COMPETITION POLICY AND THE BRITISH BUS INDUSTRY:
THE CASE OF MERGERS
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ABSTRACT
This paper assesses the role of mergers in the deregulated British bus industry by examining six recent cases. The relevant competition policy is administered by the Office of Fair Trading (OFT) and the Monopolies and Mergers Commission (MMC) and is based on the 1973 Fair Trading Act. A merger may be investigated if the merged company controls 25% of the supply of goods and services in the United Kingdom, or a substantial part of it. For the local bus industry a key issue has become what constitutes a substantial part of the United Kingdom, which in turn is dependent on the delineation of the area to be referenced.

The MMC has adopted a case by case approach but there was some indication of bright lines emerging, particularly with respect to increasing accountability and reducing the scope for short term retaliation. These have, however, been rejected by the Secretary of State in favor of divestment. Thus competition policy with respect to mergers is confused. This confusion has been exacerbated by a recent judgement from the High Court that puts into question the whole basis for current competition policy. The British experience is reviewed within the framework of regulatory policies for multi-product natural monopolies developed by Berg and Tschirhart. It is argued that the commercial bus market is imperfectly contestable and may be approximated as a weak natural monopoly. Some regulation is therefore essential to ensure that monopoly rents are not earned. By contrast, the tendered market is highly contestable and is, anyway, actively contested and requires minimal anti-trust regulation.

In the short term, the MMC should concentrate on the issue of local monopoly. The word ‘local’ should be clearly defined and be based on the market largely coincides with functional city regions. Rather than adopt a case by case approach, regulatory guidelines to increase contestability by reducing the threat of retaliation and removing barriers to entry might be employed. However, enforcing such regulations quickly and effectively may prove costly. Therefore, in the long term, a carefully specified system of comprehensive tendering/franchising should be considered as it would alleviate much of the need to consider anti-trust policies.

1. INTRODUCTION
This paper reviews the role of mergers in the British bus industry and, in the light of recent experience, draws some implications with respect to competition policy. The rest of this introduction will briefly outline the policy background of this topic. Section two goes on to describe the legislative framework concerning mergers in Britain. Section three examines six recent examples of how the law is actually practiced. Section four attempts to provide an economic background to the mergers issue against which the six recent rulings can be re-assessed. Section five goes on to examine the anti-trust implications of a system of comprehensive tendering. Lastly, section six draws some conclusions concerning the future of competition policy for the UK bus industry.

Local bus services were deregulated in Great Britain in October 1986, as a result of the 1985 Transport Act. For the first time since 1930, wide-scale on-the-road competition between bus operators was feasible. However, the 1985 Transport Act had a number of important provisions other than the abolition of quantity regulation. Certain aspects of control were tightened. For the purpose of this paper the most important aspect here was that the bus industry should be subject to competition policy in essentially the same way as other industries. For example, the bus industry’s exemption from restrictive trade practices legislation was removed and any apparent monopolies can be referred to the relevant authorities (see below) in the normal manner, rather than the need for special (or efficiency) references (see, for example, Wharton, 1988). A particular concern has emerged regarding the wide scope for anti-competitive behavior that exists under the new regime (Beesley, 1990), including collusion, predation and mergers. This paper focuses on the latter.

It is difficult to correctly ascertain the precise level of take-over activity in the bus industry. Our main source has been to monitor the trade-press. The trends towards agglomeration are best illustrated by the privatization of the National Bus Company (NBC) which has been reviewed by the National Audit Office (1990). NBC was initially split into 72 subsidiaries, although only 52 of these were principally involved in local bus operations. After privatization, these 72 subsidiaries were in the hands of 44 separate owners. However, the 52 local bus operating firms were in the hands of 40 different owners, with the maximum number of subsidiaries owned by one company being three. By the end of 1990, the 72 subsidiaries were in the hands of 33 different
owners. This activity was almost exclusively in the local bus sector, where the number of different owners had reduced to 30 and where one operator (Stagecoach) owned seven subsidiaries.

This is not, however, the only take-over trend that has emerged since 1986. A number of independent bus companies have been taken over by adjacent former NBC companies. Examples include Barton Transport (pre-deregulation Britain's largest independent operator in the bus industry) and, in one of the cases that will be studied later, Trimdon Motor Services (pre-deregulation Britain's most profitable independent operator). Similarly, a number of small undertakings operated by District Councils have been taken over by ex NBC companies, with the most notable example being National Welsh which assimilated the Taff-Ely, Rhymney Valley and Merthyr Tydfil bus operations in South Wales. However, ex NBC companies and their new owners have not been the only firms active in the take-over market. For example Yorkshire Rider, the privatized ex-PTE operator, has bought four depots from an adjacent former NBC firm. In one area (York) Yorkshire Rider also bought out two independent operators. Yorkshire Rider's acquisitions were considered by the MMC in a preliminary inquiry but were not found to be against the public interest.

The above suggests that the industry is undergoing a process of structural concentration, although exactly to what extent is difficult to ascertain. What is clear, is that the mergers are dominantly horizontal in nature, involving the take-over of companies producing similar products and, quite often, but not always, in adjacent market areas. There have been few examples of vertical mergers. Frontroute Limited initially concentrated on purchasing bus engineering companies but did, briefly, move into bus operations. Similarly, conglomerate mergers have been rare, although some local bus operators have diversified into other areas, for example Badgerline Holdings have made purchases in the retail sector.

2. THE LEGAL FRAMEWORK

The legal framework for British competition policy is outlined in a document produce by the Office of Fair Trading (1990). Overall responsibility for competition policy is in the hands of the Secretary of State for Trade and Industry, who works with two bodies specifically set up to deal with matters affecting competition. They are the Director General of Fair Trading and his Office (DGFT/OFT) and the Monopolies and Mergers Commission (MMC). The key legislation affecting monopolies and mergers is the Fair Trading Act 1973, although European Community rules such as Articles 85 and 86 of the Treaty of Rome are becoming increasingly important.

The 1973 Act defines a monopoly as a situation where a company supplies or purchases 25 per cent or more of all the goods or services of a particular type in the United Kingdom or in a specified part of it. The Act also defines complex monopoly as a situation where a group of companies that together have 25 per cent of the market all behave in some way that affects competition. Complex monopolies can exist even if the companies involved do not have an agreement to co-operate. It is likely that such complex monopolies exist in certain parts of the British bus industry (Preston, 1991) but they have yet to be investigated.

Under the 1973 Act, a merger is said to occur when two or more companies 'cease to be distinct'. This can happen even if the majority of shareholdings in the companies concerned remain in separate hands. For example, the purchase of a minority stake of, say, 10% in a company that enabled the purchaser to influence the policy of that company would come within the definition of the term merger. A number of mergers in the British bus industry have been of this type but again none have been investigated. The Act lays down two tests to determine whether a particular merger is liable to investigation:-

(i) The assets test, that the gross assets of the company to be taken over exceed £30 million in value.
(ii) The market share test, that as a result of the merger, 25 per cent or more of the supply or purchase of goods or services of a particular description in the United Kingdom, or a substantial part of it, comes under the control of the merging enterprise.

