

BUS PLANNING, PERFORMANCE AND REGULATION

**Technical Note 2 - Operator strategy and
performance**

Technical Note

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1. INTRODUCTION

Objective

1.1 This note forms part of the work undertaken for pteg during October and November 2003 to develop its understanding of the merits and drawbacks of alternative methods of procuring and regulating bus services. The purpose of this Technical Note is to facilitate discussion and increase pteg's understanding of:

- The relative importance and role of bus operations (particularly in the PTE areas) within the business portfolio of the major UK transport groups
- The investment pattern exhibited over the recent past
- The degree to which the objectives of commercial bus companies would be expected to diverge from those of PTAs in respect of the provision of services.

1.2 This work has therefore focussed on the five major transport groups which are listed on the London stock market:

- FirstGroup plc ('First')
- Stagecoach Group plc ('Stagecoach')
- Arriva plc ('Arriva')
- Go Ahead Group plc ('Go-Ahead')
- National Express Group plc ('National Express').

1.3 This analysis was resource constrained and drew on published information and informed industry sources. It does not purport to be a definitive analysis of the industry or the companies for whom data is reported.

Data sources

1.4 Two principal sources of financial data have been used:

- The latest group Annual Reports available at the time, which are the source of the group and business segment data. The year-ends of the periods covered by these reports fall between December 2002 and June 2003. Where we are aware of material and relevant events after these dates, we note these in the text.
- The Bus Industry Monitor Reports (BIM) of 2001 and 2002, produced by TAS, which have been used to analyse financial performance and investment in new vehicles by local authority type. This data for the 2002 BIM draws on annual reports covering periods ending between December 2000 and June 2001. The 2003 BIM had not been published at the time of the analysis.

1.5 The interpretation of the data and the opinions expressed are our own and are based on our knowledge of the industry. The analysis reported in this note is intended to inform the high-level review required by pteg, and it does not purport to be fully comprehensive. Steer Davies Gleave has agreed that this note may publicly released but does not and will not accept any responsibility for its use by any third party.

2. THE ROLE OF THE BUS WITHIN THE MAJOR GROUPS

Degree of diversification across business sectors

- 2.1 Table 2.1 summarises the turnover, operating profit and margin of each major group by major business sector – namely UK Bus, UK Coach, UK Rail, Overseas Bus & Rail and Other business.
- 2.2 The figures are taken from group Annual Reports for the years shown. Some adjustments have been made to bring the individual group reports into line with the table format. Only National Express reports a separate UK Coach activity but most other groups operate some coach activities within UK Bus. The major “Other” activities are Arriva vehicle sales and Go-Ahead airport ground handling.
- 2.3 It will be noted that the UK Bus sector generates over 25% of the turnover and over 50% of the operating profit of the five groups in aggregate. In all groups it generates a larger proportion of operating profit than turnover. At one extreme, although UK Bus business generates less than 10% of turnover for National Express, it produces nearly 40% of operating profit. This will, in part, reflect the different business economics of bus operations and train operating company operations, and the fact that the latter incurs fixed costs such as access and lease charges which are effectively revenue pass-throughs.
- 2.4 The UK Bus sector remains the core business of all five groups. Although all the groups (except Arriva) have diversified their business portfolios since bus deregulation, their original UK bus business remain at the core of their activities.
- 2.5 Arriva differs, since its origins lie in the vehicle sales and hire business. It has chosen to buy into the UK bus and rail sectors and it is still pursuing overseas growth opportunities.

Performance within different UK Bus market segments

- 2.6 Table 2.2 summarises the turnover and operating profit generated within the UK bus sector disaggregated into five types of environment:
- London,
 - The PTE areas,
 - Urban areas of over 250,000 population,
 - Urban areas of 150-250,000 population, and
 - Other (smaller urban areas and rural areas).
- 2.7 The analysis has used data from the BIMs for 2001 and 2002 which have been averaged to reduce the impact of any unusual events. Every company covered by the BIM has been allocated to category even though many will operate across more than one types of environment. Furthermore, the BIM does not include small companies. Accordingly the analysis is approximate and the overall market share of the major groups will be slightly overstated.

