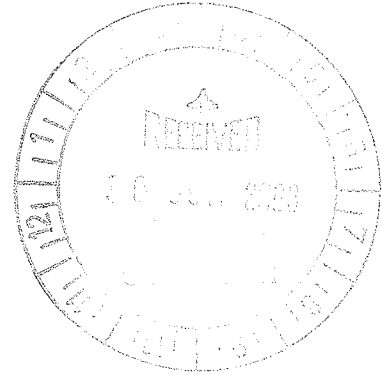




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Taxi Fare Review
Essential Services Commission
Level 2/35 Spring Street
MELBOURNE VIC 3000

30 June 2008

Dear ESC Reviewer,

**VTA SUBMISSION
DRAFT REPORT – TAXI FARE REVIEW 2007-08**

Further to my letter of 16 June 2008, covering the VTA's interim response to the ESC Draft Report – Taxi Fare Review 2007-08, the VTA now submits its substantive response to this review.

This VTA response has been prepared by the VTA in conjunction with Professor Harry Clarke and Dr John Shannon, Professor of Economics and Senior Lecturer in Economics respectively, Department of Economics and Finance, School of Business, Faculty of Law and Management, La Trobe University .

Should you or the Commission wish to discuss the matters raised in the submission, please contact David Samuel at the VTA to arrange such.

Yours faithfully

NEIL SACH
Chief Executive Officer

The VTA working for the: *Taxi Industry *Community *Environment *Taxi Industry



**VICTORIAN
TAXI
ASSOCIATION**

VTA SUBMISSION TO ESSENTIAL SERVICES COMMISSION (ESC) REVIEW OF TAXI FARES 2007-08

BACKGROUND

The Victorian Taxi Association (VTA) has presented the ESC with four submissions (including this one) to their Review of Taxi Fares 2007-08. The VTA has over time remained consistent in its message to the ESC:

Fares must accurately reflect the costs of the industry and be set at such a level so as to ensure industry participants are financially viable, and adequately rewarded, to the extent necessary to provide a service to the community in the accordance with the standard they expect.

This is the second submission by the VTA to the ESC's Draft Report on their Review of Taxis Fares 2007-08. The first submission provided the ESC with a new, and more accurate, cost structure of the industry. The VTA maintains the stance that our revised figures need to be used, in place of the figures supplied by Price Waterhouse Coopers (PwC) contained in the ESC Interim Report, to determine fare and fare structure issues as a part of the review. These issues are discussed further in section 2 of the submission.

The VTA has also made it clear that it is inappropriate to treat Victoria as one taxi market. Rather, we have said when setting fares and determining price path formulas the industry should be treated as three distinct markets:

- Metropolitan
- Urban
- Country.

The cost and profit structures of these distinct geographic regions are vastly different, as the ESC Interim Report clearly demonstrates. This fact renders the ESC "Median Taxi" as somewhat meaningless. It would be more appropriate to evaluate fares and fares structures on the basis of geographic location – as is done in other jurisdictions.

This issue is not covered further in detail as a part of this submission but the VTA believe it is vitally important in assessing the appropriateness of the ESC recommendations presented in their Draft Report, and more broadly in assessing their understanding of the Victorian taxi industry.

CONTENTS AND STRUCTURE OF THIS SUBMISSION

This submission provides comment on a number of the recommendations and comments made by the ESC in their Draft Report. Given the short time frame for response we do not intend to comment on all the ESC recommendations – rather we will provide comment on, and give alternate recommendations for, those parts of the report we feel require the most attention.

The first part of the submission will provide a summary of our specific recommendations. The key areas we intend to comment on include:

- The price path formula
- Fare levels
- Fare structure
- Driver remuneration.

The second part of the submission will provide the evidence and economic argument that underlies the VTA's comments and alternate set of recommendations. This part of the submission was prepared in consultation with Professor Harry Clarke and Dr John Shannon of the Department of Economics and Finance, La Trobe University.

Finally, attached at Appendix A is a matrix that demonstrates how increased fare levels will assist in improving service delivery standards across the taxi industry.

PART 1 - VTA RESPONSE TO KEY RECOMMENDATIONS

a. The Price Path Formula

The VTA firmly believe that a specific taxi industry based index should be developed. We urge the ESC to reconsider this recommendation and develop an industry based cost index for the Minister's consideration.

The VTA submit that the productivity factor should be lowered to 0.25% to reflect the impact of increased congestion on industry productivity.

In the Draft Report the ESC recommend a Composite Input Price Index (CIPI). While the VTA sees this recommendation as a 'step in the right direction', in that it moves away from the previous CPI-X model, we are still of the firm belief that a specific taxi industry based index should be developed. We urge the ESC to reconsider this recommendation and develop and maintain an industry based cost index for the Minister's consideration.

Such a model may be more expensive to develop but the benefits to industry would far outweigh the costs. While we note that no model is perfect, we do not believe that all the disadvantages listed by the ESC in table 4.1 on page 71 of the Draft Report are accurate, and those that are we see as not being unique to this model. A similar industry index has proven effective in other jurisdictions such as NSW.

