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SUBMISSION TO THE VICTORIAN TAXI INDUSTRY INQUIRY

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1 | INTRODUCTION

The Essential Services Commission (the ESC) welcomes the opportunity to make a submission to the Taxi Industry Inquiry's draft report. The ESC is Victoria's independent economic regulator of prescribed services supplied by the water and sewerage, electricity and gas, ports and rail freight industries.

On transport matters, the ESC has a role in undertaking investigations and reviews as requested by relevant Ministers under industry specific legislation — Division 9 of Part VI of the *Transport (Compliance and Miscellaneous) Act 1983* (Transport Act) and Part 8, section 212 of the *Accident Towing Services Act 2007*.

Under current legislation, the Minister for Public Transport must obtain a report from the ESC prior to changing the schedule of any taxi fares. Having an independent economic agency like the ESC to review and advise on taxi fares at arm's length from Government, lobbyists, and industry regulators¹ promotes the transparency and independence of the taxi fare setting process.

1.1 The focus of this submission

This submission does not attempt to respond to all of the recommendations made in the Inquiry's draft report. Instead, the ESC provides comment on the overall direction of reform proposed by the Inquiry as well as responding to a small number of specific recommendations where it believes it is able to add most value or contribute an alternate view, given the insights gained through the ESC's previous taxi fare reviews and subsequent research and analysis.

¹ For example the Victorian Taxi Directorate and the Taxi Services Commission (TSC).

2 | REFORMING THE TAXI AND HIRE CAR INDUSTRY

2.1 The Inquiry's approach to reform

The Inquiry has proposed a broad reform agenda to tackle the problems of poor performance in the taxi and hire car industry, grouping its recommendations under three themes — improving and increasing supply, restoring trust and boosting demand.

The ESC notes that the Inquiry's proposed reforms seek to increase competition and innovation across the taxi and hire car industry by removing unnecessary regulation. Reforms also seek to direct revenues to those delivering taxi services, i.e. drivers and operators. The setting of maximum rather than prescribed fares is seen as a step towards an eventual light-handed approach of price monitoring when sufficient competition in the industry emerges. While some new driver qualification requirements are proposed, changes to safety and quality standards are otherwise less prescriptive and emphasis is given to outcomes-based regulation versus prescriptive regulation.

Specific reforms include:

- removing taxi licence number restrictions — instead licences are to be made available for a \$20 000 annual fee,
- removing restrictions on hire cars, such as the public interest test in country areas, zoning restrictions and the requirement for luxury vehicles. An unrestricted, one-off \$40 000 licence fee for a broader category of hire cars, known as Pre-Booked Only (PBO) licences,
- uniting the metropolitan and outer suburban zones to form a Greater Melbourne zone,
- removing mandatory network service provider affiliation,
- requiring taxi drivers to pass a Greater Melbourne knowledge test,
- increasing drivers' share of fare box revenue,
- the replacement of prescribed fares by a regulated maximum fare, allowing operators to offer prices below this ceiling, and
- lowering the fee for electronic payments facilities.

2.2 The benefits of reform

As discussed in the ESC's initial submission and the Inquiry's draft report, removing unnecessary regulation and increasing competition can produce benefits for the industry and consumers. Taxi industries in industrialised countries were, as a rule, heavily regulated until the 1970s when jurisdictions first moved to deregulate. Experience with deregulation illustrates the possible benefits when reform is undertaken in a well thought out, coherent way.

Key benefits associated with reform include:

- market entry, leading to reduced waiting times and improved service availability — for example, in Ireland, New Zealand, Sweden, and the Netherlands a removal of entry restrictions led to increased supply and reduced waiting times (although in some cases it has been argued that entry increased excessively),
- increased flexibility and service innovation — for example, after deregulation in New Zealand, taxi vans and executive taxis were introduced as well as a new taxi-charge credit system, and
- fare competition — for example, after deregulation in New Zealand, average fares fell in urban areas² and, in the United States, some studies found that fares either fell or remained constant³. Overall, the ESC notes that the evidence for fare reductions following deregulation appears mixed. This suggests a cautious approach to fare deregulation is warranted, as well as reforms that encourage competition and innovation.

While the ESC supports reforms to remove unnecessary regulation, it notes that immediate and full deregulation can be problematic. The following section considers issues in transitioning to a more competitive market.

2.3 Transitioning to a more competitive market

The Inquiry's draft recommendations address the key areas of government intervention in the taxi and hire car industry — market entry, fare regulation and safety/quality standards. How reform in these areas is implemented can have important implications for the success, or otherwise, of the reform package. The literature on taxi regulation and national and overseas experience provide useful information on how best to transition to a more competitive market.

² Bekken, J.-T. and Longva, F. 2003, *Impacts of taxi market regulation – an international comparison*. TØI report. Oslo, Norway.

