

Agenda

Advancing economics in business

Bus deregulation: driving a third phase?

The British bus industry has reached a fork in the road: in one direction, it faces a regulated or franchised future, and in the other, the possibility that 'deregulation' might be about to address market failure and deliver significant growth. Dr Matthew Bradley, Group Marketing Manager, Go-Ahead Group, explains why the industry should opt for the deregulation route

Recent activity in the British bus industry suggests a period of market change. Such activity includes:

- Passenger Transport Executive (PTE) market testing of franchising in South Yorkshire and Tyne Wear;
- the Department for Transport's Third Way initiative;¹
- the apparent competitive positioning of the PLCs;
- the increasing roll-out of innovative market-growing projects.

In addition, the arrival of new chief executives at three of the 'big five' PLCs may herald a new approach.

While debate has centred on the prospects for franchising and/or competition for the market and an increased role for the local state, the question of what continued liberalisation might have in store for the market outside London has received scant attention. Yet it is a significant omission, for there is growing evidence to suggest that, far from being clogged by failure, the deregulated market may be entering a new and 'third phase'. At the same time, there is the emerging prospect

of road pricing to evenly load (for the first time) the market for travel between the bus and its main competitor, the private car.

So what is the third phase and how is it significant for the industry? To answer these questions and understand where we are today, we need to examine the market that was established in the 1980s. With the benefit of a longer-run perspective, it has become clear that deregulation in 1986—and the privatisation that accompanied it—was neither the coherently executed policy that the government had hoped for, nor a neat, one-off event for which an 'outcome' could be conveniently measured. The events of the 1980s, 1990s and right up to the present day can be better understood as phases of market response to partial liberalisation and a flawed privatisation process.

This article discusses this context and argues that it is only now, 20 years on, that the market is ripe for the kinds of outcome hoped for back in 1986.

The challenges of privatisation faced by managers

- Understanding the legislation
- Defining a business that could stand alone as a sustainable commercial concern, and registering networks that could be operated commercially
- Altering subsidy arrangements, both from government and between routes, and dramatically reducing business costs
- Preparing for and establishing new management, administrative and legal structures (some National Bus Company and Scottish Bus Group subsidiaries were broken up prior to privatisation, while PTE and municipal companies were required to be set up as limited companies, at arm's length from their council owners)
- Deploying fleets of minibuses on high-frequency networks, many of which were entirely new services
- Preparing for privatisation, including the formulation of in-house management and employee buy-outs and securing the necessary financial backing
- Reviewing and restructuring traditional operating and employment practices, and the negotiation of new relationships with the trade unions
- Developing pricing and marketing strategies

The views expressed in this article of those of the author, and do not necessarily reflect the views of Go-Ahead Group.

The first phase

Transition to marketisation and privatisation (1980–88)

For much of the 1980s, the British bus industry was subject to a prolonged upheaval rather than the single 'big bang' that is commonly perceived. While October 26th 1986 caught the headlines as 'D-day' for deregulation of the bus industry, the first phase of deregulation—the transition to market liberalisation—can be regarded as an extended process that started in 1980, with express coach service deregulation and the abolition of local bus and express coach pricing controls. It continued throughout the 1980s with the abolition of local bus quantity controls and the gradual roll-out of privatisation. For many managers, the period was defined by simply getting through and surviving the greatest change to the industry in 50 years—and performing several challenging tasks simultaneously (see box above).

The first phase of deregulation was therefore one of intense activity and the catalogue of market events is well documented. However, at the very time the industry was expected to respond to customer needs, innovate, and identify new opportunities and new ways of doing business, many managers were also busy attempting to buy their own companies or prepare them for sale. Between 1986 and 1991, the entire nationalised National Bus Company (NBC) and Scottish Bus Group (SBG) were privatised. Indeed, the programme for the bus industry was bold—the combination of a large-scale privatisation with the possibility for genuine market contestability was untested in a British context. Thus the Transport Act 1985 established a market in which the participants—bus managers and companies, as well as politicians and civil servants—were operating in a new and uncertain environment and juggling many onerous and unfamiliar tasks.

However, the market was not solely shaped by the policy prescriptions of deregulation and privatisation. Two other factors—political process and a deeply ingrained bus industry culture—were also at work, and have arguably exercised as much influence over the evolution of the market as the legislation itself. Largely overlooked by the considerable academic research of the period, these factors became highly significant in driving the market in unexpected ways towards rapid agglomeration and a filtering-out of competition.

The second phase

Agglomeration and limited on-street competition (1988–2000)

The late-1980s was the high watermark of competitive activity in the bus and coach market. It was perhaps the

'classic' period of market response for which the architect of deregulation, Sir Nicholas Ridley, had hoped, where the industry largely comprised former state-owned companies that had been broken down into smaller units which competed in a contestable market. However, from the late 1980s, the market decisively changed, entering a new phase, with the fragmented industry rapidly agglomerating. On-street competition declined as the market appeared less contestable and the focus switched to business expansion through acquisition.

