

Bus indexation review

August 2024 consultation document

Feedback sought by 30 August 2024

Executive Summary

NZ Transport Agency Waka Kotahi (NZTA) is seeking feedback on proposed changes to improve how indexation is applied to bus operating contracts.

Background

The NZ bus indexation mechanism adjusts payments to contracted bus operators to reflect general inflationary changes in input costs for labour, fuel, road user charges (RUC) and other costs over time.

The current bus indexation mechanism was developed in the early 1990s with periodic reviews since that time. Sector stakeholders have raised concerns that elements of the bus indexation mechanism may no longer be fit for purpose. In response to these concerns, NZTA has undertaken a review of the bus indexation mechanism focusing on the following key areas:

- Accommodating different delivery models and levels of complexity
- Indexation of bus driver and other labour costs
- Indexation of capital costs
- Indexation payment timing

Key proposed changes are summarised on this page with further content and context included within the body of this document.

New indexation methods proposed

To help accommodate different delivery models and levels of complexity, NZTA proposes to retain the current indexation method and introduce two additional methods as follows:

- Composite method (existing)
- Elemental method (new)
- Advanced method (new)

Labour costs

Some stakeholders consider that an inability of the current indexation mechanism to respond to changing labour market conditions contributed to the recent bus driver shortages. To address these concerns, the review proposes that indexation of bus driver labour costs moves to a new 'hybrid' method that retains use of the current labour cost index (LCI) while maintaining a prescribed buffer for bus driver wages over the minimum wage.

Related to this, NZTA proposes publishing and annually updating sector minimum bus driver wage rates for tendering purposes; and formalising a procurement rule that requires the labour component of indexation payments to be passed through at least annually to the bus driver workforce in full for all new contracts.

Capital costs

There are different sector views on whether to index capital-related costs. This document proposes that the composite index retains the current practice of indexing capital costs, while the new elemental and custom indexation methods will allow for alternative approaches.

Indexation timing

There is an unavoidable lag in the publication of index values for a prior quarter, which causes a corresponding lag in the timing of when indexation payments for a quarter can be made. Some in the sector have expressed concern that this lag impacts operators' cashflow. To address this and enable consistency in application across the sector, we propose to establish monthly indexation payments with quarterly washups as standard practice.

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Introduction

This document sets out a range of options for consideration and feedback on potential changes to the bus indexation mechanism.

Bus operating contracts funded by public transport authorities (PTAs) and NZTA are required to be indexed using the NZTA bus indexation mechanism. The mechanism provides PTAs with the basis on which to calculate periodic adjustments to contract payments based on changes in input costs for labour, fuel, road user charges (RUC) and other costs over time.

The objectives of this approach are to support efficient tender pricing by reducing the amount of cost fluctuation risk that would otherwise be priced in by tenderers. It also ensures that PTOs are not placed at financial risk due to exposure to unquantifiable cost fluctuation risk over the term of their contracts.

Sector stakeholders have identified aspects of the bus indexation mechanism that may no longer be fit for purpose for the current PT commercial environment.

The primary focus of concerns have centered on:

- Application of indexation under different PT delivery models,
- The effectiveness of the current mechanism to respond to other influences impacting bus driver and other wage rates,
- Application of indexation to capital related costs, and
- The effect of indexation payment timing on cashflow.

In response to these concerns, NZTA is undertaking a review of the bus indexation mechanism. A key input to this review is research undertaken by Deloitte for NZTA that involved interviews with stakeholders and analysis of underlying drivers of indexation.

The scope of the indexation review covers the following key focus areas:

- Accommodating different delivery models and levels of complexity
- Indexation of bus driver and other labour costs
- Indexation of capital costs
- Indexation payment timing

This document sets out a range of options for consideration and feedback on potential changes to the bus indexation mechanism.

At this stage, this indexation review applies to the bus sector. It is intended that a similar review will be undertaken for the ferry and rail sectors in due course.

NZTA is seeking feedback from the public transport sector on the information and options presented in this engagement document. Engagement questions are included at the end of the document to help prompt feedback.

Feedback sought by 30 August 2024

Please submit feedback by responding to the questions in this document and emailing your responses to public.transport@nzta.govt.nz by 30 August 2024.

Current approach to indexation

The bus industry currently uses two composite indices, which are applied quarterly by PTAs to the annual contract price and variation rates within individual bus operating contracts.

The current bus indexation mechanism was developed in the early 1990s, based on the New Zealand standard construction contract (NZ3910) and has been applied to all new bus contracts since then, with two updates to the mechanism during that time.

Recognising the transition to zero emission buses, there are now two bus indexation mechanisms – one for diesel buses and one for electric buses, both of which are composite indices. In these indices fuel, labour and road user charges (RUC) are linked to specific input indices, while the ‘Other’ component uses a tailored Producer Price Index (PPI) prepared by Statistics New Zealand to track specific costs in the road transport industry that are relevant to the bus sector.

A composite index is one in which more than one component is used to make up a single index value, with each component driven by an input index and an average weighting. The average weighting reflects the proportion of costs that each component represents in the total cost when considered as an industry average. The weightings are intended to be representative of the national bus industry averages, and not a direct reflection of the cost base for each individual operator.

Following a 2020 review of the bus indices by PwC two key changes were made:

1. The Stats NZ index used for driver labour was updated from LCIQ.SH3119 Machinery Operators & Drivers to a tailored sub-index Road & Rail Drivers (Series ref: 31240206).
2. The ‘Other’ index was updated to a sub-index prepared by Stats NZ for NZTA: Other costs (bus) - Road transport excluding fuel, road and water transport (Series ref: 31240165).

Diesel bus index

Component	Average % of contract cost	Index
Driver labour	46.5%	LCI (road and rail drivers)
Fuel	7.9%	Commercial diesel (bulk)
RUC	8.5%	RUC (representative bus rates)
Other	37.1%	PPI (road transport, excl. fuel, road and water transport)

Electric bus index

Component	Average % of contract cost	Index
Driver labour	53.4%	LCI (road and rail drivers)
Fuel	4.0%	Electricity (commercial consumers)
RUC	0.0%	Not currently applicable
Other	42.6%	PPI (road transport, excl. fuel, road and water transport)

Purpose of indexation and principles

The purpose of indexation is to adjust payments to PTOs to reflect the general movement of input costs that are outside the control of the PTO.

Purpose of indexation

Indexation is the mechanism used in contracts to adjust the contracted price over time, thereby allocating general cost fluctuation risk to the PTA and NZTA.

Indexation is intended to de-risk cost changes for PTOs due to inflationary effects on cost inputs, while maintaining incentives for PTO efficiency.

Indexation is not intended to compensate PTOs for increases beyond economy wide cost fluctuation or to address all unforeseen changes during the contract term.

An indexation mechanism is used in contracts because it:

- Reduces the risk premium associated with general cost fluctuation risk, which PTOs would otherwise price in.
- Saves effort and resources by linking prices to an agreed mechanism and indices, minimising the need for ad hoc negotiations and contract variations.
- Provides a consistent approach that is largely perceived as fair (driven by actual data from an impartial third party).
- Maintains commercial tension on PTOs to source and consume inputs as efficiently as possible as they are not directly compensated for cost increases beyond general economy wide movements.

Design principles

Supports intended risk allocation

Ensures payments to PTOs reflects changes in the nominal value of relevant cost inputs resulting from inflation. Indexation is meant to ensure PTOs are compensated for underlying inflation while also preserving incentives to efficiently control costs.

LTMA aligned

Supports realisation of LMTA objectives, including enhanced flexibility of approach, decarbonisation, improved terms and conditions for the PT workforce, and improved partnering between PTAs and PTOs while achieving value for money.