³ See for example Frankena, M. and Pulter, P. 1986, *Economic analysis of taxicab regulation*, Transportation Research Record 1103, Transportation Research Board, Washington DC, and Doxsey, L. 1986, *Interpreting the results of regulatory revisions in Seattle and San Diego*, Transportation Research Record 1103, Transport Research Board, Washington DC.

Market entry

The removal of market entry restrictions is most commonly associated with taxi deregulation.

In 1999, the Productivity Commission undertook research into the regulation of Australia's taxi industries.⁴ It found that little community benefit comes from restricting entry into taxi markets and that consumers face longer waiting times at taxi ranks and slower responses for phone bookings as a result. Fully deregulating market entry was seen to encourage operators to employ a broader range of vehicles to provide taxi services and better meet demand. Part-time taxis were also seen to help during peak periods, where the available fleet was often unable to meet demand.

While supporting reforms to increase competition, the ESC notes that immediate removal of entry restrictions may produce unstable outcomes. Perhaps most noteworthy is the case of Ireland, where the lowering of entry restrictions saw a tenfold increase in taxi numbers in some cities.⁵ Other jurisdictions, such as the Northern Territory and most major US cities, have returned to imposing entry restrictions after larger than expected rises in taxi numbers resulted in service quality issues (e.g. poorly trained and motivated drivers) and or excessive fares in areas where there was limited competition (e.g. airports).⁶ Even when deregulation has been a success, such as in New Zealand, there have still been instances of poor service quality which have required a regulatory response.

The ESC notes that the Inquiry's deregulation proposal cannot be considered equivalent to the open entry reforms of many US cities, Ireland and Darwin, with the Inquiry proposing that entry be restricted to those willing to pay the \$20 000 annual licence fee, rather than there being an 'open entry' approach. This approach to deregulation is supported by the ESC.

Fare regulation

Some form of fare regulation may be maintained when a taxi market is deregulated. This is applied as a protection to consumers as competition develops. The Productivity Commission noted that the approach to fare deregulation could depend on the specific taxi market, i.e. phone booking, rank and hail, or trips from the airport. It concluded that for:

- phone bookings — price comparisons could be undertaken with relative ease, and thus a fully deregulated fare system could apply to phone bookings,

⁴ Productivity Commission 1999, *Regulation of the Taxi Industry*, Ausinfo, Canberra.

⁵ Sinnott, Kathy, MEP, Question to European Commission, accessed at www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+WQ+E-2008-1411+0+DOC+XML+V0//EN on 4 July 2012.

⁶ In these cases of excessive fares, open entry in those US jurisdictions that deregulated was accompanied with removal of fare regulation.

- rank and hail trips — in the absence of any controls on price, the lack of consumer bargaining power could lead to exorbitant prices being charged, particularly during periods of high demand; hence a system of posted prices is likely to be appropriate for the rank and hail market, and
- trips from the airport — given congestion and other issues that make price comparisons and touting both difficult and undesirable, a regulated fare is advisable for trips from major airports.

The Inquiry's recommendation to retain fare regulation, rather than pursuing full deregulation or posted prices, is an approach that provides time for competition to emerge with the reduction in entry restrictions (and other associated measures proposed by the Inquiry).

With maximum fare regulation intended to apply under the initial reforms and entry not being deregulated, the type of issues associated with fare competition from airports are less likely to emerge. However, if competition from Melbourne airport is to be promoted, it is likely that its facilities (e.g. rank design) may need some remodelling. This will involve some negotiation between the airport operator and the Government.

The ESC notes that the proposed review after three years should consider the extent of competition at Melbourne airport in particular; and the effects of any fare competition in terms of the smooth flow of passengers and taxis from the airport. There may be evidence that points towards the need to treat airports as a special case.

Safety and quality regulation

While full deregulation would see the removal of entry restrictions and fare regulation, there may be a need for a minimum level of safety and quality regulation. For example, vehicles should meet vehicle roadworthiness requirements and drivers should have relevant local knowledge.

The reforms proposed by the Inquiry seek to simplify aspects of safety regulation, while also improving driver quality through a Melbourne knowledge test. These reforms are supported by the ESC. However, the ESC also believes the Inquiry should provide more detailed discussion and options as to how safety can be ensured in practice within a partially deregulated market for new and innovative services such as share rides and taxi shuttles as outlined in recommendation 12.1 'New and more flexible taxi services'.

2.4 Concluding comments on reform

Overall, the ESC supports the pro-competitive reforms proposed by the Inquiry. The ESC notes that the Inquiry is not proposing open entry — instead, entry will be limited to those paying the \$20 000 annual licence fee and fare regulation will continue until competition emerges.

