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**Metropolitan bus service
contracts (MBSC): Thoughts
on the next round**

By

David A Hensher and John Stanley

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ABSTRACT: This paper revisits a number of themes that have played a crucial role in the debate on alternative contracting regimes for the provision and bus and coach services. We have selected seven crucial issues to reflect on: (i) contractual regimes (in particular negotiated performance based contracts linked to benchmarking and competitive tendering); (ii) contract completeness (focussing on *ex ante* and *ex post* elements and what can be improved within the context of current contracts); (iii) building trust through partnership; (iv) number of contract areas (emphasising the crucial demand-side objective); (v) tactical or system level planning for bus services; (vi) asset ownership; and (vii) margins.

KEY WORDS: *Bus contracts, trusting partnerships, margins, tendering, negotiation, performance based contracts, asset ownership*

AUTHORS: David A Hensher and John Stanley

CONTACT: Institute of Transport and Logistics Studies (C37)
The Australian Key Centre in Transport Management
The University of Sydney NSW 2006 Australia

Telephone: +61 9351 0071
Facsimile: +61 9351 0088
E-mail: itls@sydney.edu.au
Internet: <http://www.itls.sydney.edu.au>

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1. Background

Operators under contract to deliver bus services in Sydney are at various timing points in their initial contract since the introduction of the new service provision contracts, known as Metropolitan Bus Service Contracts (MBSCs). In the lead up to the signing of these contracts, there were many issues that needed resolution, in large part due to the inadequacy of the 1990 Passenger Transport Act (and associated revisions). In particular, government wanted to refocus on the business of providing ‘continuity of service’ and ‘value for money’. To achieve this, government developed a contract regime that was extremely detailed in its prescription of what operators must do to comply with the terms of a contract (what we refer to as *ex ante* prescription). The excessive *ex ante* prescription on a very new contract left little room for *ex post* negotiation to resolve matters that would inevitably arise with overly prescriptive and yet inevitably incomplete contracts.

As government commences its next round of deliberations with incumbent operators, it is useful to reflect on the effectiveness of the initial contract round and to suggest what might be a sensible way forward. A lot of new experiences are now with us to assist the next round deliberations. This short paper reflects on what we regard are key issues that should be central to ongoing deliberations, ensuring that we preserve the good features of the current contractual regime while improving where deficiencies have been identified.

In drawing together the experiences in the field under MBSCs, we also draw on the extensive body of experience around the world with alternative contracting regimes, that is distilled every two years in the International Conference series on Competition and Ownership of Land Passenger Transport (known as the *Thredbo Series*¹). This Series is now in its 22nd year, having held 11 very influential meetings throughout the world. As convenor of the Thredbo series, the first author is well placed to distil the experiences around the world, and the second author is well placed as an active member of the Thredbo series, in particular as a workshop chair over the last 8 years as well as helping to guide the focus of the series.

We have selected seven crucial issues to reflect on: (i) contractual regimes (in particular negotiated performance based contracts linked to benchmarking and competitive tendering); (ii) contract completeness (focussing on *ex ante* and *ex post* elements and what can be improved within the context of current contracts); (iii) building trust through partnership; (iv) number of contract areas (emphasising the crucial demand-side objective); (v) tactical or system level planning for bus services; (vi) asset ownership; and (vii) margins.

It is important from the outset to be aware of a crucial challenge that regulators should recognise and advise on, namely given the focus on growing patronage, ‘How much of patronage growth can be attributed to the specific contract design, and how much is due to other factors?’. The answer may well guide the contractual regime, and in particular highlight the importance of appropriate payable incentives.

2. Contract regimes: The case for negotiation

The broad objective(s) of government is to provide a good quality, integrated and continually improving transit service for a fair price, with reasonable return to operators that gives value for money under a regime of continuity and community obligation (update based on Hensher and Stanley 2008).