In regard to the X factor in the price path formula the VTA support the decrease in level. However, we believe it should go further than it does. While a 50% reduction is acceptable, the rate from which it is being cut was always too high and over predicted the impacts of productivity increases in the industry.

The biggest factor in taxi productivity is traffic congestion. The VTA reject the ESC's assertion that forecasted congestion rates increasing by 3.3% per annum over the next 5 years do not represent a serious burden to taxi productivity. The VTA submit that the productivity factor should be lowered to 0.25% to reflect the impact of increased congestion in industry productivity. This issue is discussed further in section 2 of this submission.

b. Fare Levels

The VTA believe that a 5.08% increase must be the base fare increase in the September fare review. This will ensure that in September 'a line is drawn in the sand' and any further increases at that time will be forward looking rather than retrospective.

The VTA firmly reject the claim by the ESC that current fare levels are adequate to ensure the financial viability of the industry. On the ESC's own figures the industry is 5.08% behind where it should be as a result of the CPI-X price path formula (see appendix B, ESC Draft Report). As a result of this the VTA believe that a 5.08% increase must be the base increase for the September fare review. This will ensure

that in September 'a line is drawn in the sand' and any further increases at that time will be forward looking rather than retrospective.

Other costs that will need to be considered in September 2008 above and beyond the 5.08% are:

- Fare increase as a result of using the new price path formula for September 2008 - September 2009 – remembering that 5.08% is a 'catch up' amount.
- Full cost of safety screens (0.2%) - 0.2% is the full cost of screens going forward – the Minister has only committed to 50% funding of screens by Government (in other words the ESC 0.1% is based on half the real cost) until 31 December. After that time operators will have to pay 100% of cost and the Minister has asked the ESC to include this factor in any industry cost structure.
- Introduction of Emission trading Scheme (ETS) - Cost offset for the anticipated rise in LPG and fuel prices as a result of the introduction of an ETS in 2010.
- Incentive Payment – an incentive payment should be granted to country operators and drivers to encourage them to service after dark demand in these areas (this issue is covered in a proceeding section).

c. Fare Structure

The VTA does not support the extension of the late night 20% surcharge to urban and country areas in lieu of a flat surcharge. It should only be extended to the outer suburban areas. Country and urban areas should retain a flat surcharge that applies at the beginning of the journey. The VTA believes the flat rate surcharge should be lifted to encourage more business operators to provide late night services and provide drivers with increased incentives to take up late night shifts.

The VTA also rejects the recommendation that flagfall rates should be reduced and booking fees increased. The VTA submits that flagfall rates should be increased to a level where they cover the entire cost of the short trip to encourage drivers to do them.

The VTA support the extension of the surcharge to include at least Christmas Day, Boxing Day and New Year's Day.

The VTA does not support the extension of the late night 20% surcharge to urban and country areas in lieu of a flat surcharge. It should only be extended to the outer suburban areas (Frankston and Dandenong). Country and urban areas should retain a flat surcharge that applies at the beginning of the journey. The application of the 20% surcharge would mean country taxis would have to undertake a 13km trip to recover the current \$2.80 flat surcharge – the current average distance of a fare in country Victoria is around 4km. In country and urban areas attracting drivers to work the shifts when the surcharge applies is already difficult – the ESC recommendation would make it more difficult.

The introduction of a late night 20% surcharge in lieu of a flat surcharge would significantly reduce the incentive for drivers to work the more difficult and risky shifts and lower country and urban taxi revenue further. From a social perspective there would also be no transport available, given that in many areas

taxis are the only form of public transport at night. Furthermore, the VTA believes the flat rate surcharge should be lifted according to the following formula:

Country Late Night Surcharge Equation:

Existing Fare + 5.08% + September 08-09 fare adj + **incentive amount** = new late night surcharge for country and urban areas.

The implementation of such a formula will encourage more business operators to provide night services and provide drivers with increased incentives to take up night shifts.

The VTA also rejects the recommendation that flagfall rates should be reduced and booking fees increased (the revenue neutrality of this is covered in section 2 of the submission). We believe that this would have a detrimental effect on short trips and whilst it may encourage customers to take them it would reduce driver incentives to pick up short trip passengers. The VTA submits that flagfall rates should be increased to a level where they cover the entire cost of the short trip to encourage drivers to undertake short trips.

The VTA believe the existing New Year's Eve surcharge should be extended to include all public holidays, however, we are pleased to see that the ESC recommend the surcharge should be extended to at least Christmas Day, Boxing Day and New Year's Day. We believe that it provides increased incentives to drivers to work these days and recognises the significant sacrifice they are making.

d. Driver Remuneration

The VTA strongly believe that any 'general' fare increase (unlike the 'specific' 4.2% increase recently granted) will benefit drivers because they will retain 50% of a bigger fare box.

The ESC claim that a fare increase would not flow to drivers due to their weak bargaining position - asserting that any benefits from a fare increase would flow to licence owners/holders. The ESC uses the recent 4.2% fare rise, granted to offset recent rises in the cost of LPG, as evidence of this. This issue is covered in Part 2 of the submission but it must also be stated at this point that the ESC reasoning on this point is completely erroneous and misguided.

