ESSENTIAL SERVICES COMMISSION

Level 2, 35 Spring St
Melbourne 3000, Australia
Telephone +61 3 9651 0222
+61 1300 664 969
Facsimile +61 3 9651 3688

# SUBMISSION TO THE VICTORIAN TAXI INDUSTRY INQUIRY

## STAFF PAPER

JULY 2011

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# GLOSSARY

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| Accreditation | A Victorian Taxi Directorate approval scheme, which establishes the roles and responsibilities for each of the key taxi industry participants: Licence Holders; Operators; Drivers; and Network Service Providers. This scheme was established under the *Transport (Taxi-Cab Accreditation and Other Amendments) Act 2006*. |
| Affiliation | An arrangement by which a taxi operator utilises the booking and dispatch services of a Network Service Provider in return for a fee. |
| Assignment | A commercial arrangement by which a licence holder leases the right to operate a taxi to an operator. For licences designated to the metropolitan area, this arrangement, including the fees to be paid for the assignment, is required to be facilitated through a broker authorised by the Bendigo Stock Exchange. |
| Assignment price stickiness | The observation that the fees operators pay licence holders for assignments, do not reflect underlying taxi industry profitability, and are therefore not responsive to changes in demand. |
| Bailment agreement | A commercial contract between an operator and driver. It sets out the terms and conditions for which the driver is to deliver the taxi service on the operator's behalf. It also specifies the manner in which the revenue received is distributed between the driver and operator. |
| Economic regulation | A form of government intervention usually designed to influence supply, demand and/or price outcomes in a particular market. |
| Economic rent | The generation of profits considered to be 'abnormal', due to the restrictions on supply or limitations on market entry. As such, the profits generated from taxi licences are considered to be abnormal, as the supply is largely fixed by government policy. |

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| Fixed pay in | An arrangement in which a driver pays an operator a set amount for the use of the taxi. Under such an arrangement, drivers are typically responsible for the costs of fuel and cleaning, but retain the remainder of gross fare revenue generated during the shift. The operator remains responsible for meeting all other costs. |
| Driver | A person who delivers the taxi service on behalf of an operator. |
| Licence | The right to provide a taxi service in Victoria is held in the issue of a licence (one vehicle per licence). Each licence on issue specifies the conditions under which the taxi service is to be provided. |
| Licence holder | A person who acquires the right to provide a taxi service, as specified in the issue of a licence. |
| Mandatory affiliation | The legal requirement for all taxi operators in Victoria to have an arrangement in place with a primary Network Service Provider. |
| Network service provider (NSP) | A provider of booking and dispatch services, who acts as an intermediary between taxi service operators and potential taxi customers. |
| Off market consideration | The payment of an additional assignment fee by an operator to a licence holder, which is not officially reported to the Bendigo Stock Exchange. |
| Operator | A person who purchases, maintains and operates the taxi and delivers the taxi service. |
| Primary NSP | A provider of a centralised communications, GPS locator and brand identification services for taxi operators (in addition to bookings and dispatch). |
| Revenue sharing | An arrangement between an operator and driver, in which the revenue received from the operation of a taxi is distributed on a pre-determined basis (such as a 50-50 split between each party). Under such an arrangement, the operator is typically responsible for all expenses relating to the operation of the taxi, including fuel, insurance and repairs and maintenance. |

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| Secondary NSP | A provider of booking and dispatch services, supplementary to those of a Primary NSP. These networks range in size and complexity from small groups of drivers communicating with mobile phones, to larger, more formal operations. |
| Secretariat | Staff of the Essential Services Commission (the Commission). |

# EXECUTIVE SUMMARY

The Essential Services Commission (the Commission) is Victoria's independent economic regulator. On transport matters (taxis and accident towing), the Commission has a role in undertaking reviews as requested by relevant Ministers under industry specific legislation. For example, under section 144A(1) of the *Transport (Compliance and Miscellaneous) Act 1983*, taxi fares are set by the Minister for Public Transport. However, under section 144A(2), the Minister must obtain a report from the Commission prior to changing the schedule of taxi fares.

This submission from the Secretariat of the Commission does not attempt to answer all of the questions raised in the Taxi Industry Inquiry's *Setting the Scene* consultation paper. The following issues are the focus of this submission.

## Mandatory network affiliation

The market for Network Service Provider (NSP) services in Victoria is characterised by limited competition, e.g. the NSPs of the Metropolitan Melbourne zone effectively operate within a duopoly. NSP market power can influence their service offerings (e.g. bundling of services) and the level of fees they charge. It is also unclear whether existing accountability and performance mechanisms mitigate market power as they appear to focus more closely on operators and drivers, rather than NSPs.

In light of these issues, a number of reform options are presented for consideration. Options include:

- reforming NSP obligations to improve competition — e.g. options exist to either remove or relax mandatory affiliation. Such changes would likely reduce NSP market power and promote improved service offerings and innovation
- unbundling services — i.e. permitting only key NSP services (dispatch and security services) to be covered by the affiliation fee
- regulating NSP fees — depending on market power concerns, regulation could be applied in the form of light handed price monitoring, or more stringent price setting processes could be applied by the relevant regulator.

## Bailment agreements

Bailment agreements benefit both the taxi operator and driver, providing both parties with the opportunity to maximise income. However, the relative bargaining strengths of operators versus drivers is an issue, as is the prevalence of oral agreements (which limits market transparency and is a particular issue when disputes arise).

Options for consideration by the Taxi Industry Inquiry to improve bailment market outcomes include regulating income distribution, improving driver representation and mandating written agreements. The first two options can address the imbalance in bargaining power. Mandating written agreements would address transparency issues, and in particular would provide information to the Government to assess any issues with bailment agreements.

## Assignment fees

The market for taxi assignments is characterised by effectively fixed supply (due to restrictions on the number of licences) and high demand as potential taxi operators compete for assignments. Coupled with the strong bargaining position of licence holders, operator returns (and therefore driver payments) are driven towards a minimum level, as any economic profits likely to be accrued to operators or drivers are directly transferred to licence holders.

More specifically, the bargaining strength of licence holders may also promote assignment fee ‘stickiness’ (i.e. fees do not fall when industry profitability falls), allow for the negotiation of assignment terms and conditions in their favour, and lead to ‘off market’ payments by operators to attain an assignment. Reform options that could be considered by the Taxi Industry Inquiry include:

- removing supply constraints — removing or relaxing supply constraints (i.e. Government policy that limits the number of taxi licences) could reduce assignment fees and limit the transfer of industry profits to licence holders
- other measures to affect assignment fees — a fee cap would limit the economic profits being transferred to licence holders. Also, removing the maximum assignment term (currently three years) would allow operators to better match the term to their vehicle lease arrangements, which could act to reduce the strong bargaining position of licence holders.

## Other issues

***Entry restrictions*** — more broadly than in relation to addressing assignment fee issues, the removal of entry restrictions is supported by the Secretariat. Removal of entry restrictions could significantly reduce current licence holder market power and provide improved remuneration to operators and drivers, as well as better services to customers.

***Licence categories*** — the existing licence categories, in particular the separation of the Metropolitan Melbourne and Outer suburban zones is illogical. This has been raised as far back as 1986, and creates inefficiencies in terms of drivers not being able to accept a job that starts outside their zone, but travels back into their licensed zone. Amalgamation of zones also has the real potential to increase competition between NSPs, as the established providers in the Outer suburban zone could compete with the existing Metropolitan Melbourne NSP duopoly.

***Credit card facilities*** — the provision of credit card facilities is dominated by Cabcharge. Its market dominance and misuse of that market power has been considered by the Australian Competition and Consumer Commission, which brought legal proceedings against Cabcharge in the Federal Court. Options could be explored to increase the level of competition in the provision of electronic payment facilities.

# 1 INTRODUCTION

The Secretariat of the Essential Services Commission (the Commission) welcomes the opportunity to make a submission to the Taxi Industry Inquiry. The Commission is Victoria's independent economic regulator of prescribed services supplied by the water and sewerage, ports and rail freight industries. It is also responsible for developing and administering the Victorian Energy Efficiency Target Scheme.

On transport matters, the Commission has a role in undertaking 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 section 144A(1) of the Transport Act, taxi fares are set by the Minister for Public Transport. However, under section 144A(2), the Minister must obtain a report from the Commission prior to changing the schedule of taxi fares.

## 1.1 Previous Commission taxi reviews

The Commission has previously conducted two taxi fare reviews (2005 and 2007-08), as well as a review of the New Year's Eve taxi surcharge (2007). This has provided the Commission with a strong knowledge of the industry, its structure and factors affecting its performance.