TABLE 2.1 MAJOR UK GROUPS – BUSINESS SECTOR ANALYSIS

Figures in £ millions

	Company	First	Stage-coach	Arriva	National Express	Go-Ahead	Total
	Y/E	31-Mar-03	30-Apr-03	31-Dec-02	31-Dec-02	28-Jun-03	
Turnover							
UK	Bus	£859	£598	£560	£209	£311	£2,537
UK	Coach	£0	£0	£0	£185	£0	£185
UK	Rail	£842	£690	£419	£1,553	£561	£4,065
Overseas	Bus & rail	£582	£798	£304	£466	£0	£2,150
Other		£7	£-9	£108	£0	£230	£336
Total		£2,291	£2,077	£1,390	£2,412	£1,102	£9,272
		Percentage of group total					
UK	Bus	38%	29%	40%	9%	28%	27%
UK	Coach	0%	0%	0%	8%	0%	2%
UK	Rail	37%	33%	30%	64%	51%	44%
Overseas	Bus & rail	25%	38%	22%	19%	0%	23%
Other		0%	0%	8%	0%	21%	4%
Operating profit		<i>(before interest, tax, goodwill charges and exceptional items)</i>					
UK	Bus	£110	£67	£65	£50	£44	£336
UK	Coach	£0	£0	£0	£12	£0	£12
UK	Rail	£59	£41	£15	£34	£25	£173
Overseas	Bus & rail	£32	£44	£19	£35	£0	£131
Other		£-11	£-6	£10	£0	£1	£-5
Total		£190	£146	£110	£131	£70	£647
		Percentage of group total					
UK	Bus	58%	46%	60%	38%	63%	52%
UK	Coach	0%	0%	0%	9%	0%	2%
UK	Rail	31%	28%	14%	26%	36%	27%
Overseas	Bus & rail	17%	30%	17%	27%	0%	20%
Other		-6%	-4%	9%	0%	2%	-1%
Operating margin							
UK	Bus	12.8%	11.2%	11.7%	23.9%	14.1%	13.2%
UK	Coach	-	-	-	6.6%	-	6.6%
UK	Rail	6.9%	6.0%	3.6%	2.2%	4.5%	4.3%
Overseas	Bus & rail	5.6%	5.6%	6.3%	7.5%	-	6.1%
Other		-158.0%	65.2%	9.6%	-	0.6%	-1.6%
Total		8.3%	7.0%	7.9%	5.4%	6.4%	7.0%

