Draft Report:
Inquiry on School Bus Operators' Charter Bus Operations

2 May 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.

In accordance with the Terms of Reference, 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.

This Draft Report presents the initial views of the Authority, and the reasoning behind those views, on the issues in the Terms of Reference. It is intended to facilitate public comment and debate.

Submissions on any matters raised in this Draft Report or in response to any matters in the Terms of Reference must be received by 4.00 pm Thursday 31 May 2007 WST and 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

Section 1.4 of this Draft Report provides further information regarding the process for making a submission.

The Final Report for the inquiry was originally scheduled to be delivered to the State Government by 31 May 2007. However, the Authority will be applying to the Treasurer to have the final reporting date deferred until 29 June 2007 to allow sufficient time for public consultation on the Draft Report. Following receipt of the Final Report, 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 Draft Report and prepare a submission to the inquiry.

LYNDON ROWE
CHAIRMAN

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2) The indications to date suggest that any impacts of school bus operators on competition in the charter industry are likely to be highly localised, and limited to situations where:

   - the commercial charter work is outside the school hours covered by the school bus contracts; and
   - there is sufficient charter work in a region to sustain more than one operator, but not where there is a shortage of buses to meet demand.

3) Any changes to the remuneration model for school bus operators will need to take into account impacts on charter services for schools and community organisations.

4) While school bus operators do often provide charter services to schools and community organisations at variable cost, the practice of setting prices to cover variable costs alone encourages the utilisation of the school bus fleet outside school hours.

5) While the question of how the fixed costs of school buses are apportioned between government and school bus charter customers is matter for government social policy, the Authority is of the view that any change to the existing cost allocation is unlikely to be justified on the basis that the costs of such changes are likely to exceed the benefits.

6) There is no indication from submissions that investment and/or service standards in the charter bus industry are adversely affected by the participation of school bus operators in the commercial charter bus industry.

7) The information currently available to the Authority suggests that:

   - commercial charter buses require higher service standards than those allowed for under the school bus contracts; and that
   - school bus operators who actively engage in commercial work often make additional investments in their buses, not covered by the CRM, to bring them up to the standards required for charter work.

8) Whether or not additional capital expenditure on school buses is treated as part of the asset value will depend on whether that expenditure is deemed under the school bus contract to be necessary to meet the service standards in the contract, which is a matter outside the Terms of Reference for this inquiry.

9) It is likely that the risks facing school bus operators are less than the risks in other markets. This would imply that an appropriate real pre-tax rate of return for school bus operators is in the order of 8.6 per cent.

10) On the basis that the return on and of assets other than the school bus itself (e.g. garaging) are adequately provided for as part of operating expenditure, the appropriate asset value to which a rate of return is applied is the depreciated value of the school bus.

11) The determination of depreciation in the CRM through straight line depreciation

over the life of the asset and allowing for a residual value at the end of the asset life is consistent with a standard regulatory approach to depreciation.

12) As an average cost model, the CRM will disadvantage some contractors on some cost parameters and advantage others. However, whether the average values for each cost component are set at the right level is a matter to be resolved through the periodic reviews of CRM components rather than in this inquiry.

13) As each CRM cost component is reviewed every three years, these costs are likely to be close to estimated efficient costs.

14) The CRM generates revenue in excess of the costs that are specified in the CRM. However, the Authority is reluctant at this stage to conclude that the higher revenue could be impacting on competition in the charter industry because the Authority has not had sufficient time to confirm that the CRM makes sufficient allowance for all of the costs associated with a school bus contract (e.g. the CRM does not appear to allow for a management fee). In addition, school bus contractors have no incentive to charge less than variable cost and the Authority is not aware of any situations where this has actually occurred.

15) On the evidence available, the Authority considers that there are likely to be few net benefits to the State from introducing charter fees for charter work undertaken by school bus operators.

- Any impacts of school bus operators on the commercial bus industry are likely to be highly localised and might be better addressed locally.
- A charter fee, if introduced, could have unintended impacts on local communities, including school and community charters.
- The use of the school bus fleet outside school hours at prices which cover variable cost is economically efficient.

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 as defined by the Act.[1]

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.

[1] A regulated industry is defined within the Act as the electricity industry, the gas industry, the rail industry, the water industry, or any other industry prescribed for the purposes of the Act.

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.[2] 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 (**PTA**). 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.

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.

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 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.

1.3 Review Process

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

- The Authority published an Issues Paper on 30 January 2007 and invited submissions from stakeholder groups, industry, Government and the general community on the matters in the Terms of Reference. Public notices announcing the Issues Paper and providing information on how to obtain the Issues Paper were published in the *West Australian* and 14 major regional newspapers around

[2] 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.

Western Australia. In addition, interested party emails announcing the Issues Paper were sent out through the Authority and by peak industry bodies representing school bus operators and commercial charter bus operators.

- The Authority met with representatives of Transport Forum WA (representing school bus operators) and the Motor Trade Association of WA (representing commercial bus operators and some school bus operators) on 14 February 2007 for a round table discussion of the matters raised in the Issues Paper and other issues of concern to the bus operators.
- Fifteen submissions were received in response to the Issues Paper. These can be viewed on the Authority's web site.
- The Authority consulted its Consumer Consultative Committee on 21 March 2007 and received comments on issues arising out of the inquiry.
- Further public submissions are invited on this Draft Report, by Thursday 31 May 2007.
- The Terms of Reference require the Final Report for the inquiry to be delivered to the Treasurer by 31 May 2007. However, the Authority will be applying to the Treasurer to have the final reporting date deferred until 29 June 2007 to allow sufficient time for public consultation on the Draft Report. Following receipt of the Final Report, 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 Draft Report 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 4.00 pm Thursday 31 May 2007 WST.

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.

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:

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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**), held by 390 contractors. The majority of CRM contractors (89 per cent) are small operators who own one or two contracts. The remaining contractors own between three and 15 contracts, although one large contractor owns 45 contracts. Of the current CRM contracts:

- 53 per cent are due to expire in 2022 (15 years);
- 34 per cent are due to expire in 2027 (20 years); and
- 14 per cent 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 tender 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.[3]
- 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.[4] Analysis by independent transport 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

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

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

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,[5] 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.[6]
- 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".[7]

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.[8] A compromise was reached whereby contractors were given a period of notice of 20 to 30 years (from 2002) until the contracts are re-tendered. 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

[5] 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.

