

Issues Paper: Inquiry on School Bus Operators' Charter Bus Operations

30 January 2007

Economic Regulation Authority



WESTERN AUSTRALIA

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Foreword

The State Government of Western Australia has requested the Economic Regulation Authority (**Authority**) to undertake an inquiry into school bus operators' charter bus operations.

The Authority will examine and report on:

- the impact that the participation by school bus contractors in the commercial bus charter industry has on competition, prices and pricing policy, investment and business practices, and service quality and reliability in the industry;
- the revenues and costs of school bus contractors under their contracts with the Public Transport Authority; and
- whether, and how, the service charge model in the school bus service contracts could be amended to remedy any competitive unfairness which might arise from the participation by school bus contractors in the commercial bus charter industry.

The Authority's evaluation will inform Government and contribute to the existing review processes for school bus service contracts within the Public Transport Authority.

The purpose of this Issues Paper is to provide background information and outline the issues to be investigated. It is intended to assist stakeholders to understand the nature of the issues under review and to facilitate public comment and debate. Throughout this Issues Paper questions are raised, highlighted in boxes, that may be of particular interest to stakeholders.

Submissions on any matters, including those raised in this Issues Paper, should be submitted no later than 4.00 pm (Western Daylight Saving Time) 26 February 2007 to schoolbuses@era.wa.gov.au or addressed to:

Inquiry on School Bus Operators' Charter Bus Operations
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Section 1.4 of this Issues Paper provides further information regarding the process for making a submission.

Interested parties and stakeholders will have a further opportunity to make submissions following the release of the Authority's draft report in late March. The final report for the inquiry is scheduled to be delivered to the State Government by 31 May 2007, following which the Government will have 28 days to table the report in Parliament.

I encourage interested parties to consider the terms of reference and the matters raised in this Issues Paper and prepare a submission to the inquiry.

LYNDON ROWE
CHAIRMAN

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1 Introduction

The Treasurer of Western Australia gave written notice to the Economic Regulation Authority (**Authority**), dated the 22 January 2007, to undertake an inquiry into school bus operators' charter bus operations.

The inquiry has been referred to the Authority under Section 38(1)(a) of the *Economic Regulation Authority Act 2003 (Act)*, which provides for the Treasurer to refer to the Authority for an inquiry any matter relating to an industry that is not a regulated industry.

1.1 Terms of Reference

The Terms of Reference for the inquiry are provided in Appendix 1.

In accordance with the Terms of Reference, the Authority is to consider and report on:

- the impact that the participation by school bus contractors in the commercial bus charter industry has on competition, prices and pricing policy, investment and business practices, and service quality and reliability in the industry;
- the revenues and costs of school bus contractors under their contracts with the Public Transport Authority; and
- whether, and how, the service charge model in the school bus service contracts could be amended to remedy any competitive unfairness which might arise from the participation by school bus contractors in the commercial bus charter industry.

In undertaking the inquiry, the Authority recognises section 26 of the Act, which requires the Authority to have regard to:

- the need to promote regulatory outcomes that are in the public interest;
- the long-term interests of consumers in relation to the price, quality and reliability of goods and services provided in relevant markets;
- the legitimate business interests of investors and service providers in relevant markets;
- the need to promote competitive and fair market conduct;
- the need to prevent abuse of monopoly or market power; and
- the need to promote transparent decision making processes that involve public consultation.

The Authority invites interested parties to consider the Terms of Reference and the issues discussed in this issues paper and prepare a submission to the inquiry.

1.2 Background to the Inquiry

Contract school buses have been operating in Western Australia for over 80 years and are a major form of transport assistance provided by the State Government to transport school students to school.¹ They are provided to students in regional areas who live outside areas serviced by public transport, and also to transport students with special needs and disabilities to specialised education support facilities. School bus services are an integral part of many Western Australian communities. Each school day, more than 800 vehicles transport over 24,000 eligible students over 140,000 km.

The majority of school bus operators are remunerated for their costs and services through a contract with the Government (through the Public Transport Authority). The cost model used to determine the majority of contractors' payments is known as the Composite Rate Model (**CRM**), and was implemented in January 2004, following several years of reviews and negotiations between Government and the industry regarding school bus services and the payment of contractors.

School bus contractors are required by their contracts to provide their services on school days (189 per year). Outside school hours, contractors are free to use their buses to provide other services, such as charter bus services. Some complaints have arisen from other charter bus companies that the remuneration given to school bus contractors through the CRM contracts allows school bus operators to undercut other operators. Other charter bus companies consider that this impacts on their ability to compete in the charter bus market.

This inquiry will provide the Government with an independent assessment of specific issues regarding the CRM contracts. The CRM contract already provides for a review process, administered by the Public Transport Authority (**PTA**) in consultation with industry, whereby parameters in the CRM are reviewed every three years. The findings of the Authority through this inquiry will inform these reviews.