The implied notion that a fare increase will lead to a shift in bailment agreements in favor of operators to support higher licence assignment values is not supported by any historical evidence. Despite the fact that there have been numerous fare increases over the years, bailment agreements have remained close to 50/50, reflecting a fairly even share of bargaining power within the industry. The VTA strongly believe that any 'general' fare increase (unlike the 'specific' 4.2% increase recently granted) will benefit drivers because they will retain 50% of a bigger fare box.

Further, the ESC state in the Draft Report that the VTA controls driver remuneration by providing bailment agreement templates. The VTA, as is its role to do, provides standard industry bailment

agreements. Nowhere in that document do the VTA advise the relevant parties on what the driver/operator split should be. This is an unsubstantiated and offensive claim that is firmly rejected here. The VTA are concerned that the ESC may have failed to completely comprehend how the VTA bailment agreement is designed to work, and does work in reality.

PART 2 – VTA ECONOMIC ANALYSIS

Commenting on the ESC's views on these issues provides the main part of our response and is addressed first below. The ESC claim that taxi services will continue to remain viable even in a period of unparalleled increases in fuel costs even without significant fare adjustments. This view is inconsistent with reliable evidence on cost increases and is also at odds with social objectives of improving service quality. It is also inconsistent with interstate data provided by the ESC in its earlier *Issues Paper* showing that taxi fares in Victoria as at July 2007 remained well below the level of those in comparable eastern states.

After commenting on fare issues we must comment on those issues, raised in the Draft Report, which are outside of its *Terms of Reference* but which deserve comment. The VTA wish to point out that the ESC's Draft Report is a lengthy document of 225 pages of rather technical writing. Being given one month to respond to it imposes challenges.

Part 2 of the submission covers, in detail:

- Fare Issues
- Calculating Industry Costs
- Demand Characteristics
- Other Issues.

1. Fare Issues

The ESC sees no reason for a further taxi fare increase beyond the 4.2% increase awarded in March 2008, which is seen as sufficient to guarantee industry viability. This is based on exclusive use of a *PwC* sample survey cost data – with low response rate and hence low sample size - and a rejection of cost estimates provided by the VTA on the grounds that the estimates they provided 'seemed' too high. No other reason is provided for rejecting the VTA data.

Average fares for a given distance were provided in *Tables 5.1 and 5.3* of the *Issues Paper* and showed that Victorian taxi fares were significantly lower than other eastern-Australian states. This was due to distinctively lower (approximately 22%) distance-related charges in both Metropolitan and Country areas in Victoria. The fares computed after the Victorian LPG price adjustment in March 2008 are presented in the Draft Report *Appendix C*. Charges per kilometre in Victoria remain 14% below those in NSW and Queensland. Overall fares in Victoria for a 7.7km trip are 15% lower than in NSW and 5.2% less than in Queensland (Draft Report, p. 116).

Since vehicle, fuel and labour costs are approximately comparable across States, the VTA cannot understand where the lower input costs lie for the Victorian industry. Equally the VTA is not persuaded that the industry in other eastern states is earning markedly higher excess returns.

For determining future price increases the ESC advocate using a composite price index on the grounds that it is not costly to use and has the potential to provide strong efficiency incentives¹. The formula then provided adjusts fares by the composite price index less assumed productivity growth X where X, reflecting productivity growth, is taken to be 0.5.

Applying this formula retrospectively from the period March 2001 to March 2008 (the date of the LPG fare increase) the composite input price index has risen 22.27% which net of claimed productivity growth over 7 years of 3.50% gives a net implied fare increase of 25.77%. In fact the fare increases over this period were 8% in 2005, 3% in 2006, 1.1% in 2007 and 4.2% in March this year. The compound rate of increase is 17.19% which falls short of the increase suggested by the formula by 5.08%. Thus *on the basis of the ESC's own suggested formula there should be a minimum increase of 5.08% in September this year.*

The 5.08% does not include adjustments required for unit cost movements in the period from the December quarter 2007 to the June quarter 2008 (Draft Report, p. 9) as well as the industry share of the costs of fitting security screens estimated by the ESC to be 0.1%. The 0.1% figure provided for by the ESC is calculated on the basis that the Government will provide half the cost of the screen up until 31 December 2008. After this time the Government subsidy will be removed and the burden for the full cost will be accrued by the operator. In keeping with the Minister's request, that the cost of screens should be included in the ESC fare review, the VTA submit that the ESC should include the full amount of the cost of screens (0.2%) in calculating a new fare level given that this ESC review covers the next 3-5 years.

The reasons for selecting X=0.5% as the productivity adjustment factor are anything but clear in the discussion provided by *Appendix B* of the Draft Report. It would be helpful to indicate where these productivity increases stem from and why, for example, productivity is viewed as falling over the period 2000-2004 but rising from 2004-2007 (Draft Report, page 207). Indeed the guessed at productivity growth over the period of 0.6% is an average of trends over these periods.

The VTA confirm their view that productivity gains in a complex service industry, such as the taxi industry, are low and difficult to estimate. The reasons for selecting X=0.5 need to be more accurately spelt out and explained.

