



independent competition and regulatory commission

Issues Paper
**Review of ACTION
Buses pricing
for 2006-07**

**Report 5 of 2006
February 2006**

The Independent Competition and Regulatory Commission (the Commission) was established by the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act) to determine prices for regulated industries, advise government about industry matters, advise on access to infrastructure and determine access disputes. The Commission also has responsibilities under the Act for determining competitive neutrality complaints and providing advice about other government-regulated activities.

The Commission has three commissioners:

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For further information on this investigation or any other matters of concern to the Commission please contact Ian Primrose, Chief Executive Officer, on 6205 0779.

Foreword

The Minister for Urban Services wrote to the Commission on 10 January 2006 to advise that as the referring authority for ACTION Buses for price inquiries for regulated industries under the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act), he was issuing an industry reference to the Commission. The reference was for the investigation and making of a direction for the prices to apply for ACTION bus services in the period from 1 July 2006 to 30 June 2007.

The Minister attached two instruments, one notifiable and the other disallowable, to the reference setting out the terms of reference for the Commission. The notifiable instrument (N12006) referred to the investigation in the following terms:

Under subsection 15(1) I refer to the Commission the matter of an investigation into the determination of prices for public passenger bus services provided by ACTION.

The commission, in conducting its investigation into the determination of prices, shall determine a price path capable of being applied for the period 1 July 2006 to 30 June 2007.

The disallowable instrument (D12006) declared the following:

Under 16(1) I specify the following requirements in relation to the conduct of the investigation:

(a) the final report is to be provided, by 19 May 2006, to the Minister for Urban Services in relation to determined public passenger bus service prices for the period from 1 July 2006 to 30 June 2007;

(b) a draft report in relation to determined public bus passenger services for the period from 1 July 2006 to 30 June 2007 is to be provided to the Minister for Urban Services and made available for public examination and consultation in accordance with section 18 of the Act; and

(c) the determination should consider the impact on ACTION's cost of fuel prices.

The Commission is releasing this issues paper to stimulate debate about the issues involved in providing public transport through the ACTION network, especially those issues that impinge upon the cost of those services to public transport users. The Commission is aware that many people will have views about the issues raised in the paper and encourages submission of those views to the inquiry. The inquiry will involve responses in writing to this issues paper and, later, to the Commission's draft report. Written submissions may be delivered by hand to the tender box at the Commission's office at Level 7, 197 London Circuit, Canberra, by mail to PO Box 975, Civic Square ACT 2608 or electronically to icrc@act.gov.au.

Paul Baxter
Senior Commissioner

20 February 2006

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1 Introduction

1.1 Commission's role in setting ACTION prices

The *Independent Competition and Regulatory Commission Act 1997* [ACT] (ICRC Act) makes the Commission responsible for determining prices for regulated industries in the ACT. Regulated industries are declared 'regulated industries' by the Minister under the ICRC Act. ACTION Buses is a declared regulated industry. The Commission has determined ACTION Buses pricing since 1998, initially in a series on annual price directions and from 2000 in directions over three-year price paths. The Commission's current direction, released in 2003, provided for no increase in prices for 2003-04 and 2004-05 and a CPI adjustment for the final year, 2005-06. The current direction will expire on 30 June 2006. This investigation is to determine prices to apply for the period from 1 July 2006 to 30 June 2007. A further review will be required prior to any price adjustment from 1 July 2007.

1.2 Context of the investigation

Particularly in the two most recent investigations, the Commission has addressed a number of issues relating to ACTION bus services about which the Government and the Commission have concerns. The Commission has sought to set ACTION Buses pricing in the context of an integrated transport plan for the ACT that would give guidance about what services might be needed, and where, to contribute efficiently to the growth of the city and its population in the future. The Commission has sought in a number of decisions to give effect to government's desire for ACTION Buses to recover more of its costs through the farebox, and to reduce ACTION's dependence on funding from the territory's budget. The Commission supported the government's decision to make ACTION Buses a statutory authority, overseen by a commercial board charged with raising patronage and gaining efficiencies.

Many of those issues, which have been addressed or continue to be addressed, are characteristic of public bus services in most other states and territories in Australia and as such may be mitigated but not finally resolved. The Commission has sought to provide information through pricing signals to consumers, and advice to ACTION Buses about the need for efficiencies and those issues that require continuous and urgent attention. It has also sought to provide a set of financial guidelines and to encourage the development of a framework within which ACTION can reduce costs and increase patronage.

