

# RURAL AND REGIONAL BUS FARES

## 2011 fare review

August 2011

Our fare review will determine the maximum fares that can be charged from January 2012 for regular bus services in rural and regional NSW. This review does not cover fares for services in other areas, such as Sydney, the Newcastle/Hunter region, Wollongong region, the Central Coast or the Blue Mountains.

We determine maximum fares only. As a result, we do not review the discount applied to pensioner or student concession tickets or the cost or availability of the Regional Excursion Daily (RED) ticket. Bus operators can, and commonly do, charge fares below the maximum fares determined.

### How the review will be conducted

We will make an assessment of how the cost of providing bus services in rural and regional NSW has changed over the previous year using a cost index we developed for these services called the Bus Industry Cost Index (BICI) and then determine maximum bus fares taking into account the factors we are required to consider and the comments provided to us in submissions.

We do not intend to review the weights of the various cost components in the BICI this year but will apply the weightings and inflators determined previously.<sup>1</sup> However, we will consider issues such as how to adjust the BICI to take into account changes in productivity as we do each year.

We will also review information collected on the profitability of rural and regional bus services provided by bus operators to NSW Department of Transport under each operator's service contract. This information will be used to inform, in particular, whether we should further reduce maximum fares for rural services, as we did last year. (Currently fares for rural services are 10% to 14% higher than the same distance journey on a country town service.)

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<sup>1</sup> In 2007, we extensively reviewed and consulted on the BICI and indicated that we would use the weightings, updated for changes in relative prices of cost items, and inflators for the next 5 years. See IPART, *Review of fares for rural and regional buses and private ferries from 2 January 2008*, December 2007.

We are seeking public submissions on this discussion paper by 30 September 2011. It is helpful if submissions address the factors that we are obliged to consider. Stakeholders may also wish to refer to the estimated increases in the BICI and the fare differences between country town and rural services. These issues are discussed below.

We expect to hold a public hearing in late October. We will publish our final report and fare determination in December 2011 and fare changes will take effect from January 2012. The report and determination will be available from the IPART website and mailed to people who make a submission to the review or request a copy.

The review timetable is available from our website ([www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au)). This timetable will be updated from time to time.

### **Factors we must consider when making the determination**

Our determination of maximum fares for rural and regional bus services is conducted under section 28J of the *Passenger Transport Act 1990*, which requires us to consider the following matters:

- ▼ the cost of providing the services concerned
- ▼ the protection of consumers from abuses of monopoly power in terms of prices, pricing policies and standards of service
- ▼ the need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers and taxpayers
- ▼ the need to maintain ecologically sustainable development (within the meaning of section 6 of the *Protection of the Environment Administration Act 1991*) by appropriate pricing policies that take account of all of the feasible options to protect the environment
- ▼ the social impact of the determination
- ▼ standards of quality, reliability and safety of the services concerned (whether those standards are specified by legislation, agreement or otherwise) and any suggested or actual changes to those standards
- ▼ contractual arrangements prevailing in the industry
- ▼ such other matters as we consider relevant.

### **Estimated change in the bus industry cost index (BICI)**

In recent years, we have changed maximum fares in line with the change in the cost of providing bus services. To estimate the change in costs we used an industry specific cost index called the Bus Industry Cost Index (BICI) – See Appendix A for an explanation of how the BICI is calculated.

Table 1 below provides an estimate of the likely increase in costs using the most up to date data available. The likely increase based on the data currently available is 2.7%. This estimate includes all data that will be used to calculate the BICI for our final decision except as noted below. The inflators for workers' compensation, superannuation, and payroll tax are estimates only and will be updated before IPART finalises its decision. Further, at this stage no adjustment has been made to the wage price index (WPI) to reflect changes in productivity. As a result, IPART's final calculation of the BICI will differ from the figures shown below.