Promotes confidence

Supports industry confidence and trust in the indexation mechanism by enabling consistent and transparent application by PTAs.

Minimises transaction costs

To the extent practicable, minimises administrative costs and complexity of indexation. This includes consideration of the level of skill required to apply and understand the indexation option.

Responsive

Indexation mechanism works in conjunction with other contractual mechanisms to respond to changes in inflation, but also unforeseen material cost shocks – recognising that indexation cannot deal with all circumstances.

1. Indexation methods

Indexation under different models and complexity

The transition to zero emission bus fleets will impact cost structures and the complexity of some contracts, impacting how indexation may be applied in some contracts.

Significant capital investment, in fleet and charging infrastructure, is expected as the bus fleet shifts to zero emission buses which may be undertaken by PTAs, PTOs or a mixture.

Cost structures are also likely to be more dynamic during the transition period from diesel fleets to zero emission and as technology develops. The result is the potential for misalignment with the current composite index as these changes create greater variation in the relevant cost inputs for different PTOs.

To improve effectiveness in delivering PT services, there is a need for the sector to develop a range of new delivery models for public transport. New, more complex models such as alliancing for PT contracts may require contract specific approaches and new indexation guidance.

Contract management capacity and capability differs across the sector. PTAs need to consider the level of complexity that they and their contracted service providers can effectively manage.

In recognition of this, NZTA proposes to retain the current indexation method and introduce two additional methods to enable indexation to be better tailored to the nature of context of different contracts.

The methods are summarised as follows.

1. **Composite method** – the status quo bus indexation mechanism that applies specified cost indices to cost weightings that are based on an industry average.
2. **Cost elemental method** – status quo cost indices applied to cost weightings that are reflective of the actual costs for each year of a specific contract, rather than using the current industry average cost weightings.
3. **Advanced method** – a tailored approach to meet the needs of alternative delivery models or non-standard contract features.

An additional approach that may be appropriate in certain circumstances is not to apply indexation to a contract at all. The 'No Indexation' approach may be appropriate in circumstances where indexation is not needed or best sits with the PTO due to the nature of the proposed contract, delivery model and/or procurement approach, e.g. short-term contracts where the forecast inflation risk is low, and PTOs are able to price the contracts in nominal terms.

The indexation method to be applied to specific contracts would need to be identified in PTAs' procurement strategies with a brief commentary on why the method is applicable within a specific contractual context.

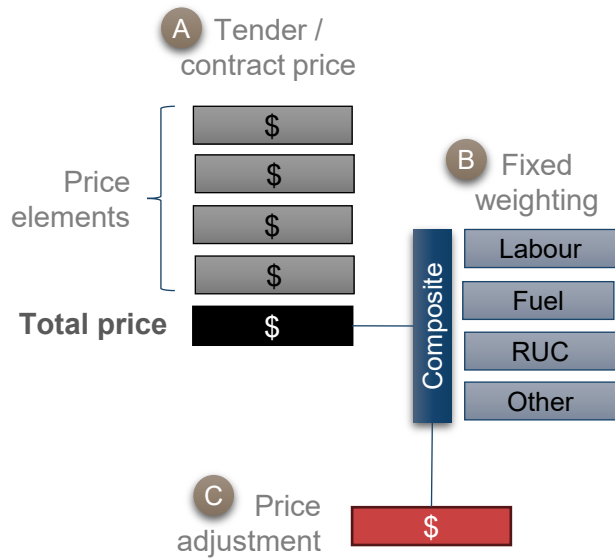
Indexation methods

Three indexation methods have been identified to provide different tools for managing cost fluctuation risk.

1

Composite indexation method

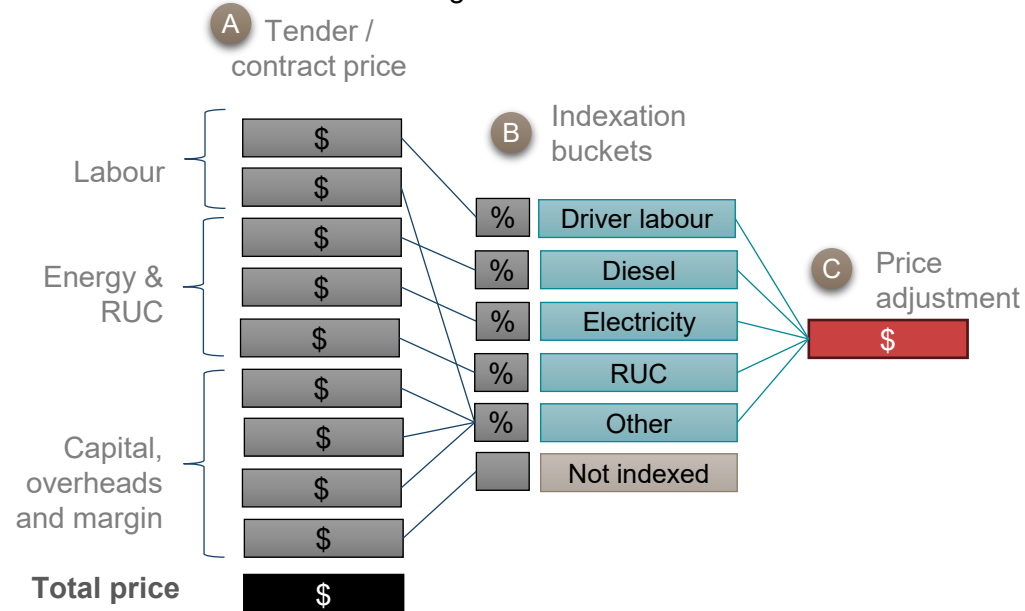
Indexation weightings are fixed and based on an industry average cost structure.



2

Cost elemental indexation method

Cost structure and indexation weightings are derived from the tender pricing submission. Potential to adjust for material changes during the contract term by agreed variation.



3

Advanced or customised method
Subject to NZTA agreement on a case-by-case basis

CUSTOM MADE

Application of the composite indexation method

To address the transition to electric bus fleets, the current composite index has been updated to provide the sector with a quarterly diesel bus index and electric bus index.

During the indexation review, some stakeholders questioned the appropriate application of the two indices for diesel and electric buses.

NZTA is comfortable with and recommends the common practice approach adopted by most PTAs for application of the two indices for contracts operated using both diesel and electric vehicles.

The common practice approach adopts the following methodology:

1. Calculate an index weighting (out of 100%) using the in-service kilometres undertaken by each vehicle type (diesel and electric) for the month in question as a proxy for weighting the proportion of the Monthly Service Payment to be indexed by the diesel bus index and the electric bus index respectively.
2. Multiply the Monthly Service Payment by the diesel bus weighting (e.g. 40%) for the month and apply the relevant diesel bus index to calculate the indexation for the month relevant to the PTO's diesel bus operations.
3. Multiply the Monthly Service Payment by the electric bus weighting (e.g. 60%) for the month and apply relevant electric bus index to calculate the indexation for the month relevant to the PTO's electric bus operations.
4. Add the two indexation values together to calculate the total indexation amount payable by the PTA for the month in question.

A worked example is provided below.

Monthly Service Payment	A	\$500,000
Proportion of in-service km by diesel bus	B	40%
Proportion of in-service km by electric bus	C	60%
Diesel Bus Index movement for the quarter (relative to tender close)	D	7%
Electric Bus Index movement for the quarter (relative to tender close)	E	5%
Calculation	$(A \times B \times D) + (A \times C \times E)$	
Result	\$29,000 = 14,000 + 15,000	

Application of the cost elemental indexation method

The cost elemental indexation method is able to more accurately reflect the changes in cost structure of a specific contract over the term of the contract.