Source: Group Annual Reports for Y/E shown

TABLE 2.2 ANALYSIS OF UK BUS SECTOR BY AREA

Figures are the average of years 2001 and 2002.
Figures are in £000s

	Company	First	Stage-coach	Arriva	National Express	Go-Ahead	Large groups	Other	Total
Turnover									
London		£96,660	£106,818	£122,879	£0	£138,779	£465,136	£183,094	£648,230
PTE		£302,916	£94,257	£141,795	£178,989	£61,109	£779,065	£81,140	£860,204
Major urban		£173,810	£7,855	£30,917	£0	£25,771	£238,352	£113,763	£352,115
Medium urban		£37,421	£74,968	£57,907	£11,693	£18,864	£200,852	£112,671	£313,523
Other		£138,990	£262,581	£156,965	£0	£0	£558,535	£143,192	£701,726
	Total	£749,796	£546,478	£510,462	£190,681	£244,523	£2,241,939	£633,858	£2,875,797
London		15%	16%	19%	0%	21%	72%	28%	100%
PTE		35%	11%	16%	21%	7%	91%	9%	100%
Major urban		49%	2%	9%	0%	7%	68%	32%	100%
Medium urban		12%	24%	18%	4%	6%	64%	36%	100%
Other		20%	37%	22%	0%	0%	80%	20%	100%
	Total	26%	19%	18%	7%	9%	78%	22%	100%
Percentage of group total									
London		13%	20%	24%	0%	57%	21%	29%	23%
PTE		40%	17%	28%	94%	25%	35%	13%	30%
Major urban		23%	1%	6%	0%	11%	11%	18%	12%
Medium urban		5%	14%	11%	6%	8%	9%	18%	11%
Other		19%	48%	31%	0%	0%	25%	23%	24%
Operating profit									
London		£8,953	£9,063	£11,034	£0	£12,424	£41,474	£14,860	£56,333
PTE		£45,489	£15,271	£14,264	£42,874	£6,083	£123,979	£4,206	£128,185
Major urban		£26,020	£603	£6,046	£0	£4,167	£36,835	£8,926	£45,761
Medium urban		£4,160	£10,159	£6,233	£1,566	£1,722	£23,839	£3,331	£27,169
Other		£12,717	£28,088	£17,401	£0	£0	£58,205	£10,870	£69,075
	Total	£97,338	£63,182	£54,976	£44,440	£24,395	£284,331	£42,191	£326,522
London		16%	16%	20%	0%	22%	74%	26%	100%
PTE		35%	12%	11%	33%	5%	97%	3%	100%
Major urban		57%	1%	13%	0%	9%	80%	20%	100%
Medium urban		15%	37%	23%	6%	6%	88%	12%	100%
Other		18%	41%	25%	0%	0%	84%	16%	100%
	Total	30%	19%	17%	14%	7%	87%	13%	100%
Percentage of group total									
London		9%	14%	20%	0%	51%	15%	35%	17%
PTE		47%	24%	26%	96%	25%	44%	10%	39%
Major urban		27%	1%	11%	0%	17%	13%	21%	14%
Medium urban		4%	16%	11%	4%	7%	8%	8%	8%
Other		13%	44%	32%	0%	0%	20%	26%	21%
Operating margin									
London		9.3%	8.5%	9.0%	-	9.0%	8.9%	8.1%	8.7%
PTE		15.0%	16.2%	10.1%	24.0%	10.0%	15.9%	5.2%	14.9%
Major urban		15.0%	7.7%	19.6%	-	16.2%	15.5%	7.8%	13.0%
Medium urban		11.1%	13.6%	10.8%	13.4%	9.1%	11.9%	3.0%	8.7%
Other		9.1%	10.7%	11.1%	-	-	10.4%	7.6%	9.8%
	Total	13.0%	11.6%	10.8%	23.3%	10.0%	12.7%	6.7%	11.4%

Data source: Bus Industry Monitor 2001 and 2002 (TAS)

- 2.8 The turnover and profit totals by group are broadly comparable with those in Table 2.1. However they will differ at the detailed level because of the different periods covered and also the treatment of group costs and charges which may not be reflected at the subsidiary level.
- 2.9 We have not included a Return on Capital Employed indicator because differences can depend on the accounting treatment of capital, on intra-group arrangements and other factors, which makes it difficult to draw firm conclusions without more detailed analysis.
- 2.10 It is possible to make a number of observations on this data:
- The major groups dominate the PTE areas more than they do the other types of environment. They earn over 90% of the available turnover. First is the largest single operator within the PTEs with some 35% of total PTE area business.
 - Operations within the PTE areas generate more turnover and profit for the major groups as a whole than any other environment category. In particular National Express and First have generate high proportions of their turnover through the PTE areas (91% and 40% respectively).
 - The operating margin earned in the PTE areas is higher than in any other area for the major groups as a whole, but this is dominated by National Express through its subsidiary Travel West Midlands (24% margin). First and Stagecoach earn margins of 15-16%. However, several of the groups earn equivalent or higher margins in other major urban areas.
- 2.11 Across the industry as a whole, operations in the PTE areas and also major urban centres generate considerably higher margins than elsewhere. There are several reasons for this including a better operating environment for buses (a higher population density, relatively low car ownership and greater propensity to use the bus etc), a relatively low proportion of contracted services, and arguably, less effective competition. However, we are not in a position to say whether these returns are “fair”. To do so would require further analysis to assess what return a theoretical operator would need to earn to reflect the risks in the industry, given the mix of vehicle ages, leasing arrangements and cost of capital available. We would also need to benchmark the transport industry against other sectors.
- 2.12 Nonetheless, it is possible to conclude that, given the profitability and scale of their operations in the PTE areas, it is unlikely that the major groups would willingly surrender their current positions within that market.