Cases are examined individually to establish their likely impact on the public interest.

The DGFT monitors British industry to identify cases of monopoly and mergers. If, after preliminary inquiries, there are reasonable grounds for believing a monopoly or merger is to the detriment of the public interest, the DGFT can advise the Secretary of State to refer the case to the MMC. This usually happens before mergers have taken place but in the case of the bus industry, investigations have always occurred after a merger. A merger can be referred to the MMC up to six months after it has taken place. In the case of completed mergers, the DGFT can seek undertakings from the parties not to integrate their businesses, although this has not occurred in the case of the bus industry.

Investigations into the local bus industry by the MMC date back to the 1982 study of the bus operations of West Midlands PTE, Cardiff District Council and two NBC subsidiaries (MMC, 1982). This was a form of the special reference mentioned earlier. Recent references have concentrated on mergers rather than monopolies,
with, by January 1991, six reports having been published, namely

(i) Badgerline Holdings Ltd and Midland Red West Ltd (MMC, 1989)
(ii) Stagecoach (Holdings) Ltd and Portsmouth Citybus Ltd (MMC, 1990A)
(iii) South Yorkshire Transport Ltd acquisitions (MMC, 1990B)
(iv) Western Travel Ltd and G and G Coaches (Leamington) Ltd (MMC, 1990C).
(v) Stagecoach (Holdings) Ltd and Formia Ltd (MMC, 1990D).

In addition, the MMC has investigated Highland Scottish Omnibus Ltd (MMC, 1990E), but this referral was made on the basis of the 1980 Competition Act and is concerned primarily with the detection of predatory behavior.

The procedures implemented in the case of mergers are outlined in a guide produced by the OFT (1985). Before a merger can be investigated, the OFT has to ask two basic questions. Firstly, does the merger come within the scope of the Act? In order to perform the assets test the OFT will examine the latest annual reports and accounts of the targeted company. For the market share test, statistics for the United Kingdom, or a substantial part of it, of the value or volume of the markets for products which both firms produce (or consume) need to be assembled. In the case of the bus industry this test has been based on vehicle kilometers, although other measures (e.g. passenger revenue) might provide better indicators.

Secondly, are there sufficient reasons for seeking an investigation? The OFT’s approach is not identical in each case but the general approach is to begin with a consideration of the possible competitive effects of the merger, followed by an examination of other aspects. In examining the competitive effects of mergers, the OFT takes into account the degree to which there are substitutes for the product in question, the extent to which the producer’s customers (or suppliers) possess buying (or selling) power and the ease with which new competitors enter the market. The assertion that a market is contestable will not be accepted at face value but those providing such arguments will be invited to substantiate them. The other aspects that will be considered include efficiency, employment and regional considerations, international competitiveness, foreign firms and, in the case of a rescue operation, failing firms. Once the OFT has received all the necessary material information to answer the above questions, as a rough guide, it will take about a month for a decision to be reached. The DGFT then advises the Secretary of State whether his discretionary power to make a reference to the MMC should be used.

3. IMPLEMENTATION OF POLICY – THE PRACTICE

In this section, the six MMC reports on mergers in the bus industry are summarized under three main headings. Firstly, whether the statutory criteria are met is analyzed. Secondly, the various issues of public interest that have emerged are analyzed. Lastly, the conclusions and recommendations of the MMC are assessed.

3.1 Satisfying the Statutory Requirements

In strict financial terms, the recent take-over activity in the bus industry has been relatively minor. As a result, the assets test is inappropriate. None of the acquired companies have assets in excess of £30 million and indeed only one of the acquiring companies (Stagecoach) has assets above this level. Table 1 shows that these stood at almost £54 million in 1989, although this was immediately after a period of rapid expansion through acquisition. Table 1 shows that the largest amount of money to change hands was in the case of Badgerline’s purchase of Midland Red West for in excess of £7 million.

Thus, all that is left is the market share test. A problem emerged here in that the MMC had previously only investigated one example of a merger at a local scale, that of the Co-operative Wholesale Society/House of Fraser (reported in 1987), with respect to funeral services in Scotland. There was thus limited case-law on what constituted a ‘substantial part’ of the United Kingdom, particularly as there was an obvious case for arguing that the Kingdom of Scotland was a substantial part of the United Kingdom (a point recognized by Stagecoach, itself a Scottish based company). The MMC reviewed a number of legal cases and concluded that the phrase ‘substantial part’ meant something real or important as distinct from something merely nominal. In coming to this conclusion the MMC alluded to the inherently spatially concentrated nature of the bus industry. In effect, this is a de-minimis test. An area is regarded as substantial if ‘it could not be regarded as not substantial’.

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This interpretation has been challenged in the courts by South Yorkshire Transport. The High Court recently ruled in South Yorkshire Transport's favor, with Mr Justice Otton saying that "so small an area measured in size, population and economic activity in relation to the whole of the UK cannot be said to be substantial". The MMC appealed but the ruling was upheld by the Court of Appeal in December 1991. Thus merger policy has been thrown into disarray. Nonetheless, it is worth investigating the MMC reports further because they provide important information on the economic characteristics of the bus industry and have important implications for competition policy.

A key issue has therefore become defining the extent of the reference area. Table 1 seems to suggest that a threshold population of around 1 million plus has been important. The definition of the reference area is then loosely based on the market areas of the acquired company and the acquiring company. In the Badgerline case, the reference area was the County of Avon and those parts of the Counties of Somerset, Wiltshire and Gloucestershire east of the Severn which lies within 15 miles of the County of Avon. This definition cuts across administrative boundaries and the 15 mile limit might be thought of being based on the feasible limit of operating buses from depots within Avon. It is important to note that the area of Midland Red West's operations, in nearby Hereford and Worcester, were excluded from the analysis. It appears that MMC are only interested in contiguous areas. The bus operations of Western Travel's Gloucester and Cheltenham subsidiary lies between the services in the Avon area and those in Hereford and Worcester.

In the first Stagecoach case, the reference area was defined broadly to include Southampton, Winchester and Chichester, even though it was acknowledged that the merger mainly affected Portsmouth and Havant, and parts of Stagecoach's operations by its Hampshire and Southdown subsidiaries in contiguous areas were excluded.