¹ For more details, see <http://www.thredbo.itls.usyd.edu.au/>

Australian bus contracts have been pioneers in the development of negotiated performance-based contracts (NPBCs), founded on trusting partnerships, whereby contracts are re-negotiated with existing operators, subject to meeting certain conditions. Melbourne and more recently Sydney are examples of this approach². Wallis et al. (2009) review the Adelaide experience with three rounds of tendering and conclude that there is little to gain in terms of cost efficiency and quality enhancement by going to a fourth round of tendering. They argue that a move to NPBCs not only can reduce transactions costs (associated with tendering) but also offers the opportunity to work closely with efficient incumbents to grow trust and build patronage where possible (mindful of the realities of the market for public transport services). It also reduces the uncertainty associated with renewal through tendering where a very efficient incumbent operator can still lose the right to provide services. Under tendering, there is a real and observed risk of incumbents tending to not commit to longer term investment in the industry (both physical and human resources) where contract continuity is uncertain, even when all the boxes are ticked on performance. Tendering also has a negative impact on building and maintaining a trusting partnership (in addition to high transactions (including transitional) costs every time re-tendering is put in place).

In very general terms, negotiation is the process through which parties perceive one or more incompatibilities between them, and work to find a mutually acceptable solution³. In contrast to competitive tendering, which is framed to *determine* the value of a product or service, negotiation is designed to *create* the value of the product or service.

Provisions to guard against regulatory capture are critical in a negotiated performance-based contractual process. Australian experience suggests that, under NPBCs, transparency and accountability can be achieved if the following four conditions are in place:

1. Performance benchmarking to ensure that operator performance is efficient and effective. This benchmarking needs to be subjected to independent verification. Key performance indicators (KPIs) and the threat of competition (through tendering)⁴, in the event of inadequate performance, assists the maintenance of competitive pressure and efficient performance.
2. An open book approach to costs, achieved through an independent auditor. Operators whose costs appear to be high through this analysis must justify their numbers or face a cut in remuneration⁵. Those whose costs appear low have the opportunity to argue for an increase.
3. The appointment of a probity auditor to oversee the negotiation process.
4. Public disclosure of the contract.

² Melbourne started it in about 2002 with a focus at the tactical or system planning level.

³ We would suggest that, where a body of expertise exists in an Association that operators belong to, that with permission from the operators, there is much to be gained by at least including such an Association where elements of negotiation are generic in scope. This has the supplementary benefit of accessing the expertise of consultants and saving costs which ultimately are met by government

⁴ In a very real sense, negotiation and competitive tendering might be seen not as alternatives but as complements in a sequence (Ivanova-Stenzel and Kroger 2005), where the competitive tendering stage is only necessary where certain conditions are not satisfied within the negotiation stage and during the agreed service delivery period. This is consistent with the promotion in Hensher (2007) of negotiated PBCs, with competitive tendering invoked when a service provider fails to deliver under the agreed contract with reasonable notice.

⁵ Under competitive tendering, it is less likely that operators see any obligations to reveal their cost structures, since government has awarded them a contract based on the offered price under competition. Thus the benchmarking and open book auditing under NPBCs provides a much better way to obtain detailed data on operator performance that can be used to benchmark in a very meaningful way, controlling for differences that are not under the control of the operator.

Australian experience across jurisdictions that tender and those that negotiate is that there is a tendency for cost convergence. A number of operators who provide service under each regime have noted this trend.

We want to reinforce the importance of benchmarking in order to deliver continuity of service and value for money under this model. This is designed to monitor and ensure efficiency and effectiveness through the life of a contract, and not just at the point of contract completion. Incentives built into a negotiated contract conditioned on market-linked benchmarks and the ultimate sanction of tendering if non-compliant, enable the incumbent operator to at least prove their worth initially and then, provided the regulator does their job, would deliver true value for money at minimum transaction cost, even after allowing for the regulatory costs that should be common to all regimes, be they competitive tendering or negotiation.

There is a growing body of theoretical and empirical evidence to support the promotion of awarding mechanisms with formal and informal devices, aimed at economic efficiency and effectiveness through the life of the contract i.e., *ex ante* and *ex post* coordination. Building on growing arguments to support NPBCs instead of CT, Bajari *et al.* (2002) suggest that CT performs poorly when ‘projects’ are complex and contractual design is incomplete. Area-wide metropolitan bus contracts fit this circumstance. This literature argues that competitive tendering can stifle communication between buyers (i.e., the regulator) and sellers (i.e., the service provider), preventing the buyer from utilising the contractor’s expertise when designing the project (which could be a network in the public transport setting). Authors such as Yvrande-Billon (2007), drawing on the French experience, promote the case for greater emphasis on establishing a credible regulatory scheme able to govern the procurement of public services *ex post*, arguing that focusing on introducing market mechanisms *via* competitive tendering per se *ex ante* does not guarantee better value for money. *Implicit in her arguments is the need to develop trusting partnerships and (incomplete) commercial contracts with unambiguous incentive and penalty structures throughout the life of a contract, with market mechanisms such as competitive tendering always present as a way forward when operators fail to comply under reasonable notice.*

