Auckland Transport
20 Viaduct Harbour Avenue, Auckland 1010
Private Bag 92250, Auckland 1142, New Zealand
Phone 09 355 3553 **Website** www.AT.govt.nz

30 August 2024

Talia Cohen - Wolf
Manager, Public Transport
New Zealand Transport Agency

Via email

Kia Ora Talia,

Feedback on proposes changes to bus indexation

Thank you for the opportunity to review and provide comment on these proposes changes. Auckland Transport agrees with the stated purpose of indexation. Out of the three options, AT's preferred method is Option 3. We believe this method provides the greatest flexibility to achieve outcomes tailored to the Auckland context, while also providing scope to address key procurement issues. We believe any downsides, such as the associated administrative requirements can be addressed and mitigated.

Our detailed feedback follows the questions outlined in the consultation document.

General

1. Please provide any feedback on the stated purpose of indexation mechanisms and the design principles on page 6.

Auckland Transport agrees with the stated purpose of indexation and the design principles as listed on page 6 of the consultation document.

AT fully supports the statement that indexation is not intended to compensate PTOs for increases beyond economy wide cost fluctuation or to address all unforeseen changes during the contract term.

Managing for change and complexity

2. To what extent do the 3 indexation methods presented in Section 1 provide adequate flexibility for the sector to accommodate different levels of complexity in the contracting and procurement models being adopted?

Neither Option 1 or 2 address the true "complexity in the contracting and procurement models being adopted". Both Option 1 and 2 will achieve what the current purpose of the indexation process is, which is providing a means to reimburse operators for movements in the actual cost components of the inputs for a service contract by having an appropriate composite index that accurately adjusts the Contract Price in the period being measured.

Option 2 provides the flexibility to expand the basket of component indices used to achieve an index. This flexibility though makes the processes to price contract procurements and administer them more complex than Option 1. However, assuming it is more relevant any such complexity should not be the basis for dismissing the option.

Our view on Option 3 is that it provides the greatest amount of flexibility and allows for the truest form of indexation pass-through and application. It does have the potential to be the most complex, but this is dependent on meaningful transparency (i.e. pricing templates and appropriate granular visibility of actual cost for operators.

Option 3 requires an increased (significant) amount of workload and effort to manage and administer. This could be minimised by the introduction of more granular and clearer costing models. Whilst we appreciate that PT contracts are likely to become more complex, application of this as an approach will require to be led, or at least facilitated, on a national basis to avoid the cost of contracts in Auckland being disproportionately indexed and potentially overpriced compared to the rest of the country.

However, Option 3 also provides the greater scope to address all contract and procurement issues:

- requirements for whole of contract life bidding and costing;
- classification of contract costs;
- ensuring that specific service input elements (e.g. driver remuneration) and clearly detailed;
- application of pertinent specific indices to different contract input components;
- ensuring that policy issues are addressed e.g. ensuring required levels of Driver Wages are maintained in each contract year;
- specific treatment of capital;
- making retrospective indexation adjustments to the Contract Price redundant - instead the index applied to the Contract Price is the resetting of the Contract value for the forthcoming period.

The above can be achieved by Option 3, allowing contract rates setting adjusted to the future value at the end of the contract. This eliminates the requirement for retrospective indexation of contracts, and requires only the Contract Price to be reset for each new period.

<u>3. Of the 3 indexation methods presented, which method or methods are you most likely to utilise/prefer and why?</u>

Option 1 is not supported, and replicates (with improvements) the current methodology around indexation. This method does not meet the goals identified in the document on page 6.

Option 2 does provide an improvement on the specificity around indexation application. However, it also retains a centralised, national approach to indexation application. This has benefits in providing consistency across the range of national operators that AT contracts with, but it does result in a sub-optimal level of granularity in price transparency and indexation application. Option 2 does assist with challenges associated with the move to LEVs, and also helps to relieve some of the current issues associated with national consistency of application challenges. If relevant guidelines / WK NZTA Procurement Manual is clearly updated to remove any potential for regionalised ambiguity, then the advantage that Option 3 provides over Option 2 may be diluted.

If systems, inputs and guidance concerns can be addressed, Option 3 would be our preferred as not only does it provide the means to break from the flawed approach that underpins Option 1 (and also to a lesser degree Option 2) with regards to contract costing and pricing. By doing so, it also requires the increased granularity and transparency around pricing which will more successfully enable NFI variations to be delivered and not just volume (i.e. service / timetable variations). A key positive outcome from Option 3 is that it allows for more accurate reflection of actual cost variations in the future. Complexity would be reduced if pricing templates are reviewed and updated in parallel. It is important for Option 3 to be viable that cost inputs are detailed sufficiently to allow

Option 3 indexation to be applied. Another key benefit from Option 3 is that PTAs will have greater visibility of the pricing and structure of bidders' proposals and application of future indexation adjustments.

We note that PTO's are not required to demonstrate that their costs have actually changed, nor do they need to represent how the change in indexation will be applied in their business.

Labour costs

4. Please provide any feedback on the proposed change for indexing bus driver labour costs to incorporate reference to the Minimum Wage. Refer Section 2.

