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Submission Draft Report

Inquiry on School Bus Operators Charter Bus Operations

Executive Summary

1. TFWA generally agrees with the thrust of the Draft Report.

2. There does not appear that there is an adverse affect on the commercial charters in the face of anecdotal and other evidence available to TFWA.

3. It would be counter productive for PTA to impose charter fees for charter work undertaken by school bus operators.

4. Caution should be exercised when using a 50% debt/equity ratio as an appropriate financial data base of contracts and their financial attributes is not available.

5. The use of equity beta of .8 is questionable as market evidence is limited and no useful benchmarking has been completed.

6. Assuming that the above figures are correct, a rate of return of 8.6% should be highly qualified as not all cost components have been captured and some of those identified are not appropriately remunerated. In addition, useful benchmarking with all components has not been undertaken and the review process is legalistic, complex and extremely slow and indeed, some element costings lie outside the jurisdiction of the Panel.

Introduction.

Transport Forum WA (TFWA) welcomes the opportunity to present another submission as a result of the Draft Report into the Enquiry on School Bus Operators' Charter Bus Operations.

Generally, TFWA agrees with the ERA preliminary views. There are however, items that need clarification and Preliminary Views that need qualification. In the submission dated 27 February, 2007 Forum noted that very few of its members were involved in commercial charters and there was nothing to suggest that there is an adverse impact on commercial charter operations. Forum strongly agrees that "there are likely to be few net benefits to the state from introducing charter fees for charter work undertaken by school bus operators". Introduction of such a fee particularly with curriculum based and extra curricula activities would result in many operators not accepting such tasks which would impact adversely on a students' education.

In the lead up to the remuneration negotiations, TFWA developed the Minimum Rate Model (MRM) where minimum rates across the board would be paid with the addition of loadings for specific items. These included a Responsibility and Productivity Allowance as well as a loading for transporting children with special needs. The Industry believed that the MRM was the way to go as it rewarded productivity and recognized some

efficiency. Following a number of reviews, Mr. Tim Shanahan was contracted to look at Forum model and previous reports and to recommend a way forward. Mr. Shanahan coined the phrase Composite Rate Model (CRM) and not Forum. Price Waterhouse Coopers (PwC) were contracted by the Department of Transport (DoT) to examine the newly named CRM. PwC disallowed a number of components and altered the amounts in other areas. DoT accepted the PwC Report despite protestation by the Industry. The final CRM differs somewhat to the proposed Industry MRM.

On 9 May 2002, the then Minister for Transport met with the Industry stating that there was no legal basis for "in perpetuity" contracts. The Minister cited crown law advice that supported this claim. The Industry requested that the advice be made public stating that industry exemptions can be recommended to the State Supply Commission. This request was denied. The Minister then announced that contracts would have definite end dates. What was offered at that meeting and accepted by the contractors attending is still subject to debate and interpretation. In the end, contractors were told that they were going to get either a 20 or 25 year (except in a Transperth zone) contract and this position was not negotiable.

Schedule 5 of the Contract sets out the process for periodic reviews. When a Component is due for a periodic review, there is an exchange of Issues Notifications between PTA and Industry. Then follows a period of rebuttals and if agreement or compromise cannot be reached, the item is referred to the Review Panel to determine whether it is an issue or not. If deemed to be an Issue, the Review Panel will deal with it. Notwithstanding, the review process is complex and very slow. A component for review in 2005 (Repairs and Maintenance) has still not been determined and will not be completed in the near future.

The issue of what standards should apply to school bus services and what assets are necessary should be a matter for negotiation between the contractors and the PTA. However, it is very difficult to negotiate with PTA. For some items, Forum has been negotiating for over four years. If it is difficult for the Industry Organization to negotiate, how much harder is it for an individual contractor to do so? PTA is not in the habit in allowing extra items to be included in the purchase of a bus even though the contractor wishes to purchase these items at their own expense. PTA demands the purchase of a bus to fulfill the **minimum** standard and nothing more. Since PTA is the approving authority for the purchase of a bus, it is difficult to negotiate anything different.