The Department of Urban Services is also pursuing reforms to the way in which ACTION Buses operates and the role it plays in providing services, as one of the modes of transport available to the public in the ACT. The department has developed a number of policy options for consideration by government and ministers that may have a bearing on the price direction the Commission may have determined for the period from 1 July 2006. To allow the government time to consider properly the reform proposals that may be put to it, the Minister for Urban Services has issued a reference for a price to be determined only for the financial year 2006-07. The Commission expects that the Minister will issue a reference for an investigation later in 2006 for a longer price path to have effect from 1 July 2007.

As a result, this price investigation will consider a range of issues that may have a bearing on the price to have effect in the financial year 2006-07 and other issues which may contribute to the longer term price path from 1 July 2007.

1.3 Purpose and timing of issues paper

The Commission is releasing this issues paper as the initial step in determining the prices to be applied to ACTION bus services in the 2006-07 financial year. The issues paper is intended to raise awareness of the matters that will be considered in determining the price and to seek both comments on those issues and advice about any other issues that should be considered but which have not been included.

The Commission will provide a brief period during which interested parties will be able to make written submissions to the Commission on the issues in the paper and any other issues of importance to the outcome of the investigation.

A draft report will be released providing the Commission's preliminary assessment and analysis of the issues and information provided by ACTION Buses itself and in submissions from interested parties. The submissions received will be published on the Commission's website and made available for scrutiny at the Commission's offices. The Commission is bound by law to protect commercially sensitive or private information but will make all other information publicly available. The Commission has a relatively short period available for this investigation and proposes to follow the timetable below:

Release of issues paper	20 February 2006
Submissions on issues paper close	20 March 2006
Release of draft report	31 March 2006
Submissions on draft report close	24 April 2006
Release of final report	19 May 2006

Submissions may be made to the Commission in writing or electronically (the postal address, street and e-mail addresses are provided inside the cover of this document). Alternatively, interested persons may wish to seek a meeting with the Commission, and parties should contact the Commission offices to arrange an appointment to meet the investigating officers.

2 General direction

2.1 ACTION price direction of May 2003

In the current price direction for ACTION Buses which ceases on 30 June 2006, the Commission determined that there should be no change to the weighted average price cap for the two years 2003-04 and 2004-05 but that from 1 July 2005 the weighted average price cap would increase by the extent to which the Canberra-based CPI increased for the twelve months ending March 2005. In holding prices steady for the period, the Commission believed that this should contribute to the government's public transport strategy. The Commission expected that at the next review, in 2006, the benefit of a clear policy direction for public transport and a greater ability to assess ACTION's performance in satisfying the demand for public transport services would be evident. It also expected to be in a position to assess the extent to which ACTION Buses' farebox revenue had increased as a result of increasing patronage, resulting from ACTION's management of the transport strategy and pursuit of market objectives under its statutory authority structure. The authority structure offered the prospect of ACTION's board achieving substantial operating efficiencies.

The Commission anticipated in 2003 that by 2006 the basis of ACTION Buses' government-funded services would have improved as a result of implementing a more appropriate funding model. The Commission expected that a new funding model would achieve a higher level of transparency about costs and a higher level of guidance from government about planning and industrial and workforce management in ACTION.

The Commission recognises that in the period since 2003 the government has agreed to a set of planning policies that have the clear intention of fostering greater integration of planning for urban growth and public transport. While those policies were relatively general, they provide a framework in which further policies and practices could be developed and implemented. The Commission will consider the contribution that such integrated planning processes have made to the efficiency and effectiveness of ACTION bus services and in particular whether they have resulted in improvements in patronage.

2.2 Options for consideration

In considering the issues that might be examined in the course of determining a price for ACTION bus services for 2006-07, the Commission has identified two approaches that would set a framework for the review:

- maintain the current direction for a further year; or
- extend the current direction for a further year with adjustments for any significant variations in ACTION Buses' costs, such as fuel if it is found to be materially changed, and any other adjustments reflecting changes in ACTION's operating circumstances that the Commission is satisfied warrant attention in this interim review.

The Commission understands that the reference issued by the Minister is concerned with extending the current price direction, with attention being given to a narrow set of other issues, such as the

impact of fuel cost increases on operating costs, rather than a full scale review. To identify whether there are costs (other than the possible impact of fuel costs) that should be included in that list of issues, the Commission need to consider both the outcomes and the range of issues raised in the last report on ACTION bus pricing released in May 2003.