Since 1995, new bus contracts have been awarded by competitive tender. While these new tendered contracts are not the focus of this inquiry, the Authority's recommendations regarding the CRM contracts may also inform reviews of the tender model used to assign new contracts.

1.3 Review Process

The recommendations of this inquiry will be informed by the following public consultation process:

- This issues paper invites submissions from stakeholder groups, industry, Government and the general community on the matters in the Terms of Reference. Submissions are due by Monday 26 February 2007.

¹ There are other forms of transport assistance to students apart from the provision of school bus services. Where eligible students can not be provided with a school bus service, parents or carers are paid a conveyance allowance to help meet the costs of transporting the students to school. There are also seven contracts for regular passenger transport, which are licence arrangements involving fare subsidies that apply to networks in large towns (e.g. Bunbury and Busselton). Students in the Perth metropolitan area are also eligible for fare concessions when travelling to school.

- Following consideration of submissions received on the issues paper, the Authority intends to publish a draft report by 30 March 2007. Public submissions on the draft report will be invited.
- The Authority will consult its Consumer Consultative Committee during the course of the inquiry.
- The final report for the inquiry is to be delivered to the Treasurer by 31 May 2007, and the Treasurer will, in accordance with the Act, have 28 days to table the report in Parliament.

In accordance with section 45 of the Act, the Authority will act through the Chairman and other members in conducting this inquiry.

1.4 How to Make a Submission

Submissions on any matters raised in this Issues Paper or in response to any matters in the Terms of Reference should be in written and electronic form (where possible) and addressed to:

Inquiry on School Bus Operators' Charter Bus Operations
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Email: schoolbuses@era.wa.gov.au
Fax: (08) 9213 1999

Submissions must be received by Monday 26 February 2007.

In general, submissions from interested parties will be treated as in the public domain and placed on the Authority's web site. Where an interested party wishes to make a confidential submission, it should clearly indicate the parts of the submission that are confidential. For more information about the Authority's submissions policy, see the Authority's web site, www.era.wa.gov.au

The receipt and publication of a submission shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, whether the submission in whole or in part contains information of a confidential nature and no duty of confidence will arise for the Authority in these circumstances.

Further information regarding this inquiry can be obtained from:

Mr Greg Watkinson
Director, References and Research
Economic Regulation Authority
Ph (08) 9213 1965
E-mail: greg.watkinson@era.wa.gov.au

Media enquiries should be directed to:

Mr Paul Byrne
Byrne & Byrne Corporate Communications
Ph (08) 9385 9941
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2 How Do School Bus Contracts Work?

2.1 History of School Bus Contracts

There are currently 693 school bus contracts remunerated under the Composite Rate Model (**CRM**), discussed in the following section, held by 390 contractors, with contract lives of between 20-30 years. The majority of CRM contractors (89 per cent) are small operators who own one or two contracts. The remaining contractors own between 3 and 15 contracts, although one large contractor owns 45 contracts. Of the current CRM contracts:

- 361 are due to expire in 2022 (15 years);
- 237 are due to expire in 2027 (20 years); and
- the remaining 93 contracts are due to expire between 2027 and 2032 (20-25 years).

Since March 1995, all new bus contracts (including CRM contracts which have expired) have been awarded by competitive tender. These contracts are known as Fixed Term Contracts, and are for fixed contract periods based on the service life of the bus (anywhere between 1 and 15 years). Tenders for Fixed Term Contracts are based on the most competitive daily rate, along with some consideration of service quality. They are subject to five-yearly reviews and are re-tendered at the expiry of the contract. There are currently 118 Fixed Term Contracts.

In January 1996, responsibility for school bus services was transferred from the then Ministry of Education to the Department of Transport, which was later subsumed under the Department of Planning and Infrastructure in 2001. In July 2003, the School Bus Services division was transferred to the Public Transport Authority, which is now responsible for the delivery of transport assistance and for the operational management of contract school bus services.

2.1.1 Past Reviews

In recent years, there have been several reviews of the school bus contracts and transport assistance in general in Western Australia.

- In 1995, the State Supply Commission investigated the contracting methodology used for school bus contracts and concluded that it was potentially anti-competitive and did not meet the Government's principles on value for money.
- The Morrell Review of Transport Assistance for Students (1997-1999), reviewed the availability of different types of transport assistance services, service and safety standards, eligibility criteria and the management of transport assistance.²
- The Shanahan Review (2000), carried out by a Committee comprising representatives of the school bus industry and Government, reviewed the remuneration of school bus contractors.³ Analysis by independent transport

² Morrell Review Report (January 1999), *Review of Transport Assistance for Students: Final Recommendations Report*.

³ Shanahan Review Report (October 2000), *School Bus Rate Renegotiation: Final Report*, prepared by Sinclair Knight Merz.

consultants identified several deficiencies in the remuneration model used at the time, the Standard Rate Model (**SRM**). The SRM was based on a model of the notional costs of operating a school bus service, but bore little relationship to actual costs. The final report recommended the replacement of the SRM by a model based on a composite rate.