The case of air conditioning is not a matter which can be dealt with through the CRM review process as this is a Government policy and not a contract item. It was discussed during the negotiation process and Industry received assurances that it would be examined once the Industry had settled following the signing of the new Contract in January of 2004. With air conditioning, the current provisions use the Bureau of Meteorology Index called the Relative Stress Index (RSI) for remuneration purposes. RSI is produced in an attempt to better describe thermal comfort for humans. To simplify a complex issue, the developers of the RSI (Lee and Henschel 1963, USA) adopted the characteristics of a "standard man" who was defined as about 25 years of age, healthy,

not acclimatized to local conditions and wearing standard clothing that was moist due to perspiration, had a specified metabolic rate and in an area with slight air movement.

The Index was developed for indoor use only (inside buildings) and assumed that the subject was exposed to no "extra" radiation (i.e. not exposed to sunlight or to radiation from any body other than those at air temperature). After a number of experiments with humans, an RSI of 0.3 has been adopted as the threshold comfort value i.e. anything greater that 0.3 causes distress to a "standard man".

Using the RSI for school bus operations is inappropriate as:

- The criteria of being nearly 25 years old and an assumption of health is not relevant. For school bus operations the average age would be much lower than 25 years of age and indeed young children dehydrate must faster than an adult in similar circumstances.
- The definition of standard clothing is a little nebulous
- The RSI is calculated for inside buildings and not for inside the confined space of a school bus
- The RSI assumes airflow which may not be possible with the sealed windows standard in many new vehicles.
- The RSI does not take into consideration transference of body heat which may be extremely high with many students present with up to three per seat.
- Traveling in the bus with students on board causes a rise in relative humidity (breathing and perspiration) and an RSI of 0.3 can be reached quite quickly. The higher the relative humidity, the less temperature required to reach 0.3.
- The RSI assumes that no extra radiation is involved. A school bus is exposed to solar radiation and the presence of many large windows would have a strong convective effect
- The RSI is calculated using the 3pm figures of relative humidity and air temperature. However, conditions may not be at the extreme at 3pm. Quite conceivably extreme temperatures may be reached a little earlier and particularly in coastal regions may change rapidly with the arrival of the sea breeze. The bus may however still retain the heat from earlier in the day without appropriate air conditioning. In country WA, it is likely that the temperature will not peak until after 3pm (the period when students are being transported home) due to the lack of cooling effect of the ocean and local topography.
- The RSI would only be relevant when using air conditioning solely for cooling purposes. It is at least as important for heating purposes to keep windows defrosted in some regions during winter.

Clearly the current methodology is at best clumsy and at worst, dangerous. Many operators install air conditioners at their own expence and this could cost anything up to $35000. Industry believed that there was an agreement that air conditioning would be looked at following the signing of the contract in January, 2004. As there was no evidence that this was happening, Forum presented a submission on air conditioning to the Minister in the latter part of 2006. To date, there has been no response.

Financial Remuneration to School Bus Operators

PwC derived some of their data from the Business Benchmarking Guide for Bus and Coach Operators (EBC, 2001). At the time, Industry disputed this data. EBC surveyed 40 bus and coach operators throughout Australia for the financial year 2000. Only three came from WA and these were not school bus operators. Not a single dedicated school bus operator was contacted. Those surveyed were coach operators with no links to the transportation of school children to and from schools in rural WA. The WA school bus industry is unique as it is a dedicated fleet. Operators in other states combine school bus contracts with charter operations and are generally true coach operators. The operators surveyed by EBC were companies operating an average of 11 buses. In addition, with the larger firms, just under half of their revenue came from school runs. In comparison, some 65% of operators in WA operate two or less buses and derive nearly 100% of revenue from school runs. Also, with the average results – turnover published by EBC, PwC discounted some of the components. Forum understands and welcomes benchmarking. However, it must be done accurately using the correct inputs. Because of the above mentioned issues with the EBC survey, Forum does not support this type of benchmarking – **PwC did not determine all items by reference to the true market.**

