

Introduction

This submission relates to two elements, profit and bus replacement, contained within the composite rate model (CRM) proposed to be used as the basis for remuneration of Western Australian school bus contractors. The CRM, developed by industry and put forward as an alternative to the existing standard rate model (SRM), has been reviewed by PricewaterhouseCoopers (PWC) on behalf of the Department of Planning and Infrastructure.

The results of the PWC review are contained in a report dated January 2002. That report states that the objective of the review “. . . is to assess the commerciality of the cost elements . . . and based on the review, an annual cost to government is to be calculated and a cash flow prepared.” The assessment of commerciality, it is stated, has been based on firstly assessing whether costs are actually incurred, and secondly assessing the assumptions on which the costs have been calculated and indexed.

The report also refers to the review being undertaken to “. . . ascertain whether the model would provide an equitable return to the contractors whilst providing value for money for government.”

Following their review, it was determined “. . . that the objective of ensuring that the result is cost effective for government . . .” was overlooked by the CRM as developed by industry. The recommendations contained within the report are based on achieving a base for costs which is said to be commercially transparent and readily verifiable, while at the same time able to be verified against agreed benchmarks. Notwithstanding that agreement has not been reached on all elements of the CRM, or on the benchmarks in many instances, industry has been advised that this model has been implemented, and failing mutual agreement to amendments, variations or changes, school bus contractors will be paid in accordance with the model as reviewed by PWC.

Recommendations

It is recommended that the CRM bus replacement and profit elements be reworked to ensure that the resulting profit recognises the cost of investment by the operators, and that equity is maintained across all types of contracts.

Further, it is recommended that the bus replacement and profit elements be calculated by reference to a return on capital invested, as opposed to a profit margin based on a markup on costs, and that the return delivered to industry should equate to a return on investment of 20% after allowing for owners' benefits. That is, that there be reimbursements to contractors of costs incurred in providing the service, and a profit returned that acknowledges the level of investment required to provide that service.

Further, that there be a recognition within the detail of the CRM that fairness, equity and commerciality reflect the imposts of providing the service regardless of location.

It is noted that the 43% profit margin recommended by PWC, when applied to the Western Australian school bus industry, does not provide an asset turnover ratio overall comparable to the EBC Benchmarking Guide, which supports industry's position that insufficient emphasis has been given to the amount of capital required to maintain the Western Australian school bus service. To this end PWC has been selective in applying its own benchmarking criteria to determine returns to the school bus industry.

Industry position

Industry believes the implementation of the CRM in its present form is premature. It is inequitable and many of its premises do not reflect the Western Australian operation.

Covenants are placed on contractors that require capital to be invested every ten or fifteen years. This condition is fundamental to the safety history of the service. The cost of maintaining this record, in part, results in a higher cost of assets being used, and this must be recognised in calculating a return to service providers.

The second objective, that the assumptions on which costs are calculated and indexed, be reasonable, has not been met. Additionally, there are specific cost elements, the basis of which are yet to be agreed, including repairs and maintenance and administration. At the date of submission, no agreement has yet been reached on areas ignored by the PWC CRM, these being productivity/responsibility, and regional allowance.

It is apparent that the approach taken to date by the Department, and the brief given to PWC, concentrates on cost to government. Recommended changes to the CRM have been made to ensure that the overall cost of providing the service is made to fit government budgetary constraints, rather than assessing the real cost of providing the service. Insufficient or no consideration has been given to the financial viability of individual contracts, nor has any assessment been made as to whether the overall returns provided under the CRM are equitable to the contractors.

To maintain a safe and sustainable service, this consideration must be recognised.

Industry agrees with the principle that a remuneration package based on firstly identifying and reimbursing direct costs, and secondly providing a return or profit, is acceptable, and believes government should recognise that this return needs to fairly and commercially compensate operators.

PricewaterhouseCoopers profit recommendation

The CRM as reviewed by PWC bases an assumption of fair return to operators as a margin on total revenue. The margin which has been considered fair by PWC is calculated by way of reference to direct costs, including a notional remuneration package to owner drivers.

PWC has determined that 43% profit margin represents an average return within the industry, and uses as their benchmark the EBC Benchmarking Guide for Bus and Coach Operators (30 June 1999).

Industry does not accept that the EBC Benchmarking Guide is representative of the Western Australian school bus industry, nor does it accept that a 43% profit margin is necessarily a fair and equitable return across all contract types. The survey for the year ended 30 June 1999 by EBC was based on thirty businesses drawn from most states of Australia. Of the thirty businesses, three were from Western Australia and it is not known whether any of those were from the Western Australian school bus industry. It is apparent from the results that the survey is primarily drawn from unregulated bus and coach operations, as distinct from the prescribed, regulated and dedicated school bus operations which exist in Western Australia. As a consequence, businesses operating buses in an unregulated market can influence their financial position by

- running the bus for more hours per week
- running the bus over more kilometres per week
- increasing the capacity factor and minimising the number of empty seats
- applying other management, enterprise and marketing practices to determine income and expenses.

