There are other reasons why a franchise may need to be awarded to a different company. For example, severe safety concerns, insolvency, persistent poor performance.
17. The Commission appreciates that some of the proposals presented above may not be straightforward to implement. We stand ready to assist, including in relation to the practical implementation of the above.

Part C - Reorganising bus franchises

18. The Commission notes paragraph 25 of the Consultation Paper as well as media reporting that NWFB and Citybus, having merged, may wish for the different franchises they operate to be unified.⁷
19. Before commenting on this proposal, the Commission is concerned about the possibility of future mergers or joint ventures between franchised bus operators causing further concentration and diminishing the prospect of competition in the transport sector. The Commission is uncertain what the approval process is for such arrangements is but firmly believes that (a) they should be subject to TD's approval such that proceeding without approval is a ground for termination of the franchise; (b) that approval should only be given following a competition assessment. A similar mechanism should apply to purchases of franchised bus operators by other major transport operators. Absent provisions of this kind, the TD risks being reliant on a very small number of firms with very significant market power.
20. In relation to the proposed reorganisation of NWFB and Citybus's franchises post-merger the Commission believes that:

⁷ See 新巴城巴管理層首認研兩巴合併 統一票價或致部分票價大增成障礙, HKO1

- a. reorganisation may bring about genuine efficiencies as it potentially reduces overlaps and allows streamlining of management; but
 - b. has the potential to benefit the merged NWFB/Citybus without those benefits being passed on to passengers (or TD).
21. The TD should work with the Competition Commission to identify how competition can be used as a mechanism to allow any increased efficiency generated from reorganising bus franchises to be passed on to passengers.
22. One example of this is to redraw franchises and/or bus routes to include one or more “contestable franchises” designed to be suitable for more frequent public tendering. Such “contestable franchises” may be designed to include routes that would be easier for competing bus companies to operate. This would allow vigorous competition between different bus companies to operate the franchise. This could also help TD benchmark the performance of the bus companies in other franchises.
23. Ultimately the reorganisation of franchise provides the TD with the opportunity to at least partly address the concerns set out in Part A of this response and the Commission believes the TD should seriously consider this.

Part D - Preparing for autonomous driving and other innovations

24. The Commission notes that self-driving busses have recently been introduced in some overseas economies.⁸ It is reasonable to predict that between the start of the new franchise in 2023 and its expiry in 2033 the landscape of public transport could change dramatically. This will be in both what is powering buses and the use of autonomous-driving technology.
25. Self-driving technology, if and when it is introduced, will have several significant implications for how bus services to be provided. For example:
- a. The need for route terminuses may be lessened as there is no need for driver changes;
 - b. Busses may operate overnight or alternatively could park a considerable distance from their route expanding their range;
 - c. The optimal size of a bus may change;
 - d. How bus stops operate may need to be reconsidered;
 - e. The efficiencies related to running a network of routes that form a franchise may drop.

⁸ <https://www.weforum.org/agenda/2021/03/europe-first-autonomous-electric-buses-spain/>

26. There are doubtless many other implications. While it is not yet clear what form the innovative disruption brought about by autonomous vehicles will take, the TD should ensure that its long term franchises take account of it. Ways of doing so may include:
- a. providing break clauses;
 - b. carving out the operation of autonomous vehicles from the scope of the franchise; and/or
 - c. requiring franchisees to cooperate in trials of autonomous vehicles.
27. Ultimately, the current franchise model should not stand in the way of Hong Kong being able to benefit from the potentials of technological innovation to transform the transport sector.

Concluding remarks

28. The Commission appreciates the TD's efforts to ensure high-quality, low-cost bus services via the existing performance assessment and renewal mechanism. However, we would also like to reiterate that competition has an important role to play, while not being oblivious to the practical challenges that a switch to public tendering would present.