The Economic Analysis of WACC prepared by Economic Research Associates assumes a debt/equity ration of 50%. For the purpose of this exercise this may be correct. However, without a data base of contracts and their financial attributes, it is hard to determine what the actual balance is. It could be that the debt proportion is well below 50% and this would make a big difference to the bottom line. Discussion with Forum's preferred financier for school bus finance and who has been financing school buses for nearly 20 years strongly supports this claim and this is based on the way that finance is generally sourced. Contractors usually take out finance with a five year balloon and a 30 – 40 per cent residual which is further financed over two years. Economic Research Associates assert "PwC had access to financial data for bus operators….". Forum seriously questions this assertion. Therefore, caution should be exercised with using a 50% debt/equity ratio.

Economic Research Associates assume an equity beta of .8. Whether it is indeed .8 is a moot point and some in the industry would argue that it is close to 1. It is acknowledged that school bus contracts have a monopoly on a particular run for as long as that run operates as this is the nature of the business. The contract operates only if there is a need. If the need is not there, PTA can under Clause 17 of the generic contract, terminate by giving three months notice (PTA being the absolute authority and there is not an appeals mechanism). Cash flows are subject in an indirect way to climate, distribution of population and the price of local primary produce. Larger rural towns now have town boundaries where children have to pay for the school bus (not unlike metropolitan students) and are therefore removed from the orange school system. These boundaries can change quickly and dramatically without prior consultation with the school bus industry. Town boundaries have recently changed in two of the country towns and this has caused grave concern with operators who do not have any say in the process and PTA could well use and do use Clause 17 to terminate. The current drought has changed rural

WA. People have left the land and labourers are not required to harvest the crop. Therefore, schools close (at least 5 in the last few years), children change schools resulting in PTA decreasing the size of runs or demanding a downsizing of a bus class. If the price of farm products is down, this affects the whole community resulting in a changing population pattern and this is currently happening in rural WA. The clauses within the contract document contain many business risks. The document is terribly rigid, inflexible and controlling. There are many punitive clauses, the penalty for non compliance being a default notice or a breach of contract. In the majority of cases (estimated to be 99%), the contract is not a simple multiple of bus life and therefore at the end of contract, a bus still may have many years to run for its life of type. The second hand bus market in WA is not a robust one and in some cases, contractors resort to selling their buses in the eastern states or converting the bus to another item i.e. campervan. The use of an equity beta of .8 is questionable as **market evidence is limited** and no useful benchmarking has been completed.

As well as economic risks, school bus operators experience huge financial and other risks. Some of these include but not limited to:

- traveling on main roads for up to five hours per day and mixing it with seasonal traffic like grain and logging trucks and the likelihood of incidences are high,
- the service is required for all runs during the school year i.e. if there is a breakdown or a crash, a replacement bus is immediately required without question (requirement under 5.2 of the contract). Hiring of larger buses in rural WA is problematical and can cost up to $300 per day. In smaller country towns, replacement buses are just not available and contractors are forced to hire buses from as far as 500 kilometres away. Also, breakdowns can be expensive. In the recent past, a Forum member cracked a front stub axle (Mercedes Chassis). The part costing $1291 had to be sourced in Brazil and at the end of the exercise cost the operator nearly $10000 with the bus being out of action for nine weeks,
- traveling on unsealed and rough roads which increase wear and tear and does untold damage to tyres and bodywork without adequate compensation. Many roads in country WA are still gravel,
- traveling on country roads with the prevalence of livestock and kangaroos and the possibility of a collision is high,
- the vagaries of the weather including cyclones, storms, dust storms, floods and bushfires. WA has had many examples of these over the past two years.
- school bus inspectors can order unwarranted mechanical repairs and without an effective independent appeals process, the repairs must be done as PTA is the ultimate authority. Forum has evidence of unwarranted repairs costing thousands that had to be carried out,
- PTA at any time (under clause 4.2) can vary the approved route, the approved depot, the schools, the nominated students, the pick up and drop off locations and the contractor must give immediate effect to the variation. This can significantly affect income depending on the kilometers. There is not an appeals mechanism. Variations can be communicated verbally. Once again, PTA is the ultimate authority,