		Contract Year 1	Contract Year 2	Contract Year 3	Contract Year 4
Contract pricing from tender pricing template	Labour	\$	\$	\$	\$
		\$	\$	\$	\$
	Energy & RUC	\$	\$	\$	\$
		\$	\$	\$	\$
		\$	\$	\$	\$
	Assets, overheads and margin	\$	\$	\$	\$
		\$	\$	\$	\$
		\$	\$	\$	\$
		\$	\$	\$	\$
	Total price	\$	\$	\$	\$
Indexation bucket weightings	Driver labour	%	%	%	%
	Fuel	%	%	%	%
	Electricity	%	%	%	%
	RUC	%	%	%	%
	Other	%	%	%	%

Example Contract Indexation Cost Weightings

Contract year	1	2	3	4
Labour	40%	48%	50%	53%
Diesel	20%	12%	8%	0%
Electricity	0%	5%	9%	13%
RUC	5%	6%	7%	8%
Other	15%	29%	26%	26%

The contract indexation cost weightings are derived from the PTO's tender pricing submission and entered into the PTO's contract in an applicable table (per example) in the contract payments schedule.

The quarterly movements in each of the NZTA bus indexation mechanism indices are applied to the PTO's monthly payments in accordance with the weightings for the relevant financial year.

The weightings remain fixed for the term of the contract subject to any major variations that may have a material effect on the PTO's cost structure and the PTA and PTO agree to vary the indexation cost weightings for the remainder years of the contract.

The weightings would not be adjusted for minor variations.

Indexation methods

Enabling PTAs to choose between three indexation methods provides flexibility for managing inflation risk in a way that is most appropriate for the contracting arrangement.

	Method 1 Composite Index	Method 2 Cost Elemental	Method 3 Advanced
Why choose this pathway?	<ul style="list-style-type: none"> • Simple to administer. • Easy to understand and the industry already has a high level of familiarity with it. • Familiarity and simplicity promotes confidence. • Does not require additional resources or capability. 	<ul style="list-style-type: none"> • Aligns with intended risk allocation. • Can support a range of different delivery models. • Better reflects the underlying cost structure of each PTO. 	<ul style="list-style-type: none"> • Allows tailored risk allocation. • Supports advanced service delivery models. • Supports alternative pricing approaches.
When is it appropriate?	<ul style="list-style-type: none"> • Appropriate in circumstances where PTAs want to adopt a more simplified hands-off approach. • Appropriate under standard delivery models • PTOs have confidence in the certainty of the indexation approach and price accordingly. 	<ul style="list-style-type: none"> • Appropriate where PTAs and PTOs are willing and able to take a more active role in contract administration. • More appropriate where contract cost structure is different to the industry average and /or likely to change over the terms of the contract. • Requires greater price transparency in tenders (or negotiations) to enable actual weightings of the cost categories to be determined. 	<ul style="list-style-type: none"> • Appropriate for when alternative delivery models and contract features are to be utilised.
Cost indices and weightings	Existing Diesel and Electric bus indexation indices applied at a composite level using industry average cost category weightings.	Existing Diesel and Electric bus indexation indices applied using contract specific cost category weightings.	Cost items could be indexed on a more granular level and different cost categories indexed by applicable indices.

2. Labour costs

Indexation and labour costs

As well as addressing general cost movement risk, a focus of the indexation review is to identify options that will help support a sustainable public transport workforce.

The labour component of the current indexation mechanism relates to bus driver labour costs and is considered by some in the sector to have contributed to the recent bus driver shortages by not adequately responding to changing market conditions and consequential impacts on driver wage rates.

The sector has recently lifted bus driver wages through specific interventions, and in conjunction with other measures, such as immigration settings, has largely resolved the sector shortages for the time being.

While the indexation mechanism is not intended to manage for all labour market challenges, an objective of the indexation review has been to consider options that will respond more effectively to such challenges in the future, including options that sit alongside the indexation mechanism.

Outcomes sought from the review of labour cost indexation include:

- Be more responsive to external forces that may drive up labour supply costs, such as relativity to competing sector wage rates,
- Enable 'sector minimum' wage rates to be adjusted on an annual basis to reflect inflationary movements,
- Retain tension on PTOs to operate efficiently and maintain value for money,
- Ensure the mechanism is simple to understand and to administer.

The review in relation to labour cost indexation has sought to respond to the following primary concerns raised by stakeholders with the current approach to labour cost indexation:

- The effectiveness of the current Labour Cost Index (LCI) to enable bus driver wages to be adjusted in line with cost of living increases,
- The effectiveness of the current LCI index to maintain relativity against other reference wages, such as the minimum wage, and
- The appropriateness of non-driver costs being included under 'Other cost' and indexed by Producer Price Index (PPI) (road transport).

Summary of proposed changes for feedback:

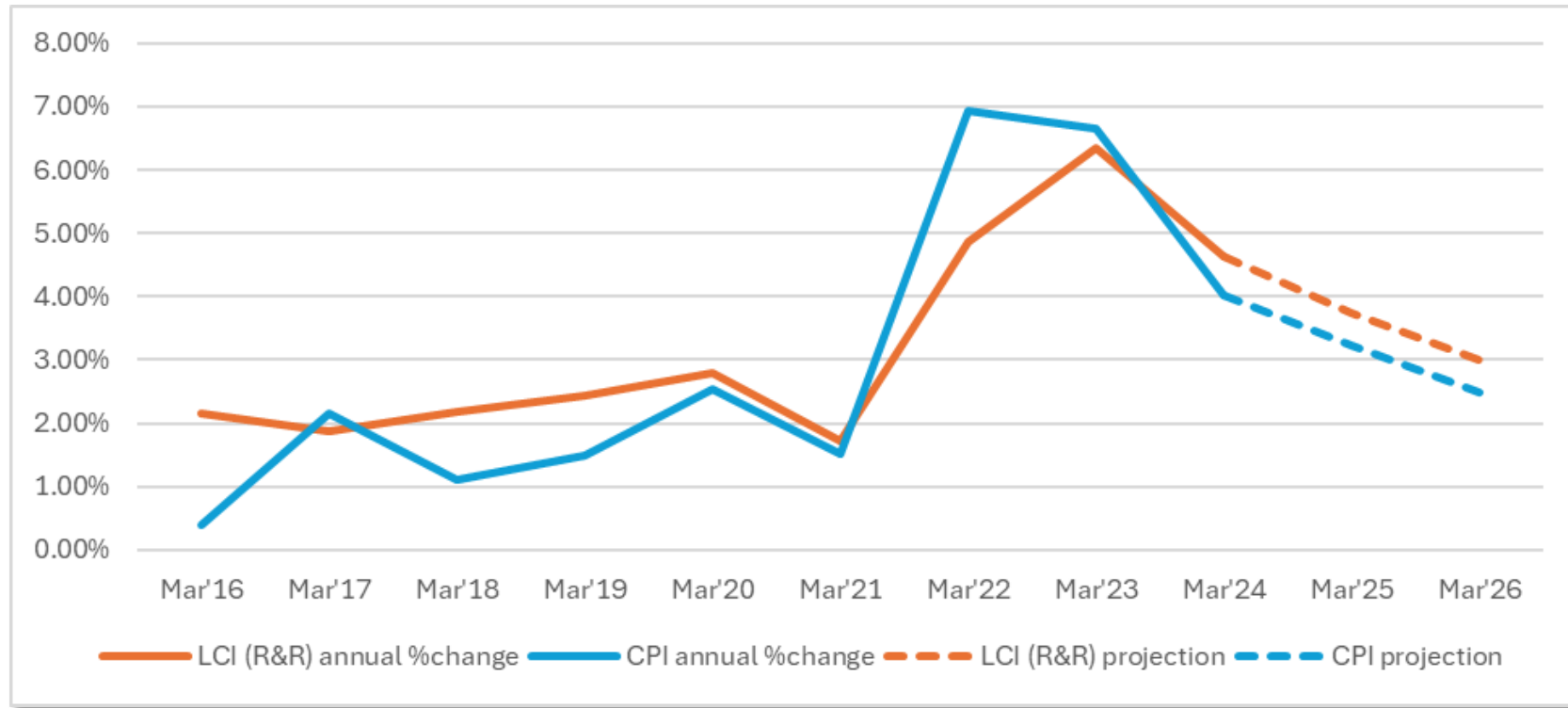
- Bus driver labour costs continue to be indexed using the existing LCI sub-index with an additional mechanism introduced to maintain a prescribed relativity (e.g. 20%) above the Minimum Wage.
- Associated with this, new procurement rules would be established:
 - A rule requiring PTOs to pass on the full labour cost component of indexation payments to drivers through wage adjustments that occur at least annually.
 - A rule to ensure sector minimum bus driver base wage rates are matched or exceeded when procuring bus services. To enable this, existing sector minimum base rates (urban and regional) will be indexed annually by NZTA and the updated rates communicated to the sector for tendering purposes.