The 2005 review was the first conducted by the Commission. It was asked to report on the appropriateness of the level of each taxi fare component, whether the components should be varied and to advise on a potential process for dealing with future fare variations. The final report was submitted to the Minister on 30 June 2005, and recommended that a CPI-X model be used to set taxi fares, both to give an immediate increase and then applied annually for the next two years. As there were no reliable data or measures of actual productivity improvements available, the Commission made a conservative estimate of the X factor of one per cent for 2005 to 2007 recommending that the Victorian Taxi Directorate commence collecting relevant industry data to support that approach.[1]

The Commission completed its most recent taxi fare review in August 2008.[2] In this review it was asked to report on:

- the impact of further and sustained upward pressure on liquid petroleum gas prices on taxi operators
- an appropriate price-setting model to provide for automated fare adjustment for the next 3-5 years, including the timing of such adjustments

[1] ESC 2005, *Taxi Fare Review 2005*, Final Report, June, p. 8.

[2] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August.

- the appropriateness of the taxi fare structure within the current market
- the appropriateness of selected surcharges, namely the New Year's Eve non-metropolitan taxi surcharge, and the surcharge for pre-booked premium service taxis, and whether they should form a permanent part of the taxi fare structure
- the distribution of taxi fare revenue and measures that may be considered by Government to improve taxi driver remuneration, and
- information reporting by the taxi industry and performance measurement.

The Commission's recommendations included:

- a fare increase of 6.1 per cent in September 2008 on top of the 4.2 per cent interim increase in April 2008
- a composite input price index less a productivity improvement (CIPI-X) approach be used to adjust fares annually, with X set at 0.1 per cent
- the 20 per cent Late Night Surcharge applicable in the metropolitan zone applying in both the metropolitan and outer suburban zone from midnight to 5am
- the NYE surcharge being replaced by the Late Night Surcharge (i.e. 20 per cent).
- capping licence assignment fees at $20 000 escalated by CPI
- development of a taxi industry performance monitoring report, to be published every six months.

While the terms of reference focussed primarily on issues associated with fare levels and structures, the review provided the Commission with the opportunity to comment on a range of broader reform issues.

## 1.2 The focus of this submission

This submission by the Secretariat does not attempt to respond to all of the questions raised in the *Setting the Scene* consultation paper. Instead, the Secretariat has chosen to comment on those issues where it believes it is able to add most value, given the insights gained through the Commission's previous taxi fare reviews and subsequent research and analysis. The questions the Secretariat has responded to are listed at the beginning of each section in this submission.

Questions about this taxi submission may be directed to Dominic L'Huillier, Acting Director (Transport and Industry Sectors Branch) and Senior Regulatory Manager (Transport) on 03 9651 3782.

# 2 MANDATORY NETWORK AFFILIATION AND MARKET OUTCOMES

**Taxi Industry Inquiry questions**

*Are there any restrictions or impediments to supply side forces as a result of regulatory restrictions or limited supply in the taxi industry? (p. 13)*

*Does the limited number of Network Service Providers have an impact on service delivery? (p. 16)*

*What is the impact of the current Network Service Provider industry structure on competition? (p. 16)*

*Should government mandate affiliation of taxi operators to depots and/or Network Service Providers? (p. 17)*

*How reasonable are the charges imposed by Network Service Providers for their services? (p. 17)*

The market for Network Service Provider (NSP) services in Victoria is characterised by limited competition. NSPs act as an intermediary between taxi service operators[3] and potential taxi customers in the pre-booked taxi market.

The two primary NSPs in metropolitan Melbourne are the Silver Top Taxi Service (Silver Top) owned by the Gange Corporation, and Black Cabs Combined (Black Cabs), owned by Cabcharge. Silver Top and Black Cabs account for 99 per cent of the Melbourne taxi market. In particular, the NSPs of the Metropolitan Melbourne zone effectively operate within a duopoly. There are a range of factors contributing to this structure, including market and regulatory barriers to entry. A number of reform options have been identified by the Secretariat for consideration by the Taxi Industry Inquiry.

## 2.1 Background

The Transport Act defines an NSP as a person who provides a 'taxi-cab network service'. This includes the receipt and dispatch of taxi bookings, or the provision of a central communications system to taxis. Depending on the range of services provided, an NSP is classified as either 'primary' or 'secondary'. All NSPs are

[3] A taxi operator is someone who purchases, maintains and operates the taxi and delivers the taxi service.

accredited by the Victorian Taxi Directorate, with more stringent requirements applying to primary NSPs.

A primary NSP provides a central communications system, GPS locator, brand identification as well as a booking system for the receipt and dispatch of taxis. Secondary networks are much smaller in size, ranging from small groups of drivers communicating with mobile phones to larger, more formal arrangements. Such networks normally only provide a booking and dispatch service, which is commonly arranged through direct customer to driver contact, for example by drivers handing out business cards with direct mobile phone contact details to customers. Secondary networks typically differentiate their services by offering what customers may perceive to be superior vehicles, and route knowledge, improved reliability and service standards and/or a more courteous service. In this way, secondary networks can often develop a reputation for being more customer-focused and familiar and lead to repeat business.

### 2.1.1 Mandatory affiliation

All taxi operators are required to be affiliated with a primary NSP for two key reasons:

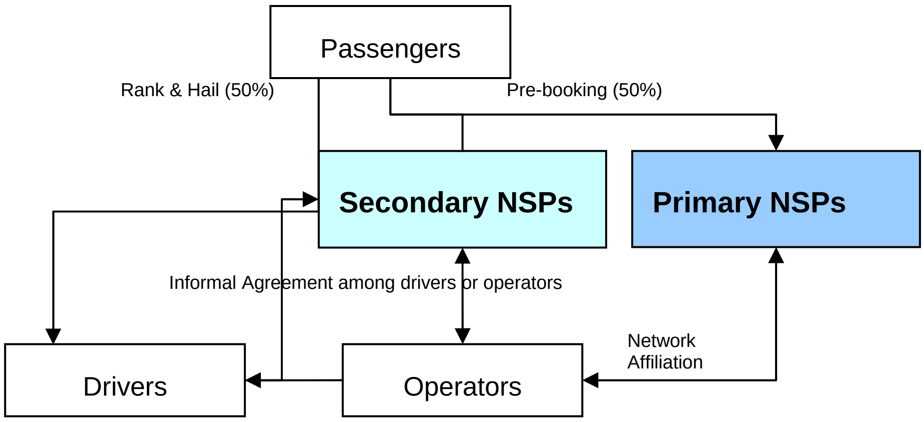
- to provide safety, i.e. NSPs can track a taxi's location and instigate appropriate action if driver or passenger safety is threatened
- to facilitate universal access to taxi services, i.e. NSPs provide a mechanism whereby a customer can access a taxi at any time of the day or night.

These NSPs charge a fee for their services (the affiliation fee). The Secretariat understands that in metropolitan Melbourne these fees are approximately $7,000 per annum per operator, and around $10 000 per annum in other regions of the State. SilverTop Taxis and Black Cabs Combined are the two dominant NSPs in metropolitan Victoria. Platinum Taxis is also a primary NSP operating in metropolitan Melbourne, having previously operated as a secondary network.

In the Outer Suburban zone, network services are provided by Frankston Radio Cabs and Dandenong Taxis. In the urban regional and country areas, NSPs are locally owned and vertically integrated with the driver owning the licence, taxi and network dispatch services.

Figure 2.1 illustrates how the primary and secondary NSPs interact with taxi operators and drivers. Operators or drivers can also choose to be affiliated with a secondary network to supplement (or replace) work obtained through their mandatory affiliation with a primary NSP.

**Figure 2.1 NSPs and their relationship with the broader industry**




## 2.2 Issues with mandatory affiliation

Three key issues associated with mandatory affiliation of taxi operators to a primary NSP have been identified. These issues are likely to have a significant effect on the market structure for NSP services.

### NSPs potential market power

Primary NSPs may have some market power arising from the mandatory affiliation requirement and barriers to entry. For a prospective NSP to enter the market a number of barriers to entry exist, including:

- costs of establishing a call centre and network services
- economies of scale associated with booking and dispatch services
- ‘consumer’ network effects, i.e. a network will be more attractive to consumers when it has sufficient coverage and number of affiliated taxis, as these suggest the network can service a large area and respond to bookings in a timely manner
- constraints on the size of the market given restrictions on licence numbers
- accreditation requirements and processes slowing or dissuading new entrants.

The existence of barriers to entry, particularly those that reflect ‘the cost of doing business’, is not a sufficient argument for government intervention or economic regulation. However, there may be a role where market power is abused to restrict competition. For example, the market power resulting from mandatory affiliation, coupled with these barriers to entry, may have important market outcomes in terms of the:

- ability of NSPs to bundle services together
- quality of service provided and level of innovation, and

- terms and conditions of affiliation agreements (e.g. difficulties moving to another service provider).

Given the limited number of primary NSPs, they may be in a strong position to bundle their service offerings. For example, bundling equipment (meters, cameras, and payment systems), insurance and training. Operators may have little option but to buy services they do not require or value.