- Following the Shanahan Review, an industry representative body, the Transport Forum,⁴ developed a composite rate model (CRM), based on a survey of operating expenditures of some of its members. The Department of Planning and Infrastructure engaged PricewaterhouseCoopers to conduct an independent assessment of the proposed CRM, including whether it covered all costs of contract bus services, provided equitable returns to contractors and value for money to Government. However, no agreement was reached between the industry and the Government on a final model.
- The Guise Task Force (2001-2002), chaired by Diane Guise MLA and including industry representative bodies, the Transport Forum and the Bus & Coach Association, was appointed to examine a range of issues in the school bus industry, including finalising the remuneration model. The Task Force recommended that all pre-1996 contracts be revised, and that a payment model based on a composite rate approach be developed and implemented.⁵
- Following on from the Guise Task Force, a School Bus Reform Team was established to work with industry to develop new contracts.

The CRM contract in its current form was adopted in January 2004. All existing SRM contracts at that time were converted to CRM contracts. In the future, as CRM contracts expire, they will be re-tendered under a competitive tender process.

2.1.2 Contract Tenure

A key issue in the development of the CRM as it now stands was the notion of “perpetuity” in the life of the school bus contracts. Prior to 1995, school bus contracts were originally granted by competitive tender. Once granted, the contracts were traditionally renewed every five years (subject to the continuing need for the service and acceptable performance by the contractor). This led to the perception by industry that contracts were “in perpetuity”.⁶

Following the SSC review, school bus contracts already in place were renewed, but new contracts awarded (by competitive tender) after March 1995 were for a fixed contract period based on the safe driving life of the bus (usually 10 or 15 years), with five-yearly reviews. Contracts are re-tendered at the expiry of the bus life.

During the Guise review, agreement on a new CRM was made difficult by the view by contractors that they had paid a premium for contracts “in perpetuity”. Legal advice from the Crown Solicitor’s Office, however, confirmed that there was no legal basis for such a status, and that a previous memorandum signed by two Ministers regarding perpetuity of contracts had no legal standing.⁷ A compromise was reached whereby contractors are given a period of notice of 20 to 30 years (from 2002) until the contracts are re-tendered.

⁴ Transport Forum (TFWA) is a peak industry body for road transport in Western Australia representing, amongst others, school bus contractors and long distance, heavy and bulk haulage operators.

⁵ Guise Task Force Report (April 2002), *School Bus Task Force Report*.

⁶ Ibid, pp13-17.

⁷ A letter dated 8 March 1995 and titled “Memorandum of Agreement on the Security of Tenure of School Bus Contractors” was signed by the Minister for Education and the Minister for Transport.

However, contracts that may be affected by the expansion of Transperth networks in the near future were given a period of notice of 10 years. Another compromise was the inclusion of provisions to ensure that no contractors are made worse off by moving to a CRM contract.⁸

2.2 Overview of Terms and Conditions in the Contracts

A generic CRM Contract for Provision of School Bus Service, which is between the contractor and the PTA, can be viewed on the Authority's [web site](#).⁹ The CRM school bus service contract includes, among other things, conditions relating to:

- the service to be provided, including service standards, and procedures for variations to the service;
- school bus specifications, including specifications for wheel chairs;
- bus drivers and bus aides, including requirements, instructions and duties;
- payment for services, including calculation and periodic review of components of the CRM, and treatment of GST;
- records, reporting, inspection and performance review;
- risk, indemnity and insurance;
- default and termination of contract; and
- the process for appeals.

Schedule 5 of the contract sets out the process for periodic reviews of the CRM components. Reviews are carried out annually on the existence, manner of calculation, and indexation of one third of the components of the CRM (so that each component is reviewed every three years). Reviews are carried out by the PTA along with a representative of the contractors.

⁸ The level of payment at the time of the introduction of the CRM contract was used as a benchmark minimum for existing contractors. This ensured that contractors of B and C class buses, who were better off under the SRM, incurred no reduction in their payments, until such time as their payments under the CRM surpassed the payments they would have received under the SRM.

⁹ See www.era.wa.gov.au/water/schoolBusesRelatedPaper.cfm.

3 Financial Remuneration of School Bus Contractors

3.1 Terms of Reference

The Authority is to consider and report on:

- 2) ...the revenues and commercially benchmarked costs of school bus contractors under their contracts (based on the payment model known as the Composite Rate Model) with the Public Transport Authority.
- 3) whether a change in the calculation of the service charge paid to the school bus contractors under the contract, to reduce the extent to which the Public Transport Authority reimburses school bus contractors for fixed overheads (i.e. by adjusting components which form part of the composite rate model) by reference to the proportion of the kilometres travelled by the school bus for the purposes of charter work; whether such a change, could remedy any competitive unfairness which may otherwise arise from the participation by school bus contractors in the commercial bus charter industry.