[6] Guise Task Force Report (April 2002), *School Bus Task Force Report*.

[7] Ibid, pp13-17.

[8] 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.

inclusion of provisions to ensure that no contractors are made worse off by moving to a CRM contract.[9]

2.2 Composite Rate Model (CRM)

The Composite Rate Model (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. Fixed costs include:

- return on investment
- depreciation
- administration
- vehicle registration and third party insurance
- comprehensive insurance
- garaging; and
- communications.

Variable costs are calculated on the basis of the Standard Daily Kilometres associated with each contract (i.e. the mileage covered on the school bus route), and include:

- fuel
- repairs and maintenance
- air conditioning
- tyres
- unsealed road running costs
- car running costs
- wages (for drivers and bus aides)
- superannuation
- workers' compensation.

For a full description of the CRM cost parameters and how they are calculated, see Appendix 2. A generic CRM Contract for Provision of a School Bus Service, which is between the contractor and the PTA, can be viewed on the Authority's web site.[10]

Calculation of some of the cost components in the CRM (return on investment, insurance) depends on the type of bus that the contractor uses. There are seven classes of buses, defined on the basis of maximum seating capacity and wheelchair facilities. For each class of bus, there is an associated Class Bus Price, revised annually by the Public Transport Authority. (See Appendix 2 for a list of the various classes of school buses and the Class Bus Price for each category for 2006.)

Under the CRM, the return on investment each year is calculated as 10.5 per cent of the Class Bus Price for that year.

[9] 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.

[10] See www.era.wa.gov.au, under Investigations, Current Investigations, School Buses Inquiry, Related Papers.

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.[11]

Schedule 5 of the CRM 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.

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

3 Impact of School Bus Operators on the Commercial Bus Charter Industry

3.1 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.

3.2 Services Provided by School Bus Operators

The Terms of Reference for this inquiry focus on the impact of school bus operators' charter bus activities on the commercial bus industry. Prior to considering this matter, it is important to understand how commercial operations fit within the range of services provided by school bus operators. There are four different types of service which may be provided by school bus contractors, in addition to the school bus services covered by the CRM:

- curriculum-based charters (relating to compulsory aspects of the school curriculum such as geography excursions);
- extra-curricular school bus services (e.g. transporting students to swimming pools, school excursions, sports carnivals);
- community bus services (e.g. Red Cross Association, blue light discos); and
- commercial charter services.

Submissions in response to the Issues Paper indicated that the primary services provided by most school bus operators outside school hours is for extra-curricular school activities, and for community clubs and charities.

Schools are encouraged by the Education Department to use orange school buses for school excursions. School bus operators do not need a charter licence to provide bus services for curriculum-based activities, or for extra-curricular activities where there are no regular transport services in the area. However, school bus operators do require a charter licence for community bus services, commercial charter services, and extra-curricular school excursions where there is a regular transport service in the area.

Commercial charter companies are also able to provide charter services for school excursions and community organisations.

3.3 Competition in the Commercial Charter Industry

The Terms of Reference require a consideration of whether or not competition in the commercial charter bus industry in Western Australia is being adversely impacted by the participation of school bus contractors in the market.

In the past, there have been 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.[12] The concern is that the school bus contracts provide school bus operators with an unfair advantage over other commercial bus charter operators. However, none of the fifteen submissions in response to the Issues Paper were from charter operators concerned about the impact of school bus contractors on their operations.

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.

3.3.1 Issues Raised in Submissions

The general view expressed in the submissions was that commercial charter work does not form a large part of the services provided by most school bus operators. Transport Forum WA, representing the school bus industry, submitted that very few school bus contractors (less than one per cent) engage in a substantial amount of commercial charter work, and that the remainder of school bus operators do either no commercial charter work, or a few commercial charter jobs per year:

> A recent poll of Transport Forum WA members indicates that:
>
> - Up to 80 per cent of members carry out curriculum based or extra curricular trips
> - Up to 45 per cent carry out community based charters
> - Up to 40 per cent undertake some commercial charters but this is generally limited to one or two per year
> - It is estimated that up to 1 per cent of members undertake frequent charters.
>
> (Transport Forum WA submission, p8)

> Majority of orange school buses in small country towns only do school based curriculum excursions, e.g. school swimming lessons, sports carnivals, educational excursions. (M. and M. Pearce, Mingenew West Run)

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. For example,

> School bus operators live and provide services in such diverse rural towns in WA including (but not limited to) Lake King, Fitzroy Crossing, Bridgetown, Wangkatjunka and Yuna.

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

> There are no commercial operators in these places and none within reasonable range and therefore the orange school bus is the only suitable vehicle to provide a service. (Transport Forum WA submission, p8)

> [The charter bus industry is not adversely impacted by school bus operators] in locations such as Esperance, Ravensthorpe, Munglinup, Condingup, Salmon Gums, etc as the school bus service provides the charter service that would not otherwise be available. (Goldfields-Esperance Development Commission, p2)

> Small country town without any local charter buses – nearest charter service is 110 kms. (M. and M. Pearce, Mingenew West Run)

However, in larger regional towns, particularly those with appreciable tourist or mining industries, the demand for charter services could support multiple providers. In some areas, the amount of charter work available is such that school bus operators and commercial bus operators co-exist without conflict. One school bus operator who also operates a charter coach submitted that:

> There are another five school bus operators in [Waroona] – most who are not interested and do not do charter work with their school buses. If and when any of these contractors do charter work it is on a very small scale and does not interfere in any noticeable way with the charter work we do. In fact, in our area, there is a shortage of vehicles available for charter work.
>
> During the past month we have had enquiries from as far afield as Esperance and Bunbury. Bunbury Senior High School was recently looking to hire three coaches for Country Week sport in June. As our coaches are already booked we suggested they try Mandurah Bus Charters who operate a fleet of charter vehicles. They had already contacted this company to be told that all their vehicles were contracted to mining companies and were unavailable. (K. Nottle)

It is difficult to assess the degree of interest of commercial companies in school-based charters or community charters, as none of the submissions addressed this issue. The Motor Trade Association of WA noted, following a survey of its tourist charter members, that:

> Many charter operators are not interested in school based charter work as their coaches are of a standard that they do not wish to risk damage by large groups of students. (Motor Trade Association of WA, p3)

Where commercial bus companies are interested in and do succeed in winning school work, they are likely to be using older buses:

> In some of the urban fringes of Perth, charter bus companies have purchased a number of old buses (including old MTT buses) some being more than 25 years old. The cost of these units is between six and seven thousand dollars. These companies are providing bus services in different areas and indeed provide some schools with transport because they can do this at a much cheaper rate. In these cases, charter buses are impacting on the orange school bus charters. (Transport Forum, p9)

> Some of the buses which belong to private companies are definitely not as well maintained as orange buses which would be carrying school children and do not match the standard to which the Education Department expects the orange buses to maintain. (P. and J. M. Sotiroff)

The Motor Trade Association of WA noted that:

> The area identified as having a negative impact on commercial charter operators due to the activity of school bus operators is in the Perth metropolitan area. (Motor Trade Association of WA, p3)

3.3.2 Authority Assessment

It is significant that there were no submissions from commercial charter operators who were concerned about adverse impacts on their businesses due to the commercial charter activities of school bus operators. This may indicate that competition by school bus contractors is not a widespread or significant concern amongst commercial bus operators. Alternatively, it may be that there was not sufficient awareness of the inquiry in the industry, despite the wide advertising of the Issues Paper. The Authority will seek additional means of publicising the Draft Report to commercial bus operators and the community.

The submissions suggest that the circumstances where conflicts between commercial charter operators and school bus operators occur are likely to be limited. First, school buses are not available for commercial charter work during the hours they are required to provide school bus services. In addition, there are no competition issues in areas where there is not enough charter work to sustain more than one operator – or in areas where there are not enough buses to meet available demand for charter services.

Preliminary Views

1) It appears that only a small percentage of school bus contractors engage in frequent commercial charter work.

2) The indications to date suggest that any impacts of school bus operators on competition in the charter industry are likely to be highly localised, and limited to situations where:

   - the commercial charter work is outside the school hours covered by the school bus contracts; and
   - there is sufficient charter work in a region to sustain more than one operator, but not where there is a shortage of buses to meet demand.

3.4 Prices and Pricing Policy for Services

The CRM covers the fixed costs of running a school bus (return on investment, depreciation, administration, insurance, vehicle registration, garaging and superannuation) – setting aside arguments as to whether these parameters are set at the right level. Allowances for variable costs are based on the Standard Daily Kilometres (SDK) for each bus contract, so the variable costs associated with any additional mileage (e.g. costs of additional repairs and maintenance, fuel, wages, air conditioning, tyres) are not covered. This means that for their charter services, school bus contractors only need to cover their additional variable costs, but none of their fixed costs, which are covered by the school bus contract.

3.4.1 Issues Raised in Submissions

Many submissions made the point that school buses are commonly used to provide services at low prices to schools for extra-curricular activities and for community groups. There was a general concern that any adjustment in the CRM, such as a levy for charter work, would have adverse impacts on the use of school buses for these services, by raising the school bus charter prices.

> The school bus system has been providing schools with an efficient, safe, flexible and affordable transport requirement for many years and this should continue. Any attempt to change this would result in many operators refusing to undertake school based curriculum activities which would have serious ramifications for education facilities and in some cases detrimental as some schools may abandon extra curricular activities because of cost and inefficiencies. Therefore, extra curricular activities undertaken by the orange school bus system must be quarantined from this inquiry. (Transport Forum, p5)

> There is a general concern that this may result in increased costs to our students and their parents if a levy is instigated so that the charter bus operators are not disadvantaged. My view on this is likely to be shared by many other rural communities. In Merredin, we don't have a series of charter bus companies to access and our school bus operators accommodate our needs where Perth companies could not compare simply because they need to add to the cost the reality of journeying to Merredin with an empty bus in the first place. We are already severely disadvantaged by being located 260 kilometres in land and do not believe that a levy that will result in prices being comparable is reasonable. (K. Ward)

> We support the use of the school bus for charter transport. As any Lions Club, we are here to raise money for worthy causes and with less expense this can be used towards them. (Lions Club of Capel)

> There is no doubt that our school bus contractors provide a completely reliable and high quality service to our school at a reasonable price…We need the school bus operators to provide a reasonably priced “charter bus service” in our town, otherwise our children would not be able to attend events that are part of their schooling. (Cunderdin District High School P&C)

> School bus contractors play and important part in providing some additional service at a reasonable cost for their community, especially schools, and if we were to have our income further eroded because of the small amount that most contractors earn from predominantly school-based charters, this will greatly impact on the community. (I. A. Farrower, p2)

> In most country towns, school buses are the only buses available to the community and if used by groups within the community it is to assist them and is not part of a profit making venture by school bus operators. (K. Nottle)

> The impact on organisations in small country towns such as Capel would be significant as they would have to hire buses from larger towns at a much higher cost plus additional cost to travel to Capel to commence the charter trip. (Capel Chamber of Commerce)

The Motor Trade Association of WA recommended:

> that added financial burden in the form of a fee not be applied by government to school bus contractors doing school based or regional community charter work. (Motor Trade Association of WA, p9)

The Public Transport Authority agreed that if school bus contractors were to be required to pay some form of rebate on their charter earnings, such as in the form of a charter fee, it would not be desirable for this to impact negatively on the provision of bus services for school excursions or community charters.

> The PTA acknowledges that some School Bus Contractors occasionally undertake charter operations at either marginal cost rates or even occasionally for free, in support of community groups or local school excursions; it would not be desirable for these community spirited actions to be quashed and a mechanism to isolate such work from a Bus Charter Fee could be considered. (Public Transport Authority, p2)

None of the submissions provided information on the prices charged by school bus operators for commercial charter work, although the submission by Goldfields-Esperance Development Commission suggested that bus operators do set higher prices for commercial customers than for community groups:

> The price charged in the Esperance area is cheaper than the charter rates in the [Perth metropolitan area] as the users of the services are generally service clubs, community groups or schools. The exception is the bus service provided to employees at the Ravensthorpe Nickel Operation. (Goldfields-Esperance Development Commission, p2)

3.4.2 Authority Assessment

Submissions suggest that it is common practice for school bus contractors to offer charter services to community groups and schools at low cost. Any recommendations from this inquiry regarding the remuneration of school bus contractors, including adjustments to the CRM for work outside of school contract obligations, would need to take into account any subsidiary impacts on school excursions and community charter work.