**Table 1 Estimated change in the cost of providing bus services over the past year**

Cost item	Index weight	Inflator	Inflator value	Contribution to 2010 change
Salaries & Wages	43.4%	Productivity adjusted WPI <sup>a</sup>	3.8%	1.6%
Workers Compensation	1.6%	NWPI - Workers Compensation <sup>a,b</sup>	3.8%	0.1%
Superannuation	3.7%	NWPI – Superannuation <sup>a,b</sup>	3.8%	0.1%
Payroll Tax	2.1%	NWPI - Payroll Tax <sup>a,b</sup>	3.8%	0.1%
Bus Fuel and Lubricants	9.3%	Average daily price of diesel across rural and regional NSW (obtained from FUELtrac)	11.9%	1.1%
Bus Repair and Maintenance	4.6%	CPI - Repair and Servicing	0.3%	0.0%
Insurance	2.0%	CPI – Insurance	2.3%	0.0%
Capital Costs - Bus	18.8%	Bus Lease Payment	-4.1%	-0.8%
Other Costs	14.7%	CPI	3.0%	0.4%
<b>Total</b>	<b>100%</b>			<b>2.7%</b>

<sup>a</sup> WPI is the Wage Price Index published by the Australian Bureau of Statistics. NWPI is the Non-wage Price Index also published by the Australian Bureau of Statistics. At this stage no productivity adjustment has been applied to these figures.

<sup>b</sup> The inflators for Workers Compensation, Superannuation and Payroll Tax are not yet available. Estimates based on WPI data from June 2010 – June 2011 are used in this table.

**Note:** Columns may not add due to rounding.

**Source:** Index weights are sourced from IPART, *Spreadsheet Model — Bus Industry Cost Index 2010*.

In 2007, we decided that the quantity weights and inflators in the BICI should remain fixed for a period of 5 years, with expenditure weights updated only to reflect relative price movements between components.<sup>2</sup> As a result, we do not intend to review in detail the quantity weights and inflators in the BICI this year. However, we would welcome comment on the following related issues:

- ▼ The extent to which changes in labour costs or other costs should be adjusted to take account of any potential productivity gains (so the benefits of productivity gains are shared by passengers, through lower fares, and operators)<sup>3</sup> and appropriate methods of measuring productivity gains for rural and regional buses.
- ▼ The appropriate indicator of changes in purchase costs of buses for rural and regional bus operators.

## Productivity

Cost indices, such as the BICI, are likely to overstate price increases necessary to adequately compensate bus operators in the absence of an allowance for productivity growth. This is most obvious in the case of an input such as wages, which tends to grow at a faster rate than final consumer prices. This occurs because inputs, such as labour, are able to be used more productively and hence increases in wages and other input costs translate into a lower increase in final prices.

IPART seeks comments on the following

1. What productivity adjustment should IPART apply for rural and regional buses for this year's review? Should productivity adjustments be made only to labour inputs or also to other costs, such as fuel costs?

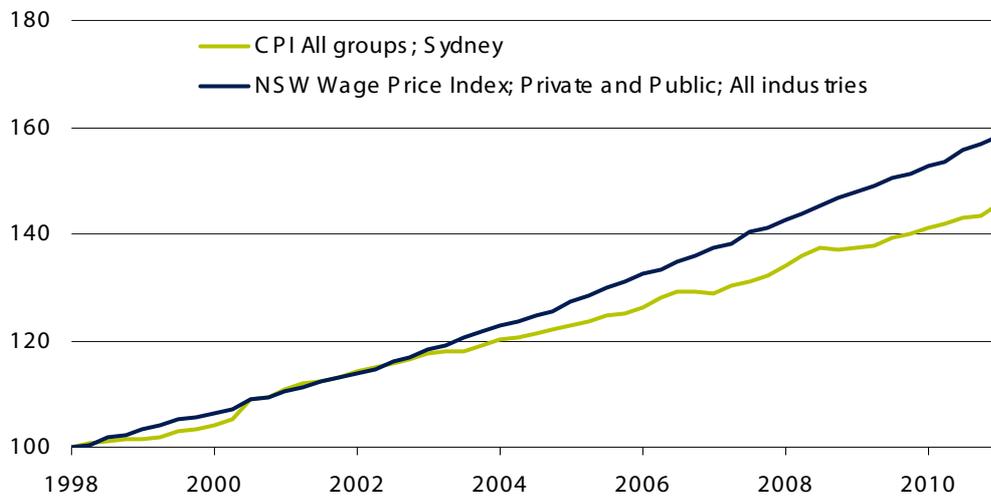
Growth in the wage price index (43.5%) has outpaced that of the consumer price index (31.3%) over the past decade (Figure 1).