Depending on how competition develops over time, Government may need to consider the extent to which fare regulation needs to be maintained for trips originating from Melbourne airport (and perhaps Avalon Airport depending on its growth).

There are a number of Inquiry recommendations that directly impact on the roles and responsibilities of the ESC. The following provides comment on these recommendations as well as other recommendations where the ESC believes it could have a role.

3.1 Pre-booked only cab licences

In recommendation 2.5 the Inquiry's draft report states:

PBO licences should be available for purchase by approved applicants at a one-off set price of \$40,000. The Essential Services Commission (ESC), with input from the Taxi Services Commission (TSC), should undertake a review of this price point after three years.

The ESC agrees that it is appropriate to review the set price for pre-booked only (PBO) licences after three years. It notes that similar reviews are often provided for in legislation to track how industry regulation and or reforms are performing, e.g. section 53 of the *Port Management Act 1995* provides for the ESC to conduct a review, every five years, and make recommendations as to whether or not certain services are to be subject to price regulation and the form of that price regulation.

The ESC is therefore comfortable being given the role of reviewing the one-off set price for PBO cab licences.

For the conduct of such reviews, it is important that the Government is clear (e.g. through legislation or policy statements) on what it is looking to achieve through the PBO reforms (and hence entry price), as this will inform any future assessment by the ESC. Further, it may be useful if the TSC could start thinking about the statistics/information it will collect on the performance of the PBO market and taxi market more generally, as this information would be useful for the ESC's review of the PBO licence fee. For the PBO and taxi markets separately, such information could include:

- the number of licences issued by the Government,
- the demand for services, e.g. total trips by time of day, day of the week, monthly and yearly trips,
- trip distances, and other demand characteristics such as trip purpose and frequency, and
- customer satisfaction surveys.

The taxi licence fee

Under the Inquiry's proposed reforms, PBO and standard taxi services will increasingly become substitute services. However, while the ESC has an intended role in assessing the PBO licence fee, it does not have a role in assessing the \$20 000 annual taxi licence fee. The ESC believes it is worth considering whether it should also have a role in assessing the proposed annual taxi licence fee.

In particular, while noting the Inquiry's statement that this fee should not be increased or indexed over time, depending on the number of new licences issued and the level of competition emerging in the reformed market, there may be merit in reviewing whether the fee should be *decreased*. The Government could put this review requirement into legislation, or alternatively could issue terms of reference to the ESC to undertake such a review.

As the Inquiry has done in recommending the \$20 000 fee, any such review would balance the interests of current licence owners, (i.e. those that have previously purchased perpetual licences) with other industry participants and customers.

3.2 Fare setting processes and fare structure

The Inquiry makes a number of draft recommendations on the taxi fare setting process and issues of fare structure. In terms of the fare setting process, the Inquiry's draft recommendations include:

Fares should be determined by the ESC. To implement this, the Government should issue an order to declare the taxi industry to be a regulated industry under Section 4 of the Essential Services Commission Act 2001. (recommendation 13.2)

Regulated fares should change from being prescribed fares (fixed amounts) to maximum fares, giving permit holders and ATOs [Authorised Taxi Organisations] the ability to offer discounted rates below the maximum level to consumers. (recommendation 13.4)

Fare reviews should be undertaken periodically with the capacity to undertake interim reviews should certain cost thresholds (for example, LPG [liquefied petroleum gas] price movements) be reached. (recommendation 13.10)

The ESC supports each of these recommendations.

Having fares determined by the ESC recognises that regulation of fares is an economic issue, and the determination of fare changes should be made by an independent economic regulator. As well as the ESC's independence from industry and government, it has the skills and the understanding of the fare review task, including a well-developed public consultation process. Therefore it is less likely that the fare setting process will be caught up in political trade-offs or captured by industry or user groups if the ESC sets fares.

The Inquiry's recommendation for fares to be set as a maximum is consistent with its overall reform agenda of increasing competition and innovation within the industry. Setting a maximum fare will allow market participants to pursue negotiation and discounting below the maximum rates. Further, over the medium term it is likely that taxi fares applying to pre-booked trips may be able to be deregulated. This could be considered as part of the ESC's future fare reviews.

Finally, the ESC agrees that fare reviews should be undertaken periodically, with Government able to set their frequency. Further, having the capacity for interim reviews when certain cost thresholds are met is supported. The ESC notes that an interim taxi fare review process is undertaken by the Independent Pricing and Regulatory Tribunal (IPART) in NSW in regard to changes in LPG fuel costs. A fare change is only recommended by IPART if costs have changed by more than 20 per cent.