Congestion costs are recognised by the ESC as significant factors reducing productivity in the taxi industry with transit delays increasing by 3.7% annually from 2000-2007. These are forecast to increase by only 3.3% annually over the next 5 years (p. 85). It is difficult to understand how the growth rate in congestion costs can be expected to fall. The impact of these costs on productivity growth needs to be comprehensively accounted for in an assessment of likely productivity growth in the taxi industry. Congestion costs seem likely to swamp productivity growth in metropolitan taxi markets.

The approach taken to fares by the ESC is analogous to the approach they adopt towards adjustments in LPG prices. It reflects the market model they see as appropriate to describing the taxi industry in

¹ The argument here is the curious one that were the composite index to accurately *represent* costs in the taxi industry it would have reduced efficiency benefits because there would be reduced incentives to cut costs. Hence one seeks an unrepresentative index that does not, for example, directly measure the cost of labour used in the taxi industry! Draft Report, page 72, 75.

Victoria. Apart from supposing monopsonistic operator market (discussed further below) the surprising feature of the ESC view of the industry is its textbook simplicity and lack of business realism. The ESC take the view that licence holders in Victoria act as a cohesive monopoly which operates in an environment where operators have some market power and the market for drivers is competitive.

Hence an increase in operator costs (such as LPG costs) will (subject to certain 'price stickiness') only reduce licence values while, given their concentration, fare increases will mainly boost licence values giving a little to operators but nothing to taxi drivers (Draft Report, p 141, 143). Therefore denying LPG price increases or denying fare increases will simply result in reduced licence values.

This view is inconsistent with the stated rationale for providing a 4.2% fare increase in March 2008 to cover increased LPG costs and is also inconsistent with the existence of *resilient* 50:50 bailment agreements continuing to operate in the industry as they have for many years.

The ESC claims that the proposed alteration of bailment arrangements that occurred in March 2008 following the 4.2% fare increase illustrates that these arrangements can change (Draft Report, p. 143). The ESC claim that the decision of the VTA to ensure that the whole 4.2% awarded went to the operators means that the VTA has unilateral power to set bailment arrangements. This is inaccurate as the ESC must know. The 4.2% increase was described by the Minister in her statement of March 19 as *a compensation for increased LPG prices*. In accord with almost all bailment agreements, operators pay the full cost of LPG so that it was natural and expected that this increase should accrue to them. Drivers do not pay this fuel cost so fare increases directed at covering the fuel price hikes were not intended to accrue to them. It should also be noted that many operators decided to split the LPG increase with drivers in any case.

2. Calculating Industry Costs

A central issue that needs to be addressed is an appropriate procedure for measuring costs in this industry. As has been noted the values arrived at using the VTA and the ESC/PWC surveys are quite different. This can be seen from the following table which shows costs for different categories.

MEDIAN TAXI PROFILE – VTA/PWC COSTS (includes GST)

COST ITEM	VTA 2008 PROFILE (P.A.)*	ESC/PWC 2007 PROFILE
Driver Payments	\$80,600 (4 drivers to every cab)	\$71,411
Lease Vehicle funding payments	\$6,840	\$6,653
Licence assignment fee	\$27,000	\$23,418
LPG/fuel cost	\$20,352	12,314
Network costs	\$6,245	\$6,739
Repairs maintenance	\$13,000	\$3,311 incl. cleaning
Cleaning costs	\$1,300	-
Tyre costs	\$1,757	\$1,130
Insurance and rego costs	8,156	\$4,274
Office costs	\$4,168	\$2,521
Workcover	3,062	\$840(?)
Total cost per Median Taxi	\$172,480	\$132,611
Cost per km		
Cost paid per km		
Estimated total revenue	\$161,200	\$142,823
Margin	-6.5% (CAGR)	8%

There are a number of reasons why the two studies give such different results but the key issue appears to be that the cost structures for different types of taxi owners and operators appear to be quite different. While random samples possess certain desirable statistical properties with only an 8% response rate in the ESC/PWC study it is quite possible that this study does not reflect the cost structures of key groups in the taxi industry. If the different types of owners and operators can be identified then the appropriate sampling procedure that should be used is a random stratified sample.

When we examine the VTA returns, to its more formal survey (submitted to the ESC in June 2008), we also see that there is significant variation between the values for different types of costs for the 14 respondents. The ESC/PWC results reported in the ESC's interim report do not give any information concerning the range of values obtained for different types of costs. The very large differences suggest that it may not be appropriate to use a simple point estimate such as the median as a measure of cost levels. If we are concerned with maintaining the viability of an essential industry we need to consider providing an interval measure of key costs.

Another issue which needs to be considered is the ESC's approach to measuring industry costs with a Composite Input Price Index. The appropriate way to select the weights which are given to each index is to run a regression in which industry costs are treated as a function of each of these relevant indices. The ESC approach however is to use a particular index to represent a particular category of costs and then calculate the share of that category of costs in total costs. There are two major problems with this approach. The indices and the different categories of costs are never a perfect match and at different times may not be close matches. For example insurance costs are very different between taxis and private cars. The use of these shares also raises issues even when the indices are closely related to each other. This approach assumes that these shares are very stable over time.