This focus may well enable a greater emphasis on achieving social objectives in contrast to commercial objectives; some might say the tendering “paranoid” may have taken governments away from the real objectives of social obligation and maximising net social benefit per dollar of subsidy, as recognised by Preston (2007), to a disproportionate and over-zealous focus on cost containment and reduction. We would argue that the key issue is not ‘applying the wrong kind of competitive tender to the wrong market’ (Preston 2007), but the inappropriateness of any form of competitive tender where the transaction costs are so high as to nullify any financial gains at the expense of the relative neglect of broader social obligations, which place as much emphasis on benefits as on costs. The exception is typically a *first round* tender when moving from an historically entrenched publicly provided public transport service. The latter usually delivers huge windfall financial gains in the range 20-30 percent (Hensher and Wallis 2005).

3. Contract completeness: why trust is fundamental

In the transport sector, many types of contracts exist. Some are very precise, and strive for completeness; others are very ‘light-weight’ and are incomplete. Bus and coach contracts, won through competitive tendering or negotiation, are typically incomplete in the sense of an inability to verify all the relevant obligations, as articulated through a set of deliverables (see Hensher 2007).

When a principal (i.e., the government) and an agent (i.e., the bus operator) decide to collaborate, they create a ‘contract interface’ to guide the transaction, the subject of the collaboration. To maximise the gains, the interface must be correctly designed. Desirably, the parties should be able to foresee all contingencies that might affect the contract, and be able to decide what they should do.

Contracts, however, will never be complete in the sense that every single obligation is so clear that it can be written down *ex ante*. There is a huge body of literature that has studied the appropriate mix of *ex ante* (before contract is signed) and *ex post* (after contract is signed) contractual obligations. Incompleteness is a natural consequence of the bounded rationality of the parties, linked to service provision complexity, and is an important element of the case for negotiation.

The risk of contract ambiguity (or lack of clarity) without adequate and effective mechanisms to resolve the ambiguity in a timely way after a contract is signed, has surfaced as a major issue for both government (‘the regulator’) and operator (or contract region service provider).

In terms of the experiences with the NSW MBSC contracts over the period 2002 to 2008, research undertaken by Hensher (2009) presented an innovative analysis of operator perceptions of contract completeness and clarity, as rated before and after contract signing. To identify the extent of incompleteness and clarity across a sample of bus contracts, Hensher (2009) investigated the extent of discrepancy between the regulator and the operators’ perceived ‘understanding’ of contract obligations. Incompleteness and clarity are in one sense a matter of perception and interpretation, but are clearly major features of doing business, especially in *ex post* commitment to contract variations and accumulating transaction costs. Hensher (2009) also investigated the role of trust between regulator and the operators in minimizing the lack of clarity and in establishing an understanding of the true nature of contract completeness. He found a very low degree of contract clarity in respect of ‘incentives to improve performance and grow patronage’, ‘contract renewal procedures’, and ‘ad hoc claims’. There was, however, a high level of contract clarity on ‘maintenance of accreditation currency’, ‘obligations regarding bus maintenance within the contract’, ‘agreements and obligations in respect of rights of operators in adjacent locations in joint service provision (integrated networks)’, and ‘payment procedures’. Evidence from Europe also suggests that the greatest challenge in terms of ambiguity after a contract is signed is on the demand side with service planning, network design, and marketing.

Hensher also investigated how successful the bus operation has been under the contract in addressing (or resolving) issues that have arisen during this first contract period. He found that the most successful issues that have been resolved through communication are: ‘contract renewal procedures’; ‘maintenance of accreditation currency’; and ‘contract end procedures’. The issues where success has been perceived as quite ineffective have been ‘depot upgrades and expansion’, ‘change events’, and ‘incentives to improve performance and grow patronage’. This evidence should be taken into account in the next round of negotiations. Overlaying all this evidence was a finding that, where operators reported a higher level of trust between themselves and the regulator, there was greater communication and quicker resolution of issues, saving money and time.