3 Issues raised in price direction

3.1 Operating costs and efficiencies

In previous determinations, the Commission has expressed concerns about ACTION Buses' progress in achieving efficiency improvements. There were differing views about how much of its annual costs were potentially reducible with increased efficiencies, taking account of industrial matters. In 2003 the range of potential annual cost savings through efficiency improvements was considered to be between \$2.6 million and \$9 million.

The Commission believes that three years is a sufficient time since the last determination for ACTION Buses to demonstrate whether and how it has continued to achieve efficiency improvements beyond those already achieved by 2003 and what effects such improvements have had on its annual operating costs since that time.

During the previous inquiry ACTION Buses advised that forecast annual operating costs for 2002-03 through to 2004-05 were estimated to increase to around \$66.3 million. However, according to its annual report for 2004-05 ACTION's operating costs for that financial year amounted to \$83.9 million, an increase of more than 26%. The largest part of the increase appears to be in the area of employee costs, which reflect the application of the latest industrial awards and an increase in staff numbers. Between 1999-2000 and 2001-02 employee numbers fell from 693 to 679. According to the 2004-05 annual report, employee numbers increased from 677 in 2003-04 to 700 in 2004-05. The Commission was previously concerned that the forecast labour costs were likely to be significantly understated and this appears to have been the case. It is not clear, with increasing unit costs and employee numbers, whether there has been any success in continuing the earlier efficiency improvement path.

Although the current reference only covers the 12-month period to 30 June 2007, the Commission believes that the consideration of any price change should take account of whether further efficiency improvements have been achieved since 2003, even though more substantive analysis would be taken up in deliberations on establishing a longer-term price path from July 2007.

The Commission invites submissions on efficiency issues relating to ACTION Buses. In particular, the Commission invites comments on why there appears to have been a reversal in the trend for ACTION Buses to reduce employee numbers by improving labour productivity, given the very small increases in patronage which have occurred, and to what extent further efficiency improvements may be tackled.

The other major issue affecting operating costs, specifically mentioned in the current reference, is the impact of higher fuel costs on ACTION's operating costs. According to the 2004-05 annual report, bus running expenses increased by \$1.24 million between 2003-04 and 2004-05 (p.103). That expense category included increases in diesel fuel costs, which according to ACTION Buses consisted of \$1.7 million in fuel costs above those originally budgeted. Government contributions to ACTION were increased in 2004-05 and included an additional \$2.3 million for increased fuel

costs. Clearly, fuel increases in the last year have been funded through higher government payments rather than increased efficiency. Given the current reference, the Commission needs to consider the merits of passing on in full or in part increases in fuel costs through higher fares or maintaining the current funding contribution mechanism from government.

In assessing the impact of higher fuel costs, the Commission needs to understand the components of energy use by ACTION Buses. The introduction of new CNG-fuelled buses has led to a shift in energy use from automotive diesel to natural gas. Automotive diesel, as a proportion of total energy share, has fallen from 93% in 2002-03 to 84% in 2004-05, while at the same time natural gas use has increased more than fourfold (ACTION annual report, page 56). The Commission is interested in the relative contributions of automotive diesel and natural gas to ACTION's overall operating costs and the changes noted in the last two years.

According to the annual report, assuming that all bus running expenses were fuel costs, this item constituted 11% of total operating costs in 2004-05. Clearly, fuel prices have increased significantly since July 2005 and these costs will impact on the 2005-06 financial outcome.

However, increases in fuel costs also impact on private transport costs and there is evidence to suggest that recent increases in adult passenger boardings might in part be attributable to these higher petrol prices, according to an ACT Government media release in December 2005. To that extent, ACTION Buses is likely to have enjoyed higher farebox revenues.

It is not clear whether any changes in patronage as a result of these recent fuel price increases would be sustained if fuel prices were to fall again.

The Commission would be interested to know whether the incremental revenues attributable to higher car petrol costs are greater or less than the incremental operating costs attributable to ACTION's higher fuel bills. (This might potentially influence ACTION passengers' willingness to pay higher fares as a result of private fuel cost savings.)

The Commission invites submissions on operating cost issues with particular reference to the effect of higher fuel costs on

- ACTION Buses' financial ability to sustain service levels through to mid 2007, and
- private motorists and their potential shift to ACTION bus services as a result of higher prices.