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<sup>2</sup> In 2007, we extensively reviewed and consulted on the BICI and indicated that we would use the weightings, updated for changes in relative prices of cost items, and inflators for the next 5 years. See IPART, *Review of fares for rural and regional buses and private ferries from 2 January 2008*, December 2007.

<sup>3</sup> In 2009, 2010 and 2011, we set the productivity adjustment to zero for rural and regional buses. We noted the lack of data about industry specific productivity gains and the desirability of obtaining more data, particularly passenger kilometres. For further detail see IPART, *Review of fares for rural and regional buses from January 2010*, December 2009, Appendix E.

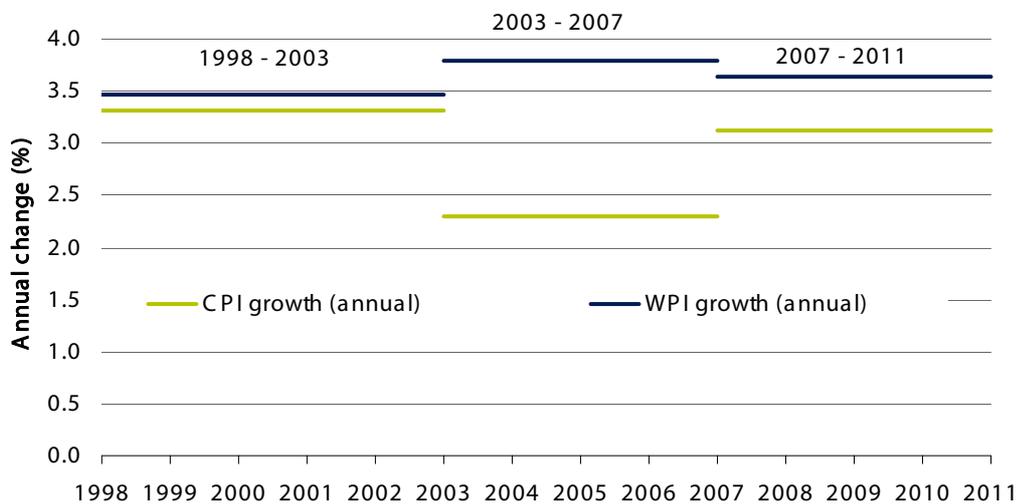
**Figure 1 CPI and WPI growth**



**Data source:** ABS, 2011 Labour Price Index, Cat. No. 6345.0 and ABS 2011, Consumer Price Index, Cat. No. 6401.0.

Averaged over 4- to 5-year periods from 1998, wages have increased by more than CPI by 0.1% from 1998 to 2003, 1.5% from 2003 to 2007 and 0.5% from 2007 to 2011 (Figure 2).

**Figure 2 CPI and WPI growth**



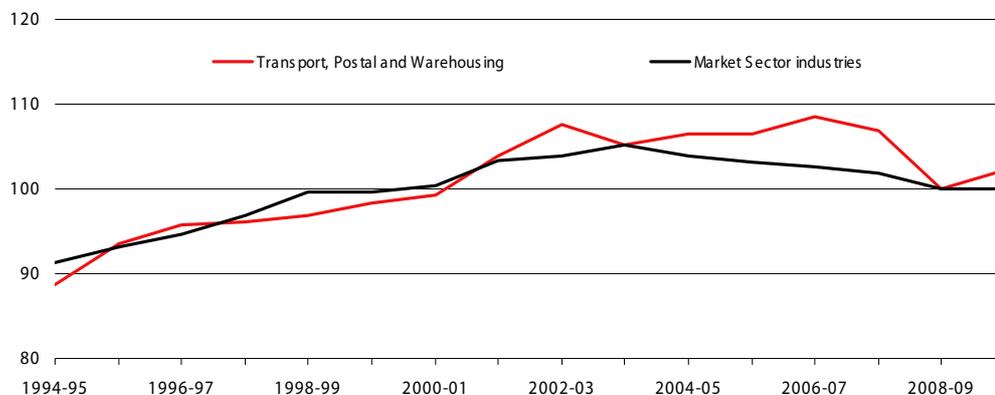
**Data source:** ABS, 2011 Labour Price Index, Cat. No. 6345.0 and ABS 2011, Consumer Price Index, Cat. No. 6401.0.