The following pages provide further content and context relevant to the proposed changes.

Labour cost movements and general inflation

Historically, the LCI index (including the road and rail drivers sub-index) has maintained parity or exceeded cost of living increases (as represented by CPI). However, very high inflation in the cost of goods and services post-Covid created a short-term disruption to this trend.

LCI(R&R)* vs CPI annual % change and projection**



Other than the post-Covid CPI spike, indexation of bus driver wages based on the LCI sub-index for road and rail drivers has generally matched or exceeded movements in CPI over the past decade.

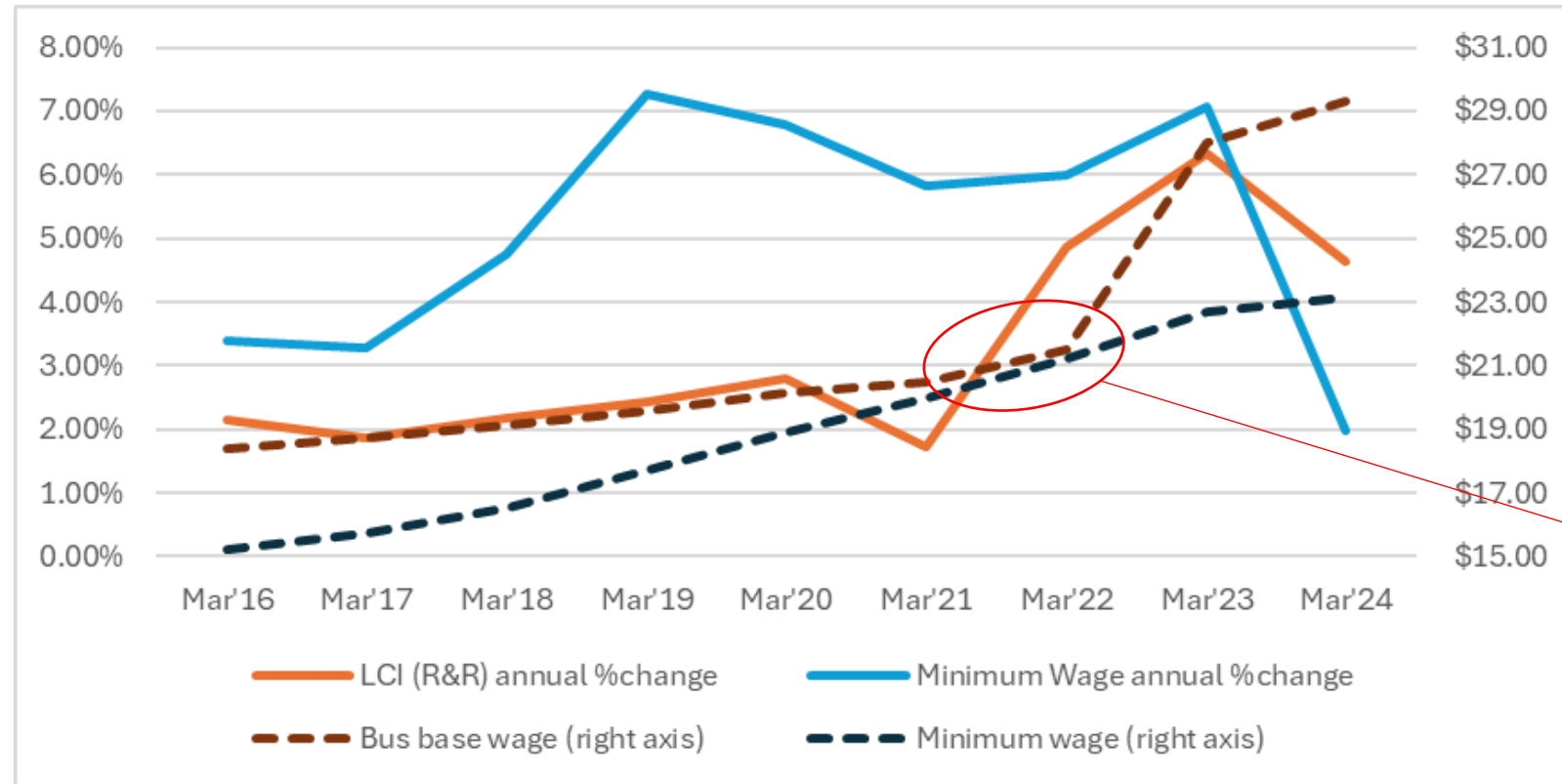
* The updated NZTA labour index based on road and rail drivers was re-baselined to June 2014, therefore there is no movement data available prior to this period.

** Projections in movements in CPI and wage growth have been interpolated from [Reserve Bank of NZ - Survey of Expectations \(Business\) – February 2024](#).

Bus driver wages relativity to minimum wage

Until the recent intervention to lift driver wages, increases in the minimum wage at rates greater than LCI have resulted in a closing gap between bus driver wages and the minimum wage in recent years.

LCI(R&R) vs Minimum Wage



	Indicative bus driver base wage	Minimum Wage	Relativity
Mar '15	\$ 18.00	\$ 14.75	22.0%
Mar'16	\$ 18.39	\$ 15.25	20.6%
Mar'17	\$ 18.73	\$ 15.75	18.9%
Mar'18	\$ 19.14	\$ 16.50	16.0%
Mar'19	\$ 19.60	\$ 17.70	10.8%
Mar'20	\$ 20.15	\$ 18.90	6.6%
Mar'21	\$ 20.50	\$ 20.00	2.5%
Mar'22	\$ 21.49	\$ 21.20	1.4%
Mar'23	\$ 28.00	\$ 22.70	23.3%
Mar'24	\$ 29.29	\$ 23.15	26.5%

For discussion – not government policy

Proposed change to indexation of driver labour costs

The review of indexation for bus driver labour costs considers the use of the current LCI mechanism against other general inflation measures and relativity against the Minimum Wage.

Analysis undertaken during this review indicates that the longer-term systemic trend of the closing gap between bus driver wages and the Minimum Wage over the period 2016-2022 is more likely to have contributed to the challenges in recruiting bus drivers than the differences between the LCI and CPI index over the same period.

Therefore, expanding the scope of labour cost indexation to consider, not only wage growth in directly competing sectors (i.e. the wider road and rail sector on which the LCI sub-index is based) but also lower skilled roles that earn at or close to the Minimum Wage, will help to maintain bus driver wage rates at a level that is competitive against similarly skilled career options.