Review of existing fare setting methodology

It would be the ESC's preference that prior to its next taxi fare review, the Government requests the ESC to review the fare setting methodology. The ESC believes there is merit in moving away from a rigid building block (cost of service) approach to fare setting and exploring new approaches and methods for setting fares that take greater account of the dynamic interaction between the demand side and supply side of the taxi market (see section 4.3.2 of this submission) and other relevant markets.

3.2.1 Fare structure

The ESC notes the following Inquiry draft recommendation on fare structure:

- *Better match operators' costs with fares, which requires an increase in taxi fares late on Friday and Saturday nights (peak times), offset against a reduction in fares at all other times (off-peak)*
- *Increase the flagfall and reduce the price per kilometre for the Greater Melbourne zone to address the undesirable practices of short fare refusal and inefficient behaviour such as airport overcrowding*
- *Replace the 'Tariff 3' 50 per cent surcharge on the distance rate with a flat fee of between \$10 to \$15, which customers should be advised of when they book a higher occupancy vehicle or when they select one from a rank, such as at the airport*
- *Simplify 'multiple hire' fare charging to support the industry to offer more flexible, innovative shared ride type services (for example, by allowing flat fee amounts for passengers in a shared ride trip that total more than the meter) and include provisions for MPTP [Multi Purpose Taxi Program] members to use their subsidy for shared rides. (recommendation 13.11)*

The information and analysis required to assess fare structure, especially if the aim is to develop an optimal fare structure, is very detailed. The ESC's 2008 taxi fare review undertook some fare structure analysis; however it concluded that '*there is insufficient confidence that the analysis could be used to formulate detailed recommendations in relation to the tariff structure*'.⁷ The ESC notes that:

*The Inquiry has begun some preliminary modelling, but it is not sufficiently developed to produce reliable estimates of optimal fare structures. However, the inquiry believes there is already sufficient evidence to support a change in fare structure even without this modelling.*⁸

The following addresses each of the fare structure recommendations listed above.

Peak and off peak fares

The Inquiry recommends an increase in fares to meet peak demand during Friday and Saturday nights. The Inquiry is also concerned that the proposed increase in driver revenues (a 60:40 split of fare revenue) may affect taxi availability during peak periods, and hence there is a need to increase peak period fares to compensate operators. A reduction in off peak fares is recommended by the Inquiry to compensate for this rise.

Presenting an alternative argument, the ESC notes that:

- bailment arrangements that provide for a fixed share of revenue for operators and drivers maintain incentives for both to maximise taxi use, and
- other Inquiry recommendations are aimed at removing entry restrictions and increasing taxi supply, the operators of which will similarly have incentives to maximise taxi use.

Therefore, the ESC notes that further detailed analysis will be required to assess the merits of the proposal to increase taxi fares on Friday and Saturday nights (and the corresponding reduction in fares at all other times to compensate for the peak fare increase).

Flagfall versus distance rate

Increasing the flagfall and reducing the distance rate to address short trip refusal and airport overcrowding is an issue that the Commission would welcome the opportunity to explore in more detail.

⁷ Essential Services Commission 2008, *Taxi fare review 2007-08*, Final Report, August, p. 124.

⁸ Taxi Industry Inquiry 2012, *Customers First: Service, Safety, Choice*, Draft Report, May, p. 478.

Rates for high occupancy taxis

High occupancy taxis are able to charge a higher fare as these vehicles cost more than conventional taxis.⁹ The ESC notes the Inquiry's recommendation to replace the current 50 per cent distance rate surcharge with a flat fee of between \$10 and \$15, in order to address the long wait times for maxi taxis and to discourage drivers from waiting at Melbourne airport in the hope of applying the maxi taxi rate.

Long wait times and taxis queuing at Melbourne airport affect service availability to passengers who use a wheelchair. As these taxis are required to give priority to bookings made by people who use a wheelchair, better enforcement of this requirement may be part of the approach of addressing any current 'availability' issues. Consistent with this, some Inquiry recommendations under the *Restoring Trust* theme should improve service provision from high occupancy taxi operators and drivers.

Notwithstanding the above, on the basis that the change in structure is intended to leave high occupancy taxi operators no worse off, the change appears reasonable. That it addresses airport queuing is also a favourable outcome.

Multiple hire fare

Simplifying the multiple hire fare to allow operators to offer a flat fare, share-ride service represents a potentially useful innovation in taxi services. The ESC notes that Queensland has successfully operated these services in Brisbane and other main centres since December 2005. The ESC also notes that the Victorian Taxi Association has recently put forward a proposal for a share ride trial service in Melbourne, offering a single flat fare of \$30.¹⁰

The ESC would welcome the opportunity to provide advice on the appropriate fare for this type of service.