### Aggregate productivity trends

ABS estimates of multifactor productivity growth (which take into account both labour and capital<sup>4</sup>) indicate gains of 2.3% in the transport, postal and warehousing sector in 2009/10. This estimate exceeds the average for 'market sector industries' which remained flat in 2009/10.

Average annual MFP growth in the transport, postal and warehousing sector outpaced MFP growth for the general market sector between 1985/86 and 2005/06, but has fallen by an annual average of 0.8% over the last 5 years (Figure 3).

**Figure 3 ABS estimates of multifactor productivity**



**Data source:** ABS, *Experimental Estimates of Industry Multifactor Productivity, Australia: Detailed Productivity Estimates*, Cat No. 5260.0.55.002, December 2010.

### Bus fuel efficiency

Productivity may occur outside of the use of labour. For buses, one major aspect of productivity might be fuel efficiency. A recent ABARE review found that vehicle fuel efficiency in the bus transport sector has improved at an annual average rate of 1.3% (from 12.1 megajoules per passenger-kilometre in 1989/90 to 9.7 megajoules per kilometre travelled in 2006/07).<sup>5</sup>

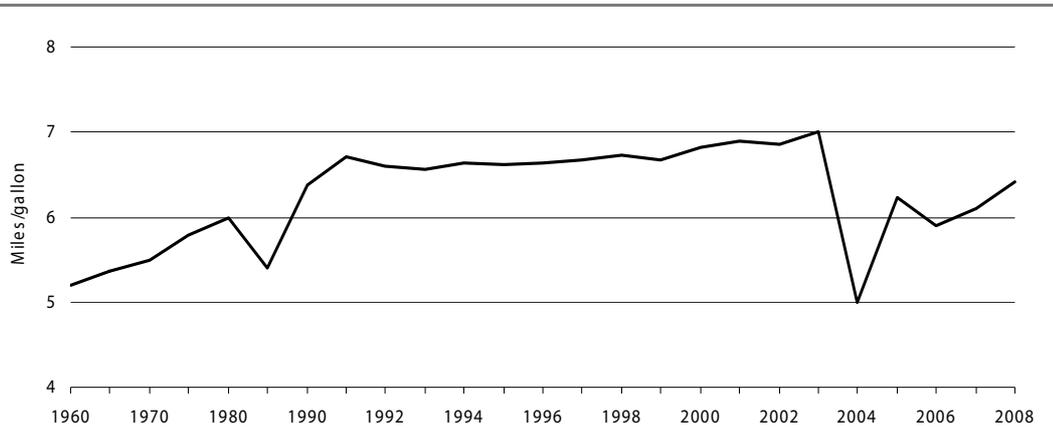
This finding is supported by data compiled by the US Bureau of Transportation Statistics which found that average bus miles travelled per gallon increased by 1.4% per year between 1990 and 2008, although with significant volatility (Figure 4).

<sup>4</sup> MFP statistics use industry gross value added (in volume terms) to measure economic output and total hours worked to measure labour input. The capital input is a measure of different capital assets such as dwellings, other buildings and structures, and machinery and equipment, along with livestock, intangibles and non-agricultural land.

<sup>5</sup> ABARE, *End use energy intensity in the Australian economy*, Research report 09.17, November 2009, p 33.

The impact on the overall level of fuel efficiency for rural and regional bus services would depend on the rate at which old buses are retired and replaced with new, more fuel efficient, buses.