Table 1: Statistics Used to Determine Jurisdiction

<table>
<thead>
<tr>
<th></th>
<th>Assets of Acquiring Comp. (£m)</th>
<th>Cost of Acquisitions (£m)</th>
<th>Populatio of Reference Area (£m)</th>
<th>Populatio of Competed Area (m)</th>
<th>Market Share (%)_ in Reference Area</th>
<th>Market Share (%) in Competed Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Badgerline (1)</td>
<td>12.534</td>
<td>7.616</td>
<td>1.5</td>
<td>0.915</td>
<td>82</td>
<td>91</td>
</tr>
<tr>
<td>Stagecoach - First Case (2)</td>
<td>53.566</td>
<td>0.550</td>
<td>1.141</td>
<td>0.362</td>
<td>41</td>
<td>85</td>
</tr>
<tr>
<td>S. Yorks Transport (3)</td>
<td>22.734</td>
<td>3.296</td>
<td>1.815</td>
<td>0.780</td>
<td>50</td>
<td>81</td>
</tr>
<tr>
<td>Western Travel (4)</td>
<td>7.079</td>
<td>Not given</td>
<td>0.996</td>
<td>0.116</td>
<td>34</td>
<td>87</td>
</tr>
<tr>
<td>Stagecoach - Second Case (5)</td>
<td>53.566</td>
<td>1.1</td>
<td>1.616</td>
<td>0.382</td>
<td>36</td>
<td>66</td>
</tr>
<tr>
<td>Caldeire (6)</td>
<td>26.846</td>
<td>3.1</td>
<td>1.148</td>
<td>0.501</td>
<td>48</td>
<td>50</td>
</tr>
</tbody>
</table>

(1) MMC, 1989  (2) MMC, 1990A  (3) MMC, 1990B  

In the SYT case, the reference area included all of South Yorkshire (even though in one District (Barnsley) another company was, by far, the dominant company) and parts of Derbyshire (where again SYT played a very minor role) but excluded other neighboring areas (e.g. Wakefield, Bassetlaw) where it played a similar minor role. Again it was acknowledged that competition was concentrated in Sheffield and Rotherham.
In the Western Travel case, competition was concentrated in the Warwick District but the reference area was extended to include the whole of the County of Warwickshire, where Western Travel's Midland Red South subsidiary was the dominant operator, and the Districts of Coventry and Solihull where Midland Red South had a small presence. The reference area excluded Midland Red South's Banbury operations in adjacent Oxfordshire even though there had been some significant competition here and excluded the nearby operating areas of Midland Red South's sister company, Cheltenham and Gloucester.

In the second Stagecoach case, the reference area was delineated as East and West Sussex (excluding Crawley) and the Ashford, Shepway and Tunbridge Wells districts of Kent, despite the fact that Stagecoach's subsidiary in the area (Southdown) only had a minor presence in the main urban area (Brighton) and that competition had been limited to the Hastings, Wealden, Rother and Eastbourne districts in East Sussex. A small part of the reference area (Chichester district) coincided with the reference area in the first Stagecoach case but no attempt has been made to draw the two studies together.

In the Caldaire case, the reference area was delineated as the counties of Cleveland and Durham, even though competition was limited to the Easington and Sedgefield districts of Durham and the Middlesbrough and Stockton districts of Cleveland. This interpretation was challenged by Caldaire as being "arbitrary and irrational". Caldaire believed that the reference area should also include Tyne and Wear, as it contains the area's main urban centre (based on Newcastle upon Tyne) and accounts for 10% of Caldaire's revenue in North Eastern England, and parts of North Yorkshire, where Caldaire is the principal bus operator. The MMC's response to this challenge was interesting. In a masterly use of legal-speak, the MMC (1991, pp 51-52) appears to say that it has the right to specify the reference area so long as there is a reasonable basis and goes on to say that "we do not accept that this should correspond to the entire market served by those enterprises (being investigated)".

It is therefore difficult to determine a consistent rationale behind MMC's definitions of the various reference areas. To some extent they may be seen as attempts to define city region more clearly. An alternative approach, which the MMC recognizes in part, is to define the reference area on the basis of the location of depots owned by the acquired and acquiring companies. The reference area might then be defined on the basis of the area within, say, 15 miles of each depot. This could then be rationalized so as to coincide with existing administrative boundaries. The basis for this definition is the effect depot location has on costs in the local bus industry. Services operated at great distance from a depot can prove to be expensive as the resultant dead mileage involved in getting the bus into and out of service acts as an unnecessary transport cost in the production process.

Given the MMC's definition of reference areas, it is clear that all six cases pass the market share test threshold of 25%, although it is interesting to note that in none of the cases did the merger result in the threshold being passed. If the main areas of competition only are examined, it can be seen that four of the six cases would have passed a market share test of 80%, whilst all but one would have been well below the 1 million plus population threshold that has previously been identified.

Given the High Court and Court of Appeal rulings, it seems essential that the statutory requirements be revised. For industries that involve spatial competition, such as transport, the starting point should be a firm definition of the geographical area to be studied. This ought to be based on the contiguous markets of the acquired and acquiring firms, possibly based on depot location in the manner suggested above. The next decision is whether these markets are large enough to warrant the MMC's attention. Clarification is required on what is meant by the word 'substantial'. The reference areas in the six cases may not constitute substantial parts of the UK but they do represent important bus markets. Where the bus markets being investigated largely coincide with city regions with a population in excess of 1 million they are probably worth investigating. On this basis, the Badgerline, the first Stagecoach, the South Yorkshire Transport and the Caldaire cases were probably worth investigating, although the reference areas ought to have been defined differently. For example, the Caldaire case ought to have focused on the Teeside region, based on Cleveland, southern County Durham and the northern parts of North Yorkshire. The Western Travel and the second Stagecoach cases were rather more borderline, as the merged companies failed to have a major presence in the main cities in the two areas (Coventry and Brighton respectively). In a similar case elsewhere (East Midland Motor Services take-over of Maun International) does not appear to have met the statutory requirements. In retrospect, it may have been a mistake for the MMC to concentrate on the mergers issue in the first place. The issue of local monopolies is just as important, particularly as, by the MMC's definitions, all of the acquiring firms constituted monopolies even before their acquisitions. If the MMC had concentrated on the monopolies, rather than the mergers, issue it would have avoided the need to justify that the areas being investigated were substantial parts of the UK and could have studied specified bus markets centered around main towns and cities. Time consuming litigation in the High Courts would have been avoided. A consistent definition of the main local bus markets might also assist in the automatic detection of local monopolies.
3.2 Identifying the Areas of Public Interest

The two main areas of 'public interest' investigated by the MMC are those of efficiency and competition. In terms of technical efficiency, there has been only slight consideration of economies of scale in the bus industry. Badgerline believed merger would result in annual savings of £590,000 due to rationalization of corporate functions and computer services, greater financial power (leading to lower interest rates on borrowings) and enhanced purchasing power. Amalgamation and rationalization of separately located engineering facilities would reduce costs and release a major site in the city centre for re-development, hence raising capital. Similarly, in Portsmouth the merger would allow one of the two main depots to be released for re-development. By contrast, Caldaire believed that there were few gains in productive efficiency and even warned of diseconomies of scale.