The Western Australian school bus industry has no such options.

It is also noted that the operators in the school bus industry in states other than Western Australia are less restricted with regard to the type and age of buses, and therefore have the opportunity to provide a service with buses which have lower capital values, thereby requiring less investment.

EBC Benchmarking Guide

PWC has based its recommendations as to fair profit on the EBC Benchmarking Guide. The guide summarises financial information under a number of categories relating to level of business revenue, and also whether income is mainly from school transport. The recommended margin of 43% comes from the average of two groups within these categories. Industry does not accept the premise that 43% is necessarily a fair margin. This recommendation ignores completely the capital required to be invested by the operators. Industry believes that fair remuneration can only be considered fair if it recognises the financial risk taken by individual operators as represented by the cost of investment in a bus. Industry does not accept the proposition that a fair and equitable result to all types of contracts can be achieved by a “one size fits all” approach, based on a mark up on costs to achieve the required profit margin.

The EBC Benchmarking Guide does not provide details of capital invested by the businesses surveyed, however it does provide reference to a ratio “asset turnover”. The average of the asset turnover for the two categories which form the basis of PWC’s recommended profit margin is \$0.77. The CRM, in its current form, provides a return on assets in excess of this ratio for bus type A only. In all other types, the return ranges between \$0.46 and \$0.70. The degree to which operators included in the survey can gain revenue with less restriction as to the type and age of buses being used, highlights industry’s contention that the survey upon which the recommendations are based is not representative of the Western Australian school bus industry.

As stated previously, the results summarised under two categories within the EBC Benchmarking Guide, have been used as the basis of the PWC recommendation on profit margin. Even if it is accepted that the average of these two categories can be used to assess average and fair return, they include elements of cost which are not included as a component of the CRM. As such, it is contended that these cost elements should be removed from the results, and if a profit margin is to be based on the survey results, it should be based on the results which are adjusted for these non relevant cost elements.

For the year ended 30 June 1999, the average profit for the two categories selected, adjusted in this manner, was 47.49%.

In preparing this submission, industry has obtained the latest EBC Benchmarking Guide for Bus and Coach Operators for the year ended 30 June 2000, the results of which are based on a survey of forty businesses, of which again three are from Western Australia. It is noted that the profit margin as

recommended by PWC based on these survey results is 44%, the average asset turnover is \$0.73, and that the adjusted average profit margin after the deduction of non-relevant cost elements, is 48.44%.

Financial position of contractors

As stated previously, reviews done to date do not take into account the financial position of individual contractors. Insufficient weight has been given to the capital invested by contractors, and too much emphasis has been placed on remuneration based on a mark up on costs. By referencing profit as a mark up on costs, those contract types which have higher overheads are rewarded, while a contract type which has a similar financial risk by way of the capital costs, is by comparison disadvantaged. Further, no assessment has been carried out to determine whether the return provided to operators by the CRM would be considered fair and reasonable in commercial terms, when related to other small business returns and expectations.

In preparing this submission, detailed financial analysis has been done from the bus operators' perspective. The analysis consisted of assessing the position of individual contracts for all types, firstly on the basis of a profit before the implications of tax and finance, and secondly after taking into account tax and finance. These results were compared with the existing remuneration base provided by the SRM.

It should be noted that for the purposes of amortising the original historical cost of the bus used in each contract, depreciation has been calculated on the straight line method over 10 years for type A buses, and 15 years for all other types, assuming a residual value of 10% for type A and 5% for all others. The results gained present the individual contract positions on the traditional notion of profit and loss. The aim of the analysis was to determine firstly, real profit to the contractors and secondly, in the year that financing applies to a contract, real disposable income. This form of analysis also provided the opportunity to calculate return on investment and asset turnover for comparison with the EBC Benchmarking Guide for Bus and Coach Operators. More importantly, from an equity point of view, the analysis provides the opportunity to compare the actual results between types of contracts, to assess the relative fairness of the proposed basis of remuneration.

The analysis is drawn from the whole contract population, with the exception of those contracts which have been allowed to continue using out of life buses. The financial information for individual contracts was provided by the Department on an anonymous basis, and its use in the preparation of this submission is not acceptance that the financial information is correct or complete. Each contract was

analysed separately, and for each type an average result obtained. This submission includes average results for contracts by type, and a comparison between types based on those average results.

In addition, a schedule summarising the effect of the PWC CRM on those contracts where new buses will be required in 2003 is included.

Small business comparatives

Industry believes that insufficient consideration has been given to the amount of capital investment required by operators to fulfil their obligations under the contracts and provide the service. Industry does not believe that relating a profit margin to turnover solely, is fair and equitable.

It is apparent that the most common form of assessing financial viability used by small business is return on investment. This measure aims to assess the overall return to an owner against the capital required to provide the opportunity to obtain that return. The analysis of individual contracts enables comparison between the return on investment which would accrue to school bus operators under the CRM against other small business expectations. It is acknowledged that there is no right or wrong in relation to a return expectation, and that the return expectations will differ depending on the individuals concerned and their personal circumstances. It is possible, however, to obtain some feel as to how the school bus contractors would compare. We should also be mindful that the prescriptive nature of the service, and in many cases the demographics, denies the operators the opportunity to alter their return.