We argue that attempts to burden the contract with complexity, instead of recognising sensible boundaries for an incomplete contract that allow for incompleteness and negotiation, is not a preferred strategy. Incompleteness and negotiation gives both parties the opportunity to suggest changes (or variations) that move towards efficient and effective delivery, in contrast to the often seen evidence that overly complex contracts lead to ambiguity in translation and operator focus on such compliance with a diminished interest in exercising a

commitment to continuous improvement in the service (through risk sharing outside of the contract). Such complexity may also result in budget blow out as a consequence of high transaction costs in ensuring compliance (especially if it ends up in court) and, depending on the bargaining base of each party, a risk of high outlays with little gain in service. Considerable management time can be consumed by such distractions, which remove the focus from system and service design and delivery. Negotiation under incomplete contracts is relatively more transparent in that the defined variation is clarified during negotiation.

4. Building trust through partnership

Building an efficient and effective supply chain of stakeholders in public transit provision requires a foundation strong in trust, with its distinct commitment to cooperation and collaboration (Hensher and Stanley 2008).

It is possible to build a quality trusting partnership with well defined commercial (contracted) obligations; however, the contracting process will always be incomplete in practice, and hence there is a need to recognise that the contribution of each party in a service delivery chain requires close cooperation and collaboration. Continuity of *compliant* contracts is one important way of ensuring this (Hensher and Stanley 2008).

Where the government and operator(s) work in a trusting partnership, especially at the Tactical level, we expect the best outcomes to result. This expectation partly reflects the shortage of skilled people and the associated need to draw on all available skills to the maximum extent possible wherever they are located. It also reflects the expectation that if the government and operator are jointly focused on achieving common goals (patronage and related outcomes), rather than on watching each other, the best patronage outcomes are likely to follow. This notion of a trusting partnership has evolved through the recent Thredbo conferences as being grounded in five Cs:

1. **common** core objectives tied to public policy purposes;
2. **consistency** of behaviour and direction;
3. **confidence** in a partner's capacity to deliver;
4. respect for each other's **competencies**; and,
5. demonstrated **commitment** to good faith in making and keeping arrangements and in principled behaviour.

The 5 C's support Contract Clarity (before signing the contract), and Clarity of obligations once the contract is signed.

Agreed and shared governance arrangements reflecting these principles are the glue to tie the principles together. These governance arrangements would also need to include (for example) accountability and transparency provisions that guard against regulatory capture, financing arrangements and relationship management provisions. The governance arrangements may be spelt out in a service contract, included in a document that supports the service contract and/or be part of an Authority/industry-wide agreement that sets out behavioural expectations for all individual contracted operators in a wide market (e.g., all bus operators within a metropolitan area).

A trusting partnership is seen as particularly important because of the problems posed by incomplete contracts. A changing market environment makes the complete specification of contractual obligations extremely difficult. Furthermore, much experience (e.g., in many contracts in the Netherlands, as reported by Bakker and van de Velde (2009), Dijkstra and

Verheijdt (2009) and Eerdmans et al. (2009)) suggests that a contractual focus on such detail discourages operator innovation and encourages an operational focus on cost cutting, to increase profits.

The absence of trust will typically see the Authority seeking to fully specify a contract, to protect its interests. This invites complex legal argument and a loss of focus on the main service delivery outcomes, while lawyers debate what the contract intended and what was delivered. However, in a context of trust, backed by transparency and accountability, there is no need to fully specify requirements. In a context where trust exists, the contract need only set down requirements that are clear, and then specify a process that will be used for making decisions in areas of uncertainty, as the contract develops. This has been the approach taken in the Melbourne bus contracts, arguably the first international public transport service delivery contracts where a trusting partnership has been consciously pursued between purchaser and provider over a sustained period of (seven or so) years (Stanley 2009).