From the outset, the conditions for rapid concentration of ownership emerged. The process continued throughout the late 1980s and the first half of the 1990s, gaining an unstoppable momentum as PTE and council-owned companies were privatised, and then as ex-NBC and ex-SBG subsidiaries that had been sold to management and employee teams were sold on in increasing numbers to the emerging groups.

By 1997, the industry had changed completely from that of the mid-1980s, with the bulk of the market—including the now privatised London Buses subsidiaries—controlled by five UK listed companies (Stagecoach, First, Arriva, National Express and Go-Ahead). Although the process of agglomeration had largely run its course by this time, more recent activity has been evident with the sale of Yorkshire Traction Group and Blazefield to PLC interests. Thus, instead of responding to the market in ways that Ridley had intended—innovating and growing the customer base—the focus now centred on agglomeration and dealing with the company restructuring that necessarily accompanied it. Just as managers had to restructure their companies to be fit for purpose in the new market, so agglomeration required a further round of restructuring.

While the market that emerged during this second phase is quite different from Ridley's original vision, much good has been achieved. The industry has dramatically reduced its cost base and subsidy requirement (for example, helping to secure previously precarious rural services) and now actually contributes to the Exchequer as a financially profitable sector. It is on a secure financial footing with access to capital for investment.

Nevertheless, the dash for agglomeration and the consequential focus on structural change came at a cost. The merger of companies into ever-larger units reversed much of the devolution undertaken by NBC and SBG in preparation for deregulation and privatisation, while an increasing focus on continued cost reductions appeared to eclipse efforts to grow the market. For example, many of the minibus networks that had shown that customers do indeed respond to service frequency allied to a new approach ('hail & ride', friendly service and prominent

marketing) began to melt away. With managers increasingly remote from the market and covering ever-larger areas, how could they satisfactorily seek out and respond to market signals?

A number of issues concerning the privatisation process are now apparent.

- The process was staggered over a period of time, with different rules for different industry sectors, and inconsistencies in the approach within sectors. The privatisation of NBC extended from August 1986 to March 1988, while the SBG sale did not get under way until 1990. The privatisation of PTE companies was not concluded until 1991 with the sale of West Midlands Travel, and a number of companies remain under council ownership to this day.
- This staggered process allowed early privatisers to benefit from the lower sale prices at the outset of the process. (There appears to be a clear relationship between company sale, its price, its method of privatisation, tendency for post-privatisation sale and its timing in the privatisation process.) Early NBC sales tended to be made to management buyers at or below asset value (perhaps reflecting the risks of a new market) and with little or no competition from other bidders, while many late privatisers were sold at significantly above their stated asset value with up to 15 buyers bidding. Not only did early privatisers gain a head start in restructuring their businesses, but, reflecting the lower purchase price, restructuring to service or eliminate debts tended to be a less painful process than for later privatisers, which invariably paid far higher prices.
- The sale of NBC permitted the possibility of multiple purchases (up to three) by a single company. A level playing field of sorts could have been established by selling all companies to management and employee buyouts, but this did not happen. Even before the NBC sale process was complete, embryonic groups such as Stagecoach had appeared and the momentum towards agglomeration had begun. These companies were then in a strong position to dominate the sale of SBG, and later on to offer attractive prices to companies that had originally sold to management buyouts but were then subsequently offered for sale.

It is notable that the average SBG company price was £4.5m, in contrast to the NBC average of £2.7m. Significant property clawback agreements were also attached to SBG and later NBC sales—the government apparently learning from the early NBC experience where purchasers were often able to profit from property sales that exceeded the sale price of the company. By the time West Midlands Travel was

sold in 1991, prices had risen to the extent that the company was sold for £80m—half the entire proceeds of the NBC sale.

A loaded market was thus established, with the nature of the privatisation programme creating conditions that made companies ripe for sale and takeover. In addition, economic recession in the early 1990s, and the consequent fall in passenger numbers, exerted considerable pressure on management-owned companies. The inconsistencies in the privatisation process are not easily explained in a short article such as this, but the political process was an important factor, with transport ministers and political priorities frequently changing and British privatisation policy evolving.

The third phase

Forward-thinking companies show the way (2000–)

While the industry was largely engaged in a period of agglomeration during the 1990s, and the focus was on structural change and cost efficiencies, most acquisition targets have since dried up, and although keeping costs down is as important in this industry as in any other, it is unlikely that great increases in efficiency are possible. Reflecting these market realities is evidence that the bus industry is entering a new, or third, phase where patronage and revenue growth is rapidly becoming the primary focus. There is every possibility that the third phase might deliver significant benefits and—after a 20-year time lag—some of the market outcomes forecast by Ridley.

Supporting this theory is strong evidence that a number of forward-thinking operators are steadily growing the market through a combination of innovation, market-focused management, the testing of new business models, and long-term partnerships with key stakeholders. These companies have clearly shown that, far from leading to unnecessary cost, localised, properly resourced management teams are an essential aspect of the business structure that leads to improved performance. For example, in Brighton, patronage has increased by 5% year on year, yielding over 50% market growth since 1995, and in Oxford, the passenger market has doubled since the 1980s.