If we have interpreted the documentation correctly, we do not believe that using indexation to set and maintain specific cost elements (e.g. Driver Wage) at a specific level throughout the life of a contract is the correct approach. This error reflects the mistaken assumption underlying the rationale of the approach that it is possible to reimburse operators for costs changes through setting the cost value of inputs that are then sustained by applying a particular index to the Contract Price. This assumption incorrectly assumes that:

1. the index will sustain the cost element (e.g. Driver Wages) at the specific value desired;
2. the margin level of the operator will also be sustained, although the cost input in question is in fact a pass through; and
3. that the operator will pass through to the Drivers each quarter the index movement, rather than retain the additional Contract value until the next adjustment to Driver Pay.

To satisfactorily sustain specific levels of remuneration for operator staff, we believe that Option 3 would require to be adopted, complimented by more detailed pricing inputs down to individual types and position level of employees. During future procurement, for the benefits from Option 3 to be realised, PTAs should be encouraged to include additional specific clauses in contract(s) committing the parties to the outcomes sought, supported by full open book accounting (and reporting) to validate that levels of remuneration are being sustained.

5. Is 20% relativity over the Minimum Wage for the Sector Minimum Bus Driver Wage (Regional) appropriate? If not, what should it be and why?

From an Auckland perspective, we believe that the benchmark point should be the 'Living Wage' ($27.80 from 1 September 2024) as opposed to the Minimum Wage. Wages in Auckland are traditionally higher across many sectors, and by pegging wages to the national minimum wage impacts the ability of Auckland public transport operators to recruit drivers to a labour market that has a higher cost of living compared to the rest of the nation.

There is also a consideration regarding how any Collective Agreements are to be dealt with. In numerous cases, where there is a Collective Agreement in place, these agreements often extend for a period of more than 12 months and are progressed outside of any indexation methodology.

6. Please provide any feedback on the intention to retain the status quo for indexing non-driver labour costs.

From our interpretation of the indexation application methodology proposed, the status quo (whilst more closely aligned with Option 1) is not a viable option moving forward.

We are aware that several PTOs align other grades and positions within their workforce to those of bus drivers (and ferry skippers), these include various mechanics, roster staff, and training personnel. There are a variety of "Other" Labour types so would be difficult to have a separate LCI for them, unless defined / broken down into further categories'; to pin other parts of the workforce to the Living Wage or Minimum Wage would potentially lead to increased wage inflation and would also transfer the risk around future salaries to the PTA. This would not be supported as PTOs are best placed to manage labour relations, and this is one of the major activities that PTAs are buying in from PTOs.

If individual labour rates are clearly identified in financial bid models, then in support of the operators bid, the financial bid model could typically employ the LCI to all indirect labour inputs. Should there be a requirement for PTOs to remunerate their staff with pre-determined minimum levels of remuneration, these costs would need to be:

1. Specified as a requirement to bidders to be met (Floor);
2. Specifically identified in the bidder's financial model supporting the bid proposal;
3. Specified in the Contract Partnering Agreement as a requirement to be met by the operator;
4. able to be validated through the application of open book costing and accounting.

Capital costs

7. Please provide any feedback on the issues and considerations in relation to the indexation of capital costs in Section 3.

Using Option 3 would enable PTAs to construct an indexation mechanism relevant to the specific contract model in question and is far more preferable and suitable to where there is considerable capital outlay.

We believe that the indexation of Capital Costs or any other costs that are fixed in nature or are inputs required to provide the contracted services, provides a guaranteed unearned profit stream to the operator, and that applying indexation on capital and PVR costs does not reflect the cost of capital, the hedging of debt or fixed term leases.

Returns to operators for capital employed in meeting contract commitments is generally ensured through the Weighted Average Cost of Capital (WACC) and Internal Rate of Return Mechanisms earned by the contract and returned to the Operator. Having a pricing template whereby WACC is included for the whole of the contract is a preferred methodology for Auckland Transport, and agreement can be reached between PTAs and PTOs that should the WACC assumed for the life of the contract varying substantially through the contract term that the variation mechanism is available for either party to reasonably raise a variation request.

8. Please provide any feedback on the treatment of capital costs under each of the indexation methods.

Option 3 is the only suitable option that can ensure that contract cost inputs are indexed appropriately throughout the life of the contract. As discussed above, these would be set at the time of bidding where costs are correctly classified and indexed in order to set the future Contract Start Price.

Option 1 and 2 appear to continue the current state of play that provides PTOs with a guaranteed unearned profit stream by indexation being applied on top of cost of capital already included in contract price.

Indexation timing

9. Please provide any feedback on the proposed change to the timing of indexation payments in Section 4.

Our understanding of the options presented are that options 1 and 2 apply indexation and results in similar outcomes in the same manner as the current approach, (i.e. retrospectively back to the quarter in which the expenditure was incurred). This reflects the assumption that it is necessary to reimburse operators for actual movement in the costs of service inputs in the period the services are delivered via an index adjustment (that reflects the movement) to the Contract Price. By doing so, minimising the risk for PTOs and removing the need / requirement for PTOs to manage their cost base and purchasing position. Furthermore, the retrospective nature of the current approach results in complex washups of past contractual commitments and accounting for back payments on contract variations (read 10 below), and KPI bonus/deduction commitments.