Limited NSP competition may also impact service quality and innovation from NSPs. Further, the size of primary NSPs is likely to put them in a strong bargaining position when determining affiliation terms and conditions with taxi operators, most of which only own a single taxi licence.

A key question is whether market power is being abused, and whether government intervention and economic regulation can improve market outcomes.

### Network affiliation fees

A number of factors suggest that NSPs are in a position to charge excessive affiliation fees. First, limited competition between NSPs can result in fees above efficient costs. This issue was discussed in the Commission's 2007-08 Taxi Fare Review Final Report, where it was noted that:

> *… in Victoria, network fees may contain a component of 'monopoly rent' because in most localities there is only a single taxi network, and in the greater part [of] the metropolitan areas there are only two competing networks.*[4]

Second, operators face transaction costs if they were to opt out of their affiliation arrangements and switch to another network. This provides further opportunity for network fees to move beyond those that would be considered efficient.

The level of network fees has implications for operator and driver returns. For example, network fees are directly paid by the taxi operator. Operators can either accept the impact on their returns, or seek to recover some of these costs through other means, namely through revenue share arrangements with taxi drivers.

### Accountability for performance

The potential for primary NSPs to exploit market power could be mitigated through accountability and performance mechanisms. However, it appears that existing performance mechanisms are focussed on operators and drivers, rather than NSPs. For example, performance reporting and record keeping requirements apply to primary NSPs as part of their accreditation. These requirements differ depending on the size of the NSP — those with 40 or more affiliated taxis are required to provide information relating to taxi trips and the NSP's policies and procedures, including:

- booking details, including time, date, location, whether the booking is for a wheelchair accessible taxi (WAT) and when the meter started

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[4] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, p. 117.

- complaint details, including date, nature, action taken and outcome
- details of any disciplinary procedures against drivers
- instances of non operation of the central communications system or GPS
- details of agreements with operators and drivers.

Smaller primary NSPs (less than 40 affiliated taxis) have reduced reporting obligations. For example, records of when meters are started are not required.

While the above information is useful in understanding aspects of the taxi market, there is little reporting on the efficiency and performance of primary NSPs. For example, the information provides little insight in relation to the reasonableness of affiliation fees, or waiting time in relation to taxi pick-ups or phone call answering.

## 2.3 Network reform options — a role for economic regulation?

Given the issues arising from mandatory network affiliation and the potential for market power to rest with primary NSPs, a number of reform options are presented. These are discussed in the following subsections.

### Reforming NSP obligations to improve competition

A range of options could be considered that either relax, or remove entirely, existing requirements to affiliate with a primary NSP. Such a change may produce a number of benefits. For example, the options may, to varying degrees, reduce NSP market power and promote competition between NSPs, as well as increasing NSP product and service innovation.

Specific options to reform mandatory network affiliation include:

- **Removing mandatory affiliation, but introducing a requirement on operators to demonstrate safety obligations** — this option removes market power issues and would be expected to have the greatest impact on NSP efficiency and innovation. While NSPs would appear to be well suited to pursue the objectives of safety and universal access it is not clear that mandatory affiliation is necessary to ensure they are achieved. With regard to driver safety, NSPs are able to locate all vehicles through GPS technology as drivers are logged onto communications networks for the duration of their shift. However, safety objectives could be met by other means and without the potential for increased NSP fees that arise through mandatory affiliation. For example, technological developments in an automated taxi ordering system that use GPS technology to log and track trips via mobile phone, could potentially achieve the same safety objectives.[5]
- Similarly with universal access, it is unclear as to whether mandatory affiliation is necessary. If the aim of affiliation with a network is to ensure that customers have a number to call to access the available taxi services, it is possible that secondary NSPs alone could achieve this goal. However, significant thought by the industry regulator (the Victorian Taxi Directorate) would be required in

[5] P.Rolfe, 2009, *GPS to drive safer taxis*, Sunday Herald Sun, 11 October, p.19

relation to specifying safety obligations, and it is likely that greater resources would be required to enforce these obligations (particularly if many operators do not affiliate with an NSP).

- **Allowing for affiliation with either a primary or secondary NSP** — providing for greater flexibility in affiliation should reduce existing NSP market power. Further, improved innovation and efficiency should result, although these benefits may be less, compared to the option of removing mandatory affiliation. Under this option the industry regulator may need to amend accreditation requirements (to reflect the increased role of secondary NSPs), and may need to devote additional resources to enforcing safety requirements.
- **Redefine NSPs** — by redefining the definition of an NSP to allow for primary and secondary networks to meet the definition. This could result in greater involvement by secondary networks and new competitive pressures on existing networks, with benefits in terms of innovation and service levels and downward pressure on fees. A focus on outcomes rather then processes and procedures would also serve to focus attention on service delivery to consumers. Under this option the industry regulator would need to carefully consider the definition of NSP and accreditation requirements and mechanisms to ensure safety is maintained.

In addition to potentially reducing market power and increasing competition, it is expected that the reform options would also lead to greater opportunity for taxi operators to negotiate service requirements. This change is linked to NSPs reduced market power, and could result in less opportunity for NSPs to bundle unwanted services into their service offerings.

Finally, it is expected that the changed market dynamics associated with relaxing or reducing affiliation requirements would encourage NSPs to operate more efficiently. This would have flow on benefits to operators (and potentially drivers) through reduced network fees.

There are however some disadvantages associated with removing affiliation requirements that would need to be considered in assessing reform options. In particular, affiliation appears to serve driver and passenger safety objectives (an NSP can track a taxi's location and instigate appropriate action when safety is threatened), as well as facilitating access for consumers (NSPs provide a mechanism whereby customers can access a taxi at any time of the day or night).

In terms of minimising industry disruption, the second and third options may present more feasible reform options. Both are likely to reduce market power issues associated with primary NSPs, and could be seen as initial steps in improving industry outcomes. However these are matters for consideration by the Taxi Industry Inquiry.

## Unbundling services

Reform options that unbundle NSP services may reduce NSP market power. For example, regulation could specify that NSP affiliation fees are only to cover dispatch and security services (or similarly, Government could contract with each NSP to provide these services, with the costs recouped by Government through a fee applied to operators). This would unbundle all other services that an NSP may currently be requiring a taxi operator to purchase. All NSPs (plus other specialist providers) would then be able to compete to provide the remaining services currently provided by incumbent NSPs.

Such a reform may reduce the market power of NSPs and remove barriers to entry. Each of these would likely put downward pressure on costs, and promote improved service offerings and innovation by NSPs.

As an important aside, the Government contracting of key NSP services can provide for data and information collected by the NSPs to be owned by the Government. Such information may be particularly important in understanding the market for taxi services and developing future reform options. For example, analysis of time-of-day booking information could suggest further reform of taxi fares (i.e. there is currently a 'standard' taxi fare and a night time surcharge – analysis of booking, supply and demand information may suggest new fare categories that promote increased use of taxis), and information could also suggest a more rational program of licence release.

Even in the absence of Government contracting, Government should explore with NSPs the type of information that is currently available on network bookings.

### Regulating NSP fees

Given barriers to entry, economies of scale and potential market power issues, consideration could be given to economic regulation, that is, price regulation of network affiliation fees. Various forms of price regulation (which includes price setting and price monitoring) are applied to other industries (e.g. electricity, gas, water and sewerage, ports, taxi fares) where these issues exist. Options for price regulation include:

- **Price monitoring** — under a price monitoring framework, NSPs would be free to set their affiliation fees. However, these fees would be reported to the industry or an economic regulator like the Essential Services Commission who would assess and report on fee levels. If prices were found to be excessive, then stronger forms of regulation may be warranted.
- **Price setting** — where concerns about market power and fee levels are strong, there may be a role for more heavy handed forms of regulation, namely price setting. Under this approach an economic regulator would consider efficient asset and cost levels associated with service provision, including a suitable rate of return, and the regulated entity would set its price within these boundaries.

Whether some form of price regulation is warranted may depend on other reforms implemented. For example, reforms that reduce or remove affiliation requirements would be expected to reduce existing NSP market power and promote service innovation. Under such an environment, price regulation may not be required.

### Refining performance reporting requirements

Whereas the option 'Redefine NSP to allow for an outcome focus' presented above simplified the definition of NSP *and* amended performance requirements, an alternative option is to refine performance reporting requirements only. Existing requirements for affiliation with a primary NSP would continue. An advantage of this approach is that more stringent and relevant performance requirements can be placed on NSPs. These can relate to outcomes rather than policies or procedures, and could also present information on fee levels and appropriate benchmarks. The industry or economic regulator could report on performance outcomes. Reporting requirements in other jurisdictions, including New South Wales and Western Australia, provide useful examples of performance reporting requirements that include NSP performance, in additional to operator and driver performance

However, while this option improves accountability, benefits in terms of increased competition, service innovation and efficiency of cost (fee) levels are likely to be relatively weak, particularly compared to reform options that directly improve competition. For this reason, refining reporting requirements should be seen as a complement to other reform options.