3.2 Capital costs

ACTION Buses has completed a \$17.2 million four-year fleet replacement program, providing new CNG-fuelled buses. This was funded by explicit government funding approved in 2001-02. In its previous determination, the Commission acknowledged that there were funding issues for ACTION Buses in undertaking future fleet replacement. In addition, there did not appear to be an appropriate strategy in place for additional and replacement buses beyond those already approved and acquired.

Part of ACTION's operating costs includes depreciation and interest associated with its capital assets. As a result, any substantive new asset acquisition over the last three years would have impacted on its cost base. The Commission would be interested to know whether ACTION Buses has developed an appropriate asset replacement and acquisition strategy following the completion

of the previous four-year funded program, what that strategy comprises and the effect of that strategy on the depreciation and interest component of ACTION's operating costs for the current and future years.

While this issue will have more relevance to a longer-term price determination, the Commission invites submissions on ACTION Buses' fleet acquisition strategy, its costs and possible funding implications for fare increases.

3.3 Patronage and transport strategy

At the time of the previous determination, ACTION Buses' share of the ACT transport market was approximately 5-6%. The Commission was of the view that any opportunity for substantial increases in that proportion was probably conditional on the formulation and execution of an integrated transport strategy with appropriate matching service levels. Since then, in April 2004 the government released its Sustainable Transport Plan (STP), which set a direction for transport in the ACT over a 25-year period. One of the targets of the STP was for ACTION Buses to increase the share of people travelling to work, from 7.5% in 2004-05 to 9% by 2010-11, rising to 16% by 2025-26. ACTION claims in its 2004-05 annual report that it exceeded the 2004-05 target through the introduction of a number of initiatives, such as the 'Xpresso' services and the increased frequency of the intertown services.

The Commission has expressed the view in the past that fare elasticities appeared to be low in the ACTION Buses network and that fare increases were unlikely to have a seriously adverse effect on overall patronage levels. Nevertheless, to support the government's intention to promote public transport through a broader-based transport strategy, the Commission only endorsed a fare increase for the third year of the recent triennium. Interestingly, it appears that recent increases in patronage have occurred during the last year when fares were increased compared with the previous two years' fare freeze. This would tend to confirm one view that patronage levels are more influenced by frequency and service patterns than by fare levels.

While the Commission is only looking at a price determination for one year at this time, it is interested to know what plans ACTION Buses has to continue to meet increasing STP targets for 2005-06 and 2006-07. This might then underpin the Commission's current deliberations to ensure that any short-term price determination is not inconsistent with the direction it may consider for the subsequent triennium. As part of this analysis, the Commission seeks information on changes to bus patronage over each of the last three years since the last price determination and any analysis which explains those changes, including changes attributable to the introduction of new routes and services compared with increased numbers of services on existing routes.

The Commission notes that the current five-year contract between the ACTION statutory authority and the Department of Urban Services for bus services expires in December 2006, halfway through the next price determination period. It would be helpful to the Commission if some indication could be given as to the nature and expectations of any new contract provisions which would apply from the end of the calendar year in order to assess to what extent any changes could be expected to have financial implications for ACTION.

The Commission invites submissions on ACTION Buses' patronage levels across the network over the past three years, with particular reference to the introduction of new services, and the perceived impact of past price determinations on those levels.

The Commission also invites submissions on ACTION's strategy to achieve Sustainable Transport Plan targets over the next few years.

3.4 Cost recovery

At the time of the previous price determination, ACTION Buses' projected cost-recovery rate though the farebox was approximately 22%. While the rate had been as high as 25% a few years before, there appeared to be significant difficulties in ACTION Buses being able to reduce costs and increase revenues sufficiently to make any substantive changes to these levels of cost recovery. Even allowing for low fare elasticities, any reasonable CPI-related price increases were not expected to make a marked difference to overall cost-recovery outcomes.

Nevertheless, the Commission was advised by the Department of Urban Services in 2003 that it was government policy to move towards a 30% cost-recovery target for ACTION Buses and that the government would support price increases consistent with that objective. A cost-recovery outcome cannot sensibly be determined without a clear picture on government funding for ACTION. In the past, deficit financing has been an inevitable consequence of the funding model used for ACTION Buses. In its last determination the Commission expressed concern that this situation would continue, although government contributions for CSO payments for non-commercial services had been revised.