In terms of allocative efficiency, the main advantages were claimed to be the introduction of co-ordinated timetables, removal of wasteful duplication and, greater inter-availability of tickets. Better deployment of vehicles was also considered an advantage in at least two cases. Some of these advantages might be considered as economies of scope which will be considered in the next section.

External effects were claimed to be important in the Caldaire case, where reduced competition was believed to have led to reductions in road congestion around Stockton High Street and Middlesbrough bus station.

The MMC put much more emphasis on competition and investigated in great detail the extent of competition in both the commercial and tendered markets. By analyzing the Bus Registration Index, it was possible to estimate the number of operators in each area (but this index was abandoned in May, 1988). In all areas, Table 2 shows that there was a large number of existing bus operators, with 120 in the Badgerline reference area and at least 23 in South Yorkshire (this figure refers to operators of tendered services only, a similar figure was given for tendered service operators in the Avon area). However, the vast majority of these operators were very small indeed. Only a maximum of 5 competing operators in any one area had more than 50 vehicles. The number of firms operating in the commercial and tendered markets appeared to be broadly equal, but in the main, acquiring firms were less successful in the tendered market than the commercial market. The exception, provided by Western Travel, was largely due to two acquisitions of firms (G and G Coaches and Vanguard) which had been successful in the tendered market.

Table 2: Some Statistics on the Extent of Competition

<table>
<thead>
<tr>
<th></th>
<th>No. of competing Firms</th>
<th>of which major Firms</th>
<th>% Market Commercial</th>
<th>Share Tendered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Badgerline</td>
<td>120</td>
<td>4</td>
<td>94 (1)</td>
<td>78 (%)</td>
</tr>
<tr>
<td>Stagecoach – First Case</td>
<td>50</td>
<td>3</td>
<td>43</td>
<td>28</td>
</tr>
<tr>
<td>South Yorkshire Transport</td>
<td>23 (2)</td>
<td>3</td>
<td>53</td>
<td>37</td>
</tr>
<tr>
<td>Western Travel</td>
<td>47</td>
<td>3</td>
<td>Not given</td>
<td>47</td>
</tr>
<tr>
<td>Stagecoach – Second Case</td>
<td>Not given</td>
<td>5</td>
<td>38</td>
<td>32</td>
</tr>
<tr>
<td>Caldaire</td>
<td>74</td>
<td>5</td>
<td>51</td>
<td>41</td>
</tr>
</tbody>
</table>

(1) Figures refer to Avon only.
(2) Figures refer to tendered services in South Yorkshire only.

The emphasis of the MMC reports has been on actual competition. With one exception, the role of potential competition has been largely ignored. In part, this may be because the MMC was aware of Badgerline's failed incursions in Poole and Salisbury leading to a belief that large scale outside entry was difficult. This led the MMC to consider the contestability of the bus industry. A number of barriers to entry/sunk costs were considered. These included the cost of buses, access to depots/maintenance facilities, access to bus stations and the costs of passenger information provision. None of these were considered to be serious. More serious barriers were believed to occur as a result of pre-paid, branded, ticketing and the threat of retaliation. All acquiring companies
had engaged in aggressive competition on certain commercial routes (referred to as spoiling operations), although in the case of two this occurred outside the reference area (Western Travel in Banbury, Stagecoach in Torbay). Another potential barrier that was alluded to arises out of differing company objectives. In the Caldaire case, it was noted that Municipal operators seemed more prepared to sustain losses and thus have a greater ability to withstand long competitive battles than privately owned firms.

The MMC also considered that barriers to entry to the tendered market existed where net cost/minimum subsidy tenders were used rather than full cost, as in the case of the former there is an incumbency advantage in possessing revenue information. The MMC also believed that issuing tenders in big batches limited the scope for entry by small companies whilst the threat of retaliation was also relevant in the tendered market; all acquiring companies had re-registered routes that they had lost to another operator as a result of the tendering process. In one instance (that of Portsmouth), it was believed that the concessionary fare scheme for the elderly and disabled might represent a serious barrier. This was because it was a token based scheme and these tokens could be exchanged for a concessionary pass that limited reduced price travel to a particular operator. Entrants could then only compete for this traffic when the tokens were being re-issued.

Thus, in five of the six cases, the MMC has not been convinced that potential competition can outweigh the loss of actual competition. For example in the South Yorkshire case it states

“We cannot therefore regard potential competition from existing local operators or new entrants as being as effective as the actual and potential competition from companies that have been acquired” (MMC, 1990B, p.71).

The one exception was in the Western Travel case where West Midlands Travel was seen as being a potential competitor due to its large size (1,700 buses), impending change of ownership (and hence removal of restrictions on its area of operations) and the proximity of its depots. The overall impression is that, to use Morrison and Winston’s (1987) term, the MMC believes the bus industry to be imperfectly contestable. From the evidence it has gathered it believes that entry is feasible but is concerned about its sustainability. Potential competition is unlikely to be as effective as actual competition, unless it is provided by very large firms. This represents a shift from the views expressed in the White Paper ‘Buses’ which believed that the local bus industry was fully contestable.

The MMC also considered the role of external competition. In the later reports evidence from the 1981 Census on bus’s market share of the journey to work was presented. The highest share was found to be in South Yorkshire (33.5%) but there had been an estimated decrease in overall bus usage of around 27% since 1981. In the Stagecoach reference area, bus’s market share varied from 21.9% in Southampton to 3.5% in Chichester, with the figure for Portsmouth being 18.0%. However, surveys by Portsmouth City Council indicate that between 1980 and 1989 buses share of trips to the central area decreased from 18.8% to 10.2%. In the Western Travel reference area bus’s market share varied from 24.1% in Coventry to 4.8% in Stratford-upon-Avon, with the figure for Warwick being 7.3%. In the second Stagecoach reference area it varied from 23.1% in Brighton to 4.4% in the Rother district, with the figure for Hastings being 11.2%. In the Caldaire reference area it varied from 25.3% in Easington to 7.0% in Teesdale, with the figure for Middlesbrough being 20.7% and Stockton 15.0%.

The MMC’s views on the role of this competition appears to vary. Badgerline argued that the main incentive for a bus company to reduce unit costs, respond to the needs of passengers and provide value for money was competition from other modes. The MMC responded that “We find this is a persuasive argument” (MMC 1989, p.39).

However, in the South Yorkshire case the MMC argued that

“In our view, the sensitivity of the overall market must be regarded as a much weaker constraint ... than the maintenance of effective competition from other operators” (MMC 1990B, p.72).

Overall, it might be concluded that the best use of the information on bus’s market share would be to determine whether a case is worthy of investigation. Cases affecting competition in major cities appear worthy of consideration as car ownership is below commercial bus’s role in the overall travel market is likely to be minor and cases may not be worth investigating, particularly if rail provides competition on the main corridors. On the other hand, it must be acknowledged that, in most areas, those without access to a car are largely a captive market for bus travel and external competition is not really effective.