When we examine the data in Table B.1 on page 204 of the ESC report we first see that the LPG share used is 7.9% as opposed to the value of 9% quoted on p 87 of the ESC report. If we use the values in this table to calculate what happens to these shares over time we find that while other shares decline the share of LPG changes from 7.9% in June 2005 to 11.6% in March 2008.

3. Demand Characteristics

The ESC discussion of demand characteristics in section 5.1.5 is open to question. In the first place using such highly aggregated variables means that it is very difficult to interpret the values of the coefficients in a reasonable way even if we were confident that they were reliably estimated.

The second point is that the existence of almost perfect R squared values and only two significant separate coefficients indicate that there could be major problems with multicollinearity. This would make the parameter estimates unreliable. In this type of situation it would be more appropriate to use an interval of possible elasticity values when calculating different measures of welfare.

Other Issues

Much of the Draft Report is taken up with regulatory issues and with proposals for deregulation – an important issue but one which lies outside the *Terms of Reference*. Moreover, the discussion of regulatory structure is inaccurate in terms of accepted economics and provides a bias to the conclusions of the report which acts against the interests of stakeholders in the taxi industry.

The main conclusion of the Draft Report is summarised by the statement that 'The Commission's recommended approach to the taxi industry is for the Government to progress pro-competitive reforms, wherever these can be identified, and wherever the case against doing so is insubstantial' (p.30).

The VTA is more than willing to discuss regulatory issues associated with the taxi industry but finds it difficult to understand the relevance of this issue in a report whose terms of reference (as accurately

summarised on page 6 of the Draft Report) specify concern with the level and structure of fares, with determining formulae for taxi fare increases, with the effects of LPG price increases, with driver incomes and so on.

Moreover, the ESC's understanding of the regulatory issues it focuses on is idiosyncratic. It misrepresents the position of key stakeholders in the taxi industry and specifically licence holders. The essential claim of the ESC is that licence values have been bid up excessively by the shortage of licences with this same shortage constraining the supply of taxi services and leading, in turn, to monopsonistic behaviour by operators in relation to taxi drivers which depresses driver earnings. The claim then is that in the absence of a mandated bailment agreement or a regulation to restrict returns to licence holders that a further taxi price increase would be unwarranted since the targeted group of drivers would receive no boost to their salaries and already over-compensated licence holders would be still better off. These claims are for the most part asserted rather than backed up by reasoned argument.

i. Licence values and rates of return.

Taxi licences are a legitimate investment by private investors under current Victorian law. A central claim of the Draft Report is that the value of a taxi licence has increased from \$265,000 in 1999 to \$475,000 in 2008 and that this increase is 'excessive' because the implied price growth of 7.3% per annum exceeds annual CPI growth over this period of 3.5% (p. 8 and p. 50). But, as the VTA pointed out in its earlier submission, licence values are an asset value not the value of a consumer good. Licences will be willingly held as an asset if and only if they yield rates of return comparable to returns on other assets such as housing investments and equities. It is as irrelevant to compare the increase in licence values with the CPI as it would be to compare the growth through time of the equity market's *All Ordinaries* index with the CPI.

Individuals hold taxi licences as a *legally acquired investment vehicle* that they hold in good faith as a basis for savings and, in some cases, for such things as retirement benefits. Owner-drivers, for example, will have invested a large fraction of their wealth in such claims to fund their retirement. More generally, investors will seek a competitive return on such assets.

While taxi licence values grew by 75% over the period indicated the prices of homes grew by 128% and equity prices grew 90% (*DX Data Base*) over this same period. In other words, while the various asset values all grew in response to the lower interest rates that emerged during much of the period, the return to owning a taxi licence was overall much *lower* than on these competing assets. Once interest rates began to increase as they have over recent years, the equity, home and taxi licence values (see Draft Report p. 50) stabilised as would be expected in a market where there is substitution between the different assets.

Moreover, on the basis of the ESC estimates there is a return to the claimed market value of a taxi licence of 5.6% which is *below* not above market norms. The average yield on equities in Australia is around 4.2% at present and the current long-term bond rate is 7.2%. Thus taxi licence values are yielding close to average rates of income yield despite the *smaller* capital gains they have generated². The ESC

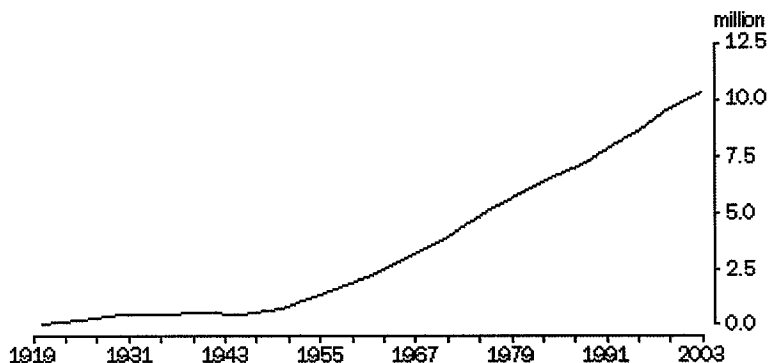
² That the return is somewhat lower than the return on equity reflects in part the lack of imputation benefits on licence-related income and, in part, a premium associated with expropriation threats whereby civil servants and others discuss the possible seizure without compensation of legitimately-held community claims on wealth. Compare the Draft Report page 137.

recognise the diminishing and low rate of return on a taxi licence – assignment fees as a percentage of income have declined from 7.1% in June 2002 but claim that ‘an increasing proportion of taxi license values are based on expected future capital gains’. As pointed out, capital gains on licenses have, in fact, been low in the past relative to other investment vehicles so this claim is puzzling and contradicted by the later correct claim in the Draft Report that ‘Licence values are the capitalised value of expected future assignment fees’ (p. 141).