3.3 Electronic payment service fees

In recommendation 14.3 the Inquiry's draft report states:

The 10 per cent service fee levied on the processing of electronic payments should be brought under regulation as part of taxi fares and set at a level that better reflects the resource costs of providing the service. The inquiry recommends this fee be set at

⁹ The high occupancy vehicle surcharge can only be applied when there are five or more passengers in the taxi or when a hirer (not using a wheelchair) specifically requests a larger taxi.

¹⁰ ABC News 2012, *Melbourne to trial taxi sharing scheme*, 1 July, accessed at www.abc.net.au/news/2012-07-01/melbourne-to-trial-taxi-sharing-scheme/4102962?section=business on 4 July 2012.

five per cent of transaction value until subject to a further evaluation by the ESC as part of a fare review.

The ESC generally agrees with this recommendation as well as the Inquiry's other recommendations that seek to reduce the electronic payment service fee. As submitted in the ESC's Staff Paper in response to the Inquiry's first call for submissions, the Government has inadvertently reinforced Cabcharge's market dominance and:

The Secretariat considers that the VTD [Victorian Taxi Directorate] should explore options to increase the level of competition in the provision of electronic payment systems.¹¹

Initially setting the fee at 5 per cent of transaction value provides immediate relief from the current high service fee of 10 per cent. To further support this reduction, it would be useful if the Inquiry's final report could present information on electronic payment service fees in industries where competition appears to be strong and hence the level of the service fee is more reasonable; the retail and utilities industries may provide useful examples.

ESC assessment of the service fee

In regard to the ESC reviewing the level of the fee as part of its next taxi fare review, the ESC is generally comfortable with making such an assessment. It is noted however that unlike other costs that the ESC considers as part of its fare reviews, the electronic payment service fee is not a taxi operator cost in the same sense that fuel, maintenance, finance costs and insurance, are operator costs.

Therefore, information on an appropriate service fee level may not arise through the usual assessment of taxi operator costs; the assessment of the fee is essentially a separate exercise, which nonetheless could be performed as part of the ESC's taxi fare review.

It would also be useful for industry participants and the ESC's future consideration of the service fee if the Inquiry's final report notes the legal basis for regulating such fees in Victoria. Similarly, if the ESC is given the role of assessing the service fee, the Government will need to ensure the ESC has appropriate powers to carry out this role, including powers to gather information from the service provider.

¹¹ Essential Services Commission 2011, *Submission to the Victorian Taxi Industry Inquiry*, Staff Paper, July, p. 38, available from www.esc.vic.gov.au/getattachment/7849468f-739b-4041-997e-4dd1df79d61c/Submission-to-the-Taxi-Industry-Inquiry.pdf.

3.4 Price (fare) monitoring

The ESC notes the following Inquiry draft recommendation on price monitoring:

Following the first three years of the reform program, the TSC should assess the extent and effectiveness of fare competition to determine if it is suitable to move from maximum to notified and monitored fares in the Greater Melbourne and Urban zones in the future. (recommendation 13.8)

In regional (Zone 3) and country (Zone 4) markets, where pre-booked services predominate, the TSC should be empowered to replace formal maximum fare regulation with a price notification system, following the implementation of price based licensing policy in these areas. (recommendation 13.9)

A role for the ESC in removing fare regulation?

The recommendations provide for the TSC to replace fare regulation with price (fare) monitoring if assessed as appropriate. The TSC, as the industry regulator, will possess a thorough operational understanding of the taxi industry and the regulations that apply to it. It should also have access to detailed performance information and statistics. However, it may not have experience or expertise in market or competition assessment.

This is one area where the ESC has past experience. For example, the *Port Management Act 1995* requires the ESC to review the extent of competition and the form of regulation every five years. The ESC has completed two such reviews, with the last review completed in July 2009. Similarly, the ESC reviewed the Victorian Rail Access Regime at the request of the then Victorian Government, completing the review in March 2010. The ESC has also reviewed fee and funding arrangements for the vocational education and training sector, which considered issues of increased market competition.

Given the background and experience of the ESC, the Inquiry may wish to consider the alternative of the ESC assessing the extent and effectiveness of fare competition. It should be required that the ESC liaise with the TSC as part of this review, and be provided with performance information and statistics that the TSC is likely to collect. The ESC could then make a recommendation to Government on whether fare regulation can be replaced by monitoring. In conducting its reviews, the ESC undertakes an open, transparent and detailed consultation process with stakeholders and the public. To add to this transparent process, the ESC could be required to respond to specific proposals submitted by the TSC, and to publish its arguments where it does not agree with the TSC.

Price monitoring in regional and country markets

Under draft recommendation 13.9, the Inquiry proposes that the TSC be empowered to replace fare regulation with price notification in regional and country

areas following the implementation of price based licensing in these areas (i.e. following a reduction in entry restrictions).