3.3 The MMC’s Conclusions and Recommendations

In reaching its conclusions, the MMC adopts a quasi-judicial approach. Evidence is taken from the acquiring and acquired firms and “third” parties. As might be expected, the acquiring firm puts forward a strong case for the merger. Rival bus companies, particularly small independents, tend to argue against the merger,
although some exceptions exist eg Midland Red North approved of Western Travel’s acquisitions as did Badgerline with respect to Stagecoach and Go-Ahead Northern and Busways with respect to Caldaire. Local authorities’ views were more mixed. Generally, they were neutral or mildly in favor, with the exceptions, somewhat paradoxically, being the Western Travel case and the second Stagecoach case. The Department of Transport tended to be more critical. It was against the mergers in the Badgerline and South Yorkshire Transport cases, but rather more neutral in the other cases. This concern with the effects of mergers might be interpreted (following the analysis of Shepherd, 1988) as being at odds with Department’s previously stated beliefs concerning contestability. Users’ groups tended to be either in favor of the merger (Badgerline, Stagecoach) or neutral (South Yorkshire), although those members of the general public that contacted the MMC tended to be more critical.

Having reviewed this evidence and gathered its own evidence the MMC came to six separate conclusions, albeit with some common threads. These will be discussed in turn.

3.3.1 Badgerline

The MMC noted that the two main companies involved, Badgerline and Cityline chose not to compete for commercial services before the merger and, indeed, regarded their services as complementary (with Cityline operating intensive services within the city of Bristol and Badgerline operating additional services on the main arterials as well as serving the surrounding towns and villages). By contrast, Badgerline and Cityline did compete for tendered services (171 out of 369 tenders issued by Avon City Council). The majority report was thus concerned that loss of competition in the tendered market was against the public interest. After negotiations with Badgerline it reached agreement that:

(i) If Badgerline de-registered a service, it would not re-register that service if it was subsequently put out to tender and won by another operator for a period of 12 months and would give Avon County Council three months warning (ie more than double the statutory 42 days notice).

(ii) In pricing tenders, Badgerline was to ensure that a contribution to profits and overheads of no greater than 20% of the difference between the direct costs and the estimated revenue received was made. If actual revenue exceeded estimated revenue this was to be returned to Avon County Council. An independent auditor, paid for by Badgerline, was given the powers to administer this arrangement.

Two members of the group (Professor SC Littlechild and DP Thomson) dissented from this view. They believed that:

“The Government's Policy, as set out in the White Paper and the Transport Act was that the market could set the pattern of operation and ownership of the ex-NBC bus companies, subject to the normal considerations of competition policy”.

The merger, they believed, had yielded benefits in the form of ticket inter-availability, increased efficiency, rationalization, cost savings and re-deployment of assets. They went on:

“We think it reasonable to give more weight to these benefits, which are expected to be substantial and have already begun to materialize, than to the loss of a major competitor and the hypothetical possibility of future increase in tender prices ...” (MMC, 1989, p.44).

3.3.2 Stagecoach -First Case

In this case the MMC’s concern was with the loss of competition in both the commercial and tendered markets and, perhaps more crucially, Stagecoach’s reputation for ‘seeing off the competition’. There was particular concern about being able to invoke the Competition and Fair Trading Acts sufficiently promptly and the fact that “there is no interim relief”. This view partly stems from the MMC’s (1990D) investigation into predatory behavior in Inverness, where the predation had ceased before the MMC could report. If the MMC was able to take punitive as well as remedial measures, such as US-style triple damages, these concerns might be reduced.

Overall, the MMC concluded that, despite some service disruptions following post-merger rationalization, the merger was not currently operating against the public interest but they were concerned about fare increases (Sunday fares had been increased) and service reductions in the future. A number of policies were considered:

(i) Divestment was not considered practical as the operations had been comprehensively merged and there were doubts, given Portsmouth’s unique geography (the city is almost an island with only one main route to the mainland), that two network operators could be sustained.
(ii) Regulation of fares and service levels was also considered. For example an RPI + X formula for fare increases could be applied. However, this was rejected on the basis of the administrative burden that would be involved and the fact that it would be contrary to the spirit of the 1985 Act.

(iii) For all individual services, revenue should cover avoidable direct costs and make some contribution to overheads (which might be seen as a form of the Areeda-Turner rule). Again this would be plagued by administrative problems but more crucially would prove unworkable in Portsmouth, where many routes were operating at a loss.

The two recommendations that were finally made were as follows. Firstly, Stagecoach should produce a publicly available annual report on the performance of its Portsmouth operations, detailing financial and operational results. It was hoped that this greater transparency/accountability would help deter predation. Secondly, on competed routes in the Portsmouth and Havant Districts, if Stagecoach was to reduce fares or increase services, these changes must be maintained for at least one year. Stagecoach’s response was to sell off its Portsmouth-Southdown subsidiary to another bus operator, Transit Holdings.

3.3.3 South Yorkshire Transport
The MMC’s main concern here was that SYT’s purchase of four operators (SUT, Sheafline, Groves and Sheffield and District) eliminated 50% of the competition it faced. The MMC’s view was that this would lead to higher fares and lower standards of service quality and frequency. As the four acquired operations had been merged into one unit (SUT) it was recommended that this unit be divested, possibly as a separate management/employee buy-out at the same time as the parent company (currently owned by the local authority but likely to be privatized in the near future).

3.3.4 Western Travel
In this case, the MMC believed that the loss of actual competition in the commercial market was compensated for by the potential competition posed by West Midlands Travel, whilst there did not appear to be any loss of competition in the tendered market as the number of bids per tender had been increasing. The conclusion was that the merger ‘does not operate and may be expected not to operate against the public interest’.

3.3.5 Stagecoach - Second Case
The MMC believed that Stagecoach’s dominant position in Hastings and Bexhill removed the main constraint on fares and tender prices and was concerned that, through further acquisitions, Stagecoach could increase its dominance further. However, as in the previous Stagecoach case, it was conceded that divestiture was impracticable and similar constraints as those imposed in the Portsmouth case were recommended. In addition, Stagecoach should agree to not to make further acquisitions of any companies operating services from a depot within the reference area without prior notification to the DGFT. It was also proposed that Stagecoach’s activity in the tendered market should be monitored in a similar way to that of Badgerline.

3.3.6 Caldaire
The MMC’s main concern was the loss of competition in the area around Trimdon in South East Durham. Once again it was thought that divestment was not feasible and the by now standard measures to improve accountability and limit short-term retaliation were recommended. In addition, further acquisitions by Caldaire in the reference area were thought to be undesirable, whilst an effective two-year freeze on service reductions and real fare increases in the Trimdon area was suggested.