As a consequence of the erroneous ESC view on rates of return on a taxi licence the ESC is led to an equally erroneous view that ‘high licence assignment fees’ provide a ‘substantial cost burden on taxi operators’ (p. 8). The alternative and more reasonable view is that licence holders are earning something less than a *normal rate of return* on a legally purchased asset that is in fact appreciating more slowly than other assets in the economy.

The ESC further claim that the value of a taxi licence ‘appears to’ (p. 8) have arisen due to restrictions on the number of licences issued relative to the growth of population in the face of an aging population (p. 51). As evidence the ESC notes the changed shift in travel patterns favouring increased use of private cars. This modal shift also reflects the markedly higher levels of car ownership in Australia partly due to steadily growing incomes, to the growth of two income families and to greatly reduced tariff protection on vehicles. The graph below (taken from the ABS) shows recent trends in Australian car ownership. Recent increases in private motor vehicle ownership continue trend increases in car ownership that have occurred from close to the start of the century. Deducing that these trends are due to imaginary excessive returns in the taxi industry is fantasy.

22.32 NUMBER OF REGISTERED CARS AND STATION WAGONS



Source: Motor Vehicle Census, Australia (9309.0).

That cars are being increasingly used to make private journeys is simply consistent with higher levels of car ownership as the ESC itself seems to recognise Draft Report (p. 60). The ESC’s table page 55 makes clear that these trends are uniform across Australia and have has no obvious links to regulatory issues in the taxi industry at all. How does the ESC come to their view? The basic misconception in the ESC’s approach lies in their misunderstanding of the nature of rents as they are described in economics.

If licences for some asset are scarce then a rent will initially develop associated with that asset. But if – as is the case with taxi licences – the assets are traded, the rent *dissipates* under the impact of competition for the asset claim and the assets trade at their value and yield a normal rate of return. The evidence cited showing that below normal rates of capital appreciation obtained in the taxi industry,

with normal income yields, suggests this reasoning applies *exactly* to the taxi industry. Imposing licences *may* have provided once-and-for-all capital gains to the initial owners of a capital asset but will not provide above-normal returns if the asset is freely traded.

To be clear the point of this inquiry is not about the initial decision to issue taxi ownership licenses but about how fares should be devised in a system where taxi licenses *are* used to regulate numbers of participants in the taxi industry.

Unfortunately the false view that rents associated with licences provide *ongoing* excess returns which impose unreasonable cost burdens on the industry pervades the ESC report. The ESC claims that 'the most significant opportunity for productivity improvement will arise from reducing the impost of licence assignment fees' (p. 8). As we have shown that these costs already provide something less than a market return on investment it seems that the ESC is seeking to regulate the rate of return on capital in the industry to some level *further below* market levels.

ii. Monopsonistic Operators?

A monopsony is an industry structure comprising a single firm that restricts the employment of one or other of its inputs to reduce the costs of employing those inputs. The ESC takes the view that the taxi depots, as they are coordinated by the VTA, provide an 'imbalance in bargaining power' that results in 'lower incomes for drivers than a more open and competitive market would be likely to achieve' (Draft Report p. 17, 137-139). Essentially they are asserting that the depots act as a monopsonist.

This argument was refuted in the VTA response to the earlier *Issues Paper*. Taxi operators compete among themselves for drivers and there is competition for drivers both from public transport providers and from other markets for unskilled and semi-skilled workers. The Draft Report claims these arguments are unconvincing but itself notes the substantial competition the taxi industry faces from hire cars, rental cars and other vehicles (Draft Report, p. 60). These forms of competition, as well as competition from public transport industries, are the day-to-day realities of business in the taxi industry. Moreover, monopsony power cannot simply be claimed it must be demonstrated – it must be showed that, given the existing stock of taxi licences, the industry restricts the supply of taxis to reduce the returns to drivers.

This claim would be difficult to demonstrate as it does not accord with business realities. Taxi operators in fact compete among themselves to keep their taxis on the road as much as possible to generate the best returns they can for themselves and bailee drivers that reflect incomes in this segment of the labour market.

The Draft Report says that taxi driving is a 'relatively liquid labour market' because it presents a greater scale of job opportunities for 'casual workers than public transport' (p. 138). As evidence it argues 26% of metropolitan workers are immigrants, 27% have been driving for less than 2 years while 32% have been driving for more than 10 years. These facts, it claims, suggests drivers have a 'reduced' range of alternative opportunities to taxi driving. In fact taxi drivers do leave the industry and move into other occupations in response to changes in relative rewards as the evidence on high turnover suggests. Some drivers with low alternative skills may have difficulty shifting to other occupations but this has nothing to do with monopsonistic power. Rather it reflects the skill endowment of part of the workforce.