In attempting to identify comparative measurements of return, we have relied firstly on the experience of small business clients of Owen & Plaistowe. That experience indicates that small business operators are reluctant to purchase businesses that provide return on investment after owners' benefits of less than 30%. There are some exceptions, and these relate to businesses which are considered to be safer than others, such as Lotto kiosks, newsagencies, TAB agencies and post offices. The common factor amongst these types of businesses, with the exception of newsagencies, is that they carry some form of statutory or quasi government licensing, conditions which could reasonably be compared with school bus operations. It is possible to measure the expected returns by enquiry through business brokers. In the preparation of this submission, we have not made specific enquiries, however we refer to two publications, "Business Values Newsletter", published bi-monthly, and "Business Opportunities", published quarterly by business brokers Goodwin Mitchell O'Hehir & Associates. Both publications provide a commentary on various industries and expected return on investment

percentages. The latter publication provides specific reference to expected returns after owners' benefits.

Comparative rates of return after owners' benefits :

Lotto kiosks	16% - 22%
Newsagencies	15% - 25%
Post offices	16% - 20%
TAB agencies	15% - 25%

Also by way of comparison, it is noted that an expected return on investment in Australian 10 year bonds is approximately 6%, and investors in commercial/industrial property are expecting returns of between 6% and 12%. The last two examples would be considered investments which have little or no finance risk.

The conclusion drawn is that the return on investment provided under the CRM based on the historical cost of the bus is significantly less than the return expectations of businesses such as those mentioned above. Further, the analysis provides the basis of comparing asset turnover under the CRM to the asset turnover as disclosed in the EBC Benchmarking Guide. With the exception of type A (with aide) and special A and B, the return is significantly less than that represented as being the industry average.

Comparison between contract types

The table on page 10 is provided in support of industry's contention that PWC's CRM in practice delivers an inequitable and uncommercial result to industry. The table sets out the financial position of industry (by types), firstly under the existing SRM, secondly under PWC's CRM as recommended (43% profit margin), thirdly PWC's CRM adjusted for non-relevant items (47.5% profit margin), and finally as it would be if industry's recommendation is accepted.

It is acknowledged that the SRM is deficient in many respects, and in recent years because profit was benchmarked to the Commonwealth Government bond rate, returns to contract operators have decreased in real terms. Notwithstanding its deficiencies, the SRM did provide some equity between types of contracts, especially in relation to providing a return on capital which although considered low by comparison with small business expectations, at least provided a semblance of equity between the types, with the exception of type A contracts. The impact of the CRM is that it creates inequality between types of contracts, delivering returns on investment ranging between 9.8% for type C to approximately 36% for special A and standard A with aides.

The inequality delivered can also be seen by comparing the return provided to type A bus contracts, with or without aides. Both receive an overall profit margin of approximately 43% and both have similar investment levels (\$71,087 and \$66,851), however the net profit after owners' benefits is, on average, \$24,930 for those with an aide compared to \$8,770 for those without. For those with aides, the return on investment is 35.9% (asset turnover \$1.37) compared to 13.4% (asset turnover \$0.91).

Further, using the measurement of asset turnover contained in the EBC Benchmarking Guide, the CRM delivers a result ranging between \$0.46 and \$1.37. In dollar terms, the CRM results in the situation where the type B operator investing approximately \$120,000 in a bus compared to a type C operator investing approximately \$165,000, receives net profit, after owners' benefits and before tax, of \$14,300 as opposed to \$15,400.

From the data provided it is possible to extrapolate the position of those contracts requiring new buses in 2003, on the assumption of average bus cost of \$73,269, \$170,723 and \$222,529, the return on investment for standard type A, B and C respectively will be 11%, 9.4% and 7% per annum (asset turnover \$0.77, \$0.44 and \$0.31). In dollar terms, the net profit after owner benefits will be \$8,280, \$16,014 and \$15,480. Disposable income, assuming 7 year hire purchase finance (7%) and income tax at 18.5%, will be \$14,235, \$8,375 and \$866 per annum. If the inequity is not conceded with the foregoing comparison between standard types, consider the position of the standard type A with an aide. Return on investment will be 29% (asset turnover \$1.12), net profit after owner benefits of \$23,344 and disposable income of \$25,142, again with an overall profit margin of 43%.

Conclusion

A comparison of the financial data obtained on those contracts requiring new buses in 2003 with the position delivered by PWC's CRM to the existing fleet, indicates that operators' returns will diminish. This fact evidences industry's view that PWC's CRM will lead to more and more contracts becoming financially unviable as the cost of replacing buses increases. It is contended that a remuneration method based on recognising the cost of investment is administratively simpler, transparent, and more likely to maintain equity and commerciality over a period of time.