The use of school buses for charter work at variable cost is consistent with making efficient use of the school bus fleet. Outside of contracted school hours, the school bus fleet can be viewed as available capacity, which it is in society's interests to fully utilise. The remuneration of school bus fixed costs under the CRM makes the school bus fleet analogous to a piece of infrastructure with fixed costs that have already been paid for, so that the additional costs of using that infrastructure is limited to variable costs only. The provision of school buses at low cost to schools and community organisations – who might be discouraged from using those services if they were priced higher – promotes the use of school buses at times when they might sit idle.

The ability of some bus companies to distinguish between different customer groups, on the basis of their willingness to pay or price sensitivity, and to set prices to reflect these differences (such as in the case of buses in Esperance), is another way in which school buses can be utilised as fully as is currently possible.

The second issue is that of who should pay for the fixed costs of school bus charters. The decision on how the fixed costs of school buses are allocated between different groups is essentially one for government social policy. Under the current arrangements, school bus fixed costs are covered by government, to the benefit of customers of school bus charter services (including schools and community groups) who pay lower prices. Alternative arrangements might involve transferring some of the allocation of fixed costs of school buses from government to the customers of school bus charters, to the advantage of commercial operators who could compete more effectively with school buses, but to the detriment of school bus charter customers, who would pay higher prices. However, in the absence of evidence of substantial problems with competition in the charter bus industry, the Authority is of the view that such a transfer of costs would not be justified.

Preliminary Views

3) Any changes to the remuneration model for school bus operators will need to take into account impacts on charter services for schools and community organisations.

4) While school bus operators do often provide charter services to schools and community organisations at variable cost, the practice of setting prices to cover variable costs alone encourages the utilisation of the school bus fleet outside school hours.

5) While the question of how the fixed costs of school buses are apportioned between government and school bus charter customers is matter for government social policy, the Authority is of the view that any change to the existing cost allocation is unlikely to be justified on the basis that the costs of such changes are likely to exceed the benefits.

3.5 Investment and Business Practices in the Industry

In the Issues Paper, the Authority asked for public comments on what indications there are that investment and/or service standards in the charter bus industry are adversely impacted by school bus operators.

None of the submissions received by the Authority indicated that commercial bus operators are being discouraged from investing in their businesses (or closing down their businesses) due to the impact of school bus operators on commercial charter work in their area. Two submissions stated that there is no clear evidence of adverse impacts of school bus operators on investment in the commercial charter sector:

> There are no clear indications that investment and/or service standards in the charter bus industry are adversely impacted by school bus operators (Motor Trade Association of WA, p4)

> There is no evidence that [investment and/or service standards in the charter bus industry are adversely impacted by school bus operators] in Esperance. Goldfields-Esperance Development Commission, p3).

Preliminary Views

6) There is no indication from submissions that investment and/or service standards in the charter bus industry are adversely affected by the participation of school bus operators in the commercial charter bus industry.

3.6 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 market. It should be

noted that the quality of *charter bus services* is a separate issue to the service standards that apply to the provision of *school bus services*, which is not a subject of this inquiry.[13]

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.

3.6.1 Issues Raised in Submissions

Transport Forum noted in their submission that school bus operators are ideally suited to providing bus services for school excursions:

- The orange school buses belong to a strict regime of inspections (twice per year), by authorised departmental inspectors.
- The driver has all the qualifications and requirements (working with children clearance, fit and proper person, first aid, OSH training) which is actively policed by state authorities.
- The buses are quite new in comparison to some commercial operators (the oldest bus is 15 years old) and they are extremely well kept.
- The children know the driver as he/she drives them to and from school twice a day.
- The driver knows the children and any particular behavioural or health issues with students.
- The school staff know the driver and are familiar with the orange bus system.
- The driver usually comes from the community.
- The bus is easily accessible, generally being garaged in close proximity to the education facility.
- In the near future, all school buses will be fitted with seat belts.

(Transport Forum, p5)

Some submissions made the point that the service standards offered by school buses makes them less suited to commercial charter work than commercial buses.

> Generally speaking, school bus charters cater to the lower end of the market. The vehicles are painted ready-mix orange and green, standard bench seats suitable for children and short distances only and in some cases not air conditioned. Therefore, it is difficult for a school bus operator to compete in other markets. (Transport Forum WA, p9)

> Most people hiring a vehicle would prefer a coach with its luxuries to a basic school bus. (K. Nottle)

> There is potentially client resistance to a big “orange” box on wheels, we have invested heavily and work hard to overcome this barrier. (R. Gannaway, p3)

[13] 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*.

Others noted that the higher service standards required for commercial charter work meant that school bus contractors seeking to engage in commercial charter work need to make substantial improvements to their buses, which are not recoverable under the CRM contracts. Some examples of the additional investments made to bring a school bus up to charter standard were provided by R. Gannaway, who operates both commercial charter buses and school buses:

- Installation of TV, DVD, VCR, CD equipment $4,000
- Installation of air conditioning, $35,000
- Installation of full through luggage bins, $9,000
- Installation of overhead luggage racks, $5,000
- Installation of interior soft furnishing, $10,000
- Fitting of roo bar and tow ball structure, $3,000
- Window treatments and double tinting, $6,000

> …We invested in an extra $80,000 in each bus to create a much safer more comfortable bus for school and general charter.
>
> (R. Gannaway, p2)

On the other hand, the imminent introduction of seat belts into all school buses could work in favour of school bus operators in gaining extra-curricular school work. Seat belts are being phased in to the school bus fleet from 2006 to 2015, with the costs of retro-fitting buses and including seat belts in new models built into the CRM. While there is no legal requirement for commercial charter buses to have seat belts fitted for the purposes of providing school charters, market demand may compel them to do so.[14]

Some school bus contractors who also engage in charter work ran different buses for each, due to the differing requirements of school bus work and charter work. In these cases, charter buses were fitted to higher standards and were generally not used for school work.

> From my experience, those contractors who carry out the majority of charter work usually have spare buses with which to do the work. (I.A. Harrower)
>
> Many charter operators are not interested in school based charter work as their coaches are of a standard that they do not wish to risk damage by large groups of students. (Motor Trade Association of WA, p3)

3.6.2 Authority Assessment

The indications from submissions are that there is a difference in the service standards required to provide school bus services (for which the school buses are ideally suited) and the higher service standards and quality required for commercial charter work. As a result, some school bus operators who engage in commercial charter work make additional investments in their buses to bring them up to charter standard. These investments are not recoverable under the CRM contract and are therefore passed through to school bus charter customers.