**Figure 4 US bus fuel efficiency (average miles travelled per gallon)**



**Data source:** US Bureau of Transportation Statistics, Table 4-15: Bus Fuel Consumption and Travel, available at [http://www.bts.gov/publications/national\\_transportation\\_statistics/html/table\\_04\\_15.html](http://www.bts.gov/publications/national_transportation_statistics/html/table_04_15.html)

### Bus lease costs

Bus purchase costs are the major driver of the estimated bus lease payments that form part of the BICI. The estimate of bus purchase costs currently used is an average of 3 quotes provided by bus manufacturers to the Department of Transport.<sup>6</sup> Although we have used this approach in the past we have expressed concerns regarding the use of industry provided data in calculating fare changes and indicated that we would re-examine this issue.

We also have some concerns regarding the methodology of the current approach. In particular, the increase in bus purchase costs is applied to all bus lease payments. This may overstate actual increases as many bus lease amounts will not increase in line with new bus costs. In particular, if bus standards increase, then the cost of these standards is implicitly applied to *all* buses used to provide contract B services. This is likely to bias upwards estimates of capital costs temporarily. The extent of the bias is difficult to determine, although we expect that it would likely be small.

Bus purchase costs allowed in the bus cost index have increased by 3.4% on average from 2001 to 2011. This is almost entirely driven by increases in the quotes of bus bodies. This rate of increase is somewhat higher than might be expected given the strong Australian dollar and importance of imports.

<sup>6</sup> Quotes are separated into the bus body and the bus chassis. There may only be a single quote for the bus body.

We are interested in whether there are viable alternatives to the current method that reduce potential bias arising from using the current approach to estimating capital costs or that provide estimates that better reflect what the market is able to provide.

NSW Department of Transport has indicated that it is also considering alternative methods of estimating bus purchase costs for government contract payments for contract B services. This includes considering using quotes provided by bus manufacturers for a panel of contractors for metropolitan and outer-metropolitan bus services. The major advantage of this approach is that quotes provided for such a panel can be taken up by the NSW Government. In comparison, current quotes provided to us by the industry may not reflect the prices at which bus manufacturers are actually willing to provide buses. This method would not be available for the current review but could be available for the 2013 review.

The second component used to determine bus lease payments in the BICI is the interest rate used to amortise the bus purchase costs discussed above. For last year's review and the BICI presented in table 1, 5-year government bond yields were used as the rate of interest to estimate the annual change in the cost of making loan repayments on a bus. However, other interest rates, for example, the bank lending to business rates published by the Reserve Bank of Australia<sup>7</sup> may better reflect the actual lending costs faced by bus operators.

IPART seeks comments on the following

2. Would the approach of using quotes provided to the Department of Transport for metro and outer metropolitan buses provide a better measure of the change in capital costs for rural and regional buses?
3. Are there alternative measures of the change in capital costs for rural and regional buses that might be preferred to the current measure?
4. Is there a more appropriate interest rate, such as the 'bank lending to business' rate to measure the change in bus lease costs?

### **Are rural and regional bus fares too high?**

Last year, we received data from the Department of Transport that was reported to it by bus operators (for the 2008/09 financial year) that suggested that, on average, operators may be making higher returns than are appropriate to the risks they are facing.

We have received preliminary data for 2009/10. This preliminary data is not as detailed as we had access to last year and in its current form may not allow the same level of analysis this year. We have requested additional information from the Department of Transport so that we can gain a better understanding of the current profitability of the bus operators.

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<sup>7</sup> Weighted-average interest rates on credit outstanding on total loans less than \$2 million.

The preliminary data shows lower levels of profitability than were reported last year, particularly for rural operators. It indicates that, on average, revenues reported by bus operators for their contract operations were 23% higher than their expenses in 2009/10 (Table 2).

Revenues for bus operators should exceed expenses in order to provide operators with a return on their assets. The appropriate revenue to expense gap will reflect the value of the assets owned by the bus operator, a return on these assets appropriate to the risks that the operator is bearing and depreciation of these assets. We do not know the value of assets dedicated to providing contracted bus services. This will differ across different business arrangements. Some bus operators will lease buses and depots rather than owning these assets. For these operators, lease costs will be included in expenses and the appropriate revenue to expense gap will be lower. Also, operators may have included depreciation in expenses reported to NSW Department of Transport.