Hensher (2009) in the context of contract experience over the period 2002-2008, showed that the building of trust “can contribute significantly in reducing the barriers to establishing a better appreciation of the degree of contract completeness, and clarity of contract specification and obligations”. The MBSC contracts were effective from 2004 onwards (depending on when they were signed). The evidence shows a strong positive link between the average level of trust per annum over the active contract period and perceived contract completeness after 2004. Leading up to 2004 there was considerable distrust. The perceived degree of trust between the operator and the regulator was obtained from the following question (and presented in Figure 1):

‘How would you describe the degree of trust that existed in previous years and today between your bus operation and the organization that has awarded you a contract to provide bus services? Use a scale of 1-100 where 100 = complete trust and 1 = no trust.’

Further analysis reported in Hensher (2009) shows definitively that when trust increases, the perception of completeness increases, which seems logical, supporting the strong gain in building a trusting partnership between operator and regulator (see Stanley and van de Velde 2008, Stanley et al. 2007). The empirical evidence confirms in a systematic way, this somewhat ‘obvious’ belief in trust as an important lever in the institutional reform of the land passenger transport sector.

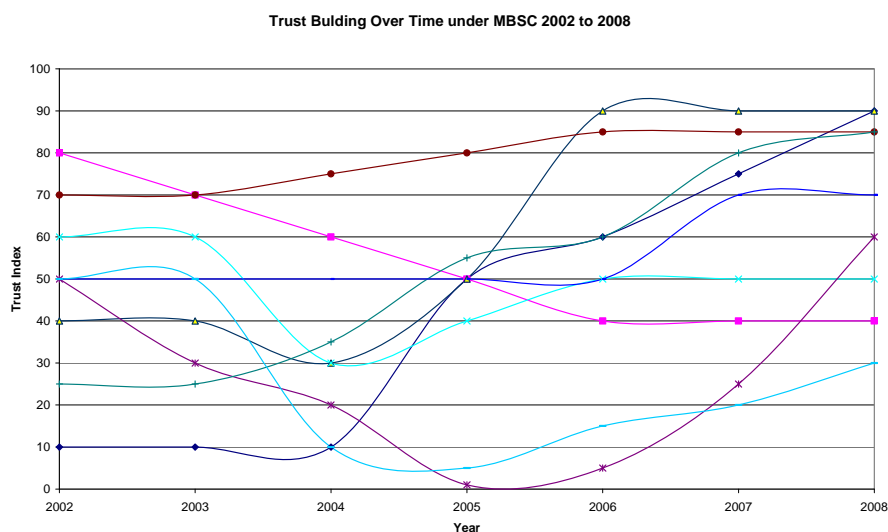


Figure 1: The trust profile of nine MBSC operators (2002-2008)

Mellish and MacDonald (2009) point out how, in two recent rounds of bus contracting in New South Wales, there has been a substantial change in the relationship between purchaser and provider. Metropolitan bus contracts were negotiated in a hostile environment, where the authors argue that the NSW Government was intent on substantially restructuring the bus industry and bus services, and on imposing its will on the contracting process. Highly detailed and prescriptive contracts resulted but without a working operational performance regime. One result has been confusion about relative roles and responsibilities, as discussed by Hensher (2009). This situation has been compounded by Government failure to deliver on some key parts of its contribution to service outcomes, such as an integrated ticketing system, new network plans, improved information systems and a benchmarking regime (although the latter is well advanced for implementation in 2010).

Partly as a response to the outcomes of the metropolitan negotiations, the more recent NSW regional bus service contracts have been negotiated between Government and the bus industry using a trusting partnership model. Independent consultants have been used for key tasks that provide transparency and accountability and help assure value for money. This has led to much greater clarity about roles and responsibilities, and allowed operators to focus more strongly on service delivery, rather than simply on survival in a combative environment.

The Melbourne contracts have embedded in them the idea of a relationship committee. At present this is not formally set up, but there is an on-going contract negotiation process with DOT and regular (weekly) meetings between the CEO of BusVic and the DOT's Director of Bus Operations, which effectively delivers the same result as what would be achieved with a formal arrangement. The strength of trust in Melbourne at present is such that neither party sees the need for a formal structure. In situations where trust and partnership is less strong, of relatively fluid, the formality of such a structure would enable the players to resolve issues before they become a problem

5. Number of contract areas: fewer not necessarily better

Is there such a thing as an optimal contract area size in a geographical sense in a predefined jurisdiction, such as a metropolitan area? What criteria might one apply to decide on this? The answer should be influenced primarily by demand-side considerations such as network connectivity impacts (economies of scope through networks, integrated fares, etc) and the supply-side in terms of cost and service delivery efficiencies. It is not dissimilar to the arguments on the optimal number of firms in an industry.

