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Dear Adrian

PTEG RESPONSE TO TAS COST OF TENDERING REPORT

I am writing in response to the recent TAS report "Lessons from London: The Costs of a Bus Tendering Regime in England".

Whilst TAS's efforts to inform this important debate are laudable, I feel that the poor quality of this piece of work actually does more to mislead and to confuse than to enlighten. This is disappointing and I fear it will do little to enhance TAS's credibility and reputation as "the public transport specialists". I would therefore suggest that you consider reviewing this report with a view to re-publishing a corrected version at some point in the future.

My concerns are centred around the following four areas, which are discussed in more detail in the rest of this letter:

- Results are presented in a confusing and inconsistent way;
- The report appears to contradict much of TAS's previous analyses on this topic, without a sufficient explanation of this change of heart;
- The discussion over bus company profitability seems to be based on a degree of confusion over the economic and financial principles involved;
- Although the report is portrayed as a comparison between the current deregulated regime and franchising, many of the assumptions made mean that the overall conclusions of the report hold little value in addressing this issue.

Confusing and inconsistent presentation

The report contains a number of inconsistent or contradictory results, which make it difficult for the reader to know what to believe. The key findings section begins by claiming that the total cost of delivering a 'bus service equivalent to that in London for the whole of England is estimated at £3.2bn', yet this figure appears nowhere else in the report. The Executive Summary instead concludes by suggesting a cost of £3.8bn by 2025 (in 2013 prices). Similarly, the final chapter refers to total costs of between £3.6bn and £3.8bn by 2025, but within a table headed 'overall summary of incremental cost estimates'.

On close inspection, it turns out that neither of these figures actually refer to the 'whole of England', but rather to the 'whole of England excluding London'. To make things even more confusing, chapter 6 then lumps in Scotland and Wales in its estimate of bus industry labour costs.

Inconsistent labelling of tables and the occasional lack of information on the price basis of results given add to the confusion. For example, it's not clear whether "today's prices" refer to 2015 or 2013 (the latter being the usual base given in most of the report).

Contradiction between 2003/4 and 2014 analysis

The report appears to arrive at very different conclusions to the work which TAS carried out for the Department for Transport and for CPT in 2003/4, which concluded that the cost of a London-style bus system elsewhere in England would come to £1.2bn. This is less than 40% of the £3.2bn figure now presented in the key findings section; and it's less than a third of the £3.8bn figure quoted as the cost of running the bus network in 2025. Bearing in mind that these figures seem to all be on the same price basis, it is difficult to believe that the real terms cost of running the bus network in England outside London could treble in just over 20 years.

It may be that these different figures are not directly comparable and that, in fact, the latest report makes very different assumptions to the previous work for DfT/CPT. If so, then the latest report should contrast its assumptions with those made in previous work, so that readers can make up their minds as to the relative robustness of the different figures available.

The economics and finance of bus company profitability

The report's discussion of bus company profitability seems to imply some confusion about the economic and financial principles involved. The key issue at stake is the claim that there would be no change in target profit levels as the result of a switch from deregulation to franchising (paragraph 3.2.11). There are at least three fundamental reasons why expected profit margins are indeed likely to vary with changes in the regulatory context:

1. Many bus operating companies appear to be making excess profits. This means that they are earning a return on capital significantly above the return which an investor would require or that which a regulator would therefore accept. One of the objectives of franchising is precisely to introduce more effective competition into the market so as to reduce excess returns. The TAS report glosses over this issue entirely and seems to imply that every operating company is earning a reasonable return on capital.
2. The expected return on capital depends on the funding mix. A bus operation funded entirely from debt would require a lower return on capital employed than a similar operation funded entirely through equity. The ratio between debt and equity varies considerably across English bus operating companies but this seems to bear little relationship to returns on capital employed. Hence, it's almost certain that at least some companies are making higher returns than their funding mix would require.
3. The expected return on capital depends on the degree of risk implicit in a given investment. It seems difficult to accept TAS's assertion that the degree of risk faced by an operating company would be the same, whether or not it's facing revenue risk, and whether or not it's facing the prospect of on-street competition. In effect, it seems very much likely that potential investors would consider a bus franchise much less risky than a similar operation in a deregulated market.

The report also seems to draw some misleading conclusions about the accounting treatment of operating leases and the effect this has on the return on capital. While it is true, by definition, that funding a vehicle fleet through an operating lease can lead to a lower operating profit margin (defined as earnings before interest and tax, or EBIT, divided by turnover) than funding vehicle ownership through debt, little or no difference would be expected in terms of pre-tax profit margin. And comparison of pre-tax profit between London and non-London bus operating companies still show much higher margins outside London.

Moreover, there is no evidence in the report of the extent to which London bus companies adopt operating leases more than in the rest of the country. Given that vehicle leases could well last the majority of the useful life of the asset, I would expect finance leases, rather than operating leases, to be the norm. And finance leases are treated much as debt in accounting terms.

A like-for-like comparison of deregulation and franchising?

TAS portray this analysis as a like-for-like comparison between bus network costs under franchising and deregulation when, in fact, the assumptions on which it is based are heavily skewed against franchising. There are three main reasons for this assessment:

1. The report largely ignores any potential benefits or savings that could result from bus franchising, portraying it as the inherently riskier and more expensive option. In effect, bus franchising may well deliver some cost savings, for example by eliminating duplication and other inefficiencies in route design and some overhead functions between neighbouring operators. There are also likely to be positive effects in terms of patronage and revenue (more on this below).
2. Rather than holding other things constant, TAS make the strange decision to compare costs under franchising and deregulation while completely changing the scale of the bus network. This makes any subsequent conclusions between the relative merits of franchising v deregulation virtually meaningless.
3. TAS also make some very peculiar choices in relation to the parameters used to estimate the demand response to fare and service changes. The fare elasticity is set at -0.3 and the bus mileage elasticity is set at 0.15, without justification or source given. In reality, accepted long run fare and service elasticities (as given, for example, in the TRL593 report) are two to three times as large as the figures used by TAS. Had TAS used more realistic parameters, any fare reductions and service increases would have had a more positive effect on patronage and revenues.

More than the results themselves, what is of particular concern to me is if readers of the report were misled to believe that this analysis is an attempt at like for like comparison between alternative regulatory options.

I hope that my comments are helpful in a possible revision of this work.

Yours sincerely,

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