- some contractors have mortgaged the family home to purchase the contract (including the "goodwill" component) and any changes in income may cause a default in payments thus putting the family home in jeopardy. The Government does not recognize "goodwill",
- it is extremely difficult to find suitably qualified drivers as there are none available due to the resources boom. This is of little concern to PTA as the service must be provided in accordance with the contract. Relief and emergency drivers who drive infrequently (and some less that five times per term) must have the first aide certificate, working with children clearance and a federal police check. PTA actively police this and failure to comply with the provisions for drivers and the requirement to provide a service can result in a default notice or a breach of contract,
- under the CRM, a master servant relationship has developed and this is unhealthy,
- contractors are only allowed to perform the very basic maintenance e.g. changing oil, replacing light globes under Schedule 9 of the contract. This becomes really difficult in rural WA where the nearest mechanic may be many hundreds of kilometers away, and
- under Clause 11, PTA can take over a contract on the death or incapacitation of the contractor if the contractor has not supplied the names of a substitute person known legally in the contract as a "Nominated Person". This has the capacity to become legally "messy" if a legitimate will provides an inheritance. PTA has promised to examine this but to date, there has been no action.

The WACC analysis also states that specific economic risks not adequately captured would "be better dealt with through specific contract arrangements". Industry unequivocally agrees with this. However, this is not possible as the current contract is very rigid as is the review process. Economic risks are not subject to review. The Industry is allowed to meet with PTA on matters relating to the Return on Investment (ROI) and this can only be done every two years. If PTA disagrees with what the Industry is saying, this is the end of the story. The Industry has already experienced this. At the invitation from PTA, Forum developed a comprehensive submission at the end of 2005. In accordance with Clause 14, a meeting was held. It took PTA just five minutes to discard Forum submission.

One of ERA's Preliminary Views states that "an appropriate pre-tax rate of return for school bus operators is in the order of 8.6 per cent" using a debt proportion of 50 per cent and a equity beta of .8. If a debt proportion of 33 per cent and an equity beta of .9 is used (and these figures have credibility) a real pre-tax WACC of 10.16 per cent results. However, for the purpose of this exercise, assuming that the debt/equity ratio and equity beta figures are correct, a figure of 8.6 per cent may be satisfactory as long as all cost items and correct remuneration are captured. **This is not the case**. There is no provision for a Management Fee. In the Minimum Rate Model (MRM) proposed by Forum, a Responsibility Fee (similar to a Management Fee) was proposed. This was disallowed by PwC and endorsed by PTA. It is a legitimate cost and most submitted tenders make reference to it. Garaging costs of $464/year are woefully inadequate. In 2002, PTA agreed with the Industry that a starting point for Garaging would be $1500. However, the