3.3.7 Implementation
The recommendations of the MMC need to be approved by the Secretary of State for Trade and Industry. In the Badgerline case the recommendations of the majority report were approved and have been implemented by Badgerline. The MMC’s recommendations in the case of SYT were approved but have been successfully challenged in the High Court. However, in three cases (both of the Stagecoach cases and the Caldaire case), Ministerial approval has not been forthcoming, with the Minister being quoted as saying of the MMC’s recommendations:

‘I am not persuaded that these remedies would, on their own, be sufficient to deal with the consequences of the loss of competition caused by the merger’. Instead divestment has been recommended. This was thought by the Government to be more consistent with the 1985 Transport Act (which split up a number of NBC subsidiaries) than the regulations proposed by the MMC.
The economic content of the MMC reports was largely limited to examination of barriers to entry and some consideration of economies of scale. A number of other factors might also have been taken into account. Reduction of transaction costs may be important, for example in the production of tender bids (Williamson, 1987). Improving managerial efficiency may be seen as an important aim; Stagecoach clearly believed their take-over of Portsmouth Citybus would have such benefits. So may improving internal capital markets. This was recognized by Badgerline who stated that Midland Red West was more profitable but with a smaller asset base, giving the combined company a more rounded financial profile. Furthermore, merger may allow risk reduction. For example, Badgerline's business was seasonal as it served mainly tourist areas. By entering the Bristol travel market it ensured a better all year round mix of traffic. Mergers may occur in declining industries, such as the bus industry in the UK, as this is the only way to ensure optimum size (possibly a factor in both Portsmouth and Hastings) and allow growth (this was mentioned by Western Travel as a factor).

The empirical evidence on whether mergers do lead to improvements in, at least, technical efficiency is varied but, in an international study, Mueller (1987) finds little evidence of increased profitability or improved stock prices as a result of merger, although this may be due to what have been termed ‘digestion’ effects or the ‘shakedown period’. He concludes that the reasons for mergers may be mainly behavioral; there are various managerial incentives in increasing company size. This may also help explain the cyclical nature of mergers; they tend to occur at the end of ‘boom' periods when managerial confidence is high and funds for ‘diversions' are available. However, increasing company size may be rational as it will have a ‘chilling effect' on the competitive environment since existing firms or potential new entrants realize that the giant firm can withstand a competitive price war longer than they can (the ‘long purse' hypothesis). Although not expressed in these terms, this appears to be have been one of the main concerns of the MMC.

Source: Steiner, 1975

Figure 1: Possible Effects of a Merger on the General Conditions of Entry
A diagrammatic representation of the case against mergers is given by Figure 1 (after Steiner, 1975). The 'optimum' price/service level mix, which might be expressed in terms of generalized cost, is denoted by C * . Assume that the overall network is served by a duopoly and that further entry can be blocked by a price/service level mix of P1. It is likely that this will consist of a high fare/high service mix - see Evans, 1987, Preston, 1991. If the two firms merge, the generalized cost of bus travel may increase further to P2. However, the merger may also allow additional barriers to be erected, for example, the combined firm's reputation for seeing-off competition may be increased. This might lead to an upward shift in the General Condition for Entry (GCE) and a further increase in the price/service level mix to P3. The key questions are, therefore, whether such limit prices exist, whether tight or loose oligopolies exist and whether significant new barriers result from mergers. If these questions can be answered then some conclusions regarding the net change in welfare as a result of a merger can be reached.

Returning to economies of scale, the MMC appears to have ignored the literature that suggests that, for a broad range of firm size, there are constant returns for the UK bus industry (Lee and Steedman, 1970, Button and O'Donnell, 1985). However, increasing returns to scale (decreasing average costs) are not a necessary condition for natural monopoly (Berg and Tschirhart, 1988). What also needs to be taken into account is a condition known as sub-additivity, whereby a firm can produce a given output at no greater cost than that incurred by two or more firms whose total productions equal the same given output. An industry which fails to exhibit decreasing average costs throughout the relevant output range but whose cost function exhibits sub-additivity may be defined as a 'weak' natural monopoly. Weak natural monopolies can undertake marginal cost pricing without incurring a deficit. The problem for the regulator is ensuring monopoly pricing does not occur. However, the nature of the demand curve needs to be taken into account in addition to that of the supply curve, because it establishes the relevant range of output. It is not inconceivable that a natural duopoly may result.

Source: Berg and Tschirhart. 1988

Moreover, it is increasingly being appreciated that the bus industry is of a multi-product nature. Implicit acknowledgement of this fact is given by the SYT case, who had developed a whole range of differentiated products such as Mainline, Eager Beaver, Little Nipper, Fastline and Coachline in addition to its standard services. The aim of the SUT acquisitions was to develop a further low cost, low quality operation. Economies of scope therefore become relevant (Panzar and Willig, 1981). These may be thought of as a restricted form of sub-additivity and occur where the total cost of producing different outputs in a single firm is less than the total cost of producing each output separately in different firms. For the bus industry this may be most important in terms of network effects (and has parallels with the connectivity issues in the telecommunications, gas and electricity industries). It may also explain the take over of firms involved almost exclusively in tendered work (eg
Western Travel's acquisition of Vanguard). It should though be noted that for multi-product firms, the sufficient conditions for strict sub-additivity are declining ray average costs (concave cost function) and trans-ray convexity (Baumol, 1977, see also Figure 2). Whether the firm is a ‘strong’ or ‘weak’ monopolist then depends on whether marginal cost pricing results in a deficit or not. Economies of joint production in the bus industry may principally result from better utilization of crew and vehicles, shared administrative costs and reduction of transaction costs (e.g. in dealing with local authorities, regulatory bodies etc). The concept of economies of density may also be relevant here. Unit costs in the bus industry may well fall with increased ridership. The moves towards inter-availability of tickets, co-ordinated timetables and, in the Portsmouth and Warwick cases, concentration of services on core routes, as a result of mergers may be seen as an attempt to develop such economies of density. The concept of economies of scope adds a further dimension to the analysis of the impact of mergers (Waterson, 1983). Using a Cournot framework, Waterson shows that if cross-elasticity of demand is low relative to own price elasticities (which seems likely for bus travel), the savings from economies of scope can outweigh the costs of monopoly power.

Berg and Tschirhart’s analysis is similar to that of Steiner, in that ‘weak’ natural monopoly/duopoly and ‘tight’ oligopoly are likely to be related and the same questions need to be asked concerning industrial structure, the extent of resource misallocation in the absence of intervention and the existence of barriers to entry. However, Berg and Tschirhart produce an up-dated approach, that incorporates the important benchmark of contestability. The first question that needs to be asked is whether the bus industry may represent a natural monopoly? When considering producer costs only, given the existence of economies of scope, there may be a case for arguing that the industry is, at least, naturally oligopolistic with some opportunities for small ‘niche’ firms (this was the view of Stagecoach). Moreover, these oligopolistic operators are only likely to compete at the margins (e.g. in border areas, in the tendered market) and may thus be represented as effectively ‘weak’ natural monopolists. If social costs are taken into account, giving the well-known Mohring effect, there may be some basis for describing the industry as a case for a ‘strong’ natural monopoly because marginal cost pricing will lead to deficits.