Taxi operators will bail drivers, as any commercial firm would do, to try to contain what is a major component of their costs. They will seek a skill and experience mix that meets the objective of keeping their taxis on the road earning as much income as possible while at the same time containing labour costs. This is not monopsonistic abuse but standard commercial practise and *the industry would need to be criticised for being inefficient if it did not seek to operate at minimum cost.*

There is no evidence of an abuse of bargaining power at all. Nor is there evidence of reducing job opportunities to restrict the scale of workers employed. The more coherent perspective is that taxi operators face markets for labour from which they must draw resources. Potential workers in these markets have considerable bargaining power in current circumstances where seasonally adjusted unemployment is 4.3% and workforce participation rates are at record levels of 65.2%.

The Draft Report claims that since 95% of bailment agreements take the form of a 50:50 revenue-sharing agreement this implies excessive bargaining power. This is simply false in terms of economics. The standard explanation for bargaining outcomes between a principal and an agent implies a 50:50 split *if both agents can be assumed to have equal bargaining power*³. There is no presumption of one-sided market power at all in a bargaining situation such as this.

iii. Driver incomes

Related to ESC misperceptions about monopsony power are misperceptions about the way driver incomes are determined. A social objective of governments and of the ESC is to boost taxi driver incomes. The ESC links this to the case for mandated bailment agreements although they seem to reject this case on the basis of its regulatory complexity. Bailment agreements, from the perspective of the VTA, should be commercial agreements that reflect an assessment of skills on the part of the driver.

Surprisingly the ESC sees the best way of increasing driver incomes as by increasing the number of taxis on the road. The relevant passage from the Draft Report reads:

The Commission's preliminary preference is for additional taxi licences to be issued through a performance-based licence release program. This would reduce the unnecessary costs associated with plate licensing that assignee operators currently face and provide greater basis for driver remuneration to be improved. This would also improve the supply of taxis and thereby reduce waiting times and improve service levels, which would be well developed to improving customer satisfaction levels. By lowering industry costs and improving service standards it would also stimulate demand for taxi and driver services. Also, a known program would provide transparency and certainty for investors.....

The Commission also favours the capping of licence fees. Already these fees are imposing a substantial burden on the industry.

³ The Nash bargaining model that is the basis of all modern bargaining theory suggests a 50:50 split *if agents have equal bargaining power.* See e.g. A. Dixit & S. Skeath, *Games of Strategy*, W.W. Norton & Co, 1999, p. 524-527.

Compensation to existing licensees should be considered, such as an open offer to buy back licences at the prices that existing licence holders paid for them. ' (Draft Report, p. 160).

There are several initial comments that should be made about these views. First, the threat of appropriating legally-acquired assets is implicit in the presumption that compensation should only be 'considered' for existing licence holders were the industry to be deregulated. Second, the compensation envisaged is at historic purchase costs not current market values. These views have seemingly nothing to do with the stated purpose of this supposed fare review. Bluntly one could ask of the civil servants who present these arguments how they would feel were the state to consider confiscating their superannuation or housing assets perhaps with 'consideration' of possible compensation at the historic value of these assets at the dates they were acquired.

A program of expropriating asset values does provide greater 'transparency and certainty to investors' since investors then know for certain that the value of their legally-acquired assets has been taken from them with compensation that, at best, undervalues the assets relative to their current market value. This type of 'transparency and certainty' should never be advanced as reasonable public policy.

The claim that putting more taxis on the road would increase the incomes of taxi drivers is unrealistic to say the least. Increasing taxi numbers may reduce licence values which reduce a cost but drivers in competitive labour markets will continue to be paid the value of their contribution to output. With more taxis average revenue per taxi will decline and that will have the effect of reducing the incomes of drivers. Moreover, with competitive enough labour markets, the reduction in revenues will overwhelm the effect of reduced licence costs.

The simple issue to resolve is this. Will currently low taxi driver incomes improve from their current low levels with *more* taxis plying for business in Victoria? The Draft Report itself noted (p. 65) the problem of excessive numbers of taxis operating in 'quiet shifts were impacting on driver earnings'.

On a final point it is argued that skill requirements of drivers should be boosted to increase their returns. Investments in skills are normally called upon to improve productivity and performance. The ESC's suggestion that training should be used as a way of restricting driver entry to the industry by increasing their costs of entry (Draft Report, p. 20) will simply disadvantage those who face problems entering the workforce.

iv. Fare Structure

Distance-related charges are claimed by the ESC to be approximately right – the booking fee needs to be increased but to maintain 'revenue-neutrality' the flag fall charge should be reduced. The obvious question is why it is required to assume that revenue neutrality needs to prevail here when the purpose of the review is to determine fares and the structure of fares.