How do operations in different areas interact?

- 2.13 There are relatively few economies of scale in the bus industry. Procurement economies of scale (principally fuel, spare parts and new vehicles) reach their maximum effect at well below the size of the major groups. Conversely many activities (such as marketing, route development and operational managements) are local in nature and therefore there is less scope for scale economies. Centralisation risks losing touch with the local base of operations, but enhances career development

opportunities and may be necessary in the face of a shortage of skilled and experienced managers.

2.14 However there are a number of ways in which the scale and geographic reach of a large group is of benefit to the industry:

- It facilitates seamless cross-boundary services. Few local authority areas are contiguous with transport catchment areas. The more extensive route networks operated by the larger groups can provide the necessary overlaps to map against natural geographical travel catchment areas.
- It internalises the cascading of buses from one area to another. Cascading has traditionally been a feature of the UK bus industry – usually with the transfer of older vehicles from urban to rural areas and consequent lighter use. Currently the major trend is to cascade buses from London to elsewhere, particularly as specifications have been raised for London contracts. Larger companies covering different operating environments can transfer buses between companies with no transaction cost, although often at book rather than market value.
- It provides a more attractive management career and training structure. The bus industry needs to attract and retain quality management. Larger groups provide more career development opportunities and have the resources to invest in group-wide training schemes. Small entrepreneurial companies find this difficult to do.

Impact of losing territory through a Quality Contract

2.15 The competitive response by an operator to a possible Quality Contract (QC) is not considered in this note, but is covered in more detail in Technical Note 1. However, we briefly review the consequences of losing territory to a successful QC operator in the paragraphs below.

2.16 If an incumbent loses business through an unsuccessful Quality Contract bid, the commercial impact of loss of profits will be painful, but the knock-on effects should not materially damage other parts of the group. The group will have three broad options:

- Re-deploy resources to compete in the existing deregulated market
- Re-deploy resources elsewhere within the group
- Dispose of resources.

2.17 Some of the groups have established low-cost subsidiaries to compete for tendered services and/or meet on-road competition. An example is Stagecoach's Magic Bus, which operates in Manchester and Glasgow. This strategy could be extended by forming the redundant resources into an operation which could compete with the new operator in another area, especially if they were seen as unstable, or enter the market in areas adjacent to the PTE.

2.18 Re-deployment of staff may be possible since many companies are short of drivers and have high staff (typically 25% or more). If the operator has other operations within the locality, it may be able to avoid significant redundancies. There will however be a

reduction in morale and this may undermine reliability in the period surrounding any change, especially one as long as the 21 months for a QC. Reportedly this has been an issue in London when contracts change hands and in Cornwall during the First changes earlier in 2003. Further comments on the application of TUPE are contained in Technical note 1.

- 2.19 Redeployment of vehicles within a group should be more readily achievable, since the large groups are purchasing significant numbers of buses each year. The degree to which this would be achievable will depend on the group's replacement requirements in terms of specification and timing. Most buses would be cascaded until the oldest and most expensive to operate were removed. There may be a book value problem if buses are scrapped before the end of their depreciation lives but this is unlikely to be material for a large group.
- 2.20 Operators are least likely to be able to re-deploy their depots and other operational premises unless a large proportion of operations from a depot are unaffected. In fact the absence of a depot in London has been the biggest barrier to entry for new operators. Most garages can be rented to the new operator temporarily but many have a commercial development value exceeding the value of such a rental.
- 2.21 Disposal of resources is the third possibility and the potential for transferring vehicles, staff and premises from the incumbent operator to the winner of the QC is discussed in more detail in Technical Note 1.