[14] The requirement for seat belts is driven by general design standards rather than service standards for school bus services. Federal Transport Department Australian Design Rule 68 (Occupant Protection in Buses) requires that all seats over one metre in height (e.g. bucket seats in coaches) must have lap/sash belts. Seats less than one metre in height (e.g. standard bench seats on old buses) are not required to have seat belts.

Preliminary Views

7) The information currently available to the Authority suggests that:

- commercial charter buses require higher service standards than those allowed for under the school bus contracts; and that
- school bus operators who actively engage in commercial work often make additional investments in their buses, not covered by the CRM, to bring them up to the standards required for charter work.

3.7 Summary

The Authority has so far seen no evidence of a widespread negative impact of school bus contractors on the commercial bus industry. Where any such problems exist, they are likely to be highly localised. In many areas, the local school bus is the sole provider of school bus and charter services. In other areas, there is excess demand and no conflict between school bus operators and commercial bus companies.

Submissions suggest that most of the charter services provided by school bus operators are for school excursions and community groups, at low cost. The allocation of the fixed costs of school buses between government and school bus charter customers is a matter for government social policy. Given the lack of evidence of competition issues in the charter industry, the Authority does not consider that a change in the allocation of costs would be justified. The pricing of school bus charter services at variable cost promotes the use of the school bus fleet when it might otherwise be idle. If any changes were to be made to the remuneration of school bus operators, the impact of such changes on school and community charter services would need to be considered.

There is no indication that the participation by school bus operators in the commercial charter bus industry has adversely impacted on investment, business practices or service standards or quality in the industry.

4 Financial Remuneration of School Bus Contractors

4.1 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.

4.2 Revenue Required to Provide School Bus Services

In order for the Authority to consider the terms of reference it will need 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.

The extent to which CRM payments cover the total efficient costs of providing the school bus service is relevant to the consideration of any impact of school bus operators on competition in the charter industry. If CRM revenues were in excess of efficient costs, this could enable school bus contractors to charge very low charter rates (e.g. below variable cost) and make it more difficult for commercial charter operators to compete for charter work.

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 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 (including items such as the driver's wages).

4.2.1 Return on Capital

Under the CRM, the return on assets is derived by multiplying the annually revised Class Bus Price (the average new cost of buses in that class) by a rate of return of 10.5 per cent.

During the development of the current CRM framework, the school bus industry recommended that returns for school bus operators should be comparable with other small businesses such as Lotto kiosks, newsagencies, post offices and TAB agencies.[15] On this basis, it is understood that the industry recommended a return on historical costs of around 20 per cent. Analysis by PricewaterhouseCoopers (**PwC**) in 2003 estimated that the industry's proposal was equivalent to a return on the market value of the business of 15.2 per cent.[16] In calculating this rate, PwC assumed, following advice from industry, that the market value of the business was twice the market value of the bus, on the basis that half of the value of the business related to goodwill associated with the contract. In comparison, PwC calculated that an appropriate return on the market value of the business was 9.0 per cent.

Following the PwC report, negotiations between Government and the school bus industry resulted in:

- acceptance that the market value of the business was twice the market value of the bus, which was approximated by assuming the relevant asset was the current replacement cost of the bus rather than the depreciated value of the bus;
  - However, calculating annual payments for a return on assets by applying a rate of return to the current replacement cost (or undepreciated value) actually results in 1.875 times the return on assets that would be calculated by applying a rate of return to the depreciated value of the bus. Further, in *present value* terms, the factor is 1.65.
- the relevant measure of the rate of return was the real pre-tax rate of return on the current replacement cost of the bus (9.4 per cent, which is the equivalent of the 9.0 per cent rate of return on the market value of the business);[17]
- the 9.4 per cent value being increased to 10.5 per cent following bargaining between the parties.

Issues Raised in Submissions

The submissions on the Issues Paper raised several matters regarding the return on capital provided by the CRM.

Some school bus contractors submitted that the listed School Bus Price did not adequately reflect the actual purchase price of buses, which had an impact on the depreciation allowance:

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

[16] 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.

[17] The PwC estimate of 9.0 per cent was based an estimated real pre-tax weighted average cost of capital (WACC) of 8.4 per cent to 9.2 per cent.

> We have just ordered two new 57 seat Hino buses fitted with automatic transmission and air conditioning at a cost of $346,690 plus GST. Depreciation is paid on a bus cost of $327,950 less 5 per cent residual, leaving a shortfall of $35,100. (I.A. Harrower, p2)

One complaint raised in several submissions was that the Class Bus Price does not cover additional capital expenditure which is considered essential or highly desirable by contractors for the provision of school bus services.

> Buses are, for a range of reasons, significantly more expensive for the contractor than is recognised within the contract.
>
> - Most contractors included accessories, some essential while others are highly desirable, with their purchase. These items include bullbars, window tinting, rust proofing and mud flaps. PTA currently pay a small allowance towards these items but those contractors purchasing the large buses can be up to $8,000 out of pocket.
> - Air-conditioning in school buses is used for comfort in hot weather but it also has a primary role in defrosting bus windows in winter which is a major safety issue that is not recognised by the PTA. If an operator installs an air-conditioning unit in a "non-airconditioning zone" then this cost of up to $35,000 is not recognised by PTA.
> - The trend with the purchase of new buses is to purchase vehicles with automatic transmissions. This can cost up to $25,000 extra. PTA does not recognise automatic transmission, and therefore, the contractor is not recompensed for this item.
>
> The contractor also then misses out on the depreciation of these items over the life of the bus.
>
> (Transport Forum, p7)

Furthermore, additional capital investments by contractors related to the maintenance of buses are not recognised as part of the asset base under the CRM.

> …many operators have garaging facilities and plant and equipment (compressors, tools and wash down facilities) and these are not taken into consideration as assets. (Transport Forum, p8)

> Cost of providing garaging is another item where the PTA does not cover the full cost. In Toodyay, an industrial block of 1,000 m^2 costs $100,000, plus the cost of a shed complete with concrete floor, power, lights, etc would be another $40,000 to $50,000. PTA pays less than $500 per year per bus under normal circumstances. The above facility would be capable of housing two 57-seat buses. (I. A. Harrower, p2)

One stakeholder also submitted that:

> Our region is not classified as requiring air conditioning, however I challenge any member of the Government or Public Service to drive a school bus with 40+ students on board on a winter's day and not consider it a very dangerous situation as the windows "fog up". (R. Gannaway, p3)

Several submissions maintained that the rate of return provided under the CRM (10.5 per cent of the annually revised Class Bus Price) is inadequate:

> When faced with the prospect of bus (two buses) replacement in 2006, we discovered that the CRM has no facility to cover interest charges on the bus purchase price. With the CRM giving only a 10.5 per cent return on investment, the interest rate of around 7.8 per cent at that time left us with a return of 2.7 per cent for the first 10 years of the contract.