The share of bus lease costs in the BICI provides one measure of the appropriate revenue to expense gap, as it captures the return on capital and depreciation for buses. This measure is likely to overstate the actual appropriate return as many operators include lease costs in their expenses or include depreciation costs for their buses. Bus lease costs are 21% of non-bus lease cost expenses, which could be seen as a maximum appropriate return for rural and regional bus operators.

While overall the reported revenue to expense gap is above 21%, there is substantial variability in the profitability reported by operators. Profitability varies between different operators and when compared with the data reported for 2008/09. This suggests that some operators may be making higher returns than appropriate but others may not. It is also likely that many of the differences simply reflect misunderstanding of reporting requirements.

**Table 2 Profitability of rural and regional bus operators (contract only)**

Item	Country town only	Country town and rural	Rural only	All
Ratio of revenues to expenses				
2009/10 (preliminary)	1.24	1.24	1.15	1.23
2008/09	1.36	1.26	1.53	1.30
Ratio of government payments to contract revenue				
2009/10 (preliminary)	0.88	0.89	0.81	0.89
2008/09	0.74	0.86	0.61	0.82

**Source:** NSW Department of Transport; IPART, *Review of fares for rural and regional buses from January 2011*, December 2010.

As has been noted by the bus industry and NSW Department of Transport, revenue and expenditure figures for rural and regional buses have a number of weaknesses and inaccuracies. For example:

- ▼ some bus businesses include costs and revenues for their other non-bus related businesses in figures provided to NSW Department of Transport
- ▼ allocating joint costs (such as corporate overheads) between bus and non-bus businesses requires assumptions, and
- ▼ allocating joint costs (such as bus capital expenditures or lease payments) between charter and contract services requires assumptions.

These weaknesses are evident in the large changes between data for 2008/09 and preliminary data for 2009/10 for rural bus operators (Table 2) and the substantial variation within operators (Table 3). For example, one operator reported that earnings before tax (EBT) made up 55% of their revenue – ie, expenses made up only 45% – while at the opposite extreme one operator reported EBT as negative 66% of revenue.

**Table 3 Variations in reported profitability (contract only)**

Item	Country town only	Country town and rural	Rural only	All
Best performing contracts — EBT as a share of revenue				
2009-10 (preliminary)	40%	45%	55%	55%
Poorest performing contracts — EBT as a share of revenue				
2009-10 (preliminary)	-18%	-17%	-23%	-23%
2008-09	-66%	-26%	-3%	-66%

**Note:** EBT is earnings before tax.

**Source:** NSW Department of Transport.

There are alternative sources for analysis of financial viability. In determining payments beginning for the contract period, Ernst and Young undertook financial analysis of a sample of bus operators. Its preliminary conclusions were that some bus operators were making high rates of return and others making negative rates of return. Ernst and Young noted that the NSW Department of Transport would be in a much better position to analyse financial performance and viability of operators following collection of data required under the new bus contracting arrangements.<sup>8</sup> (This is the data reported above.) There have also been substantial changes to contracts made by the NSW Government to bus operators since the Ernst and Young analysis was conducted including a once off 18.5% increase in contract payments.

NSW Department of Transport has advised that it is continuing to work to improve the quality of financial reporting by bus operators. This has included spot audits and following up data consistency issues. There is a continuing program to improve the

<sup>8</sup> Ernst and Young, *Funding of rural and regional bus services in NSW*, prepared for the NSW Ministry of Transport, 2008, p 67.

quality of reporting. We expect to continue working with the Department of Transport to allow us to draw appropriate conclusions from the data available.

We consider that despite its evident limitations, financial reporting under the current contract arrangements provides the best available source of information on profitability of rural and regional buses.

IPART seeks comments on the following

5. Is there scope to reduce bus fares while still allowing bus operators to earn an appropriate rate of return on their assets? What considerations might affect the use of data reported to NSW Department of Transport under rural and regional bus contracts?