3. NEW VEHICLE INVESTMENT

Vehicle age profiles

- 3.1 The target average fleet age agreed with the CPT (and reported in Bus Quality Indicators (BQI)) is 8 years.
- 3.2 Table 3.1 on the next page summarises the distribution of the UK bus fleet by area and group as at May 2002 (the source is BIM 2002) and their average and theoretical ages. The average age of 8.3 years is very similar to the value of 8.2 years reported in BQI for the total UK bus fleet.
- 3.3 The table indicates that the age of the fleet in the PTE areas is average for the country at 8.3 years, albeit greater than the national target of 8.0 years. London has the youngest fleet and is the only area with a fleet significantly younger than the target. Among the major groups, Stagecoach and Go-Ahead were the only operators with fleets at or below target age. National Express had a significantly older fleet at that date.
- 3.4 It is not clear how the target average fleet takes account of the mix of different bus types, but to assess whether it is a reasonable target we calculated the theoretical steady-state average ages of the major group's fleets assuming the theoretical lives summarised in Table 3.2, an even replacement profile and static fleet size. Across the whole fleet, this calculation results in a value of 8.0 years, implying that this is an appropriate target.
- 3.5 This implies that any target lower than this theoretical value for a particular fleet would indicate either that the buses would be cascaded elsewhere (to a location which would then experience a older fleet) or buses would be scrapped before the end of their useful lives, thereby increasing costs. Within the PTE areas, the table indicates that the actual age of the fleets of three groups is less than this theoretical steady-state age and is very slightly higher for the other two groups, implying that the PTEs overall are, if anything, receiving slightly younger vehicles from the cascade of vehicles through the national fleet. Smaller operators in the PTE areas have a generally higher average fleet age.

TABLE 3.1 UK BUS FLEETS BY AREA

Figures are for fleet at May 2002

	<i>Company</i>	First	Stage-coach	Arriva	National Express	Go-Ahead	Other	Total
Fleet								
London		1,110	1,116	1,298	0	1,371	2,185	7,080
PTE		3,627	1,095	1,599	1,762	729	937	9,749
Major urban		2,152	216	418	0	224	1,371	4,381
Medium urban		496	1,016	795	124	145	1,442	4,018
Other		2,224	3,604	2,143	0	0	2,373	10,344
Total		9,609	7,047	6,253	1,886	2,469	8,308	35,572
Percentage of group total								
London		16%	16%	18%	0%	19%	31%	100%
PTE		37%	11%	16%	18%	7%	10%	100%
Major urban		49%	5%	10%	0%	5%	31%	100%
Medium urban		12%	25%	20%	3%	4%	36%	100%
Other		22%	35%	21%	0%	0%	23%	100%
Total		27%	20%	18%	5%	7%	23%	100%
Percentage of group total								
London		12%	16%	21%	0%	56%	26%	20%
PTE		38%	16%	26%	93%	30%	11%	27%
Major urban		22%	3%	7%	0%	9%	17%	12%
Medium urban		5%	14%	13%	7%	6%	17%	11%
Other		23%	51%	34%	0%	0%	29%	29%
Average age in years								
London		5.6	4.8	11.5		8.9	7.1	7.7
PTE		8.5	7.5	6.9	8.8	7.7	10.2	8.3
Major urban		8.5	7.5	8.3		5.4	7.8	8.0
Medium urban		7.3	7.5	7.1	6.8	5.3	9.2	7.9
Other		9.5	8.6	7.6			9.8	8.9
Total		8.4	7.7	8.2	8.7	8.0	8.7	8.3
Theoretical current average age in years								
London		8.3	8.5	8.7		8.6	8.1	8.4
PTE		8.4	8.3	8.2	8.6	8.1	8.0	8.3
Major urban		7.5	7.5	7.8		8.6	8.1	7.8
Medium urban		7.5	7.7	7.7	8.2	8.5	7.8	7.8
Other		7.5	7.7	7.4			7.7	7.6
Total		7.9	7.9	7.9	8.5	8.4	7.9	8.0
Amount by which average age exceeds theoretical age								
London		-2.6	-3.7	2.9	0.0	0.3	-1.0	-0.7
PTE		0.1	-0.8	-1.3	0.3	-0.4	2.2	0.0
Major urban		1.0	0.0	0.5	0.0	-3.2	-0.3	0.3
Medium urban		-0.2	-0.2	-0.7	-1.4	-3.2	1.4	0.1
Other		2.1	0.9	0.2	0.0	0.0	2.1	1.3
Total		0.4	-0.3	0.3	0.2	-0.4	0.8	0.3