To achieve this, NZTA proposed to introduce a new 'hybrid' indexation approach for bus driver labour costs that continues to use the existing LCI road and rail driver sub-index but also seeks to maintain a prescribed relativity for bus driver wages over the Minimum Wage.

Indexing for cost-of-living increases using CPI has been considered but not recommended for the following reasons:

- The purpose of indexation is to compensate PTOs for movements in cost inputs, which for labour costs are driven primarily by labour market conditions which are reflected in movements in related sector wage costs.
- Movements in CPI are significantly more variable than LCI. Consequently, pegging labour costs to CPI is likely to have a distortionary effect on labour cost indexation.

The proposed new approach seeks to strike a balance between indexing bus driver labour costs by movements in related industry wages while also ensuring relativity is always maintained above the Minimum Wage. This supports bus driving being an attractive career option and better reflects the skills required.

Hybrid approach – status quo index with reference wage relativity

Bus driver labour costs continue to be indexed using the existing LCI sub-index while maintaining a prescribed relativity (e.g. 20%) above the Minimum Wage.

Considerations

- Historical data shows that linking driver wages to movements in the Minimum Wage would have increased driver wages at a faster rate than the current mechanism over recent years and potentially would have made bus driving more attractive.
- The wage uplift in 2022 reinstated the relativity between bus driver wages and the Minimum Wage to pre-2016 levels.
- Lesser annual increases in the Minimum Wage are expected in the medium term than occurred between 2018 and 2023.
- The new approach maintains the status quo while enabling relativity adjustments to labour costs (when necessary) to be administered as part of the business-as-usual indexation process, avoiding wage relativity risk and ad hoc sector interventions to mitigate falling relative wage rates.

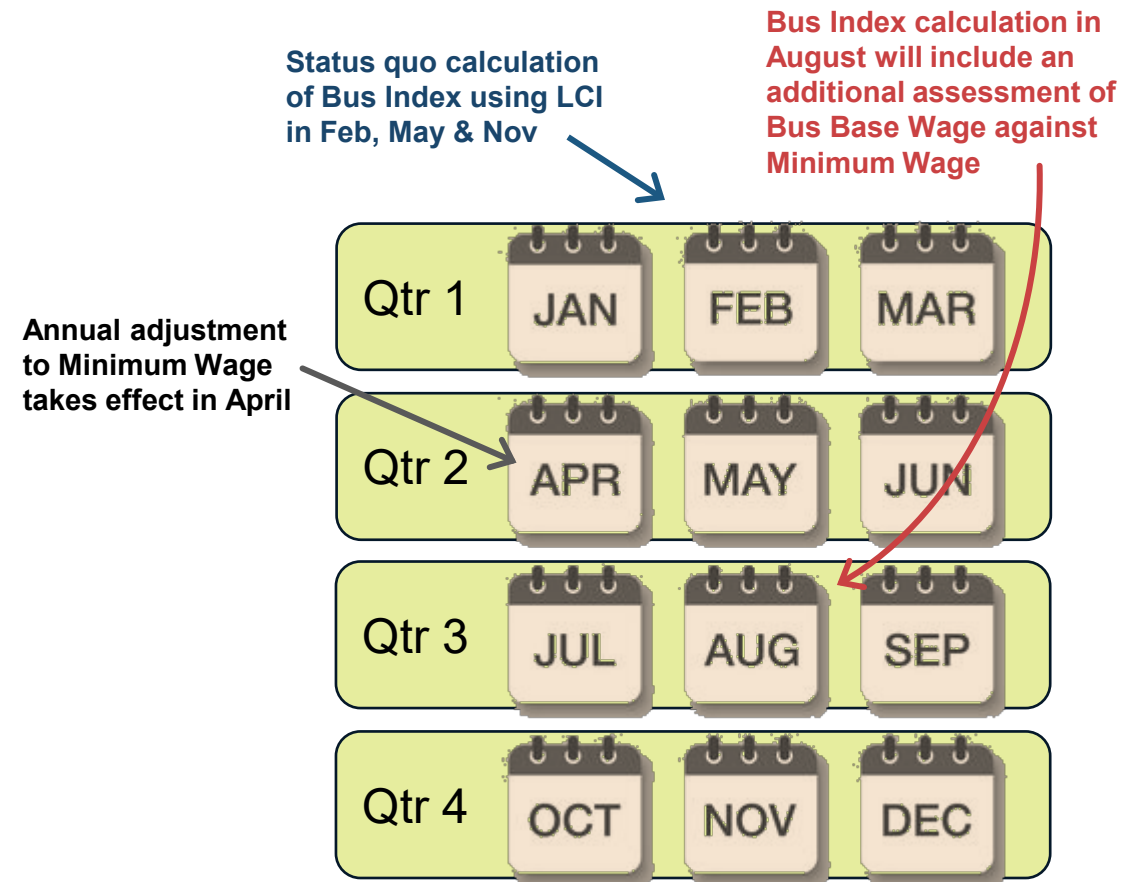
Applying the new labour indexation approach

The new method of determining the indexation adjustments for bus driver labour costs will be undertaken by NZTA as part of the quarterly publication of the Bus Indexation Mechanism.

The mechanism for determining quarterly labour cost changes will be undertaken by NZTA using the new hybrid approach as follows:

- On each of the Bus Index publish dates in February (for the index value applicable in Q4 of prior year), May (for Q1 of current year) and November (for Q3 of current year), NZTA will publish the labour cost index based on the status quo LCI index for Road & Rail Drivers, i.e. no change to current practice in these quarters.
- Adjustments to the Minimum Wage are notified in February each year and take effect in April of that year. Therefore, Q2 is the relevant quarter to consider if an additional adjustment is needed to the labour cost index to ensure bus driver wages maintain a prescribed relativity over the Minimum Wage.
- On the Bus Index publish date in August (for the index value applicable to Q2 of the current year), after applying the LCI index to the sector minimum base bus driver wage (regional), the wage would be compared against the Minimum Wage current at that time.
- Should the difference between the regional bus driver wage (after LCI indexation is applied) and the Minimum Wage be less than 20%, the percentage increase required to lift the regional bus driver wage to a level that is 20% higher than the Minimum Wage would be applied to the labour cost component of the NZTA bus index instead of the LCI value.

A worked example of how the adjustment on an annual basis would be calculated and applied is provided on the following page.



Proposed labour cost indexation worked example

Year 0 Bus Base Wage (Regional)		\$28.00								
	LCI(R&R) annual movement (hypothetical)	Minimum wage (hypothetical)	Minimum Wage annual %change (hypothetical)	Min Wage +20%	LCI or adj. to maintain 20% over Min Wage	Labour cost annual adjustment (hybrid method)	Adjusted Bus Base Wage (Regional)	Premium over Minimum Wage	Adjusted Bus Base Wage (Urban)	
Year 0		\$ 23.15		\$ 27.78			A 28.00	21.0%	\$ 30.00	
Year 1	B 2.14%	\$ 23.50	1.51%	C 28.20	\$ 0.60	D 2.14%	\$ 28.60	21.7%	\$ 30.64	
Year 2	1.88%	\$ 24.00	2.13%	\$ 28.80	\$ 0.54	1.88%	\$ 29.14	21.4%	\$ 31.22	
Year 3	2.17%	\$ 26.00	8.33%	\$ 31.20	\$ 2.06	7.08%	W 31.20	20.0%	\$ 33.43	
Year 4	X 2.44%	\$ 27.00	3.85%	Y 32.40	\$ 1.20	Z 3.85%	\$ 32.40	20.0%	\$ 34.71	
Year 5	2.80%	\$ 28.00	3.70%	\$ 33.60	\$ 1.20	3.70%	\$ 33.60	20.0%	\$ 36.00	
Year 6	1.71%	\$ 28.50	1.79%	\$ 34.20	\$ 0.60	1.79%	\$ 34.20	20.0%	\$ 36.64	
Year 7	3.00%	\$ 28.75	0.88%	\$ 34.50	\$ 1.03	3.00%	\$ 35.23	22.5%	\$ 37.74	
Year 8	1.50%	\$ 29.15	1.39%	\$ 34.98	\$ 0.53	1.50%	\$ 35.75	22.7%	\$ 38.31	
Year 9	1.20%	\$ 30.00	2.92%	\$ 36.00	\$ 0.43	1.20%	\$ 36.18	20.6%	\$ 38.77	

A x (1 + **B**) > **C**
therefore labour cost adjustment is based on LCI **D**.