The second question that needs to be asked is are there barriers to entry? For the commercial bus industry the barriers are small but enough to prevent ‘ultra free’ entry. A detailed study of competition in the town of Preston indicated that the main barriers are the economies of experience of management and staff, travelcards (a downstream manifestation of economies of scope) and in certain special instances the access to the best slots (e.g. the best stands in bus stations, the best located stop in congested high streets, access to hospital grounds) (Mackie and Preston, 1988). By contrast, the tendered market may represent near enough ultra-free entry as the economies of experience and relevant ‘slots’ are provided by the tendering authority and travelcards are not a factor.

The third question that needs to be asked is whether the monopoly is sustainable. The strict conditions for sustainability include that the entrant can not exactly duplicate the incumbent’s operations, the market limits the maximum demand for the entrant’s products and that when the entrant charges lower price for a sub-set of the goods, he will make a loss whilst the incumbent will still make a profit (Panzar and Willig, 1977). The commercial bus market probably does not represent a strictly sustainable monopoly. It seems likely that some cross subsidy still exists and there has been scope for cream-skimming by entrants (as SYT pointed out). However, this does not matter if there are barriers to entry. Incumbents have been able to retaliate quickly to entry and in most cases of major competition, advantages of incumbency have caused the entrant to withdraw. For the tendered market, the ‘monopoly’, such as it is, is sustainable, at least for the duration of the tender. Although a tendered route can be duplicated by a commercial route, this is unlikely to prove a profitable strategy, at least in the short run. The threat of retaliation is only meaningful within the context of the commercial market.

Given the above analysis, the various policies that might be directed towards a multi-product monopolist are represented in Table 3, although Berg and Tschirhart themselves note that the methods for classifying firms into the cells of Table 3 are ‘primitive’ and ‘we should be careful in drawing definitive policy recommendations from the theory’. Despite these caveats, the commercial bus market might be best represented by cell 2.1 and the tendered bus market by cell 2.2. The MMC’s conclusions in the six different cases can then be reviewed in the light of this classification.
Table 3: Regulatory Policies Toward Multi-product Natural Monopolies
Source: Berg and Tschirhart, 1988, p237.

<table>
<thead>
<tr>
<th>Type of monopoly</th>
<th>Barries to entry</th>
<th>Sustainable</th>
<th>Not sustainable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong natural monopoly (MC pricing creates deficits)</td>
<td>(1.1) Regular to deviate from MC pricing to eliminate the deficit and to avoid monopolistic prices.</td>
<td>(1.2) Do not regulate. Allow threat of entry to force break-even prices.</td>
<td>(1.3) Regulate to deviate from MC pricing both to eliminate deficits and to avoid monopolistic prices, while disallowing entry.</td>
</tr>
<tr>
<td>Weak natural monopoly (MC pricing allows nonnegative profits)</td>
<td>(2.1) Regulate to enforce MC pricing and address &quot;problem&quot; of excess profits.</td>
<td>(2.2) Do not regulate. Allow threat of entry to force MC prices.</td>
<td>(2.3) Regulate to enforce MC pricing and address &quot;problem&quot; of excess profits, while disallowing entry.</td>
</tr>
</tbody>
</table>

4.1 Badgerline

The minority report's lack of concern about the loss of competition in the tendered market is consistent with the above analysis, as the tendered market is perfectly contestable. Moreover, the rate of return regulation of Badgerline's activity in the tendered market that has been introduced by the majority report is likely to be difficult to enforce. In particular, the familiar problem of over-capitalization (eg by purchasing new buses) needed to be considered (Averch and Johnson, 1962). The conclusions of neither the majority nor minority reports with respect to the commercial bus market were consistent with an analysis based on Table 3. The, albeit, artificial duopoly did potentially ensure that some competitive pressure existed (if it did not exist there must have been collusion - in which case the merger was irrelevant). The restoration of a monopoly requires regulation. Although there may have been some benefits to passengers as the economies of scope allowed some of the external benefits of the Mohring effect to be internalized, in the longer term, monopoly rents may be earned. An important piece of economic information was provided by the sale price. Badgerline paid over £7 million for Midland Red West whose constituent companies were bought from the NBC a couple of years earlier for £3.7 million. A useful line of investigation might have been to attempt to explain this price difference.

4.2 Stagecoach - First Case

The Stagecoach recommendations were more in line with the analysis presented in Table 3 as the primary concern was with commercial operations. The requirement to produce an annual report might be seen as an attempt to remove the main barrier to entry and an acknowledgement of the role of information asymmetries. The restrictions concerning the duration of fare decreases and frequency increases in competitive situations may be seen as attempts to reduce the threat of retaliation and hence impose sustainability. This may be seen as a move to cell 2.2 of Table 3 and further regulation is no longer necessary. The main criticism here is that the decision lacks consistency. Firstly, why single out Stagecoach's operations in Portsmouth for special treatment? There are many other areas served by a monopoly operator with a similar tough reputation. Secondly, the decision can hardly be deemed consistent with the 1985 Act. At the very least, the cost of implementing the recommendations ought to have been considered.

4.3 South Yorkshire Transport

Again, given the regulatory framework that has been presented, the MMC was right to focus on the commercial market and probably right to rule that the merger was against the public interest. The recommendation of divestiture though is of some concern. The experience of the bus industry is that artificial fragmentation will quickly result in re-agglomeration whilst the recommended path of a Management Employee Buyout of SUT may be an open invitation to collusion. Application of the Stagecoach recommendations might have been more appropriate. The MMC appears to have neglected two important questions: could SYT have set up a low-cost, low-quality operation of the (current) size of SUT without the take-over and is such brand proliferation in the public interest?
4.4 Western Travel

This case should probably have been dismissed at a preliminary stage as the resource misallocations were likely to be relatively minor. However, an interesting approach to the economic analysis of the bus industry was raised by the study of profitability at depot level. Of the Midland Red South depots examined, the one which faced the most competition (Leamington) was also the least profitable. Another useful economic approach might be to determine whether non standard distance-related fares exist and if so to what extent are they determined by competition and to what extent by ‘true’ market conditions.

4.5 Stagecoach - Second Case

The conclusions that might be drawn are broadly similar to those in the first Stagecoach case although it might be argued that any further acquisitions should be examined for their effects on productive efficiency before being barred outright and, as in the Badgerline case, the proposed monitoring of activity in the tendered market is probably unnecessary. The fact that Hastings and District was bought for £1.1 million only a couple of years after being privatized for £0.3 million is again worthy of investigation.