There are two issues (at least) to address: first, what likely changes in network service delivery are desired and can be achieved by amalgamating contract areas, that cannot be achieved by alternative strategies such as establishing network alliances (even incentive-based ones) or competitive tendering of cross-regional services within the existing contract area regime?; and, second, will such amalgamations lose the internal (to an operator) efficiencies that currently exist?

In responding to how many contract areas are appropriate, Preston and van de Velde (2002) comment that the U-shaped subsidy profile detected over time in competitive tendering is in part due to excessive concentration or collusion. The upping of prices in re-bids is becoming common (as observed in Europe and New Zealand in particular) as the number of bidders drops (as a result of fewer operators in the market). This is not unrelated to the size of the contract area; fewer and hence larger contract areas tends to reduce the potential for rich benchmarking ('yardstick competition') and the opportunity to have operators who know the contract regime willing and able to take over in the event of non-compliance.

The trade-offs between network/demand economies and internal efficiency will depend on a number of structural and historically contingent characteristics, including such different aspects as urban development and operator culture (Carlquist 2002). This was certainly true in the Sydney context in the early 1990s when the NSW 1990 Passenger Transport Act was introduced. It defined a suite of 78 contract areas based primarily on incumbency (tantamount to grandfather rights). Since then the number of operators has been reduced (while the contract areas have been reduced to 15). New global operators have moved into Sydney (e.g., Comfort Del Gro from Singapore and Australia, Veolia and Transdev from France), looking for opportunities to expand in the Australian market. Where geographically adjacent operators have been willing to sell, in part due to pressures to sell from the large global operators, but also because of the perceived uncertainty of the new reforms, we have evidence of a growing number of service areas under one operator. Using 2008 data on the total cost per vehicle kilometre and fleet size (a proxy for size of the bus business), we find that 31 percent of the variation in cost per km can be explained by fleet size, with a higher cost as fleet size increases. On average, every 10 additional vehicles increases average cost per km by 7.23 c/km. This suggests diseconomies of scale on the supply side.

The arguments and evidence presented in Hensher (2003) suggest that the perceived gains from the reduction in the number of contract areas are likely to be illusory. If the gains in network economies on the demand side are not sufficiently large to outweigh any likely loss of internal efficiency, there is no case for amalgamating contract areas. Given the major focus on local service provision, opportunities to deliver appropriate cross-regional and cross-network services can be revealed and best promoted by alternative strategies. A more sensible strategy is to separate off a critical trunk network (e.g. the orbital SmartBus network in Melbourne) and agree for it to be tendered, with local service growth still ensuring operators can grow their business base.

What is far more important than simply changing contract area size is the implementation of an integrated fares strategy as pivotal to promoting network public transport activity. This facilitates all modes and not just buses, and hence is far more important than playing with the physical boundaries of bus operations. There are far more transfers **between** bus and rail, where an integrated ticketing system is a prerequisite. We are a strong believer in an integrated ticketing system, because of the user simplicity and convenience benefits.

Our experience in Australia and in many other countries (notably the UK and New Zealand) leads us to express concern about the monopoly impact of fewer and larger contract areas, especially where an operator controls more than one region. This is a worry given that the number of metropolitan operators in Australia is declining fast.

In particular, the loss of the family business is noteworthy. Most family businesses have a strong connection to the communities that they operate in and give very good "value for money" in a variety of ways. They are certainly efficient and as they disappear the "NZ model" starts to emerge in Australia, where a few large operators carve up the country. Is that what we want?

Table 1 Synthesis of key issues in determining optimal size of operator/contract area

| Theme | Comments |
|--|--|
| Density of route network and network economies | <ul style="list-style-type: none"> • As it increases there is operational dependency on availability of fixed facilities (central depot, local terminal...) • Very high fixed costs of depots which require sharing of these costs • Presence of such high costs involves a trade between sharing costs over many more activities/services, risks of diseconomies of scale and elimination of potential competition (either leading to entry under deregulation or competitive tendering or competition for incentive payments under PBC) |
| Route structure | <ul style="list-style-type: none"> • The balance between degrees of hubbing ranging from hub-dominated to more uniform distribution in urban area moves to latter as a continuous spatial diffusion of urban activities takes place. |
| Demand complements | <ul style="list-style-type: none"> • Attributes of individual services as demand complements means that a change in frequency (say) of one service affects the demand for another |
| Internal efficiency | <ul style="list-style-type: none"> • Delivering services under benchmarked best practice in respect of cost efficiency, cost effectiveness and service effectiveness |