W x (1 + **X**) < **Y**
therefore labour cost adjustment is based on **Z**, the % increase needed to increase **W** to match **Y**.

LCI adj
Min wage adj

Excel version of worked example (double-click to open):



Reviewing indexation of non-driver labour costs

The review has considered the appropriateness of indexing non-driver labour costs under the index for 'other' costs.

Some stakeholders have questioned the inclusion of non-driver labour costs under 'other' costs for the purposes of indexation and whether this appropriately reflects wage movements for the non-driver workforce, in particular mechanics.

'Other costs (bus)' are indexed using a tailored PPI of road transport costs that have been assessed to be relevant to the bus sector. Wage costs relevant to each cost category can influence the quarterly movement of each cost category. For example, wage costs for roles such as mechanics are included in costs associated with 'Repair and maintenance services'.

The tailored PPI (Road Transport) index used to index 'Other costs (bus)' is made up of the following cost components:

Input cost elements to 'Other costs (bus)'	Weighting
Renting and leasing services	28.4%
Repair and maintenance services	19.3%
Goods and materials	14.6%
Business services	13.6%
Transport and storage	13.6%
Financial and insurance services	3.7%
Communication services	2.2%
Other expenses	4.6%

Other options considered as an alternative mechanism for the indexation of non-driver wages include:

1. Changing the 'Other costs (bus)' index from the tailored PPI of road transport costs to CPI.
2. Expanding the labour cost category from bus drivers to include all other labour costs, or a subset, such as mechanics, and index by LCI (Road and Rail Drivers).
3. Creating another labour cost category for mechanics and indexing by LCI (Automotive and Engineering Trades Workers).

As illustrated in the analysis on the following page, the index options considered all generally follow similar movement trends, albeit the current index demonstrates more variability over the assessed period.

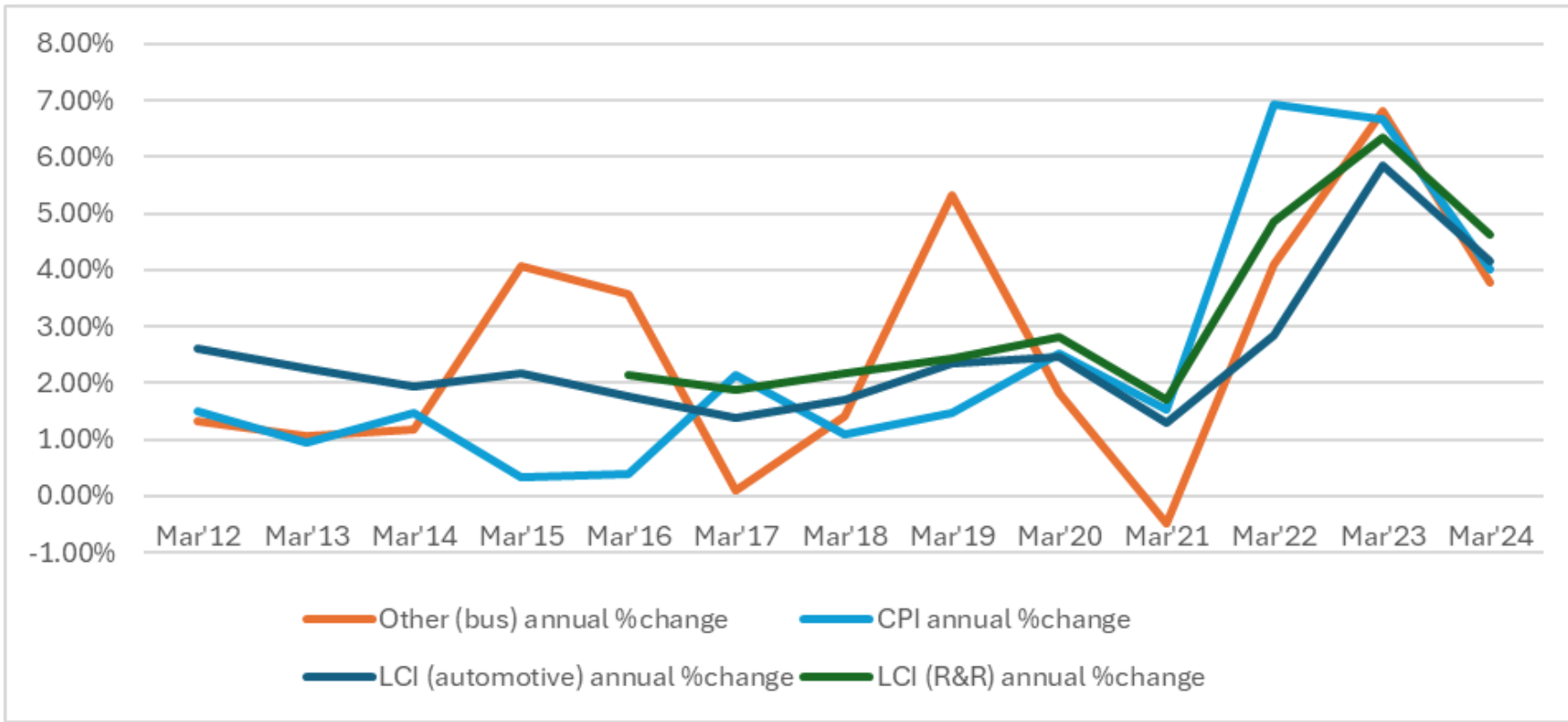
Following consideration of the options, no change is proposed to the indexation approach for this cost category for the following reasons:

- The status quo option is most consistent with the indexation design principles and allocation of cost risk and is understood by the sector.
- Remuneration of non-driver labour represents a relatively small proportion of operator costs and associated risks, with no clear material benefits to warrant a change.
- There is no clear evidence from the analysis that other index options would be more reflective of movements in non-driver labour costs.
- Categorising other roles and determining an industry standard cost weighting that these roles represent would be excessively complex.

Non-driver labour costs index comparisons

As part of 'Other costs', non-driver labour costs are indexed by the sub-index 'Other costs (bus)'. Comparisons are shown against movements in CPI and LCI (road and rail) and, in relation to bus mechanics wages, the LCI for automotive and engineering trades workers.

Other (bus) vs CPI and LCI (Automotive & Engineering Trades Workers) and LCI (road and rail drivers)*



Generally, the other indices that may be considered for indexing non-driver labour costs have tracked closely together, with greater variability in movements in the current index for other bus costs .

* The updated NZTA labour index based on road and rail drivers was re-baselined to June 2014, therefore there is no movement data available prior to this period.

Options considered for indexing non-driver labour

Following analysis and consideration of alternative options for indexing non-driver labour costs, NZTA intends to retain the status quo.