> Our accountants advised us against pursuing this aspect of our industry. (R. Gannaway, p2)

> The Return on Investment (ROI), the only profit within the school contract, is based on the Class Bus Price and set at 10.5 per cent (set in mid 2003). The Government determined this rate due to the perceived minimal risk in the industry. The industry disputes this assumption. Most vehicles are under finance and a current competitive interest rate is 8 per cent. The financing of the bus is not recognised and, as a result, a ROI of 10.5 per cent whilst financing can have serious cash flow implications. (Transport Forum, p3)

Under the 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).[18] Transport Forum noted in their submission that:

> The first of these meetings [to discuss the ROI] was held in January 2006 resulting in the Government rapidly rejecting industry claims for an increase. (Transport Forum, p4)

Authority Assessment

Method of Determining Class Bus Price

The issues of disparity between actual costs incurred by particular contractors and the average costs allowed for under the CRM is a matter which would need to be resolved through the process of periodic review of the CRM parameters. The averaging approach which underpins the CRM means that, where the payment for a cost item determined on an average basis is set correctly, half of the operators will be advantaged and half will be disadvantaged.

On the issue raised in submissions that the asset value may not reflect the investment in the school bus service, the question here is how the asset value required to provide the school bus service is determined. The asset value is based on the specified standard of service to be met. If additional capital investments need to be made to a bus in order to meet the specified service standard, then these costs should be covered in the contract, and those assets included as part of the asset base. However, if the additional capital investments are to meet standards in excess of the specified standard of service, then these investments would be at the discretion of the contractor and should not be recoverable under the CRM contract.

The issue of what service standards should apply to school bus services, and what assets are necessary to meet those standards, is a matter for negotiation between the contractors and the PTA (e.g. through the periodic reviews of the CRM components). For example, in the case of air conditioning, the current provisions in the CRM are based on the Bureau of Meteorology classifications of the number of air conditioning days required for personal comfort in each region.[19] Any changes to the remuneration of bus contractors regarding their air conditioning allowance will depend (as in the case of seat belts on school buses) on a determination on whether there are safety issues, and if so, a

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

[19] The Bureau of Meteorology uses an index called the Relative Strain Index (RSI) to measure climate stress on people. The RSI takes into account air temperature, wind, vapour pressure, metabolic rates and the effects of clothing. For most people the level of discomfort increases noticeably at an RSI of 0.3. For school bus services, Zone A is all areas in which RSI is at 0.3 or above for 50 days or more; Zone B is areas where 22-50 days are RSI 0.3 or above; and Zone C is areas where less than 22 days are RSI 0.3 or above. The CRM allows for air conditioning on all school days for Zone A; 50 days for Zone B; and no air conditioning for Zone C.

revision of the service standards for school bus contracts to increase the number of air conditioning days. This is a matter which would be dealt with through the CRM review process.

Another point raised in submissions is that depreciation in the CRM is based on the bus purchase price, and does not cover depreciation of equipment and facilities purchased by the contractor for the maintenance and garaging of the bus. Again, this relates back to how the asset value for school bus services is determined: where assets are deemed necessary to meet required standards for school bus services, then the CRM should allow for those investments and they should be included as part of the total asset value for the purposes of depreciation.

Preliminary Views

8) Whether or not additional capital expenditure on school buses is treated as part of the asset value will depend on whether that expenditure is deemed under the school bus contract to be necessary to meet the service standards in the contract, which is a matter outside the Terms of Reference for this inquiry.

Return on Capital

The return on capital is defined as follows:

Return on Capital = Rate of Return x Net Asset Value of the Business.

In assessing the return on capital provided to school bus contractors, the Authority therefore examined two issues:

1) what is the rate of return that an investor in a school bus business would need in order to cover the costs of providing that service?, and

2) what is the asset base to which the rate of return should be applied?

Rate of Return

An approach widely used by regulators and industry to determine the rate of return that investors – both the providers of debt and equity – would require in order to be adequately compensated for the cost of providing those services 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 and the riskiness of the business relative to the market (but only to the extent that such risk cannot be eliminated through diversification).

The Authority has commissioned a separate study by Economic Research Associates to assess an appropriate rate of return in the context of school bus services.[20] This report is published on the Authority's web site. The analysis by Economic Research Associates took into account the previous review by PwC in 2003 on the rate of return for school bus

[20] Economic Research Associates (March 2007), *Economic Analysis of WACC Analysis for School Bus Operations in WA*, Report prepared for the Economic Regulation Authority.

operators, evidence from other industries and current market indicators, as well as the particular characteristics of the school bus industry in WA. The report noted that some caution is needed when applying a WACC approach to an industry comprising hundreds of individual businesses (rather than to a single large enterprise). On the basis of reasonable assumptions regarding the appropriate levels of debt and tax structures for a school bus operation, the report suggested that a real pre-tax WACC in the range of 8.6 to 9.6 per cent would be sufficient to attract investment to the industry.[21] The lower estimate is based on an assumption that the level of non-diversifiable risk in the industry is slightly lower than the market risk.[22] The upper estimate assumes risks in the school bus industry are the same as the market as a whole.[23] The advice from Economic Research Associates is to apply the lower figure of 8.6 per cent, on the basis that:

- the variability of business revenues is limited by the nature of the operation;
- school bus operators have a local monopoly;
- revenue is set for the duration of the contract; and
- cash flows are not subject to forces such as the business cycle.

The rate of return that is currently applied to the Class Bus Price in the CRM is 10.5 per cent. This rate requires an assumption that the level of non-diversifiable risk in the industry is higher than the market risk. A possible source of a greater risk in the school bus market may be the risk of a loss of revenues if student numbers decline unexpectedly. Alternatively, the Government might consider that a higher rate of return may be required because of community benefits that are not captured in the cost items in the CRM. However, in such case the additional revenue should be provided as a Community Service Obligation payment rather than a rate of return.

A test of whether or not buyers value school bus contracts at more than a revenue stream based on an 8.6 per cent rate of return will be when contracts are tendered, assuming there is well-contested tender. To date, only a small number of CRM contracts have been tendered (around 17).