If the Authority reports in the affirmative in relation to item (3), then the Authority ought give consideration to, but will not be limited to the following matters:

- The preferred methodology for calculating an appropriate reduction on the service charge with reference to charter work undertaken by school bus contractors.
- The dollar amount returned to government for charter work that allows commercial operators to compete competitively.

3.2 Composite Rate Model (CRM)

The CRM is an average cost approach, in which contractors are remunerated in relation to the average actual costs incurred by school bus contractors in the provision of their services.

Under the CRM, contractors are paid a Service Charge, based on the estimated average costs of various components of fixed and variable costs. Table 3.1 sets out the cost components of the CRM and a brief description of the bases on which these are calculated. For a full description of their calculation, refer to the generic contract on the Authority's web site. The calculation of Class Bus Prices is explained below, in Table 3.1.

Table 3.1 Composite Rate Model Cost Components

CRM Cost Component	Description of Calculation
Fixed Costs	
Return on investment ^(a)	10.5 per cent of the Class Bus Price each year.
Depreciation	Determined by straight-line depreciation over the service life of a school bus, allowing for a residual value at the end of the service life of a school bus of 10 per cent for Class A and Class D buses, and 5 per cent for Class B and Class C buses.
Administration ^(b)	Fixed annual amount, with decreasing amounts whether there are more than three contracts.
Vehicle registration and third party insurance	Based on annual charges for each bus as specified under the <i>Road Traffic Act 1974</i> .
Comprehensive insurance ^(a)	Determined from quotes of annual comprehensive insurance premium, based on Class Bus Price, depreciated by the age of the bus, and a clean claims history.
Garaging	An annual fixed amount, if contractor meets specified conditions concerning garaging of bus.
Communications ^(b)	Fixed annual amount, with decreasing amounts where there are more than three contracts.
Variable Costs	
Fuel ^(c)	A daily amount, based on: an estimate of standard daily kilometres (SDK); fuel consumption (dependent on the bus class); and fuel price (three-month moving average fuel price for the metropolitan area, indexed for different operating regions).
Repairs and maintenance ^(c)	Based on a service rate per SDK, plus a fixed rate for some bus classes. Service rates vary for the school bus class, and are subject to an upper limit based on the life expectancy of the bus.
Air conditioning ^(c)	A daily amount based on the SDK, an air conditioning rate dependent on bus class, and indexed for different operating regions.
Tyres ^(c)	A daily amount dependent on the SDK, and quoted tyre repair prices and estimated tyre lives for each bus class.
Unsealed road running ^(c)	An adjustment to service rates (for the purposes of determining repairs and maintenance costs) for buses where more than 1 per cent of the SDK is on gravel roads. Another adjustment applies where more than 50 per cent of the SDK is on gravel.
Car running ^{(c)(d)}	A daily amount based on the estimated number of kilometres of car running and the private vehicle reimbursement rates published by the Royal Automobile Club of WA.
Staff-Related Costs	
Drivers' wages ^(b)	A minimum amount, based on the minimum number of hours of driving for which the PTA will pay; plus an amount reflecting the number of hours of driving above the minimum; plus an allowance for car running. Hourly rates vary with operating region, and whether the bus has more or less than 25 seats.
Bus aide's wages ^(b)	Calculated as for drivers' wages, but at a lower hourly rate.

contd...

CRM Cost Components (Contd)	Description of Calculation (contd)
Superannuation	A percentage of the drivers' (and bus aide's, if applicable) daily wages, as set out in the <i>Superannuation Guarantee (Administration) Act 1992</i> .
Worker's compensation	A percentage of the driver's wages as set out under section 147 of the Workers' Compensation and Rehabilitation Act 1981; plus stamp duty as a percentage of drivers' and bus aide's wages.
Communications ^(b)	Fixed annual amount, with decreasing amounts where there are more than three contracts.

Notes:

(a) For an explanation of the calculation of the Class Bus Price, see Table 3.2 and discussion below.

(b) Amounts vary depending on whether the contract is for mainstream school bus services or for services for education support facilities.

(c) Standard daily kilometres (**SDK**) are estimated on basis of the approved bus route for each bus contract, including whether the bus is loaded and unloaded.

(d) The car running cost component applies to bus operators who choose to leave the bus at the school and covers the bus operator's costs of driving between the bus depot and the school.

Calculation of some of the cost components (rate of return, insurance) depends on the class of bus that the contractor uses. There are seven classes of buses, defined on the basis of maximum seating capacity and wheelchair facilities (see Table 3.2). For each class of bus, there is an associated Class Bus Price, calculated by the Public Transport Authority on the basis of the average new purchase price quoted by a supplier for a standard vehicle of a model of school bus, averaged across the various models of buses in each class. Class Bus Prices are revised annually. Table 3.2 lists the various classes of school buses and the Class Bus Price for each category for 2006.