Status Quo	Alternative option considered – Change the index used for other costs to CPI	Alternative option considered – Index non-driver labour costs by LCI (Road and Rail Drivers)
<p>Non-driver labour costs continue to be included within 'Other costs' and indexed using the existing sub-index PPI (Road transport excluding fuel, road and water transport).</p>	<p>Non-driver labour costs would continue to be included within 'Other costs' with the index for 'Other costs' changed to CPI.</p>	<p>The current labour cost category would be expanded to also include non-bus driver labour costs, with costs indexed by movements in the LCI sub-index for road and rail drivers.</p>
<p>Considerations</p> <p>Historically, the current 'Other costs' index has varied from year to year against CPI and LCI, with no clear evidence that other indices would be more reflective of movements in non-driver labour costs than the existing index.</p> <p>Non-driver labour costs are a relatively small proportion of total overall costs within a bus contract and any change in the manner in which these costs are indexed is unlikely to have a material impact over the long term on any residual inflation risk faced by PTOs.</p> <p>The current approach is understood by stakeholders in the industry and is relatively simple to administer.</p>	<p>Considerations</p> <p>Historically, the current 'Other costs' index has varied from year to year against CPI, with no clear evidence that CPI would be more reflective of movements in non-driver labour costs than the existing index.</p> <p>While indexing to CPI ensures 'Other costs' maintain relative parity with inflation, CPI does not accurately reflect movements in the specific cost categories that make up 'Other costs' in the bus sector.</p>	<p>Considerations</p> <p>Historically, the current 'Other costs' index has varied from year to year against LCI, with no clear evidence that LCI would be more reflective of movements in non-driver labour costs than the existing index.</p> <p>An analysis of non-driver labour costs would need to be undertaken across the sector to determine the required changes to the current cost category weightings that make up the NZTA composite index.</p> <p>Should there be less consistency across PTOs in the proportion of cost represented by non-driver labour, the overall index may become less cost reflective for the sector.</p>

3. Capital costs

Considerations for the treatment of capital costs

There are arguments that capital charges should be treated differently for the purposes of indexation.

Currently, most capital assets are supplied by PTOs (e.g. fleet, depots, chargers, and other facilities). PTOs currently recover associated capital charges for these assets through the contract price (e.g. the cost of amortising and financing the upfront capital cost), although these costs may not always be separately identified in tender pricing responses.

Capital specific costs are currently indexed within the overall contract cost structure under the current composite index method and are considered part of 'Other costs'. The NZTA index for 'Other costs' tracks changes in transport industry costs broadly, which indirectly captures changes in capital costs (to the extent these are priced into goods and services).

Capital costs within the contract price are not necessarily subject to inflation risk given that asset prices are fixed at the point of acquisition. Financing costs are generally also fixed at the point of acquisition as a function of a PTO's weighted average cost of capital (WACC), albeit PTOs will face different refinancing risks during a contract term depending on the financing structure for their business.

Most capital cost recovered through a contract is associated with fleet, charging infrastructure, depot establishment costs and, for those PTOs that own depots, land acquisition or a return on land already acquired. Investment in these assets may be through a mixture of transferring assets (from other PTOs), existing PTO assets, new assets acquired at the start of a new contract and then acquisitions during the contract term (either planned or through variations). All have different profiles and PTOs will treat capital recovery differently.

Conversely, many PTOs lease depots and, in some cases, fleet and/or chargers, with lease costs categorized as an operational expense and subject to indexation.

A PTO's costs in procuring additional fleet and supporting infrastructure is likely to vary across the contract term as market conditions change and the timing of fleet acquisitions change. Applying general indexation to future capital costs may not be an appropriate approach when such market dynamics are at play, particularly with the potential decrease in the cost of electric buses over time.

There are divergent views as to whether capital costs should be indexed and some divergence has occurred in the application of indexation on capital costs within the sector. Consequently, we wish to establish a common understanding on approach and a set of guidelines to ensure consistency and create trust across the sector.

Alternative options for the treatment of indexation on capital costs can be tailored, in conjunction with the three indexation methods:

1. Composite index method – the status quo, with capital continuing to be indexed as part of the overall contract price.
2. Cost elemental method – the more contract specific, cost elemental approach enables capital to be isolated from other costs and removed from the application of indexation through the contract term.
3. Advanced method – the advanced method would enable PTAs to construct an indexation mechanism relevant to the specific contract model in question. The specific model may or may not result in direct pass through of actual capital costs, depending on the negotiated risk allocation/payment mechanism.

Alternative options for indexing capital

The three indexation methods enable alternative options for the treatment of capital in relation to indexation.

Method 1 Composite Index	Method 2 Cost Elemental – capital not indexed	Method 3 Advanced
<p>This option represents a continuation of the status quo approach, with the current composite index applied to all PTO payments. Under this method, indexation will continue to be applied to the contract price components that represent capital costs (e.g. financing costs, amortisation of capital).</p>	<p>Increased tender transparency enables PTAs to separate out capital costs bid by PTOs within tender prices. These costs would include amortisation and financing charges for capital assets and would be excluded from the contract price to which indexation is applied.</p>	<p>The advanced pathway would enable PTAs to construct an indexation mechanism relevant to the specific contract model in question.</p> <p>The specific model may or may not result in direct passthrough of actual capital costs, depending on the negotiated risk allocation/payment mechanism.</p>
<p>Considerations</p> <p>This method provides an established, understood and administratively simple approach.</p> <p>While this approach would result in indexation of any PTO capital costs, this is a trade off to ensure simplicity and consistency of approach. In a competitive tendering situation, PTOs will apply a value to the ongoing indexation of capital costs which will be reflected in their tender pricing.</p>	<p>Considerations</p> <p>The pathway enables PTAs to refine their indexation approach to capture operating costs (which are impacted by inflation) as opposed to up-front capital costs (which have limited escalation risk) to ensure value for money during the contract term.</p> <p>The indexation approach would need to be clearly signaled in tender documents by PTAs so that they can assess any particular impacts or risks into their tender pricing.</p> <p>PTAs may wish to consider alternative methods for how variations for future vehicle investments by PTOs are priced (currently via the “PVR variation rate”) to better balance inflation and technology risk and the potential effect of end of term transfer provisions (where applicable).</p>	<p>Considerations</p> <p>This pathway recognises that complex and / or novel approaches to PT service delivery may require development of an indexation mechanism specific to that framework. Generally, this is anticipated to result in no indexation of material capital costs given limited escalation risk.</p>

4. Timing of indexation payments

Considerations for the timing of indexation payments

To address concerns with the lag in indexation payments, a change is proposed that would apply indexation monthly using the latest available published index and a subsequent quarterly wash-up.

The NZTA quarterly bus indexation updates are made available on or after the 22nd of the second month of the quarter following the month in which costs are incurred by PTOs. This occurs as soon as possible after publication by Stats NZ of its indices on or around the 20th of the second month of the quarter following.

We have heard through engagement with the sector that this creates cashflow challenges for PTOs and is not consistently applied by PTAs:

1. The common approach adopted by most PTAs creates a potential lag of up to 5 months between the first month of the quarter and when the indexation payment adjustment for that month is made.
2. The lag creates a compounding cashflow effect for PTOs over the life of the contract.

To address the identified cash flow challenges and simplify the management of indexation, it is proposed that interim indexation adjustments be paid against each monthly contract payment using the latest available published index values, with a wash-up in the following quarter for the difference in indexation owed.