Preliminary View

9) It is likely that the risks facing school bus operators are less than the risks in other markets. This would imply that an appropriate real pre-tax rate of return for school bus operators is in the order of 8.6 per cent.

Asset Value

Discussions with the PTA have indicated that the assets associated with a school bus service include the bus, garages and offices. The CRM provides allowances for garaging and administration, based on an average of costs across the industry. Thus, these costs are allowed for as part of operating expenditure and do not need to be considered as

[21] This estimate is higher than the estimated real pre-tax WACC in the PwC report (8.4 per cent), mainly because of slight increases in the risk-free rate, inflation and the cost of debt since the time of the PwC report.

[22] Equity beta (the measure of industry risk relative to the market risk) is assumed at 0.8. If the industry risk were the same as the market, equity beta would be 1.0. If the industry were more risky than the market, the equity beta would be greater than 1.0.

[23] This assumes the equity beta is equal to 1.0 (see paper by Economic Research Associates).

assets on which a rate of return is applied. On the basis that the return on and of assets other than the school bus itself are adequately provided for as part of operating expenditure under the CRM contract, the physical assets of a school bus contract can therefore be limited to the school bus itself.

It should be noted that school bus operators who have purchased contracts from existing contractors may have invested more than the cost of the bus. However, this additional value is not typically taken into account for regulatory purposes as the relevant assets are the ones that provide a service to customers, and these assets are typically the physical assets.[24]

For regulatory purposes, the value of a business is a measure of the un-recovered value of investment in the business. This value can be determined by considering the original expenditure on physical assets in the business and subtracting any subsequent recovery of this investment in the revenues obtained from the use of the assets involved. It is this value to which a rate of return is applied.

The return on assets for a particular year is calculated by multiplying the opening asset value for that year by the rate of return, i.e.

Return on Assets (Year n) = *Opening Asset Value (Year n)*
x Rate of Return (Year n)

where the opening asset value is the previous year's opening asset value, plus capital expenditure and minus depreciation for the previous year:

Opening Asset Value (Year n) = *Opening Asset Value (Year n-1)*
\+ *Capital Expenditure (Year n-1)*
– *Depreciation (Year n-1).*

By comparison, the asset value used in the CRM model is the Class Bus Price, which is the average new cost of buses in that class, revised annually. The rate of return is applied to the Class Bus Price rather than the depreciated value of the bus. The problem with this approach is that it results in a bus owner earning a rate of return on the part of the asset that has already been returned to the bus owner via depreciation.

Preliminary View

10) On the basis that the return on and of assets other than the school bus itself (e.g. garaging) are adequately provided for as part of operating expenditure, the appropriate asset value to which a rate of return is applied is the depreciated value of the school bus.

4.2.2 Depreciation

Under the CRM, depreciation is determined on the basis of:

- the purchase price of the bus, which is the School Bus Price, a price listed in the contract for each type of bus in each year;

[24] The PTA advises that 35 per cent of contracts have changed ownership.

- a straight line method over the service life of the asset; and
- an estimated residual value at the end of the asset's life, reflecting resale or scrap value (10 per cent for Class A and Class D buses, and 5 per cent for Class B and Class C buses).[25]

This approach is consistent with a standard regulatory approach. Submissions from interested parties did not note any concerns regarding the method used for calculating depreciation in the CRM.

Preliminary Views

11) The determination of depreciation in the CRM through straight line depreciation over the life of the asset and allowing for a residual value at the end of the asset life is consistent with a standard regulatory approach to depreciation.

4.2.3 Operating and Maintenance Expenditure

In addition to the return on capital and depreciation, contractors require sufficient revenue to cover efficient operating and maintenance costs associated with the provision of school bus services.

Several submissions claimed that, due to the average cost basis of the CRM, there are instances where the model does not fully reimburse some contractors for the costs they incur, including some operating and maintenance costs. For example,

> Cost allowed for things such as tyre replacement for buses that travel a designated distance on dirt roads are not a true record of actual costs as compensation is not made for all kilometres travelled on dirt roads. (Goldfields-Esperance Development Commission, p2)

> The CRM is an average cost model and clearly one figure does not fit all circumstances. Some of the elements such as license third party, superannuation and workers' compensation are fully compensated, however, the other sixteen items are averaged out. An average system will advantage some operators and greatly disadvantage others. (Transport Forum, p6)

Transport Forum submitted that independent benchmarking research commissioned by the PTA showed large variations in the average speed and fuel consumption across the bus fleet (over 60 per cent differences between the north and mid west regions of WA).

> Currently PTA remunerates contractors in the wages component using one average speed for all classes across the state and uses a single value per class of vehicle to remunerate the fuel costs….Such a diverse range of inputs, which reflects the diversity in the fleet, creates an almost impossible task of trying to find an average – which is almost certain to disadvantage a lot of contactors. (Transport Forum, p6)

[25] 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.

It should be noted that remuneration of costs on the basis of average costs will also advantage some operators, although submissions are more likely to come from those adversely affected. The issue of whether the average itself is set appropriately, given the range of possible values for a particular cost item, is one to be addressed in the periodic parameter reviews rather than in this inquiry.

A further question is the extent to which the CRM parameters reflect *efficient* operating and maintenance costs. Given the frequency of reviews of the CRM parameters (each cost component is reviewed every three years), it is likely that current estimates of efficient costs may provide an adequate estimate of efficient costs until the time of the next review. Given the nature of the school bus services (a specified route with standard vehicles) there is probably little scope for operators to make significant efficiency gains year to year.

Preliminary Views

12) As an average cost model, the CRM will disadvantage some contractors on some cost parameters and advantage others. However, whether the average values for each cost component are set at the right level is a matter to be resolved through the periodic reviews of CRM components rather than in this inquiry.

13) As each CRM cost component is reviewed every three years, these costs are likely to be close to estimated efficient costs.

4.2.4 Overall Assessment

Competition in the charter industry could potentially be impacted if school bus contractors were to use any excess revenue derived from the school bus contract to charge lower charter rates than those offered by commercial charter operators. Based on the preliminary views presented above, the Authority has estimated that the current CRM does provide revenue to school bus contractors that is higher than the costs that are specified in the CRM. There are two reasons for the higher revenue:

- a rate of return of 10.5 per cent in the CRM rather than 8.6 per cent; and
- the application of the rate of return to the replacement cost of the bus (the Class Bus Price) in the CRM rather than the depreciated value of the bus.