### **Fare differences between country town and rural services**

Fares for the same distance journey on a rural bus service are higher than fares on a country town service. In our fare determination beginning 1 January 2011, we narrowed the gap between fares for rural routes and fares for country town routes from around 25% to around 12%. This was achieved through increasing country town fares by the estimated change in bus costs as measured by the BICI and reducing rural fares by 10%.<sup>9</sup>

In making these changes to fares we noted that:

- ▼ on the best available evidence at the time, profitability of rural bus services was high, and
- ▼ impacts on rural bus operators would be minimal as full fare paying passengers make up a very small share of passengers and in many cases maximum fares are not charged.

For this review, we are considering whether to continue reducing bus fares for rural services to the level of country town services for the same distance journeys. On initial examination of the financial data for 2009/10 there has been a substantial change in the reported average profitability of rural only bus services. We will review this information in more detail over the course of the review.

We expect that few operators would be impacted by fare convergence as few charge current maximum fares. However, we would be interested in gaining a better understanding of the financial performance of contracts for rural bus services where these services currently charge maximum fares.

IPART seeks comments on the following

6. Will a reduction in rural fares to the level of country town fares impinge on the financial viability of any bus operator?

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<sup>9</sup> IPART, *Review of fares for rural and regional buses from January 2011*, December 2010.

## How to make a submission

We invite written comment on this document and encourage all interested parties to provide us with a submission addressing the matters discussed above.

### **Submissions are due by 30 September 2011.**

Submissions received after the deadline will not be accepted unless an extension has been granted prior to the due date. Note that submissions will also be sought following the release of a draft report.

We would prefer to receive submissions by email <[ipart@ipart.nsw.gov.au](mailto:ipart@ipart.nsw.gov.au)>.

You can also send comments by fax to (02) 9290 2061, or by mail to:

**2011 Review of rural and regional bus fares**  
Independent Pricing and Regulatory Tribunal  
PO Box Q290  
QVB Post Office NSW 1230

Our normal practice is to make submissions publicly available on our website <[www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au)>. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning a member of the bus review team on (02) 9290 8400.

If you would like further information on making a submission, IPART's submission policy is available on our website. You can also sign up to our email notification service to receive updates regarding transport related matters, including information on events and documents related to this review.

## A How the BICI works

In 2007, IPART reviewed the BICI in detail and fixed its components for 5 years. This year it will apply the weightings and inflators determined previously.

The BICI is intended to measure, in percentage terms, how much the overall cost of providing bus services has changed in the 12 months since IPART's last review. The BICI consists of a basket of bus cost items – such as fuel, labour and insurance costs. These items are weighted according to the proportion of the overall cost of providing bus services they represent. IPART updated the BICI weights in 2007, based on the results of an industry survey of costs conducted by Indec consulting. IPART decided that those weights, adjusted each year for changes in the relative costs of the costs items, would apply for the next 5 years. Consequently, for the 2011 review IPART will adopt the weights used in the last review, updated for the cost increase measured by the inflator.

Each cost item has a relevant 'inflator'. The inflators are selected on the basis that they provide the best available indication of how the cost item changes over time. Wherever possible, IPART has selected inflators that are based on publicly available information. For example, the relevant inflator for the bus repair and maintenance cost item is the change in the repair and servicing component of the CPI.

At the start of each review, IPART establishes the relative weighting for each cost item in the BICI, and its relevant inflator. It then establishes the change in that inflator over the review period, and multiplies the weighting by this value, to establish the contribution of any increase or decrease in the cost item since the last review to the overall change in the cost of providing bus services. Both the weighting of the cost item and value of the inflator affect its contribution to this overall change. The table below sets out a simplified example of the BICI calculation.

**Table A.1 Illustrative example of how the change in the BICI is calculated**

Cost item	Weighting at start of the review	Change in relevant inflator	Calculated contribution to change in the BICI
	%	%	%
Labour	40	5.0	2.0
Fuel	30	10.0	3.0
Insurance	20	1.0	0.2
Maintenance	10	15.0	1.5
Total	100	-	6.7