In addition to the earlier comments on a potential role for the ESC in assessing the appropriateness of removing fare regulation, the ESC has the following comments on this recommendation. The ESC notes that, compared to other Inquiry draft recommendations which represent a staged approach to reform and deregulation, this recommendation to replace maximum fare regulation with price notification in regional and country areas appears more risky as a one-off step in deregulation. A more cautious, stepped approach, may be warranted.

The recommendation appears to be largely based on:

- the licence owner commonly being the taxi operator in regional and country areas and relying on repeat business,
- country markets being very different from each other, and hence a single regulated fare applying across regional and country areas being impractical, and
- the predominance of pre-booked taxi work rather than rank and hail.

The Inquiry acknowledges that '*One problem with this approach is that in many areas there is restricted entry and only one network*', and therefore it states that open entry and network competition will support the deregulation of fares.¹² Nonetheless, the draft recommendation does not include a review of the extent of competition prior to any decision to replace maximum fare regulation with price notification. This is different from the approach recommended for Greater Melbourne and the Urban zones, where a review is to be undertaken following the first three years of the reform program.

From the information provided, the ESC is not convinced that the one-step 'open market' approach to fare regulation in regional and country areas has been fully tested. A more cautious approach, and similar to any decision to remove fare regulation in the Greater Melbourne area, would involve an assessment of market competition and behaviour following the introduction of price based licensing and a period of time to allow competition to emerge.

3.4.1 Price monitoring – industry regulator or economic regulator?

It is noted that under the Inquiry's draft recommendations, over the longer term it is expected that fare regulation will be replaced by price monitoring and or fare notification. What is not explicit is the institution responsible for price monitoring, although it appears that the TSC is the intended institution.

¹² Taxi Industry Inquiry 2012, *Customers First: Service, Safety, Choice*, Draft Report, May, p. 460.

The Inquiry may wish to consider whether the ESC could appropriately carry out any price monitoring function. The ESC's price setting and monitoring experience extends across a range of industries, including taxis, accident towing, ports, rail, retail energy and water. It would be well placed to administer a price monitoring regime applying to the taxi industry.

Again, it would be expected that the ESC would liaise closely with the TSC as the industry regulator as part of this function.

4.1 Appointment of a TSC Commissioner to the ESC

The ESC notes the following Inquiry draft recommendation on membership between the TSC and the ESC:

A Commissioner of the TSC should be appointed a Member of the ESC to assist with taxi fare reviews. (recommendation 13.3)

As discussed above in relation to a number of matters, appropriate interaction and liaison between the ESC and the TSC would be expected as part of their respective economic and industry regulator roles. The ESC therefore questions the specific requirement for a Commissioner of the TSC to be appointed to the ESC.

The ESC also considers that some of its decisions, which should be based on price, economic and specific service factors alone, could potentially be influenced by a TSC Commissioner seeking to introduce trade-offs of other non-price factors (or price and these non-price factors). In this way, such an appointment has the potential to impact on the decisions of the ESC and diminish the ESC's independence.

Furthermore, it is recognised best practice in regulatory design to maintain clear and specific rules on the responsibilities for price setting. For this reason, industry regulators are not typically included in the price setting mechanisms of the industries they regulate. For example, the Victorian Department of Sustainability and Environment, Department of Health and Environment Protection Authority are not directly involved in the water price setting mechanism, and the Department of Transport and Public Transport Victoria are not involved in rail access price regulation.

The ESC also notes that there are alternative mechanisms that can achieve the same or similar outcomes as desired by the Inquiry's recommendation. For example, in addition to the expected interaction between an industry and economic regulator (particularly during a period of industry reform):

- the TSC could provide submissions to the ESC's reviews, and or
- terms of reference for ESC fare reviews could require the ESC to liaise with the TSC as part of the review, and or
- a memorandum of understanding, stipulating how the ESC would liaise with the TSC when conducting its reviews, could be entered into between the two organisations. This could include the requirement on the ESC to reply in detail to proposals put to it by the TSC and publish its arguments when it does not agree with the TSC (as discussed above).

The ESC considers that these options are workable (and proven in other sectors) and preferable to the Inquiry's draft recommendation.

4.2 Driver remuneration and conditions

The ESC notes that the Inquiry made a number of draft recommendations on driver remuneration and conditions, including:

Bailment agreements should be replaced with a fairer Driver Agreement for drivers who are engaged by permit holders to drive their vehicles. New legislation should be passed to require all permit holders to engage taxi drivers under the new Driver Agreement (unless the drivers are otherwise engaged as employees). (recommendation 6.13)

The Driver Agreement should provide a better revenue sharing arrangement for drivers by establishing a minimum percentage of 60 per cent of the fare box revenue to be provided to the driver. (recommendation 6.14)

The ESC agrees with the recommendations to implement a Driver Agreement and improving driver remuneration through an increase in the percentage of fare box revenue kept by the driver. These are consistent with the options raised in the ESC's initial submission, which included the mandating of written bailment agreements and income shares between the taxi driver and operator.¹³ Importantly, the ESC believes that mandating income shares is preferable to other measures to increase driver remuneration as it maintains driver and operator incentives to maximise taxi use, and it is a less complicated option. This arrangement would require the oversight of the TSC and monitoring for 'side agreements' whereby operators may attempt to collect undue benefit from drivers.