# 3 BAILMENT AGREEMENTS AND DRIVER REMUNERATION

**Taxi Industry Inquiry questions**

*Who drives taxis, and who does not drive taxis, and why? (p. 17)*

*Do the current structural arrangements for drivers encourage best practice service delivery? (p. 17)*

*How can working conditions and remuneration of drivers be improved? (p. 17)*

*Are 'bailments' a suitable employment arrangement for drivers? How difficult is it for drivers to negotiate arrangements outside a standard bailment agreement? (p. 17)*

Allowing a person other than the operator to drive a licensed taxi enables greater utilisation of the asset. Such bailment arrangements benefit the operator and the driver, with the opportunity for both parties to maximise their income. There are however a number of issues associated with the bailment market relating to the relative bargaining power of operators and drivers.

## 3.1 Background

A bailment is the contractual agreement between a taxi driver and a taxi operator. It outlines how revenue is to be shared between the parties and any other conditions relevant to the arrangement, such as the duration of the agreement, obligations on the driver and operator, and dispute resolution options.

This arrangement provides greater flexibility, cost savings, and greater incentives to maximise revenue, for both the driver and operator. For example, an agreement can be made on whatever terms are preferred by the parties, without the legislative restrictions imposed on an employment agreement. In effect, the bailment is a sub-contracting arrangement — operators are not liable for payroll tax, and drivers are not entitled to the benefits and protections afforded to employees, such as sick and annual leave, superannuation or minimum wages.

While there are numerous methods that can be used to determine bailment fees the most common in Australia are revenue sharing and fixed pay-in arrangements. Around 90 per cent of Victorian drivers are engaged through revenue sharing, which splits the gross fares generated between the driver and operator according to a percentage, usually 50/50.[6] This type of bailment arrangement, and the 50/50 split, is typical of arrangements in most Australian States.

Under a fixed pay-in arrangement the driver pays a set amount for use of the taxi each shift. This is common in metropolitan Sydney and Western Australia, where maximum pay-in rates are set by the respective industry regulator.

There is no explicit regulation governing the terms of bailment agreements. While the Victorian Taxi Directorate (VTD) and the Victorian Taxi Association (VTA), which represents the interests of NSPs, taxi operators and licensees, have model agreements, neither of these are mandatory. Aspects of the existing regulatory framework however may impact on bailment agreements. For example, schedule 1 of the *Transport (Taxi-cab Industry Accreditation) Regulations 2007* requires operators to keep evidence in writing of the contents of bailment agreements. Operators and drivers must also comply with the Business and Service Standards introduced under these regulations. These regulations set minimum standards such as requiring operators to provide assistance and support to drivers who suffer trauma or injury arising from operating the taxi.

## 3.2 Issues with bailment agreements

The Commission's 2007-08 Taxi Fare Review considered a number of issues with driver remuneration, including bailment agreements. Building on this material, three key issues have been identified. These are discussed below.

### Uneven bargaining power

The key issue with bailment agreements is the uneven bargaining power of the respective parties. Several factors contribute to operators having greater bargaining power than drivers. These include the excess supply of drivers, the relative inexperience of drivers compared with operators, and the relative strength of peak bodies representing each group.

This power imbalance leads to bailment agreements that result in below minimum wage remuneration outcomes for drivers. It gives operators the power to dictate terms such as number and timing of shifts. In jurisdictions where fixed pay-in arrangements are common, most drivers pay the maximum rate, and some pay more.[7]

*Supply of drivers*

Apart from training and accreditation requirements, the barriers to entry in becoming a taxi driver are relatively low. Consistent with this, it has been observed that many taxi drivers are unskilled, of a non-English speaking background and have few alternative employment options.[8] Conversely, the number of taxi licences

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6 ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, p. 47.

7 IPART 1999, *Review of Taxi Cab and Hire Car Industries*, Final Report, November, p. 57.

8 *Op. cit.*, p. 57.

is limited by government policy. These dynamics suggest that drivers will have less bargaining power than operators.

Interestingly, consideration of the number of active taxi drivers in metropolitan Melbourne and the number of available shifts suggests an undersupply of drivers. Based on there being around 12 000 'active' taxi drivers operating in metropolitan Melbourne[9], and approximately 55 000 shifts per week[10], there is on average 4.5 shifts per active driver per week. This significantly exceeds the 38 hours of standard full time employment. Moreover, it is likely that many drivers would want to work fewer than 5 shifts, for example to allow for other employment or study. In this regard it is noted that the majority of new taxi drivers in 2005-06 were international students[11], who are subject to visa conditions limiting them to 20 hours of work per week during study periods. This suggests a significant number of drivers are working more than five shifts per week.

However, the estimate of available shifts does not account for daily fluctuations in demand, which will moderate the number of shifts that are actually available, e.g. it would be expected that there would be more demand for taxis on Fridays than mid-week. Furthermore, there is a significant number of potential drivers that could be utilised if needed, reducing the scope for drivers to utilise any possible undersupply in negotiating with operators. Further, low barriers to entry will limit drivers' bargaining powers.

*Inexperienced drivers*

According to the VTD's accreditation data 47 per cent of taxi drivers in Victoria have less than three years experience driving taxis, with 20 per cent having less than one year experience. This suggests a complete turnover of the driver pool every six to seven years.

Inexperienced taxi drivers may therefore have limited knowledge of the taxi industry, and their rights and obligations as a participant. A lack of availability of accessible information may contribute to this issue. These factors limit the ability of drivers to effectively engage and negotiate with taxi operators.

*Relative strength of peak bodies*

Membership of the VTA is comprised primarily of NSPs, taxi operators and taxi licence holders. The VTA is connected to associations in other States through it's affiliation with the Australian Taxi Industry Association.

Taxi drivers are represented by the Victorian Taxi Drivers Association (VTDA) and the Cabbies Activity and Recreation Association (CARA).

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[9] Taxi Industry Inquiry 2011, *Setting the Scene*, May, p. 17.

[10] Based on 4 233 licences in metropolitan Melbourne, 600 of these being peak period licences, and assuming 2 twelve hour shifts per day for standard licences and one shift for peak period licences (3 633 licences x 2 shifts x 7 days + 600 licences x 1 shift x 7 days).

[11] Victorian Taxi Directorate 2007, *Taxi Industry Background – April 2007*, unpublished data provided to the Commission, cited in ESC 2008, *Taxi Fare Review 2007-08*, Final report, August, p. 153.

There is a significant funding differential between the associations representing drivers compared with the VTA. The VTA provides advice and other resources to its members, and is a strong advocate in government and public forums. While both associations representing taxi drivers have previously made submissions to the Commission in past reviews, they are less proactive and their lack of resources impacts on their ability to contribute to such processes and provide effective representation.

## Model agreements

As mentioned, both the VTA and the VTD provide non-mandatory model bailment agreements for operators and drivers to use in forming their agreements.[12] However, due to the relative bargaining power of operators, the agreements seem to be offered on a 'take it or leave it' basis.[13] The Commission has therefore given consideration to the contents of model agreements.

The VTA agreement has the potential to be balanced in favour of operators, particularly for terms and conditions in which the industry benchmark is not well established. For example, the VTA agreement includes an accident surcharge, whereby drivers are liable to contribute towards the costs of an incident occurring during their shift.[14] Depending on the exact terms of the agreement, this may work in the operators favour. Otherwise, both models are relatively well balanced. A benefit of the VTD model agreement is the transparent, plain-English wording which makes it easier for drivers to understand.

Both model bailment agreements specify courses of action for dispute resolution. The two models are similar, however the procedure outlined in the VTD model is less formal and utilises government services, such as the Victorian Small Business Commissioner. It is a less costly process than that outlined in the VTA agreement which involves independent mediation and arbitration.

In line with the prevalence of bailments reflecting the VTA model, the vast majority of resolutions currently follow this procedure. As this process takes place outside of the judicial system there is no data available outlining the number or nature of disputes and outcomes. Records are made only where the Victorian Civil and Administrative Tribunal is asked to enforce an agreement. Given this lack of data, it is difficult to estimate the effectiveness of the dispute resolution procedures.

## Oral agreements

Although bailment agreements are regarded as mandatory, and the Business and Service Standards 2007 require written evidence to be kept by operators, a 2006

[12] The most recent publicly available VTA model bailment agreement was produced in 2002. This is the version on which this discussion is based.

[13] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, pp. 70 and 153.