Table 3.2 School Bus Classes and Class Bus Prices for 2006

School Bus Class	Bus Type	Capacity	Class Bus Price (2006, Exclusive of GST)	
			Without Air Conditioning	With Air Conditioning
Class A	Toyota Coaster, Mitsubishi Rosa	20-24 adult seats	\$80,213	\$90,748
Class B	Mercedes, Hino, Iveco	29-43 adult seats	\$229,419	\$261,416
Class C	Mercedes, Hino, Iveco	51-57 adult seats	\$283,366	\$316,868
Class D	Toyota Commuter	13 adult seats		\$44,616
Class A (Wheelchair)	Toyota Coaster	1-3 wheelchairs		\$117,775
Class B (Wheelchair)	Mercedes	4-8 wheelchairs		\$335,993
Class C (Wheelchair)	Mercedes	9-12 wheelchairs		\$409,434

Source: Public Transport Authority

The Service Charge is adjusted at the end of each school term if the actual kilometres travelled differ from the Standard Daily Kilometres specified in the contract, so that contractors are paid on the basis of kilometres actually driven.¹⁰

3.3 Standard Regulatory Framework

In a competitive market, competition between firms acts to provide customers with a product or service that is of high quality at the lowest possible price. Firms compete for business on the basis of low prices (achieved through efficiency improvements) as well as on the basis of quality and choice of products. There is little role for economic regulation in a competitive market.

In the absence of a competitive market, there is a role for economic regulation to ensure that prices and services are as similar as possible to those that would be achieved under a competitive market. Some industries lack competition because they are natural monopolies, such as industries which involve large infrastructure investments and distribution networks. In these industries, it is inefficient for such infrastructure to be duplicated by more than one service provider. Thus, economic regulation has played a central role, for example, in the setting of distribution prices for gas, electricity and water.

Another potential barrier to competition is the presence of subsidies. Subsidisation of some firms can act as a barrier to entry into the market, by enabling the subsidised firms to price below the long run average costs of potential new entrants, making it uneconomic for them to enter the market.

In determining the appropriate level of regulated prices, the standard approach of regulators is to ensure that regulated firms are able to obtain a level of revenue that is sufficient to cover the efficient costs of providing their services, including an appropriate rate of return on the value of the assets used to provide the services. This approach is known as the building block methodology, and involves a determination of a total revenue requirement for a particular year from cost components, as follows:

$$\begin{aligned} \text{Total Revenue} &= \text{Net Asset Value of the Business} \times \text{Rate of Return} \\ &+ \text{Depreciation} \\ &+ \text{Forecast Efficient Operating and Maintenance Costs} \end{aligned}$$

An important distinction is between the revenue required to provide a regulated service, and other revenue which is earned by using the regulated assets to provide a non-regulated service. In this instance, the standard regulatory approach is to reasonably allocate all costs as between the regulated and non-regulated services. Total revenue for the regulated service is then determined as the sum of all costs attributable to the provision of the regulated service.

The current CRM contract allows for other (non-school bus services) income to be taken into account during reviews of the compensation of contractors. Schedule 5 of the contract, regarding the review process, states that a relevant consideration in a review of the CRM is:

actual income earned by Contractors from sources other than the [Public Transport] Authority from assets which the Contractors are compensated under School Bus

¹⁰ See part 4 of the generic CRM School Bus Service Contract for the calculation of the adjustment amount.

Contracts.¹¹ Furthermore, the CRM contract also states that the purpose of the CRM and the CRM review process is:

to balance the interests of the [Public Transport] Authority in procuring school bus services for a commercially fair value and the interests of Contractors in receiving a commercially fair income for the provision of those services in the absence of a competitive tender process.¹²

The Authority will need to establish whether the CRM in its current form properly takes into account the other services provided by school bus contractors outside the provision of school bus services. If school bus contractors' other services are not appropriately taken into consideration, the Authority would need to give consideration to how a more level playing field between school bus operators and commercial bus operators may be achieved.

The Terms of Reference suggests a possible approach involving a reduction in the service charge paid to school bus contractors under the CRM. For example, the PTA could reimburse a lower proportion of school bus contractors' fixed overheads, reflecting the portion of those costs attributable to providing non-school charter services. These costs could, for example, be calculated by reference to the kilometres travelled for the purposes of charter work. It is noted that there may be other approaches that the Authority could consider. In any event, it will be important to ensure that school bus operators are appropriately remunerated for the school bus services that they provide, while at the same time able to provide charter services on a commercial basis in competition with other charter operators.

3.4 Revenue Required to Provide School Bus Services

One of the Authority's tasks in this inquiry will be to examine whether the payments to school bus operators cover the efficient costs of providing school bus services, including an appropriate rate of return on the assets involved in providing the service.

In the case of the total revenue required to provide a school bus service, contractors need to be able to:

- earn a commercial rate of return on the un-recovered cost of assets required to provide the school bus service (return *on* capital);
- recover the costs of those assets (return *of* capital, or depreciation); and
- recover the efficient costs of maintaining and operating the assets to provide the school bus service.