The significance of the third phase is that market growth is broadening out from previously isolated pockets of success to become a growing trend. Since long-term gains are being delivered in a variety of locations, these can no longer be regarded as a temporary blip or a reflection of the favourable backdrop of particular markets. Recent examples include the use of upmarket, leather-seated vehicles on inter-urban routes in Yorkshire (Blazefield is growing the market by up to 6% per

annum), and the More package operated by Go-Ahead in Poole and Bournemouth, where air-conditioned buses featuring spacious 2+1 seating have combined with route and fares simplification and retail-style aspirational advertising to reposition the urban bus and deliver market growth of 56% since December 2004 (previously, patronage was shrinking by up to 3% per annum in Poole and Bournemouth). In Nottinghamshire and Derbyshire, TrentBarton has introduced fast, direct links capable of competing with the car, together with retail-inspired customer service such as a no-quibble, on-the-spot money-back guarantee. Through its Megabus model, Stagecoach has innovated to appeal to an entirely different market, using Internet selling and a low-cost business model inspired by the no-frills airline sector, to develop a substantial niche in the budget intercity travel sector.

The work of the Bus Design Group (a consortium of leading operators looking at how bus design can be radically improved to appeal to car owners) and the application of First's Streetcar in York, are further demonstrations of an industry increasingly willing to innovate and explore new ways of delivering bus services that will appeal to a wide market. As such projects are rolled out, the market is increasingly likely to be characterised by them. A comparison can be drawn with low-floor vehicles: early adopters spotted an opportunity and, when others could clearly see the benefits, the rest of the industry rapidly followed.

As the third phase develops, it may deliver benefit to marginal markets as well. As core markets grow, there is a stronger likelihood that a 'social network' can be sustained for longer. Where this is not possible, there is evidence that innovative micro-managed smaller firms are better placed to make a success of more marginal markets, as the continued expansion of Western Greyhound in Cornwall and Norfolk Green in East Anglia demonstrate.

A further key factor that may drive the industry towards market growth is the long-run impact of stock-market pressures. While cost-cutting, above-inflation price increases and the apparent efficiencies of mergers enabled some of the PLCs to maintain margins in the short run, successful companies are demonstrating that revenue growth is crucial to sustaining profitability. The most successful PLCs are proving to be those where management is once again devolved to the local level and where genuine efforts are made to research the market, improve the product offer, and market it effectively.

An apparent willingness of the PLCs to compete with each other is also an emerging aspect of the third phase

and one that may have a significant impact on the market—most notably, the remedying of operator failure and challenging of monopoly profit by competition in the marketplace rather than competition for the market advocated by some. This aspect of the market is very much in its infancy but may go a long way to addressing the very problems that form the basis of the PTE case to re-regulate the industry in metropolitan areas.

The third phase is also seeing the industry apply the types of management approach that were originally anticipated. Common to the success stories referred to is an open-minded management approach where 'markets' rather than 'territories' are important. Increasingly, managers are motivated by satisfying the customer and taking market share from the private car, rather than being preoccupied with controlling bus 'territory' and managing decline. Managers are discovering that a segmented approach to the market, a willingness to try new ideas, to deliver the product in different ways and to seek out and respond to market signals, and an understanding of the whole issue of brand and effective brand management, are all useful tools to growing demand for bus travel.

Looking to the future

It will be interesting over the next year or two to see how the third phase matures and whether the industry retains its freedom to exploit the opportunities that the market now offers. 2006 is the 20th anniversary of bus deregulation and there is a compelling case for a reassessment of what market liberalisation was about, what it has achieved, and what it might deliver in the future.

What is clear from a 20-year perspective is that a market of both expected and unexpected outcomes has emerged. Today's agglomerated market is at odds with that intended, yet the conditions are now right for the delivery of many of the market outcomes anticipated in the 1980s. There have been some substantial time lags that, at any point since 1985, could look like market failure, but from the 20-year horizon can now be seen to represent the evolution of a market. The most significant conclusion is that a combination of structural, political and cultural factors—notably privatisation and the execution of the privatisation process—exerted unexpectedly important influences and were critical factors in shaping the market. The Transport Act 1985 did not represent the laboratory testing of market forces, but was a flawed process that took place during a formative period in the wider British privatisation project.

It has thus taken 20 years for the market to evolve and for established bus industry cultural issues to be

replaced by a market-growth business direction. We are now in a third phase of the market where there is the real prospect of the British 'deregulated' model delivering many of the improvements that advocates of re-regulation would like to see. With the third phase not yet apparent in all areas, the advocates of a move towards a franchising approach do have an understandable case for some of their arguments. In considering what will deliver the expanding market for bus travel that all wish to see, perhaps a degree of pragmatism is required. There is a strong case for

acknowledging some of the very real benefits that the deregulated regime has delivered and for the PTEs to seek to blend into their proposals the management, innovation and customer-focused expertise that is driving the third phase.

Before we rush to franchise or introduce impediments to the evolution of this market (and crucially, to the freedom of managers to respond to and satisfy the needs of the customers), perhaps we should stand back and observe the sort of outcomes the third phase delivers.

Matthew Bradley

¹ The Department for Transport has been assessing the scope for retaining some of the benefits of competition, while gaining some of the advantages from service coordination.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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