[14] An 'incident' includes any event in which: the taxi or any fixture, fitting or equipment is damaged, stolen or lost; the taxi is involved in a collision in which any third party property is damaged or any person is injured; or a person is injured in the taxi, or when entering or exiting the taxi.

survey showed that only 59 per cent of taxi drivers have signed a written bailment agreement.[15] This creates a number of related problems, namely, implied terms and conditions, and transparency.

While a verbal agreement has equal legal standing to a written contract, in the event of a dispute the lack of a signed agreement makes it difficult for parties to prove the existence of non-industry standard terms, or to disprove their implication. Similarly, due to the wide adoption of the VTA model agreement, often terms contained in this template are implied in a verbal contract. This may be problematic for inexperienced drivers who may lack awareness of these terms, or others implied through convention, conduct or VTD accreditation requirements.

The large number of verbal agreements also reduces market transparency, which can impede the efficient operation of the bailment market. A lack of transparency leads to information shortages or asymmetries between contracting parties, which contributes to the unequal bargaining position of operators and drivers.

## 3.3 Bailment — a role for economic regulation?

Given the issues discussed above, a number of options to improve bailment market outcomes are outlined below. As per other sections where reform options are presented, the Secretariat does not advocate any particular option — rather the options are presented as a starting point for the Taxi Industry Inquiry's consideration.

### Regulate income distribution

Economic regulation could be applied to directly regulate a minimum level or share of income for the parties to bailments. Three options are presented below. These options limit the exercise of market power in negotiating terms and conditions. However, these options do not address the underlying market dynamics and incentives, meaning significant oversight and enforcement would be required to ensure compliance. Substantial knowledge of the industry would be required to make appropriate determinations, and mechanisms would be required to enable changes when circumstances change (e.g. changing fuel costs).

- **Mandating income shares** — this option involves regulating the percentage share of gross revenue attributed to each party to the bailment agreement. Currently most revenue-sharing arrangements include a 50/50 split of revenue. However, anecdotal evidence suggests there was a trend towards a 52/48 split (in favour of the operator) following LPG price increases. Mandating income shares would maintain the incentives for both parties to maximise taxi use.
- **Mandating a maximum pay-in** — this requires shifting all agreements to a pay-in arrangement, with a maximum pay-in fee set by the relevant regulator. This model is prevalent in metropolitan Sydney and in Western Australia. This option provides strong incentives for drivers to maximise revenue during a shift (as the majority of the business risk is placed on the driver), and for operators to

[15] Victorian Taxi Directorate 2006, *Taxi Driver Survey 2006*, Final Report, p. 21.

make the taxi available as much as possible. Different shifts would also justify different pay-in rates, which would complicate the system and require greater consideration by the regulator.

- **Hypothecation of a fixed amount to one or both parties** — this method guarantees a certain amount for one or both parties, for example, providing a minimum wage to drivers. This option requires significant oversight and may impact incentives for drivers to maximise revenue.

### Improve driver representation

The relative strength of bodies representing the two parties to bailment agreements contributes to the unequal bargaining positions of operators and drivers. Improving representation of drivers would help mitigate against the strong bargaining power of operators, and could provide support and advice to enable drivers to negotiate more beneficial agreements.

### Mandate written agreements

Requiring all bailment agreements to be made in writing would alleviate the problems associated with oral agreements. A requirement to lodge these agreements would further protect the rights of the parties involved, and could provide the Government with greater insight into potential problems with bailment arrangements and improve transparency.

The Secretariat does not consider mandating use of either of the model agreements necessary as there is no evidence to suggest that written agreements not based on the VTA of VTD models are a matter for concern.

# 4 ASSIGNMENT FEES AND REVENUE DISTRIBUTION

**Taxi Industry Inquiry questions**

*How can working conditions and remuneration of drivers be improved? (p. 17)*

*How do brokers assist the transfer/assignment process? Do they add unnecessarily to the costs involved? (p. 18)*

The market for taxi assignments is characterised by effectively fixed supply (due to restrictions on the number of licences) and high demand as a relatively large number of potential taxi operators compete for assignments, therefore bidding up assignment fees. Coupled with the powerful bargaining position of taxi licence holders, operator returns (and therefore driver payments) are driven towards a minimum level, as any economic profits likely to be accrued to operators or drivers are directly transferred to licence holders.

Issues of driver remuneration, including assignment fees, were considered by the Commission in its 2007-08 Taxi Fare Review.[16]

## 4.1 Background

To provide a taxi service in Victoria, a service provider must be licensed. The Victorian taxi industry features a combination of privately owned perpetual licences and Government owned licences.

Of the 4 751 taxi licences on issue, 4 150 (around 87 per cent) are perpetual.[17] A perpetual licence does not expire and the licences themselves are able to be sold or leased to operators. The remainder are Government owned and referred to as ‘Peak Service’ or ‘Green top’ licences. Peak service licences cannot be transferred or sub-leased and the right to operate a taxi is restricted to the licence applicant.

Taxi licences are designated to one of four zones within Victoria, namely: Metropolitan; Outer-suburban (comprising Frankston and Dandenong); Urban Regional (comprising Geelong, Ballarat and Bendigo); and the Country.

[16] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, p. 34.

[17] Data as at January 2010.

### 4.1.1 Assignments

Over 60 per cent of licence holders do not operate a taxi for the licences they own. They assign (lease) the right to operate a taxi under their licence to an operator (lessee or assignee). A taxi operator is defined as someone who purchases, maintains and operates the taxi and delivers the taxi service. The terms and conditions between each party are specified within an assignment agreement.

In leasing the right to operate a taxi from a licence holder, the operator pays an assignment fee, which in recent months has ranged from $2 000 to $3 000 per month in Melbourne. The differences in assignment fees may represent differences in the terms and conditions of the agreement. The terms and conditions of assignment agreements differ between contracts, according to the needs of the contracting parties. For example, assignment agreements may differ in terms of:

- whether the assignment contract is one component of a larger transaction (for example the purchase or lease of a vehicle, or where the transaction includes other goods and services, such as equipment or insurance)
- whether the assignment is the most recent of a number of contracts between a specific operator and specific licence holder
- duration, with a maximum of three years
- presence of any fees for early exit or cancellation
- linkage with a specific NSP or specific equipment or service providers (this may be particularly relevant if the licence owner is related in some way to the third party, through common ownership, for example)
- basis for variations in assignment fees (for example, in line with CPI, increases in regulated fares).

Notwithstanding the differences in terms and conditions, the spread or diversity in assignment fees is somewhat difficult to reconcile, as the taxi licence is arguably commoditised, with each licence having the same income generating capability.

Assignment fees and conditions are not regulated. However, both licence holders and operators need to be accredited by the Victorian Taxi Directorate (VTD). As with the sale or transfer of licences, assignments for licences designated to the metropolitan area, must be facilitated through a broker authorised by the Bendigo Stock Exchange (BSX). Licence assignments are typically negotiated directly between the licence holder and prospective operator, with the resulting transaction then reported to the BSX. It is also possible for licence assignments to be matched with prospective operators through the BSX trading platform, although these types of trades are uncommon. The Victorian Government requires that all assignment trades be reported to the BSX in an attempt to improve visibility or transparency on the fair value of assignment fees.

Licence transfers and assignments in regional and country areas are traded through traditional mechanisms, for example, local papers or trading posts. Trades and assignments are reported to the VTD.

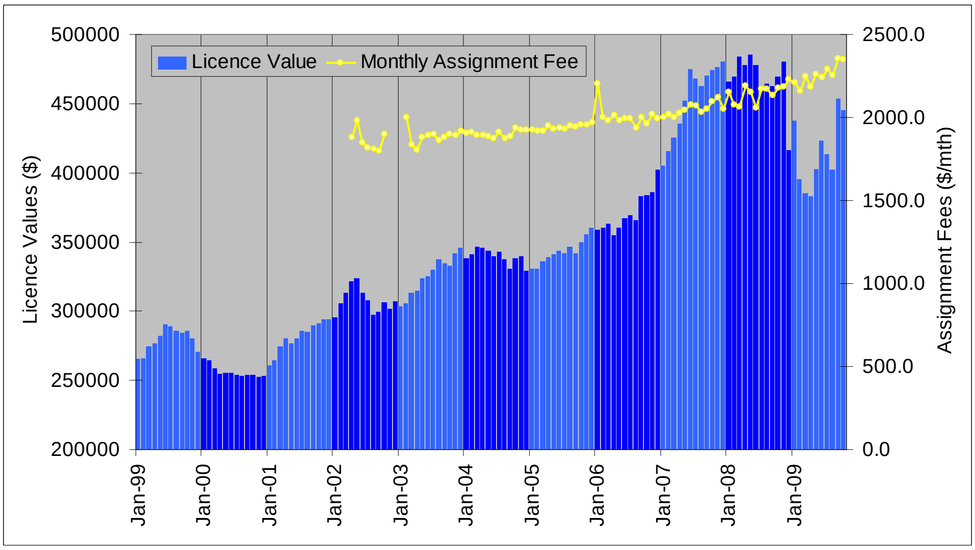
### 4.1.2 Assignment fees and contracts

Licences are assigned for between 12 months and 3 years which is the maximum period as specified in Section 150(4A) of the *Transport Act 1983*. Each year, approximately 1 300 licences are renewed or reassigned, indicating an average assignment term of 2.6 years. In contrast, approximately 120–130 licences are transferred (i.e. sold) each year, indicating they are held on average for 26–28 years.[18]

Assuming a one month sale process, only 0.3 per cent of licences are available to purchase at any one time. This suggests a reasonably *illiquid market* for licences. In particular, the shortage of licences for sale is a key factor in observed increases in licence values, which in turn increases assignment fees as new licence holders demand a return often 2–3 per cent above the risk-free rate.