The formula to calculate indexation cost adjustments in the NZTA guidance document '[Contract Price Adjustment for Cost Fluctuation for Public Transport Services Contracts](#)' will be amended to the following formula:

$$V^I = V \times \left(\frac{I^n}{I^{prime}} \right) + W^a$$

Where:

V^I = Monthly contract payment including indexation

V = Tendered monthly contract payment for the month under consideration

I^n = Value of nominated index for the latest quarter available

I^{prime} = Value of nominated index in the quarter during which tenders closed

W^a = Wash-up for the difference in actual indexation owed, payable once the index for the quarter in which the monthly payment falls is published

Under this proposed change, PTAs will pay an indexed adjusted monthly payment each month in accordance with:

$$V \times \left(\frac{I^n}{I^{prime}} \right)$$

Following the quarterly publication of the NZTA Bus Index, PTAs will then calculate the indexation due to the PTO for the prior quarter and make a wash-up payment for the difference between the indexation owed for the PTO for the prior quarter and the aggregate of indexation paid on each monthly payment in the prior quarter.

A worked example comparing the current and proposed approaches is provided on the following page.

Indexation timing worked example – current and proposed

Indexation timing worked example		Quarter 2 index published		Quarter 3 index published			Quarter 4 index published											
Annual Gross Price	\$6,000,000																	
Monthly average gross price	\$500,000																	
Index value at tender close	1000																	
	Quarter 1	Quarter 2	Quarter 3			Quarter 4			Quarter 5			Quarter 6			Quarter 7			Total payments
	Mobilisation	Mobilisation	Operations			Operations			Operations			Operations			Operations			
Quarterly index	1005	1010	1015			1035			1040			1045			1060			
Movement vs base (1000)	A 0.50%	B 1.00%	C 1.50%			D 3.50%			4.00%			4.50%			6.00%			
Monthly contract price		E	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	Month 13	Month 14	Month 15	Month 16	Month 17	Month 18	Month 19	Month 20	Month 21	
			\$495,000	\$500,000	\$505,000	\$495,000	\$500,000	\$505,000	\$495,000	\$500,000	\$505,000	\$495,000	\$500,000	\$505,000				
Monthly payment in arrears			F	G	H													\$6,000,000
Current common practice																		
Indexation payment					\$0		P	\$22,500			\$52,500			\$60,000			\$67,500	\$202,500
Monthly payment total			\$0	\$495,000	\$500,000	\$505,000	\$495,000	\$522,500	\$505,000	\$495,000	\$552,500	\$505,000	\$495,000	\$560,000	\$505,000	\$0	\$67,500	\$6,202,500
Proposed method																		
Indexation payment				W	X	Y												\$132,675
				\$2,475	\$5,000	\$5,050	\$4,950	\$7,500	\$7,575	\$7,425	\$17,500	\$17,675	\$17,325	\$20,000	\$20,200			\$69,825
Quarterly wash-up							Z	\$9,975			\$32,475			\$17,400				\$9,975
Monthly payment total			\$0	\$497,475	\$505,000	\$510,050	\$499,950	\$517,475	\$512,575	\$502,425	\$549,975	\$522,675	\$512,325	\$537,400	\$525,200	\$0	\$9,975	\$6,202,500
																		Indexation payment difference: \$0

Current indexation calculation:

$$P = E \times C$$

Proposed indexation calculation:

$$W = F \times A$$

$$X = G \times B$$

$$Y = H \times B$$

$$Z = (E \times C) - (W + X + Y)$$

Excel version of worked example
(double-click to open):



Microsoft Excel
Worksheet

Indexation application to variations

To improve consistency across the sector in the application of indexation to variations, NZTA provides the following guidance.

Sector feedback has indicated inconsistent approaches by PTAs in the application of indexation to variations, with some PTAs diverging from the commonly accepted practice of deflating the price of variations to be expressed in tender close dollars.

NZTA recommends that indexation be applied to variations in accordance with the following principles:

- a) Where variations are based on service variation rates submitted at time of tender, variation amounts should be calculated using uninflated service variation rates and the variation value added to the uninflated monthly service payment in each of the relevant months that the variation applies. Indexation should then be applied to the total monthly payment value in accordance with the contract price adjustment methodology.
- b) Where variations are based on service variation rates or as lump sum amounts negotiated during the contract term and these variations are not a one-off, variation rates or amounts should be deflated to tender close date dollars and the variations calculated using deflated service variation rates or amounts and the variation value added to the uninflated monthly service payment in each of the relevant months that the variation applies. Indexation should then be applied to the total monthly payment value in accordance with the contract price adjustment methodology.
- c) Where variations are one-off, based on a lump sum amount negotiated during the contract term, the variation value may either be deflated and indexed in accordance with principle b) above or otherwise invoiced as a one-off in present day dollars with no indexation applied.

Recommended approach to indexation application:

$$TMSP = (MBSP \times IM) + (\sum VAR \times IM)$$

Where:

TMSP = Total Monthly Service Payment

MBSP = Monthly Bus Service Payment in tender close date dollars

$\sum VAR$ = the sum of all Variation amounts calculated in tender close date dollars applicable to the relevant month

IM = the Index Multiplier applicable for the relevant month, calculated in accordance with:

$$IM = \left(\frac{I^n}{I^{prime}} \right) + W^a$$

Where:

I^n = Value of nominated index for the latest quarter available

I^{prime} = Value of nominated index in the quarter during which tenders closed

W^a = Wash-up for the difference in actual indexation owed, payable once the index for the quarter in which the monthly payment falls is published

5. Summary and implementation

Summary and implementation of proposed changes

Following sector feedback sector, NZTA will finalise indexation policy and publish updated requirements and guidance online (refer [Contract Price Adjustment for Cost Fluctuation for Public Transport Services Contracts](#)).

Proposed change	Proposed implementation approach
1. Additional methods available to the sector to apply indexation on a cost elemental basis or other customised approach as appropriate to the context and complexity of specific contracts.	Once finalised, the additional methods may be utilised for new contracts.
2. The calculation of the labour component of the Bus Index by NZTA to include an annual adjustment, where necessary, to maintain a 20% buffer between the Sector Minimum Driver Wage (Regional) and the Minimum Wage.	Once finalised, this would automatically apply to: <ul style="list-style-type: none"> • both existing and new contracts, and; • the composite and elemental index methods. The first application of the change in index calculation method would occur in August 2025.
3. The requirement that PTOs pass on the labour cost component of indexation payments to all drivers through wage adjustments at least annually.	Currently this applies to the majority existing bus contracts as per prior wage uplift agreements. The NZTA Procurement Manual would be updated requiring that all future PT contracts also stipulate this requirement.
4. Additional options for the indexation of capital through the use of cost elemental or other custom indexation approaches.	Once finalised, capital costs may be indexed differently for new contracts that utilise a cost elemental or custom indexation method.
5. The requirement for PTAs to apply indexation adjustments monthly to contract payments with a wash-up in the subsequent quarter for the difference in indexation owed to a PTO.	Once finalised, this would apply to all new contracts. PTAs should implement the change as soon as practicable for existing contracts in consultation with PTOs.
6. Other clarifications and guidance.	PTAs should implement any changes in practice to align with guidance as soon as practicable in consultation with PTOs.

6. Engagement questions

Engagement questions

Please submit feedback to public.transport@nzta.govt.nz by 30 August 2024

General

1. Please provide any feedback on the stated purpose of indexation mechanisms and the design principles on [page 6](#).

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

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

Capital costs

7. Please provide any feedback on the issues and considerations in relation to the indexation of capital costs in [Section 3](#).
8. Please provide any feedback on the treatment of capital costs under each of the indexation methods.

Indexation timing

9. Please provide any feedback on the proposed change to the timing of indexation payments in [Section 4](#).
10. Please provide any feedback on the guidance for the application of indexation to variations.

Implementation

11. Please provide any feedback on the implementation approach in [Section 5](#).

Other

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