4.3 The ESC's approach to setting fares

As noted in the Inquiry's draft report and the ESC's initial submission, the ESC has conducted two major taxi fare reviews, in 2005 and 2007-08. The following briefly summarises the ESC's approach to setting fares and responds to matters raised by the Inquiry.

4.3.1 How the ESC sets fares

The ESC's most recent review in 2008 recommended a 6.1 per cent fare increase. This increase was based on cost information gathered via a Pricewaterhouse Coopers (PWC) survey. Some adjustments were required to be made to this

¹³ Essential Services Commission 2011, *Submission to the Victorian Taxi Industry Inquiry*, Staff Paper, July, pp. 22–3.

information to reflect more recent cost movements and judgements by the ESC, but ultimately the cost survey was the basis for the fare increase.

The PWC survey

The purpose of the PWC survey was to develop a cost profile for the median taxi. 431 completed survey responses were received, 204 from operators and 227 from drivers. Table 4.1 details the outcome of the cost survey, as well as adjustments that needed to be made to the information (taken from the ESC's final report, August 2008, p. 103).

Given the range of costs reported for many cost items, median costs were used to ensure a consistency of approach in the use of survey data, given the potential bias involved in using average costs which included questionable outliers.

Based on the survey, the median Victorian taxi incurred total costs of \$136 716 in 2007 (calendar year) and received \$142 823 in revenues (i.e. double the driver payments figure as the survey indicated that the vast majority of drivers were employed under a 50/50 bailment arrangement).

Adjusting the 2007 survey information

As table 4.1 indicates, a number of adjustments were made to the 2007 cost items ('2007 adjusted'). These adjustments were made either because the original cost estimates could not be reconciled with other available information, or adjustments were based on other recommendations of the ESC. The areas of adjustment were:

- driver payments — consistent with the ESC's recommendation to cap licence assignment fees, 50 per cent of the difference between the 2007 licence assignment fee and the average 2000 to 2004 fee was added back to the base level of driver payments,
- licence assignment fees — the ESC considered that licence assignment fees are part of industry profits, and including increases in them for the purposes of determining fares would result in circularity (higher fees would result in higher fares, which in turn would result in higher assignment fees).¹⁴ The average licence fee estimates for 2000 and 2004 were used instead,
- repairs/maintenance, cleaning & tyres — adjusted to reflect excesses associated with vehicle repair,
- registration and insurance — the PWC survey results were significantly below those suggested by the Victorian Taxi Association. The ESC obtained additional independent estimates and determined an upward adjustment to the PWC results was warranted, and
- office & other — a slight upward adjustment was made to WorkCover costs to reflect risks of rounding in the survey responses.

¹⁴ This issue of circularity was also recognised by the Inquiry.

Total operator costs increased from \$136 716 to \$139 950 with these adjustments.

Table 4.1 Surveyed taxi operator costs (\$ per median Victorian taxi)

	<i>PwC 2007 estimates unadjusted</i>	<i>2007 adjusted</i>	<i>Jun 07 to Jun 08 Escalator</i>	<i>2008 estimate</i>
Driver payments	71 411	73 172	4.5	76 462
Vehicle lease payments/finance	6 653	6 653	7.3	7 137
Licence assignment fees	23 418	19 897	4.4	20 779
LPG	12 314	12 314	30.9	16 114
Network fees	6 739	6 739	4.4	7 038
Repairs/maintenance, cleaning & tyres	8 546	12 065	7.3	12 944
Registration & insurance	4 274	5 400	8.7	5 872
Office & other	3 361	3 711	4.4	3 875
Total	136 716	139 950	7.2	150 221
Operator margin	6 107	4 633		7 750 ^a
Operator margin (% of revenue)	4.3	3.2		≈5.0
Estimated revenue	142 823	142 823	10.6	157 971

^a Required margin to achieve approximately 5 per cent of revenue.

Rolling forward the 2007 information and operator margin

In order to calculate the required 2008 fare increase, the adjusted cost information needed to be rolled forward to June 2008. This was achieved by applying the Composite Input Price Index (CIPI) recommended by the ESC. (As part of the 2007-08 review, the ESC also recommended a process to adjust fares annually, and developed the CIPI for this purpose.)