Figure 4.1 plots the average assignment price against the average licence transfer market value. It demonstrates a steady increase in the value of assignment fees over the past decade. By June 2009, the average assignment fee was $26 950 per annum, representing a 6.4 per cent return on the average licence transfer price of $423 000.

**Figure 4.1 Licence values & monthly assignment fees**




**Data Source: VTD**

Table 4.2, illustrates the average yield (that is, assignment fees as a proportion of licence transfer values) over the six years from 2003-04 to 2008-09.

[18] BSX personal communication, 14 April 2008

**Table 4.2 Average yield on licence transfer**

| *Period (Financial year)* | *Average yield on licence transfer price* [19] |
|---|---|
| 2003–04 | 6.7% |
| 2004–05 | 6.8% |
| 2005–06 | 6.6% |
| 2006–07 | 5.8% |
| 2007–08 [20] | 5.2% |
| 2008–09 | 6.2% |

**Data source: VTD**

Assignment fees represent a significant proportion of taxi revenue. For an average 7.7 km journey[21] the average base fare[22] in Victoria is approximately $17.35, of which assignment fees account for $3.05, or 17 per cent. In comparison, the fare for an average 7.7 km journey in NSW is around $20.55, of which assignment fees account for around $2.65, or 13 per cent.

## 4.2 Industry participants role in the operation of licence assignments

Figure 4.2 sets out the structure of the Victorian taxi industry as it pertains to licence assignment. The principal parties to an assignment agreement are the licence holder and the operator. Each of the parties to an agreement must be accredited by the VTD. Further, assignments for licences designated to the metropolitan area must be reported to the BSX. The role of each of these industry participants is discussed below.

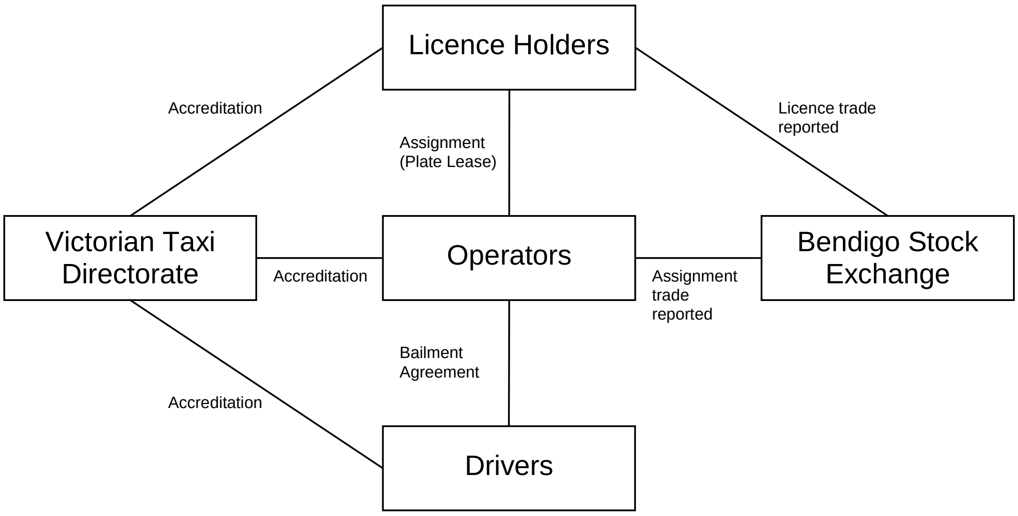
[19] The assignment price divided by the average licence price in the same month

[20] Data only available from July 2007 to October 2008

[21] Average journey for taxis in Australia, as estimated by the Australian Taxi Industry Association Statistics (ATIA) as at 31 December 2007

[22] The average base fare includes the flag-fall, distance and waiting time charges (assumed to be three minutes). All additional charges such as booking fees, time of use surcharges and road tolls have been excluded from this calculation.

### Figure 4.2 Role of key industry participants within the assignment market structure




## 4.2.1 Role of licence holders

Licence assignment is essentially a mechanism to facilitate a return to those who hold a licence but choose not to operate a taxi themselves. Licence holders receive income from assignment fees that they levy upon an operator for the use of their taxi licence. This is in addition to any capital gains (or losses) they might eventually realise from growth (or falls) in the value of the licence. Hence, the licence holder's role is primarily to earn income as a **passive investor**.

Until recently, licence holders were considered to be devolved of any legal responsibilities attached to an assigned licence. However, since the VTD's Taxi-Cab Industry Accreditation scheme was implemented in 2007, licence holders are now obliged to monitor their operator's compliance with business and service standards relating to safety and customer service. These new obligations have yet to be legally tested. However, anecdotally, no material change in owner behaviour has been evident nor have significant numbers of owners left the industry due to the new responsibilities.

## 4.2.2 Role of operators and drivers

In terms of licence assignment, the operator's role is to provide licence holders with an agreed regular fee for the use of their assigned licence. The operator maintains and operates the taxi and delivers the taxi service, the revenue from which they in turn use to cover their assignment fees to the licence holder.

Upon assignment, an operator subsequently assumes the legal responsibility for satisfying all legislative obligations and conditions attached to the operation of a taxi licence (notwithstanding the new obligations for a licence holder under the Taxi-Cab Accreditation scheme). These may include the following:

- ensure a vehicle is fitted with all prescribed equipment (meters, driver safety shields, security cameras, etc.)
- ensure a vehicle is used to maintain ‘regular and continuous service’
- ensure the vehicle operates within the geographic area for which it is licensed
- ensure that a driver possesses the prescribed or accredited training to drive a particular vehicle (Wheelchair Accessible Taxi, for example).[23]

Taxi drivers do not have a specified role in the formation and undertaking of licence assignments. Bailment agreements between taxi drivers and operators normally specify the revenue earned and the terms and conditions of engagement. However, there is scope for drivers to be affected indirectly by the outcomes of licence assignment. Assignment fees paid by operators to licence holders may in turn affect the amount and the manner in which they are prepared to negotiate with drivers. As assignment fees have increased there has been some downward pressure on the percentage of revenue retained by some drivers (i.e. from 50 per cent towards 45 per cent or sometimes even lower).[24]

It should also be noted that many operators drive the taxis they operate, which is common among smaller operators. An estimated 2 600 taxi operators in Victoria (or 55 per cent) are also licensed taxi drivers.[25] Regardless, in relation to defining the participants of licence assignment, operators have a specified role, whereas drivers do not.

Taxi drivers are also required to be accredited with the VTD, although their requirements are specified under the Taxi Driver Accreditation Scheme. In order to be accredited, drivers are assessed on: competency; the results of a medical examination and vision acuteness; and checks on criminal history.

### 4.2.3 Role of brokers and the Bendigo Stock Exchange

The role of a taxi licence broker is to facilitate the transaction of an assignment of the metropolitan taxi licence from licence holder to operator. This role may include matching the licence holder to the potential operator, co-ordinating correspondence between the two parties and reporting the agreed assignment to the BSX. The broker must be licensed by the BSX and conduct the assignment trade according to BSX rules.

The BSX’s role is to provide a platform for the trading and notification of assignments. It posts assignment rates and licence sale prices on a public register and sets business rules for brokers. The BSX was formally designated with this role by the Victorian Government in 2006, under the *Transport (Taxi-Cab Licences Market & Trading) Regulations 2005* in order to create some additional controls on

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[23] Department of Transport, *Application for Accreditation as a Taxi-cab Industry Participant (Initial Application or Renewal) – Licence Holder or Operator*

[24] Although this is influenced by other factors such as fuel price increase which can be the responsibility of the operator.

[25] As the VTD advised the Commission in the Taxi Fare Review 2007-08. See Final Report p.44.

market conduct and supervision, over and above those created through Commonwealth and state-based fair trading legislation. For example, the BSX is an approved financial market under the *Corporations Act 2001* and is subject to ongoing assessment by the Australian Securities and Investments Commission. Furthermore, the *Trade Practices Act 1974* prohibits third-line forcing, an example of this would be an insistence that an operator affiliate with a particular network or use specific equipment as a condition of assignment.