Data source: Bus Industry Monitor 2002 (TAS)

TABLE 3.2 VEHICLE TYPES, CAPACITY AND THEORETICAL LIVES

Bus type	Capacity	Life
Mini	19	10
Supermini	27	10
Midi	36	15
Single-deck	50	18
Double-deck	74	18
Coach	47	15

Why invest in new buses?

- 3.6 In practice, buses can remain in service longer than the theoretical lives in Table 3.2. Maintenance costs rise during the years after the expiry of any warranty but plateau around seven or eight years of age. Thereafter, operating the bus remains commercially viable as long as spare parts are available at a reasonable price. Investment in a new bus is not normally justified by reduced maintenance costs alone.
- 3.7 The main reason for buying a new bus is to meet changing, and rising, expectations in the market place. The rising expectations may be translated into enhanced specifications, as in London contracts, or into obligations arising within a Quality Partnership context, or they may flow directly from passenger expectations, as with kneeling and low-floor buses.
- 3.8 A Quality Partnership can enhance the business case for earlier replacement of vehicles, by bringing together three key elements:
- Reduced maintenance costs
 - Improved productivity arising from the lower and more regular journey times as a result of effective bus priorities
 - Increased revenue from the more attractive service package.
- 3.9 Ridership is also increased by accessible buses allowing easier use by those with wheelchairs and buggies. In recent years new buses have been also more comfortable for the ordinary passenger, offering more personal space, better heating and more comfortable seating than the buses they replace.

Investment profile

- 3.10 Table 3.3 summarises the total number of new vehicles delivered to the companies in each group over the three years 1999 to 2001 and the implied average annual replacement rate. In a steady state, a target age of 8 years implies a retirement age of

16 years and therefore a replacement rate of 6.25%. In fact the average replacement rate during the three years was 7.7%, implying some growth or a reduction in average age. Over the period, the replacement rate declined from 8.7% in 1999 to 6.7% in 2001. Anecdotally, we believe that the rates have declined further since.

3.11 We understand that the major groups have shifted from a general policy of fleet renewal to a more tactical approach. A profitable “modernised” network or a Quality Partnership may well experience complete fleet renewal in one year to generate a step change in quality, whereas a low margin business may only receive buses cascaded from elsewhere. However, in aggregate for a group, investment will still be influenced by group financial considerations.