¹¹ CRM School Bus Service Contract, Schedule 5, 9(b)(v)A

¹² (CRM School Bus Service Contract, Schedule 5, 9(b)(i))

3.4.1 Asset Value

Under a standard regulatory approach, the relevant annual asset value to which a rate of return is applied is the closing net asset value of the business. This takes into account any additional capital expenditure, depreciation and operating and maintenance costs of the business for the year.

The application, under the CRM, of a rate of return to a non-depreciated asset value (such as an annually revised Class Bus Price), as compared with the approach normally adopted in regulatory circumstances, would be a matter to be examined more closely by the Authority.

3.4.2 Rate of Return

Another key element in the revenue requirement under a normal regulatory approach is the rate of return that is applied to the closing net asset value of the business. This is the cost of capital that investors – both the providers of debt and equity – would require in order to be adequately compensated for the cost of providing those services.

The approach widely used by Australian utility regulators to determine rates of return is the Weighted Average Cost of Capital (**WACC**). The WACC is the average cost of debt and equity capital, weighted by the proportion of debt and equity, to reflect the financing of the business. Rates of return will vary from industry to industry depending on factors such as the debt to equity ratio, the rate of return also reflects risk but only to the extent that such risk cannot be eliminated through diversification.

Under the current CRM contract, the return on investment is determined as 10.5 per cent of the Class Bus Price each year. Under the current CRM contract, the fixed and variable costs are periodically reviewed under the standard CRM review process. The return on investment (**ROI**) is not classed as a reviewable component. However, the ROI is set down for discussion between the PTA and Contractor Representatives on a biannual basis (from December 2005)..¹³

Submissions from the school bus industry during the development of the current CRM framework recommended that returns for school bus operators should be comparable with other small businesses such as Lotto kiosks, newsagencies, post offices and TAB agencies.¹⁴ On this basis, the industry submission recommended a return on historical costs of around 20 per cent. This measure of returns is not directly comparable with a WACC. Analysis by PricewaterhouseCoopers (**PwC**) in 2003 of the industry's submission estimated that the industry's proposal was equivalent to a return on the current replacement cost of a bus of 15.8 per cent.¹⁵ By comparison, the PwC report recommended a return on current replacement cost, calculated on a real pre-tax basis of between 8.4 per cent and 9.2 per cent.

A further comparison that can be made is with the pricing decisions of other regulators on rates of returns for school bus services. In its recent review of non-metropolitan fares for private buses in NSW, IPART approved a revenue requirement for the funding of non-commercial bus services which included a rate of return on investment derived by adding

¹³ See Schedule 4 – Part 2, Section A: Regular Recalculation, CRM School Bus Service Contract.

¹⁴ For example, Owen and Plaistowe (February 2003), submission to the Department of Planning and Infrastructure on behalf of the school bus contractors.

¹⁵ PricewaterhouseCoopers (March 2003), "School bus pricing – submission by industry", comments to Department for Planning and Infrastructure on a submission by Owen and Plaistowe (February 2003), op.cit.

a margin of 8 per cent over the 10-year government bond rate. This rate of return (which is not equivalent to a WACC given it only relates to a return on equity) was estimated using a PwC model which forms the basis of non-commercial bus contracts in NSW.¹⁶ In its review of bus fares for the Sydney metropolitan area, IPART determined the user cost of capital by applying a real pre-tax rate of 6.5 per cent to the fixed value of bus assets in Sydney.¹⁷

One of the matters to be considered by the Authority will be the rate of return approach adopted in Western Australia and how this compares with other approaches (to ensure that comparisons are valid).

3.4.3 Depreciation

A standard regulatory approach to depreciation is the use of a straight line method over the life of the asset, allowing for an estimated residual value at the end of the asset's life (reflecting resale or scrap value).¹⁸ However, other methods of depreciation may be used where the utilisation and diminution in the productive value of an asset is higher in the early or latter part of its life.

3.4.4 Operating and Maintenance

In addition to the return on and of capital, contractors should be provided with sufficient revenue to cover efficient operating and maintenance costs associated with the provision of school bus services. Given the frequency of reviews of the CRM parameters (each cost component is reviewed every three years), the current estimates of efficient costs may provide an adequate estimate of efficient costs until the time of the next review. However, any cost increases (or decreases due to efficiency improvements or technological change) anticipated within the three years until the next review could also be included in the cost estimate.

A further consideration is the incentives provided by the CRM for contractors to achieve efficiency savings in their operating and maintenance costs, and the extent to which any industry-wide efficiency savings are incorporated into revised cost components for the CRM.

3.5 Issues

A key issue for the Authority in this inquiry will be to determine an appropriate treatment of costs associated with activities other than school bus services, and to examine the extent to which the existing CRM contracts reflect such arrangements. The objective is to ensure that school bus contractors (a) receive revenues from the provision of school bus services equal to, but not more than, the capital costs (including a commercial rate of return) and efficient operating and maintenance costs of providing school bus services; and (b) have an incentive to operate as efficiently as possible.