6. Tactical level planning: the foundation for unleashing value for money

Consideration of contract area boundaries is an important element in the wider issue of bus system design for service delivery, as part of the wider public transport network. A key role of service level contracts is to provide a legal and commercial framework for delivering products (services) that have been determined as needed at a higher level, the Tactical or system planning level. While there may be scope for an operator to innovate with services at a contract area level, in most cases service expectations are tightly specified as a key contract deliverable.

System planning skills in public transport are in short supply internationally. A key benefit of a trusting partnership between purchaser (government) and providers is the opportunity that this provides for both parties to draw on their expertise to help design the public transport (bus) system that will maximise value for money for the host community. Ultimate responsibility for system planning will remain with government, but bus operators can add considerable value to system planning, usually working through their industry Association, by bringing their accumulated knowledge and experience to the task, in a trusting partnership with government. Melbourne, for example, has worked this way for most of this decade, with very substantial service and patronage improvements resulting. Contract design is then structured to maximise achievement of the system level intentions.

The effort that is required to be jointly put in to system planning is a key way in which government and operators can build understanding of each others' goals and expectations. It is a vital part of relationship building, in which trust can be fostered while the importance of transparency and accountability is affirmed. Future planning for bus service contracts in NSW should build on past gains and ensure that the Tactical (system) planning task is undertaken with strong input from bus operators, through BusNSW.

7. Asset ownership: should be with the operators

The NSW government has used the ‘continuity of service’ objective as the reason underlying the decisions to have all new vehicles owned by government (although initially financed by the operator with an agreed payment and depreciation plan over 15 years).

We have discussed the issue of ownership of assets in great detail in Hensher (2007). The issue that matters is the ability of the assets to be acquired and utilized in a way that is compatible with the overall objectives of service delivery. Capital assets in the form of buses are inputs that must be worked; however, how much work one can get out of the assets may be linked to how well that asset is managed (including maintenance), and what incentives are in place for the operator to be committed to get the very best out of the asset. If the terms of access to the vehicle are less attractive under a regime of government ownership than under operator ownership, then we must ask if this impacts on the extraction of value from the asset in the delivery of service.

The two issues that matter are (i) is there a defensible link between ‘continuity of service’ and government ownership of buses? and (ii) what overall cost savings would be obtained if ownership returned to the operator. The Melbourne model under the new contracts signed in 2009 retains asset ownership in the hands of the operator, with government having access rights to assure service continuity.

Given recent evidence that there are a number of operators keen to buy other incumbent operators in Sydney (and indeed that is occurring at a faster rate than was anticipated), we do not believe that there will ever be a situation where a defaulting operator would result in loss of continuity of service. Indeed such an operator can be expected to make the existing assets available to an interim operator by an obligation in their contract, with the assets provided at an agreed market rental value. Access to assets by government in the event of high risks to service continuity, rather than ownership, is the key. So we see issue (i) as a red herring.

We find the issue of bus ownership strange since the assets that will be the main determinant of access by other operators are the depots. This could be resolved, however, through a clause in the contract similar for the buses, in the case of default. However in an environment of trust, the commitment to deliver is high and any sense of the operator defaulting will be minimised. There are operators waiting in the ‘shadow’ to buy in. There still is merit however in having relevant clauses in the next contract to protect both government and passengers in the unlikely event of default (which experience suggests has followed very quickly by another operator purchasing the business). In summary, operators should own the assets, to work them best, and that government should ensure it has rights of access to the assets via the contract in the event of poor performance/risks to continuity.

In summary, the operator is best to own the assets, because they will ensure the best use is made from them (Hart and Moore, 1990).

8. Margins

In 2005 Hensher prepared a paper for the then Bus and Coach Association of NSW (now Bus NSW) which recommended that ‘The evidence on margins from comparable operations in other countries (predominantly the UK, NZ, Europe) and other States in Australia is that the EBIT:cost margin should fall within the range 11-13 percent.’