TABLE 3.3 NEW VEHICLE DELIVERIES BY GROUP AND AREA

	Company	First	Stage-coach	Arriva	National Express	Go-Ahead	Other	Total
3-year new vehicle deliveries								
London		609	816	445	0	546	808	3,224
PTE		699	203	423	429	197	112	2,063
Major urban		305	0	31	0	69	428	833
Medium urban		77	121	205	20	57	284	764
Other		191	275	384	0	0	486	1,336
Total		1,881	1,415	1,488	449	869	2,118	8,220
		Percentage of group total						
London		32%	58%	30%	0%	63%	38%	39%
PTE		37%	14%	28%	96%	23%	5%	25%
Major urban		16%	0%	2%	0%	8%	20%	10%
Medium urban		4%	9%	14%	4%	7%	13%	9%
Other		10%	19%	26%	0%	0%	23%	16%
Annual replacement rate equivalent								
London		18.3%	24.4%	11.4%	-	13.3%	12.3%	15.2%
PTE		6.4%	6.2%	8.8%	8.1%	9.0%	4.0%	7.1%
Major urban		4.7%	0.0%	2.5%	-	10.3%	10.4%	6.3%
Medium urban		5.2%	4.0%	8.6%	5.4%	13.1%	6.6%	6.3%
Other		2.9%	2.5%	6.0%	-	-	6.8%	4.3%
Total		6.5%	6.7%	7.9%	7.9%	11.7%	8.5%	7.7%

3.12 Table 3.3 indicates that London companies have renewed by far the highest proportion of their fleet, probably as a result of the TfL contract policy. Conversely companies in the small towns and rural areas (“Other”) have renewed the least amount since cascading has long been a feature of such operations. The PTE area companies have a replacement rate slightly lower than the average but above the steady-state 6.25% level.

3.13 Go-Ahead was the most active in renewing its fleet in all four areas within which it operates. It is unlikely to maintain these rates of investment.

Cascading from London

- 3.14 A result of the London contract policy has been the cascading of buses from London to other areas. A comprehensive survey is beyond the scope of this report but, as an indicator, we reviewed the destination of 132 disposals from First Group’s London double-deck fleet during 2001 and 2002. The result is shown in Table 3.4, which indicates that only 10% were sold or scrapped. Of the 90% that were cascaded, 80% went to PTE areas.

- 3.15 The average age of the 119 cascaded buses was 11 years at the time of transfer, within a range of 5 to 21 years. However only 16 buses were more than 14 years old. Excluding them the average age of the remaining 103 buses is 8 years.

TABLE 3.4 FIRST LONDON DOUBLE DECK DISPOSALS

To	Number	%
PTE	105	80
Major Urban	14	11
Sold or scrapped	13	10
Total	132	100
Source: First London website		

4. GROUP CULTURE

Commercial objectives

- 4.1 The major groups need to earn returns that satisfy stock market expectations. The Return on Capital Employed (RoCE) has replaced the traditional operating margin as the prime financial indicator. We believe that the major groups seek around a 12% post-tax return on new investment. For a full sized local bus company this equates fairly well to a 15% operating margin. (This margin is likely to generate a higher RoCE when account is taken of the impact of leasing, inflation and the extensions of vehicle lives beyond their depreciated lives).
- 4.2 We do not comment on what would be reasonable rates of return, as this would depend on the risks being borne by the particular operation.
- 4.3 Company operating margins vary widely as indicated in Table 4.1 which shows the distribution of margins reported in BIM 2001 and 2002. The distribution ranges from a maximum margin of 30% (Arriva Derby) to a minimum of -15% (Connex), with a median slightly below 10%. A comparison of Table 4.1 with the Group results in Table 2.2 shows that Arriva and Go-ahead companies in the PTE areas perform at the median level, and First, Stagecoach and National Express companies operate in or around the upper decile level in aggregate.

TABLE 4.1 COMPANIES' OPERATING MARGIN

Margin	Number of companies
>20%	4
15% - 20%	12
10% – 15%	43
5% - 10%	42
0% - 5%	25
<0%	9
All	135

Group strategy

- 4.4 Although much of the content of the Chairman’s strategy statements within the latest Annual Reports is broad generalisation, they do provide an indication of common themes. The financial elements of the strategy are common – delivering shareholder value and strengthening cash flow. The business strategies reflect the recent issues needing to be resolved within each group:
 - First - *“Developing our business in markets which offer the best opportunity for profitable growth and in areas where we can use our core skills.”*
 - Stagecoach - *“De-risking the Group’s portfolio.” “Allow management to focus on developing our UK bus and rail businesses.”*

- Arriva - “Strengthen our position in the UK market.” “Build a strong business in Europe.” “Target acquisitions in our chosen markets”

4.5 All three imply an intention to seek growth within the UK bus sector. Although their Annual Reports do not include a similar strategy statement, the actions of both National Express (in buying an operating garage in London) and Go-Ahead (in buying Wilts & Dorset Bus Company) indicate similar intentions.