The proposed timing of the indexation will remain the same, with clarity on how to apply the indexation and the quarterly wash ups articulated clearly, as well as the indexation of variations. We would anticipate that the ‘’ finalised indexation calculation” could be implemented by AT as soon as practical.

A key outcome that AT believes should be maintained is for all Operators to retain the ability, and responsibility, to manage costs and by doing this will support the suitable allocation of risk between the parties, and that the PTOs remain accountable for their expenditure

Whichever outcome is settled, it is imperative that there is consistency across all regions and that there is clear direction provided by WK NZTA as to how indexation calculation should be applied and paid.

10. Please provide any feedback on the guidance for the application of indexation to variations.

Aside from standard timetable service variations, recent history has proven that a large number of variations are not actually executed through to payment until after the actual variation has gone live on the road. This is due to either the complexity of interpretation of the application of governmental legislation (e.g. ERAA), funding becoming available / confirmed post implementation (e.g. driver wage uplift), or a dependency on actual capital costs being confirmed before payments can be finalised (e.g. LEV roll-out). This results in a backdated liability between the PTA and PTOs, and in some cases this liability may stretch over several quarters.

This situation requires valuing the backdated payment to align with the indexation in each quarter. The situation is further complicated by the delay in publication of the index (usually the last week of the second month of the quarter following the quarter being measured). If the backdated has already been processed, it then needs to be reprocessed and a further adjustment calculated for the difference between the recalculated variation backdated and what has been previously processed. The same is also the case for KPI bonus/abatements processed in prior months.

As a result, variations require multiple transactions, to be unindexed back to base AGP (contract price), applied to contracts and then reindexed up.

Implementation

11. Please provide any feedback on the implementation approach in Section 5.

Timing and implementing any new approach will always have ramifications for current contracts and for contract tenders either being mobilised for future operation or out to tender.

AT has a new PTOM Unit going live in April 2025, and we would prefer commencement of the new application and methodology to be aligned with this contract start date.

What is required is clear timelines, a clear articulation of calculation and application, an all-of-industry understanding and alignment of the processes and systems, and ensuring that each PTA has the resources available to apply the selected option. From an AT perspective, there will be significant system change and alterations to be able to accommodate any new methodology for which AT has limited resourcing and no funding available to progress.

Other

12. Please provide feedback on any other areas of interest in relation to indexation that have not been addressed in this engagement document.

- The value of In-Service Labour must retain a constant value when moved from one index to another. This has been noted as an issue in Auckland with the transition of Contracts that have historically used Diesel Buses (and have had the Diesel Bus index applied) to EVs (which in turn uses the EV index). Because of the composition of each index (there are 4 components in the Diesel Bus index and 3 components in the EV index), the proportion of the index applied to Labour in the EV index is greater that in the Diesel index. When applied to In-Service Hours (Labour) results in different Labour Cost outcomes for EV Labour versus Diesel Labour. This occurs both within or between Contracts. This is because in each quarter, depending on the respective cost movements, each index is moving differently, and the labour cost will move in the same direction and in the same proportion according to the applicable index rate applied to the Labour Cost.
- The 'basket of goods' determination and allocation as currently used needs changing and reviewing more frequently in the future. A minimum review every 3 years as part of the GPS process would be supported, involving PTAs. We note that PTO's are not required to demonstrate that their costs have actually changed, nor do they need to represent how the change in indexation will be applied in their business.
- AT would support the release and utilisation of a monthly indexation measure to better reflect the change in the cost to operators.
- There needs to be some clearer definition of what 'other' is when used in the context of 'other costs'
- Whilst a date of July 2025 is referenced in the document for commencement, we would welcome further guidance (and confirmation that funding would be available for any resultant contract value uplift) as to how existing contracts should be treated; and whether there is an expectation for PTAs to continue with legacy process in tandem with implementing new methodology for new contracts.
- We support the requirement – as required under the Wage Uplift MOU – for PTOs to provide evidence / confirmation to PTAs that labour indexation has been passed on. Acknowledging the annual nature of wage reviews / Collective Agreements, we propose that labour indexation is considered to be applied on an annual basis and not quarterly.

- Further to consideration of an annual Labour Index, the frequency of the calculation for other cost categories should be considered and reviewed, as not all cost categories should be regarded as being appropriate for quarterly indexation application. Finally, have overseas jurisdiction's been considered and assessed in their application of indexation, Australia in particular would be of interested particularly as several of Auckland's operators have (or may have) overseas interests and experience.

We are keen to collaborate with you to achieve a public transport system that provides value for money for Auckland. Overall, we support the need to index bus pricing for the reasons outlined in the NZTA document. We would be happy to discuss any of the above feedback with you in person. and look forward to hearing from you.

Warm regards,

Stacey van der Putten
Director Public Transport & Active Modes
Auckland Transport