The extent of the higher revenue is 7.5 per cent of costs (or $4,893) for a typical Class A bus, 17.5 per cent (or $13,786) for a typical Class B bus and 14.4 per cent (or $14,454) for a typical Class C bus.

However, the Authority is reluctant at this stage to conclude that the higher revenue could be impacting on competition in the charter industry, for the following reasons:

- the Authority has not had sufficient time to confirm that the CRM makes sufficient allowance for all of the costs associated with a school bus contract. For example, the CRM does not appear to allow for a management fee;
- school bus contractors would have a financial incentive to charge at least variable cost because otherwise their charter operations would result in a financial loss; and

- the Authority is not aware of any situations where school bus contractors are using any excess revenue to reduce their charter rates.

The Authority invites interested parties to submit to the Authority any information in relation to this matter.

Preliminary Views

14) The CRM generates revenue in excess of the costs that are specified in the CRM. However, the Authority is reluctant at this stage to conclude that the higher revenue could be impacting on competition in the charter industry because the Authority has not had sufficient time to confirm that the CRM makes sufficient allowance for all of the costs associated with a school bus contract (e.g. the CRM does not appear to allow for a management fee). In addition, school bus contractors have no incentive to charge less than variable cost and the Authority is not aware of any situations where this has actually occurred.

4.2.5 Adjusting Revenues for Charter Work

The Terms of Reference require that the Authority examine whether any potential competitive unfairness could be remedied by adjusting the amount of reimbursement for fixed overheads under the CRM.

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 Contracts.[26]

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.[27]

Normally, in setting regulated prices, the Authority makes a distinction 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. Costs are allocated between the regulated and non-regulated services and revenue for the regulated service is then determined as the costs attributable to the provision of the regulated service.

Applying this approach to the calculation of a service charge for school bus services, fixed costs could be allocated across all kilometres covered by the bus (for school bus services and for additional charter work), resulting in a reduction in the service charge to school

[26] CRM School Bus Service Contract, Schedule 5, 9(b)(v)A.

[27] CRM School Bus Service Contract, Schedule 5, 9(b)(i).

bus operators, which would be recouped through higher charges to charter customers. If the charter fee is set appropriately, this would have the effect of placing school bus charter prices on a par with those of commercial charter operators.

One way to make this adjustment, suggested in the Terms of Reference, would be to apply a fee per kilometres travelled for the purposes of charter work. The PTA notes that this approach is already applied to Transperth bus contractors operating in the Perth metropolitan area, who pay a rebate to the PTA for each kilometre of charter work they undertake:

> In its metropolitan operations, the PTA's Transperth Division has three commercial bus contractors providing bus services around Perth and using buses owned by the PTA but leased to the contractors; they also predominantly use depot owned by the PTA (Government). To remove any issues of competitive advantage, Transperth bus contractors are required to pay a cents per kilometre rebate to the PTA for charter work undertaken. This rebate is 70 cents per kilometre for the use of a new bus and 35 cents per kilometre for an old bus. (Public Transport Authority, p1)

The question is whether such an adjustment is necessary or appropriate across all school buses. As noted in section 3.3, the Authority has seen little evidence to date of widespread impacts of school bus contractors on the commercial charter industry. A further consideration is the impact such an approach would have on the non-commercial charter work undertaken by school bus operators. As acknowledged by the PTA in its submission, it is not desirable for work undertaken for school excursions or community groups at low costs to be quashed by such a mechanism.

A charter fee, if introduced, would therefore need to distinguish between different types of charter work, as well as different circumstances. The PTA notes that:

> [F]actors that would need to be taken into consideration are:
>
> 1) The type of charter being undertaken, e.g. tourist charter work or school excursion;
> 2) The type of and age of vehicle, i.e. basis for fixed and variable costs;
> 3) The size of the business of commercial charter operator versus the size of the school bus operator; and
> 4) The number of operators in a particular area.
>
> (Public Transport Authority, p2)

The Authority's preliminary view is that there are likely to be no net benefits to Western Australia from introducing a charter fee for school bus operators' charter work. Any impacts of school bus operators on the commercial charter industry are likely to be highly localised, and might be better addressed on a case-by-case basis rather than by an across-the-board adjustment to the CRM for all contractors. In addition, to avoid adverse impacts on school and community charter work commonly undertaken by school bus operators, any charter fee would need to be adjusted for the type of charter work undertaken, the types and ages of buses, and industry structure. Even a sophisticated formulation of a charter fee could have some unintended local impacts.

Further, as noted in section 3.4, the issue of which group in society pays for the fixed costs of school buses (the government, or school bus charter customers) remains one of equity rather than economic efficiency. It is economically efficient for the school bus fleet to be utilised outside its contracted hours, even if the price charged for such services reflects only variable costs. It is a matter for government social policy to decide how the benefits of the use of school buses are shared across society.

Preliminary Views

15) On the evidence available, the Authority considers that there are likely to be few net benefits to the State from introducing charter fees for charter work undertaken by school bus operators.

- Any impacts of school bus operators on the commercial bus industry are likely to be highly localised and might be better addressed locally.
- A charter fee, if introduced, could have unintended impacts on local communities, including school and community charters.
- The use of the school bus fleet outside school hours at prices which cover variable cost is economically efficient.

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.

Appendix 2: Composite Rate Model (CRM) Parameters

The following table sets out the Class Bus Price for the various classes of school buses, which are calculated each year 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 used as the basis of calculating various cost parameters in the CRM model, including the return on assets.

Table A2.1 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 following table 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.

Table A2.2 Composite Rate Model (CRM) Cost Components

CRM Cost Component	Description of Calculation
Fixed Costs	
Return on investment	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[(a)]	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 *Road Traffic Act 1974*.
Comprehensive insurance	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[(a)]	Fixed annual amount, with decreasing amounts where there are more than three contracts.
Variable Costs	
Fuel[(b)]	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[(b)]	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[(b)]	A daily amount based on the SDK, an air conditioning rate dependent on bus class, and indexed for different operating regions.
Tyres[(b)]	A daily amount dependent on the SDK, and quoted tyre repair prices and estimated tyre lives for each bus class.
Unsealed road running[(b)]	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[(b)(c)]	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[(a)]	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[(a)]	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 *Superannuation Guarantee (Administration) Act 1992*.
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.

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