While the inclusion of the BSX has provided some transparency, it has rarely been utilised as a platform for metropolitan assignment trades as originally intended. In practice, the matching of assignments generally occurs through brokers off-line, with the resulting transactions subsequently reported to the BSX (known as a 'directly negotiated deal'). There appear to be few examples of licence holders and prospective operators executing trades through the BSX trading platform itself (known as a 'market deal'). However, information on assignment fee levels and trends are now more publically available, which in principle, should lead to more informed negotiations and decisions by operators.

### 4.2.4 The role of the Victorian Taxi Directorate

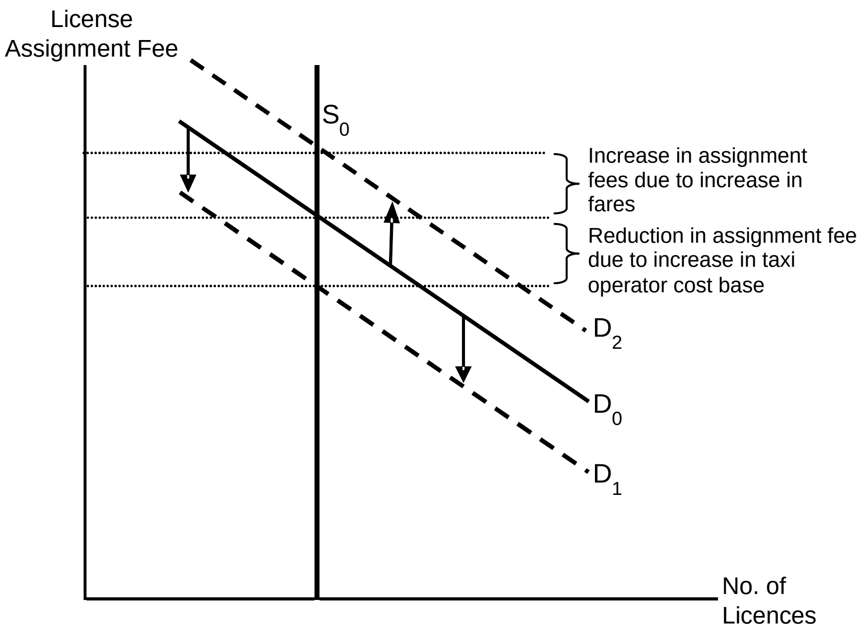
While assignment fees and conditions are not regulated, the VTD has an oversight role in the assignment market, through accreditation. As outlined in the respective sections above, it is a requirement for both the licence holder and the operator to be accredited, in order for them to be party to a licence assignment.

It is also a requirement for assignment contracts to be lodged and approved by the VTD. The VTD provides a standard assignment agreement – 'Form 3 Assignment of Taxi Licence Agreement' – which may assist the licence holder and operator in formulating the terms and conditions of their agreement. Form 3 also allows for the inclusion of "special conditions" such as the escalation of fees or a requirement to affiliate with a particular network.

## 4.3 Issues with the assignment market

The assignment market is characterised by fixed supply of licences (determined by government) and variable demand influenced by operator profits. The profitability of the taxi industry is therefore the key determinant of assignment fees. As illustrated in figure 4.3 below, if taxi operator profits fall (e.g. due to cost rises or decreased demand for services), a priori, one would expect the demand for licence assignments to decrease and therefore assignment fees fall. Conversely, if fare revenue increases, this will tend to push up licence assignment values.

Figure 4.3 **License Assignment Fees**




However, this outcome is not always observed in the assignment market. Other factors keep fees high even when demand for taxi services may drop or costs increase. This issue is referred to as price stickiness.

## Assignment fee price stickiness

With the supply of licence assignments fixed with the number of taxi licences, assignment fees are driven by demand, which in turn should be driven by the profitability of the taxi operator's business. However, assignment prices have typically demonstrated a degree of price 'stickiness' — that is, prices are not a true reflection of operator profitability.

The stickiness of assignment prices is further evidence of the 'squeeze' licence holders can exhibit on operators. It would be expected that assignment fees, being a reflection of operator profitability, would fall when substantial cost pressures arise. However, as evidenced in late 2007 when LPG prices continued rising, there appeared to be limited downward pressure on assignment fees.[26]

Three other key issues in the assignment market have been identified (discussed below), which in most cases arise as a result of the fixed supply of licences. The issues are interconnected with the nature of bailment agreements, and therefore the distribution of taxi fare revenue between drivers, operators and licence holders.

[26] ESC 2008, *Taxi Fare Review 2007-08,* Final Report, August, pp.157-158.

## Economic rents and transfer of industry profits

Ordinary workings of a competitive market do not apply in Victoria's taxi industry. The nature of restrictions on the number of taxi licences create a flow on effect to connected markets such as the assignment market, and the driver market.

In the assignment market, competition amongst a relatively large number of potential operators for a limited supply of assignments (limited to the number of licences) ensures that returns are higher than they otherwise would be, and it is licence holders who capture the available economic rent. In its 2007-08 Taxi Fare Review the Commission estimated that the value of the higher return (transferred to licence holders) was approximately $100 million per year[27] or $3 per trip.[28]

It is important to recognise that this source of inefficiency is a direct result of licence restrictions. In a market without licence restrictions (and non prohibitive licence fees), there would be no assignment fees as each operator would also be a licence holder, and operators would be free to earn economic profits that correlate with their level of input into the industry. Hence, restricting licences creates a transfer of economic profit away from operators, and licence holders receive this in the form of an economic rent.

## Terms and conditions of assignment

The fixed supply of taxi licences is likely to place licence holders in a relatively strong bargaining position compared to operators. This allows licence holders to negotiate assignment terms and conditions that are generally in their favour. In particular, the duration of agreement and the specified basis for fee variations limit the ability of the operator to renegotiate prices in light of changing market conditions (i.e. profitability). This can further provide an explanation for assignment price stickiness.

## 'Off-market' consideration and market conduct

Licence assignment prices are reported on the Bendigo Stock Exchange (BSX), however the majority of these transactions are negotiated 'off-line' and prices are then subsequently reported to the BSX. Whilst it is prohibited under the *Transport (Taxi-Cab licences – Market and Trading) Regulations 2005*, there is some suggestion that prices reported on the BSX do not reflect the full consideration paid for the assignment.

For example, licence holders may have tax related incentives to under report the value of the assignment fee or to receive additional non-reported payments. In addition, it is difficult to explain the large variance in reported assignment fees for transactions that have occurred at similar times, and the divergence between movements in taxi licence prices and reported assignment prices (i.e. licence values have increased proportionately more than assignment fees over the past

[27] ESC 2008, *Taxi Fare Review 2007-08,* Final report, August, p.171.

[28] Based on 32 million trips per year.

decade, indicating that the underlying return is in fact greater than the reported assignment fee on the BSX).

In general, the price stickiness and potential for off-market payments may reflect a lack of transparency concerning assignment arrangements. Transparency is an important factor in the functioning of markets, and a lack thereof can lead to information shortages and unequal bargaining power that shift the balance towards the licence holder, and away from the operator. Mandatory reporting of assignment transactions on the BSX offered an initial level of transparency that did not previously exist; however, there may still be scope for additional measures to be adopted.

## 4.4 The assignment market — a role for economic regulation?

Given the issues discussed above, options for economic regulation to improve market outcomes are outlined below.

### Removing supply constraints

Restrictions on the number of taxi licences result in significant adverse outcomes for the taxi industry. In particular, the restrictions place licence holders in a strong bargaining position compared to operators and drivers, and provides for the extraction of economic rents by licence holders. An unequal distribution of industry profits between market participants is the result.

These problems would most efficiently be addressed by removing, or limiting the extent of, the supply constraints. Such options include:

- **leasing new licences directly to operators at a specified period and fee** — leasing new licences, without a cap on their number, should pull down assignment fees to the cost of these new licences. This would limit the transfer of profits to licence holders. There would also be additional benefits:
    - increasing the number of operational taxis, improving response times and availability
    - removing the incentive for operators to offer off-market payments in order to access scarce assignments
- **releasing more taxi licences** — the Government could release more perpetual licences rather than directly leasing to operators. To some extent, scarcity and hence the economic rent generated by holding a licence will be addressed. However, a key disadvantage of this approach is the substantial upfront payment required to buy a perpetual licence, which would limit involvement from existing operators and drivers. Further, this approach may limit Government's flexibility to change policy in the future
- **phasing out perpetual taxi licences (i.e. buy back)** and replacing with licences directly leased from the Government — the removal (or relaxing) of supply restrictions under this approach would have similar economic benefits to the preceding options. However, there are a number of practical, political and legal considerations associated with this option. In particular, the cost to Government is an important consideration.