Table 4.2 details the escalators for each of the cost items. Table 4.1, column 'Jun 07 to Jun 08 Escalator', details the actual escalator percentage figures.

Table 4.2 Cost item escalators

	<i>Escalator</i>
Driver payments	WPI (Transport)
Vehicle lease payments/finance	PMI (Melbourne)
Licence assignment fees	CPI (Melbourne)
LPG	FuelTrac
Network fees	CPI (Melbourne)
Repairs/maintenance, cleaning & tyres	PMI (Melbourne)
Registration & insurance	Insurance component of CPI (Melbourne)
Office & other	CPI (Melbourne)

Application of the escalators to roll forward the adjusted 2007 cost figures resulted in total taxi operator costs of \$150 221.

To determine estimated revenue for 2008, the ESC needed to determine an appropriate operator margin. As shown in table 4.1, an approximate 5 per cent margin was considered appropriate. This resulted in an estimated revenue figure of \$157 971 in 2008.

Calculating the 6.1 per cent increase

Based on the above cost information, between 2007 and 2008, the ESC calculated a required revenue increase of 10.6 per cent $((\$157\,971 - \$142\,823) / \$142\,823)$.

The ESC's 2007-08 taxi fare review had previously recommended an interim 4.2 per cent fare increase, which was applied on 12 April 2008. Hence the ESC's final report recommended a further 6.1 per cent increase in fares to bring the cumulative fare increase to 10.6 per cent.

4.3.2 Improving the fare setting methodology

The Inquiry identifies a number of issues associated with current fare setting processes, many of which have also been highlighted by the ESC as part of its fare reviews. Issues discussed by the Inquiry include:

- lack of information which has made analysis of fare components and structure difficult,
- deficiencies in the cost index approach, particularly related to the treatment of driver payments and licence assignments. In regard to driver payments, the Inquiry states:

*The index used for drivers (currently a wage index) is not linked to actual changes in driver payments. The costs for drivers are purely notional.*¹⁵

- the need for taxi demand to be considered in the fare setting process, and
- the cost index approach not taking into account input substitution, i.e. taxi operator costs will not necessarily rise to the same extent as input prices (individual cost components) because operators substitute inputs or change behaviour to limit cost increases.

The Inquiry concluded that:

the best way forward is to reset the 'fare box' using an estimate of current costs, adjusted for changes in costs likely to flow from the inquiry's findings, and then to use an indexing approach with a regular cost re-set (for example, every three years)...

*This approach would largely be consistent with the approach advocated by the ESC in 2008, but enhanced with better data.*¹⁶

Consistent with considering the process and components subject to interim fare reviews (see section 3.2 of this submission), the ESC supports the collection of more accurate information on taxi costs and believes that this work should be undertaken before the ESC's next fare review.

However, building on the conclusions of the Inquiry, the ESC considers it would be worthwhile to conduct a broad review on the appropriate fare setting methodology. That is:

- is a cost index (essentially a combination of surveys and the building block method¹⁷ to set fares every three or so years and the roll forward of this index) the best way to set fares for the taxi industry?

While commonly applied by other jurisdictions nationally and overseas, it may be possible to develop and apply other methodologies especially given that the taxi

¹⁵ Taxi Industry Inquiry 2012, *Customers First: Service, Safety, Choice*, Draft Report, May, p. 464.

For clarification, the ESC notes that driver payments included in the index are based on survey information, hence they are actual payments. The roll forward (annual adjustment) is based on a wage index, and this could be said to result in a 'notional' figure for driver payments in future years.

¹⁶ Taxi Industry Inquiry 2012, *Customers First: Service, Safety, Choice*, Draft Report, May, p. 467.

¹⁷ A common approach to price/revenue regulation involving the determination of a maximum revenue requirement which is equal to the sum of underlying components (i.e. 'blocks') including a return on capital, operating and maintenance costs and administrative charges. It aims to build up a quantum of what it costs to provide the service and match an associated revenue stream.

industry does not exhibit the strong natural monopoly characteristics often found in infrastructure industries such as energy transmission or water networks.

One important issue is whether an alternative approach can be applied — which may be particularly relevant given the reforms are aimed at improving competition and removing fare controls over time. For example, rate comparison with other like jurisdictions, i.e. benchmarking. The ESC notes that several US cities use rate comparison as the main review method in adjusting fares. Others also benchmark their fares, but do so in conjunction with more traditional approaches.¹⁸

In summary, the Commission believes a review of the methodology and options for setting taxi fares is a crucial piece of work that would complement the Taxi Inquiry's reform push and should be completed well in advance of the next taxi fare review.

¹⁸ City of Houston 2012, *2012 Taxicab rate study*, City of Houston Regulatory Affairs Division, February, p. 6.