ACTION's cost-recovery position has deteriorated further since the last price determination. According to its 2004-05 annual report, ACTION's cost-recovery rate in 2003-04 was 20.5% and it fell further in 2004-05 to 18.7%. While farebox revenue only increased by around 1%, expenditure increased by over 10% as a result of increasing employee numbers, higher unit labour costs and higher fuel prices.

The Commission is interested in the government's current cost-recovery target for ACTION Buses and the status of any proposed funding model for ACTION bus services. The Commission understands that the funding model deliberations were designed to be finalised by the end of 2005. Clearly, the achievement of the government's cost-recovery target of three years ago is now more difficult than it was then, and this raises concerns about the appropriateness of small changes in fare levels. Although these issues may be viewed as more pertinent to the Commission's next deliberations on a three-year price path, they are nevertheless important inputs into its current, more limited deliberations.

The Commission would welcome views on matters relating to future cost-recovery targets for ACTION Buses and more general comments about the funding of public bus systems, in particular about any funding model (such as a structured borrowing program) that might be more effective and efficient than ACTION's current deficit funding arrangements.

4 Likely impact of options

As indicated in section 2.2, the Commission is considering two alternatives for this one-year price direction. In assessing the respective merits of each alternative, it will take into account three likely major impacts: changes in patronage levels, change in net financial position, and the trend in efficiency improvements.

4.1 Changes in patronage levels

Recent changes in patronage levels, while positive and consistent with the STP, have to date remained modest. To what extent they have been induced by the improved services or by higher private car fuel costs is uncertain.

Clearly, if car fuel prices were to fall, more recent passengers might switch back to private car use. On the other hand, if car fuel prices remained high, current patronage might well be maintained and perhaps even increased as potential passengers saw that bus travel cost advantages were sustained. Given low price elasticities, adjustments to ACTION Buses' fare levels commensurate with increases in fuel costs are unlikely to lead to significant reductions in patronage, particularly if the claimed service level improvements are maintained. However, if future car fuel prices were to fall and ACTION's fares increased as a result of past fuel increases, this could lead to a switch back to car use.

Provided bus services remain unchanged, the Commission will need to assess to what extent any change in fares will impact on patronage levels.

4.2 Change in net financial position

If incremental revenue from additional passengers exceeds the incremental costs, particularly those associated with higher fuel costs, the net effect on ACTION's financial situation should improve. On the other hand, if there is little additional net revenue forthcoming, then ACTION's financial position will deteriorate further and government will be required to provide additional deficit financing support.

On the basis of expected elasticities, increases in fares are likely to have a positive effect on ACTION's net financial outcome, with any net increase in farebox revenue leading to a reduction in the requirement for government support.

Against a background of offsetting government support requirements, the Commission needs to consider the impact of potential fare increases that are, consistent with any agreed funding model.

4.3 Trend in efficiency improvements

The Commission notes that operating costs have increased significantly since the last price determination and is concerned about the degree of success in pursuing efficiencies. If any fare increase represents compensation for past and/or prospective fuel cost increases, any such revenue increase would probably be seen as directly related to fuel price changes and not reflecting the need for further efficiencies. Any price determination will need to ensure that the appropriate

signals are sent to ACTION Buses, the government and the public that ACTION should continue to identify and pursue efficiency improvement opportunities.

The Commission would welcome submissions and comments on price determination options and the likely impact of their implementation, with particular reference to the next one-year price period but also indicating any broader issues which the Commission should take into account as a prelude to considering a longer-term price path.

In considering these options, the Commission is also required under the ICRC Act to have regard to a number of other factors when making a price direction. These other factors are:

- protection of consumers from the abuse of monopoly power
- standards of quality, reliability and safety
- principles of ecologically sustainable development
- social impacts of the decision
- considerations of demand management and least cost planning
- the effect of general price inflation over the medium term, and
- any arrangement that a person providing regulated services has entered into for the exercise of its functions by some other person.

The Commission would welcome submissions and comments on any or all of these factors as they relate to the operations of ACTION Buses and the deliberations of the Commission on an appropriate one-year price direction for bus services in the ACT.

Glossary and abbreviations

CNG	compressed natural gas
Commission	Independent Competition and Regulatory Commission
CSO	community service obligation
ICRC Act	<i>Independent Competition and Regulatory Commission Act 1997</i>
STP	Sustainable Transport Plan