It is the Secretariat's view that the above options have the advantage, relative to others which have been discussed in this submission, of addressing the root cause of the inefficiency and undesirable income distribution — that is, the root cause being the restrictions on the number of taxi licences.

## Measures to affect assignment fees

In its 2007-08 Taxi Fare Review, the Commission recommended a cap on assignment fees as one of a number of recommendations aimed at improving driver remuneration.[29] As discussed, assignment fees represent a transfer of industry profits from operators and drivers to licence holders. The fees are a fixed cost to operators, therefore absorbing operating profits that would otherwise accrue, with potential flow through to drivers.

Dependent on the outcome and recommendations of the Taxi Industry Inquiry, there exists a potential role for economic regulation through capping assignment fees, and therefore removing some of the economic rent transferred to licence holders. This would be a means to positively affect the distribution of income between industry participants. However, it should be noted that implementing an assignment fee cap is purely a distributional policy problem, and does not address the underlying problem in the industry associated with restricting licences.

A price cap could be implemented using the following types of calculations: a fixed dollar amount; a fixed proportion of fare income; or a proportion of licence values. Each option has its benefits and drawbacks.

A fixed dollar amount is limited in its ability to capture the underlying profitability of operators, but it is simple to apply. The proportion of fare income is directly linked to fare revenue, but it does not adjust for cost factors that impact the profitability of the industry. Finally, the proportion of licence values, whilst tracking the profitability of the industry (assuming there is a direct link between profitability, licence values and assignment fees), may not be practical to calculate or implement. A proportion of licence values (say, set at 'x' per cent of average licence values) would need to use regularly updated data, in addition to some assessment as to what would be an appropriate yield ('x') on licence values.

An alternative to capping assignment fees is to reconsider the regulation of assignment terms. Currently, assignments are only permitted for a maximum of three years. This will usually be less than the term of a vehicle lease, and hence places licence holders in a strong bargaining position compared to operators. In particular, the maximum term of only three years encourages off-market payments by operators in order to secure the licence for longer periods (which match more closely with their vehicle financing arrangements). Removing the maximum term could assist in providing operators with greater bargaining power, therefore putting some downward pressure on assignment fees.

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[29] Essential Services Commission 2008, *Taxi Fare Review 2007-08,* Final Report, August, p.34.

### Information provision

Information provision is seen as a relatively low cost and minor intervention into the taxi industry, and could include information on demand and supply conditions in the taxi market, and expected operator returns. Information could be circulated through brochures, websites and help lines, and could assist in improving the understanding of the rights of operators and drivers in the industry. Such increased information provision and improved market transparency would help to address concerns that operators are restricted in their ability to make informed decisions with respect to assignment contracts.

However, information provision is unlikely to have a significant effect on assignment prices and operator/driver incomes, and in addition, the bargaining power of licences holders is likely to prevail as long as there are restrictions on licence supply.

# 5 OTHER ISSUES

## 5.1 Entry restrictions

> **Taxi Industry Inquiry questions**
>
> *Should government continue to restrict industry entry through limiting licence numbers, or should the market determine taxi supply levels? (p. 12)*
>
> *Would increased competition in the industry lead to better service outcomes? (p. 12)*
>
> *What factors explain the relatively high market value of licences, and why have licence values increased sharply over the past decade? (p. 15)*

Previous Commission taxi fare reviews provided the opportunity for consideration of numerous aspects of the regulatory framework, including the process for licence release. During the 2007-08 Taxi Fare Review, the process for release of Wheel Chair Accessible (WAT) licences was considered given the relatively poor level of service provided to WAT users. The Commission made the following recommendations on this matter:

> *If performance monitoring reveals that there are significant differences in the level of service being provided to WAT users and other taxi customers, further WAT licences should be released until this difference is removed.*[30]

In this case, the Commission concluded that licence release should be based on service levels. Consistent with this, the Secretariat believes that more broadly, the criteria governing licence release requires reform. It is noted that section 143 of the Transport Act, which governs the release of licences, includes aspects that are anti-competitive. Section 143 of the Act requires the VTD, before granting or refusing to grant a taxi licence, to have regard:

> *primarily to the interests of the public generally including those of persons requiring as well as those of persons providing facilities for the transport of passengers…*

This condition is not simply a test of net social benefit. It contains a test in regard to impacts on existing taxi operators and other public transport service providers. By placing greater weight on the interests of incumbent operators, the criteria reduces the weight accorded to improving services to users of taxi services.

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[30] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, p. 34 and 205.

The Secretariat supports a process of pro-competitive reforms of the taxi industry, including with respect to competitive entry. If Government decides to reform the industry to allow greater competitive entry, an appropriate reform path will need to be identified. There may be a continued role for economic regulation in terms of taxi fare regulation, at least until sufficient competitive pressures have developed.

## 5.2 Licence categories

**Taxi Industry Inquiry question**

*Are the existing zoning and other conditions on licences appropriate? (p. 14)*

Taxi operator licences are linked to specific zones of operation. In Victoria, there are four zones: Metropolitan (i.e. Melbourne); Outer suburban – the Frankston and Dandenong areas; Urban – the cities of Ballarat, Bendigo and Geelong; and Country – other areas. Generally country taxis are licensed to operate within five to eight kilometres of the local post office.[31] Licence holders are only able to provide taxi services in the zone for which they are licensed. This includes a service that picks up in their licensed zone, but drops off the passenger outside their zone. However they cannot provide a service that picks up passengers outside of their zone, for a trip back into their licensed zone.

It was noted in the 2007-08 Taxi Fare Review that this limitation:

> *… can result in inefficiency. This inability to collect a return customer can leave customers worse off for having to wait longer and also leaves those drivers and operators worse off through forgone income.*[32]

The benefits of separating the Outer suburban zone from the Metropolitan Melbourne zone are also unclear. As well as resulting in the above inefficiencies, the fact that in parts the Metropolitan zone extends to areas beyond Dandenong or Frankston suggests the boundaries are arbitrary, if not illogical. For example, the Metropolitan zone extends to areas such as Ferntree Gully and Belgrave, which are further east of the Melbourne CBD than Dandenong. The amalgamation of the Metropolitan and Outer suburban zones was recommended as far back as 1986 in the Foletta Report, which described the boundary as illogical.[33]

It is also very important to note that amalgamation of the zones has the real potential to provide competition between NSPs. The already established network operators in the Outer suburban area would be able to provide competition to the

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[31] Department of Transport 2011, *Taxi zones*, accessed at www.transport.vic.gov.au/doi/internet/vehicles.nsf/headingpagesdisplay/about+taxis+and+hire+vehiclesthe+taxi+industrymaps+of+taxi+zones+and+network+service+providers on 9 June 2011.

[32] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, p. 234.

[33] Foletta, B. 1986, *Report of the Taxi Inquiry – Melbourne and Metropolitan Area*, Ministry of Transport, Melbourne, pp. 60-61.

current NSPs in the Metropolitan zone, thereby removing the existing very strong duopoly. Amalgamation provides a further reform option to those discussed in section 2 of this submission, which specifically addressed issues associated with network affiliation in the Metropolitan zone.

## 5.3 Credit card facilities

**Taxi Industry Inquiry question**

*Are there regulatory issues or requirements associated with the licensing regime or other aspects of the Victorian taxi industry which underpin Cabcharge's market power? (p. 18)*

*Electronic payment system providers charge customers a 10 per cent surcharge on top of the metered fare. Is this reasonable? (p. 18)*

The Commission briefly considered issues associated with credit card payment facilities in its 2007-08 Taxi Fare Review. It was noted that it is a licence requirement that all taxis be fitted with an EFTPOS terminal approved by the VTD. Further, the Directorate has a non-exclusive contract with Cabcharge in relation to Multi Purpose Taxi Program transaction processing. The 2007-08 final report stated:

> *This preferred position reinforces Cabcharge's dominance in the provision of in-vehicle electronic payment processing services for the industry. In consequence of this preferential position, Cabcharge is able to obtain a 10% fee for each credit card transaction… Options should be explored for introducing a greater degree of competition in the provision of taxi-cab credit card transaction systems.*[34]

Cabcharge's payment facilities market dominance, and misuse of that market power, has been considered by the Australian Competition and Consumer Commission (ACCC) more recently. In June 2009, the ACCC commenced legal proceedings against Cabcharge, with the Federal Court in Melbourne ultimately making declarations and orders that Cabcharge Australia Limited pay $15 million in penalties and costs for three contraventions of section 46 of the *Trade Practices Act 1974* (Cwlth).[35]

The Secretariat considers that the VTD should explore options to increase the level of competition in the provision of electronic payment facilities.

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[34] ESC 2008, *Taxi Fare Review 2007-08*, Final Report, August, p. 235.

[35] ACCC 2010, *Cabcharge penalised for misuse of market power*, 24 September, www.accc.gov.au/content/index.phtml /itemId/948779.