¹⁶ IPART (December 2006), *Review of Non-Metropolitan Fares for Private Buses in NSW from 2 January 2007: Report to the NSW Minister for Transport*. IPART noted in its decision that it considers the PwC model "flawed" and would like to review the model prior to the next fare review.

¹⁷ IPART (December 2006), *Review of Fares for Sydney Metropolitan Bus Services from 2 January 2007*.

¹⁸ The Authority notes that under Part 5 of the CRM contract, if a contractor sells a bus for more than the residual amount specified in the depreciation component at the time of the sale, the contractor must pay the PTA the lesser of (a) 50 per cent of the difference, or (b) 5 per cent of the Class Bus Price.

A further issue is to examine the approaches of the CRM and compare these with approaches to cost estimation used by the Authority and other industry regulators. Again, the aim is to identify any divergences between the CRM framework and models used to determine efficient costs and revenues in other sectors.

In considering the above cost related matters, recognition will also need to be given to the likelihood that it will be in the communities' best interest for the school bus fleet to be used fully and efficiently (by being available for use outside school hours). In other words, where spare capacity exists, it should be available to provide other services. In cases where there is existing infrastructure with considerable spare capacity, additional services can be provided at low cost by the school bus fleet, reflecting the additional marginal costs of providing those services. It may be difficult, and possibly inefficient, for new service providers to enter a market in which there is idle capacity.

Issues

- 1) How does the methodology under CRM contracts for calculating payments to school bus service providers compare with normal regulatory approaches?
- 2) Are the cost components of the CRM determined in a way that provides appropriate remuneration to school bus service contractors?
- 3) In particular, is the rate of return on investment in the current CRM contract appropriate?

4 Impact on Commercial Bus Charter Industry

4.1 Terms of Reference

The Authority is to consider and report on:

the impact the participation by school bus contractors in the commercial bus charter industry has on:

- (a) competition within the industry;
- (b) prices and pricing policy in respect of services provided in the industry;
- (c) investment and business practices in the industry, and
- (d) quality and reliability of the services provided in the industry.

4.2 Features of a Competitive Industry

The issues being examined in this inquiry would not arise if all school bus contracts were awarded through a competitive tender process. Under the current arrangements, whereby new contracts and expired CRM contracts are awarded by competitive tender, there is a process of transition toward a fully competitive tender process. Eventually, all CRM contracts will be converted into tendered rate contracts. In the interim, the Authority has been asked to examine the impact of the existing CRM school bus contracts on competition in the charter bus sector.

A useful frame of reference for this analysis is the outcomes of competition. Competitive markets are characterised by the following features:

- Prices are cost-reflective, as firms compete for customers by reducing their prices to reflect costs.
- Costs are low as competitors seek to improve efficiency in technical processes, management and technology. Companies have an incentive to reduce their costs so that they can increase their profits (the margin between prices and costs) over the short-term. Eventually, other companies adopt the same cost-saving practices and costs are lowered across the industry.
- Investment is efficient: firms make investment decisions based on their forward-looking expectations of returns and demand for services. Under-investment and over-investment are discouraged, as investments must be consistent with the provision of services at a quality and price that is demanded by the market.
- Quality and reliability of service are high, as firms compete on the basis of service standards, not just price.

4.3 How Competitive is the Charter Bus Industry?

The next question is whether or not competition in the charter bus industry in Western Australia is being adversely impacted by the participation of school bus contractors in the industry.

4.3.1 Industry Structure

In a competitive market, firms compete to provide services. In other markets, a competitive advantage on the part of one or two players can lead to market domination by a monopoly (one dominant player) or oligopoly (a few dominant players). In such markets, there are barriers to entry for potential market entrants. One example of a barrier to entry is where the cost structures and pricing behaviour of the incumbent players make it unprofitable for the potential new entrants to enter the market.

There have been numerous complaints from other (non-school) bus operators that they are unable to bid successfully for charter bus services due to the ability of school bus contractors, whose overheads and bus purchase costs are covered by school bus contracts, to price just above their operating costs.¹⁹ The concern is that the school bus contracts provide school bus operators with an unfair advantage over other commercial bus charter operators.

The market for bus charter services is not the same across Western Australia. In some small country towns, the local school bus may be the only provider of charter services, and the demand for these services in that area would not be sufficient to attract more than one bus operator. However, in larger regional towns, particularly those with appreciable tourist industries, the demand for charter services could support multiple providers.

The Authority would be interested to hear of any views or evidence on the issue of whether the provision of charter bus services in Western Australia by school bus operators adversely impacts on competition in the charter bus market.

4.3.2 Prices and Pricing Policy for Services

In order to enter a market, new entrants will need to be confident that the prices they receive will at least cover their long run average costs (i.e. their fixed and variable costs, per unit, over the long run). Conversely, entry into the market could be prevented if an incumbent were able to charge below average cost of the most efficient new entrant, in the long run.