UK Bus strategy

4.6 A focus for all the groups is growth, which they envisage arising from partnerships. All the groups comment on the need for partnerships to deliver growth. For example Brian Souter of Stagecoach writes, “Improved partnerships with local authorities ... are key to unlocking passenger growth” and Moir Lockhead of First sees the bus operator contributing “modernised route structures, newer buses, simplified ticketing, park and ride schemes and zonal fares”.

4.7 Only Bob Davies of Arriva comments in its Annual Report on the need for focus on “eliminating low margin and loss-making operations”. However we have little doubt that this theme plays an important part of in the business practice of all the groups, who will all reduce or withdraw services tactically to improve margins.

Fares policy

4.8 Fares have increased well ahead of inflation since deregulation. Table 4.2 summarises the real increase by area over the ten years between 1992/3 and 2001/2, and indicates that fares have risen fastest in the PTE areas.

TABLE 4.2 REAL FARE INCREASES BY AREA – 1992/3 TO 2001/2

Area	Real increase
London	12%
English PTEs	30%
English shire counties	24%
Scotland	24%
Wales	23%
Source: DfT Annual Transport Statistics	

4.9 Companies will structure their fares to maximise their total return from the market, applying increasingly complex pricing strategies to capture frequent users (for example through travelcards) and maximise yield from less frequent travellers with a combination of day tickets and cash fares. It is a reasonable conclusion that fares have increased fastest in the PTE areas at least partly because this leads to a profit maximising position in at least the short to medium term, through optimising the revenue received through the fare box or through compensation for concessionary fares arrangements. This must contribute to the greater profitability of companies in the PTE areas noted earlier. The PTEs do set some fares themselves but we do not believe that this has a significant impact.

- 4.10 The bus industry is currently subject to above-inflation cost pressures in two particular areas – labour and insurance. Since these costs form about 70% of total operating costs it is difficult for companies to keep fare increases at or below inflation, particularly once structural productivity improvements have been made. An exception can be where increases in demand are achieved in parallel with productivity improvements as can arise through the successful use of priority measures in some Quality Partnerships.

Management style

- 4.11 Most groups have centralised decision taking. The major exception is Go-Ahead who claims in their Annual Report that “*Go-Ahead’s success is based on a devolved management structure ... empowered to take responsibility ...*”.

Branding

- 4.12 Four of the five groups have built a national brand. Go-Ahead is again the exception. The national branding has a number of objectives. These include building shareholder awareness, promoting a consistent image in the national media and facilitating transfer of vehicles between subsidiaries. It is unlikely to influence passenger loyalty since most bus travel is local in nature.

5. POTENTIAL CONFLICTS

5.1 The commercial objectives of the major groups potentially conflict with PTA objectives in three principle areas:

- The groups will maximise their RoCE as long as they can maintain their presence in the market. They will seek a minimum RoCE that reflects the revenue, cost and investment risks in the business. These returns may be regarded as excessive by PTEs, who would prefer to provide a higher level of service or extend the network and accept lower returns.
- Commercial, profit-maximising fares are higher than fares which maximise social welfare. Commercial fare setting does take into account social inclusion or car use reduction objectives.
- Service levels can be, and are, reduced at short notice to reduce operating costs. There is no need for companies to take social requirements into account or to present transparent justification for these actions.

5.2 Nonetheless, the experience in London shows that it is possible to create an environment which harnesses the enthusiasm of the major groups to achieve a broader set of objectives and deliver services at reasonable cost. Lower profit margins appear to be acceptable if the environment offers a real prospect of patronage and revenue growth, and where there is a different allocation of risks between parties.

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