The basic assumption that ESC make is that the Booz Allen guess that the demand for short trips is more price elastic than that for long trips (Draft Report, p. 98). This view is not deduced on the basis of evidence and seems to be a pure guess. It can be questioned simply because short trip fares are a small fraction of a commuter's budget. Some evidence on this issue is required.

The issue is of substance because it provides the basis of the ESC's view that fare structures should not be shifted toward increasing fixed fare charges which many in the industry claim are currently too low to encourage drivers to pursue short trips and instead leave them queuing for long journeys.

In an inaccurate interpretation of the earlier VTA submission the ESC write in reference to the VTA emphasis on recouping costs (Draft Report, p. 99) that 'The VTA has not explained how the adoption of an assumption that the elasticity of demand is equal to zero can be superior to using a reasonable and unbiased estimate based on direct research'⁴.

The VTA made no such claim. It argued that in the absence of good elasticity information – and none with statistical significance has yet been provided on short versus long trips (see Draft Report, p. 104, 109) – the best approach to thinking about short fares is to make sure that fixed charges cover a driver's full costs. If these costs are met then drivers will have material incentives to accept short fares and better service the needs of consumers such as the elderly who urgently need to make short trips.

If the ESC guess is wrong on short trip elasticities their claims that increased use of fixed charges 'would impose a risk to revenue' will not be accurate. In fact the ESC assumption of uniform elasticity and the requirement that policies be revenue neutral virtually drives their conclusions that changes in fare structure will not improve consumer welfare as the ESC itself note (p. 110).

END

⁴ In fact in the Draft Report pages 215-216 and contrary to their claims elsewhere the ESC assume a single demand elasticity for all trip lengths. They also emphasise that there 'remains a wide range of uncertainty about demand management responses to changes in taxi fares'.



**VICTORIAN
TAXI
ASSOCIATION**

APPENDIX A

FARE INCREASE OFFSETS

1. Background

The VTA recognise that if the ESC was to recommend a fare increase, above the 5.08% base amount recommended by the VTA and the fare adjustment for September 08-09, that the industry would need to delivery measurable improved service delivery outcomes. The VTA also recognises the need to improve data gathering methods and frequency to ensure such service delivery improvements can be measured into the future. We are happy to work with Government on improving data collection across the industry as recommended by the ESC in their Draft Report.

This document is a first step in setting out:

- What the measurable improvements might be;
- What incentives a fare increase would provide; and
- How such improvements can be measured.

Given that there is an acknowledged lack of baseline data we think it is unrealistic to set Key Performance Indicators (KPI) at this stage. After a yet to be determined period of data gathering the industry should be in position to set KPI's.

Section 2 of this document outlines areas where the VTA believes the community and taxi industry stakeholders can realistically expect to see an improvement in service delivery standards as a result of a higher and adequate fare level.

2. Measurable outcomes of a fare increase

- i. Improved driver conduct, presentation and attitude
- ii. Improved service delivery standards
- iii. Improved safety for drivers
- iv. Improved vehicle standards
- v. Industry compliance with regulation and accreditation.

3. Service Delivery Matrix

OUTCOME	FARE INCENTIVES	MEASURE OF SUCCESS
i. Driver conduct, presentation and attitude	<ul style="list-style-type: none"> Improved remuneration* for drivers Greater disposable income to purchase taxi uniform. Reduced stress levels for drivers 	<ul style="list-style-type: none"> Fewer legitimate complaints registered by Victorian Taxi Directorate. Fewer legitimate complaints registered by Taxi Depots. Improved customer satisfaction.
ii. Service delivery standards	<ul style="list-style-type: none"> Increase in late night surcharge to country and urban area leads to increased service levels in these areas late at night. 	<ul style="list-style-type: none"> Number of taxis on the road after 10pm in country towns and urban areas in proportion to demand. Reduced service delivery times at night in country and urban areas.
iii. Safety for drivers	<ul style="list-style-type: none"> 0.2% fare increase for screens will ensure operators can afford to purchase safety screens for drivers now, and as new vehicle models are introduced into the fleet. Greater remuneration for drivers will make it easier for them to voluntary conflict avoidance training. 	<ul style="list-style-type: none"> Driver satisfaction with safety in the workplace. Reduction in number of assaults on drivers.
iv. Vehicle standards	<ul style="list-style-type: none"> Increased remuneration for operators encourages the purchase of insurance policies. Increased remuneration for operators means the ability to repair taxis at time of damage. Increased remuneration for operators means mechanical maintenance can be made when required. Increased remuneration for drivers means that regular taxi cleaning becomes more viable. 	<ul style="list-style-type: none"> Improvement in taxi fleet presentation. Fewer defect notices issued to taxis by the VTD. Fewer defect notices issued to taxis by Vic Police Improved customer satisfaction.
v. Industry compliance with regulation and accreditation	<ul style="list-style-type: none"> Increased remuneration assists operators in appointing the appropriate financial, and other, professionals to comply with VTD accreditation processes. 	<ul style="list-style-type: none"> VTD satisfaction with accreditation information received.

* Improved remuneration is based on a fare increase above the minimum required catch up increase of 5.08% as outlined in VTA submission 2 to the ESC Draft Report – Taxi fare Review 2007-08.