Minister stated that it was not a legitimate business cost and therefore vetoed this component. After intervention by the TWU, it was reinstated at $435/year (and CPI adjusted down or up in July each year). Public Liability is not recognized by PTA. PTA state that the Industry is a safe one and any litigation should be referred to PTA. PTA has not stated that they accept all risks under Public Liability and therefore, many Forum members finance there own Liability Insurance. Financing costs are not recognized in the CRM. Ironically, PTA has introduced another model termed the Tendered Rate Model where financial costs are considered and a profit on top of this is applied. Repairs and Maintenance costs are under funded by up to 40 per cent. In the R & M Model, items such as freight for parts, hire of alternate buses and parts such as door mechanisms (which are subject to many failures), ancillaries and exhaust systems (this list is not exhaustive) are not included. The allowance for unsealed road running is manifestly inadequate. Up to 5% extra on R & M is paid if the unsealed portion is greater than 50% of the standard daily kilometers. Dust ingress (particularly bad with rear mounted engines) destroys moving parts including bearings and fan belts. Unfortunately, no benchmarks have been done and it would take up to 15 years to have the proper inputs. An average of depreciated bus values for the basic class bus price (and this does not include the essential extras required in rural WA, air conditioning in a non air conditioned zone and automatic transmissions paid for by the contractor for the comfort and safety of the students with a total cost up to $60000 and not recognized by PTA) is used for comprehensive insurance. In many cases, the payment is inadequate and discussion with CGU Insurance (the largest insurer of school buses in WA) indicates that the bus fleet is now underinsured because of the meager payment provided by PTA. In addition, PTA only pays on a clean history sheet. This is difficult to achieve in country WA as often more than one windscreen per year require replacing. As these are expensive items ranging from $750 to $2500 (and for some overseas models, windscreens are not available in Australia), many operators claim through insurance thereby losing their no claim bonus. Fuel costing is controversial. In many areas of WA, members pay a greater amount than allowed for by PTA. PTA will pay an **annual** "top up" but only if the price paid is more than 3 cents more than what PTA pays the contractor. Therefore, many contractors are recompensing the Government by up to 3 cents/litre for fuel. Under Part 5 of Schedule 3, the contractor must pay back to PTA the Residual Difference within 30 days of disposing of the vehicle. Some contractors only had the benefit of 18 months straight line depreciation provided under the CRM before their bus was due for replacement. Admittedly, they received some replacement money under another scheme. Industry argued at the time that the fleet at the implementation date of the CRM should be quarantined and only new buses subject to this Residual Difference payment. Neither the Minister nor PTA supported this view.

The above costing list is not exhaustive. It is however, hard to quantify accurately because of the diverse range of vehicles in the WA fleet and the different topography. A quick estimate of inadequate costing with a C class (largest in the fleet) bus on an average run in rural WA would be in excess of $20,000, on an A Type (Coaster size) in excess of $12000.

A cost not captured in the CRM and one that is difficult to quantify is the community and social benefits of the orange school bus system particularly in remote and isolated regions. Most country children have traveled in the orange school bus and it has assumed iconic status. In some areas, children only attend school and school activities because the orange school bus is there to pick them up and drop them off and more importantly the patient and compassionate nature of the bus driver (usually the owner) plays a pivotal role in achieving this. These are enormous benefits that should not be discarded. How it is calculated is a real issue.

PTA will argue that CRM Components (except ROI) are subject to periodic review. This is true. However, the process is complex and the present Review Panel have adopted evidence based (similar to that imposed in a civil court) examination requiring lots of examples (proof) and in many cases, this is hard to gather. For example, how long does it take to detail and wash buses and what opportunity costs do you put on this labour? It is well known that during the school bus lifetime of 15 years and doing in excess of 500,000 kilometres, a bus will require an engine rebuild. What does this actually mean? Does it mean a long or short motor? Does it include ancillaries like injectors, radiator and clutch plate overhaul? The process requires "evidence" from all nine regions and like type comparisons. This is extremely difficult for Industry to resource and source. In the limited number of Determinations made by the Review Panel, the main criticism is "while there was considerable information, in some cases this could not be described as evidence". This makes it difficult (almost impossible) for the Industry to argue for changes as the onus of proof lies with the Industry.

Conclusion

Generally, TFWA agrees with the thrust of the ERA preliminary views published in the Draft Report. There is no evidence to suggest that there is an adverse impact on commercial charters. In addition, it would be counter productive if PTA were to introduce charter fees for charter work undertaken by school bus operators.

There are some Preliminary Views i.e. debt proportion and equity beta, that require further clarification and assuming that these figures are to be used, Preliminary View 9 should be highly qualified.