4.6 Caldaire

The recommendations of the MMC are again broadly in line with the policy prescription given by Table 3. Particularly useful information was presented on Caldaire’s profitability by depot. Losses were made by the two depots (Middlesbrough and Hartlepool) which faced the most intense competition and the highest returns on turnover were made by depots that faced little competition (Richmond, Durham). This corroborates the findings of a recent survey by accountants Price Waterhouse (1990) which found that profitability in the bus industry was positively correlated with market concentration. This leads to concerns about non-contestability and the abuse of monopoly power, although much depends on whether lack of competition leads to super-normal profits or whether active competition leads to sub-normal profits.

5. THE CASE FOR TENDERING

Given that the tendered bus market is not only contestable but is, in most cases actively contested, a system of comprehensive tendering/franchising may be worthy of consideration because it can, if the preceding analysis is correct, potentially make the issue of mergers irrelevant. In such a system the natural monopoly would lie with the network planning authority who would then put elements of the network out to tender/franchise by engaging in Chadwick style auctions. There are, of course, a number of problems with Demsetz (1968) bidding systems, as summarized by Waterson (1988). These might be addressed as follows:

1. Experience suggests that there would be few problems attracting sufficient numbers of bids and that problems related to the winner’s curse should be relatively minor, at least in the medium to long run (Glaister and Beesley, 1989).

2. Concerns about the efficiency of the winning bid (ie that it would result in average rather than marginal cost pricing) could be met by the network planning authority fixing fares (or at least a range of fares).

3. Evaluating a contract represents some problems but planners in the bus industry should have a good idea of the journey time-fare trade-off. More difficult to evaluate are aspects of quality of service such as comfort but minimum standards concerning vehicle age and specification should deal with most problems.

4. Enforcement of contracts appears to be relatively straightforward. The problems that have emerged in, say, TV franchises (Williamson, 1976) are barely relevant, because of the much higher sunk costs and more important role of technology in the TV industry.

5. Issues of contract length are relatively straightforward. Given the limited sunk costs they can be relatively short, but the preparation costs of a bid, enforcement issues and customers preference for stability gravitate against this. Three to five years seems a reasonable compromise. Contract type is perhaps more complicated. The main issues are: to what extent should operators get involved in network design, how should the network be parcelled (ie to what extent should batch tendering be encouraged?) and on what basis should the tenders be awarded. It may, in some instances, be worth considering if the planning authority should own the depots in addition to bus stations (ie the merits of complete and operating contracts should be considered). Given the analysis of the previous section, an important issue may be to what extent can economies of scope be exploited in a tendering/franchising system.
Concern about competition policy does not disappear completely with tendering. For example, the danger of regulatory capture needs to be recognized. For example, it is clearly not sensible to permit the tendering authority to be also involved in bus operations. However, some reasonable guidelines on how to avoid the main pitfalls have been drawn up (Glaister and Cox, 1991). What is now required is a review of recent experience of carefully specified tendering systems, in the UK and elsewhere, to provide the answers to these questions. An initial analysis of the relative performance of the bus markets in London and the rest of Britain suggests that tendering may be the way forward (White, 1991).

6. CONCLUSIONS

The mergers that have been investigated in the bus industry illustrate the Williamson (1968) welfare trade-off between cost savings (due to economies of scope, density and experience) and price increases (due to increased market power). The MMC has adopted a case by case approach to examining this trade-off and, given Ministerial and Judicial interference, there is no evidence of any bright lines emerging. Moreover, a number of inconsistencies have been detected in the MMC's approach to, for example, the definition of the reference area, treatment of the tendered/commercial markets and of potential competition. The recent experience of the bus industry seems to support Fisher and Lande's (1983) contention that the effects of mergers on efficiency and market power are difficult to predict, particularly as quality of output is important and there is uncertainty about appropriate demand and cost functions and the degree of oligopolistic co-ordination. As a result, a case by case approach is impractical. An ideal merger standard would prevent all market power that might be achieved through mergers, while permitting all possible efficiencies. Recent developments in the theory of multi-product natural monopolies suggest that mergers do not adversely affect the tendered bus market but they can potentially adversely affect the commercial market.

Thus, in most substantial cases a do-nothing stance (for example, as suggested by the minority report to the Badgerline investigation) is untenable because of the economies of scope inherent in network operations and the related lack of ultra-free entry conditions. However, it does have the merit of being consistent with the spirit of the 1985 Transport Act and the Government's general view that "planning, however, expertly it may be conducted, is not an acceptable substitute for the free play of market forces" (Department of Transport, 1991). The Minister's preferred option of divestment seems to be impractical both in the short run (given the acquired companies' operations have been fully integrated with those of the acquiring companies) and in the long run (how is re-agglomeration, either formally or informally through tacit collusion, prevented?). The policy may be consistent with the letter of the 1985 Transport Act but is not consistent with its spirit and fails to reflect that the 1985 Act itself contained an internal inconsistency. If the bus market was believed to be fully contestable, why were NBC subsidiaries split into smaller units before privatization? A possible justification for this apparent paradox may be that it was never really believed that the bus industry was fully contestable nor was it believed that perfect contestability was desirable. Entrepreneurial involvement and workable competition could only be achieved if there were some prospects of super normal profits. Moreover, a heavily contested industry would lead to a degree of instability that might be thought of as being undesirable for a product that contains a public service element. In other words, a political compromise was required.

Paradoxically, the most appropriate MMC recommendations appear to be those that have been rejected by the Minister of State. These regulations attempted to reduce the threat of retaliation (and hence lengthen the reaction period) and increase transparency/accountability (and hence reduce some of the economies of managerial experience). To these might be added measures to deal with the Travelcard issue to ensure that small operators may participate if they so wish. The best approach may be to have a series of regulations, applicable to bus firms above a certain size, that ensures that the commercial bus market is as contestable as possible and hence there is little scope for market abuse.

The main concerns with such a regulatory policy are ones of consistency, practicality and cost. The MMC's recent, somewhat disproportionate, interest in the bus industry, combined with the recent downturn in the UK economy appears to have slowed down merger activity in the industry but for how long and at what cost? When the MMC moves on to other industries and the economy picks up, no mechanism will be in place to automatically detect, and regulate for, mergers. The MMC may be better advised to concentrate on monopoly rather than merger issues in the local bus market. If so it will require logically consistent rules in order to delineate specific areas to be investigated. In the short term such intervention will continue to be necessary to prevent bus operators earning monopoly rents and ensuring bus travel plays its full social role. This should be borne in mind if, and when, buses are deregulated in London and London Buses Limited is privatized as a dozen separate companies. In the longer term, replacing the current UK system with that of comprehensive tendering/franchising should be considered, particularly when the lessons of experiments throughout the world, including London, are
fully digested. It seems that Government agencies are beginning to realize that the bus industry is not fully contestable and that issues of residual regulation are therefore important but the full implications of these findings have yet to be appreciated by Ministers.

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