Customers of charter bus services may be benefiting from the use of school buses in the form of lower prices for charter services. However, a wider issue is the incentive for school bus operators to improve the efficiency of their charter bus services. In a competitive market, the incentive to reduce costs arises from the increase in profit margins for firms who can improve their efficiency. Larger operators in a competitive market may also be able to achieve economies of scale (a reduction in unit costs with the size of an operation) which would lead to a further reduction in prices.

The Authority would be interested in submissions on the pricing of charter bus services, particularly in relation to long run average costs in the industry.

4.3.3 Quality and Reliability of Services

The Terms of Reference request that the Authority examines the impact of school bus contracts on the quality and reliability of services in the bus charter industry. It should be noted that the quality of charter bus services, which is not a subject of this inquiry, is a

¹⁹ The Authority has sighted several letters of complaint sent by charter bus operators in 2003-04 to the then Minister of Planning and Infrastructure.

separate issue to the service standards that apply to the provision of school bus services.²⁰

In a competitive charter bus industry, operators compete not only in terms of price, but also on the basis of the quality of customer service. Again, if some operators can consistently undercut potential competitors on the basis of price, there is less of a need for these operators to focus on the quality of the service.

The Authority would be interested to hear of any views regarding the quality and reliability of school and charter bus services.

4.4 Issues

A primary focus for the Authority in this inquiry is to establish the impact on the charter bus industry of participation by school bus contractors. In addition to examining the remuneration of school bus contractors (discussed in section 3), the Authority will also be seeking evidence from industry participants and interested parties regarding the degree of competition in the charter bus industry. If it is the case that remuneration under CRM contracts enables school bus contractors, through their pricing behaviour, to maintain dominance in the market for charter services, then there is the potential for incentives for investment and high service quality to be below what they would be in a competitive environment.

Issues

- 4) Is the charter bus industry in Western Australia adversely impacted by school bus operators?
- 5) How do the prices charged by school bus operators for their charter bus services compare with the costs of providing charter bus services?
- 6) What indications are there that investment and/or service standards in the charter bus industry are adversely impacted by school bus operators?
- 7) How do service standards in the charter bus industry compare with customer demands?

²⁰ The quality of school bus services provided by school bus contractors is monitored annually by the PTA and is generally regarded as high. Key performance indicators include reliability, safety and cost efficiency. In 2005/06, timetable reliability for school buses was over 97 per cent (measured as the number of buses in a random sample which dropped off no less than 10 minutes before the start of school and picked up within 10 minutes of school ending). There were 16 on-road accidents involving school buses in 2005/06, which was above the target of 6 for the year. The PTA does not measure customer satisfaction for school bus services as these are provided on an entitlement basis. Source: Public Transport Authority (2006), *Annual Report 2005/06*.

APPENDICES

Appendix 1: Terms of Reference

INQUIRY ON SCHOOL BUS OPERATORS' CHARTER BUS OPERATIONS

TERMS OF REFERENCE

I, ERIC RIPPER, Treasurer (following consultation with the Minister for Planning and Infrastructure), and pursuant to section 38(1)(a) of the *Economic Regulation Authority Act 2003* (the ERA Act), request that the Economic Regulation Authority (the Authority) undertake an inquiry into the participation by school bus contractors in the commercial bus charter industry.

In conducting its investigations the Authority is to report on the following matters:

- 1) the impact the participation by school bus contractors in the commercial bus charter industry has on:
 - (a) competition within the industry;
 - (b) prices and pricing policy in respect of services provided in the industry;
 - (c) investment and business practices in the industry, and
 - (d) quality and reliability of the services provided in the industry.
- 2) To the extent necessary to report on the previous matter, the Authority should consider and report on the revenues and commercially benchmarked costs of school bus contractors under their contracts (based on the payment model known as the Composite Rate Model) with the Public Transport Authority.
- 3) Whether a change in the calculation of the service charge paid to the school bus contractors under the contract, to reduce the extent to which the Public Transport Authority reimburses school bus contractors for fixed overheads (i.e. by adjusting components which form part of the composite rate model) by reference to the proportion of the kilometres travelled by the school bus for the purposes of charter work; whether such a change, could remedy any competitive unfairness which may otherwise arise from the participation by school bus contractors in the commercial bus charter industry.

If the Authority reports in the affirmative in relation to item 3, then the Authority ought give consideration to, but will not be limited to the following matters:

- The preferred methodology for calculating an appropriate reduction on the service charge with reference to charter work undertaken by school bus contractors.
- The dollar amount returned to government for charter work that allows commercial operators to compete competitively.

The Authority will release an issues paper as soon as possible after receiving the reference. The paper is to facilitate public consultation on the basis of invitations for initial written submissions from industry, government and all other stakeholder groups. The Authority will also release a draft report for further public consultation.

A final report is to be completed by no later than 31 May 2007.