A crucial element of the argument was related to evidence from comparable settings for bus operators and the level of risk in the Sydney environment both having an influence on the opportunity cost of capital, and hence return on investment. The paper had a significant

influence on the margins agreed to by both government and operators. Each operator negotiated a margin, which remains confidential to the two parties.

As operators enter the next round of contract negotiation, if that is how the government will proceed, the issue of margins, should be revisited. The key issue is to see if there are any changes in the financial environment that may have altered the risk profile of relevance. A risk that may have to be rethought relates to the bus, now that some vehicles are owned by government. Although we might suggest a four percent downward adjustment in the margin if *all* assets (buses and depot) were owned by government, the situation in NSW would take many years before all buses are in the hands of government.

The current situation of a 'shandy' of asset ownership should revert back to operators owning all assets and margins be recalculated on that basis, since the arguments that government ownership will ensure a 'continuity of service' (implying the opposite otherwise) are simply not valid.

In summary, operators should get a fair return for effort, given the level of risk. There is a wide range of evidence around Australia on which this can now be based. In addition, international evidence on margins in bus service provision has not changed noticeably since the last inquiry in 2005. We suggest for Metropolitan Australia a 10 to 15 percent EBIT to turnover as an appropriate broad range. The lower end is predominantly Queensland, and the higher end is predominantly those operators that are more market exposed. 13 to 15 percent is not an unreasonable range for Sydney. We would also support a funding model that is sufficiently dynamic in its recognition of the risks that are not under the control of the operator or government such as the Global Financial Crises which makes the continued use of the bond rate plus a small margin problematic.

9. Conclusions

A successful contractual setting must align with the following Strategic and Tactical Level Commitments. At the Strategic level, political support for public transport, a clear statement of the policy goals that the public transport system is to pursue and a whole-of-government (integrated) approach to the policy framework within which public transport system operates, will provide the ideal foundation for subsequent contracting. Service providers operating within this framework should understand the policy goals and be fully committed to their achievement.

The Tactical level needs to be supportive of the Strategic policy context and to provide a clear sense of direction for service development. Clarity in, and agreement about, the relative roles and responsibilities between purchaser and provider at the tactical level is important. These roles and responsibilities will depend on the context in the particular jurisdiction (e.g., patronage growth prospects and the government's willingness to invest for service development), and may sometimes include the public transport acting as an industry (e.g., through an Industry Association). A trusting partnership between the parties, whatever their specific roles and responsibilities, is thought likely to enhance performance, reflecting the growing focus on the importance of relationship management. This focus leads to an emphasis on an even-handed contract.

A trusting partnership between purchaser and provider at the Tactical level, which flows through to the contractual/operational level, is likely to improve service delivery outcomes, as compared to a relationship that lacks this trust. The circumstances most likely to encourage a trusting partnership seem likely to be where the five C's identified above are alive and well, the awarding mechanism is a negotiated performance-based contract, with suitable provisions

for accountability and transparency, and in a tendering regime, there is provision for possible contract roll-over, related to performance, and/or a long contractual term.

The contractual environment must demonstrate transparency and accountability to the efficient achievement of the public policy purposes that provide the service foundation. The contract itself should not be overly prescriptive, but should assure a fair commercial outcome, while sustaining performance pressure on both provider and purchaser. Both parties should be judged on their performance, not just the provider, and must have the competencies to undertake their roles and responsibilities. Key Performance Indicators against which performance is assessed should be **SMART**: **S**pecific, **M**easureable, **A**chievable, the **R**esponsibility of the party being assessed, and **T**imely. These indicators should be linked to performance consequences, which should include some possibilities of contract roll-over where the provider's performance has been of a high order (even if the contract was let by competitive tender).

These contexts provide room for the partnership to develop while reducing operator risk of loss of intellectual property to third parties (potential competitors) because of the trusting relationship with the purchaser. The contract should include a process for managing changes/variations, clear processes for managing poor performance and defaults (a cure regime, including termination provisions), and transitioning arrangements in the event that the service is subsequently to be provided by another operator.

Greater clarity and greater completeness not only supports more effective contracting between a principal and an agent, but also ensures greater trust between the parties, which will reinforce effectiveness and reduce uncertainty in ex post negotiation to clarify obligations. This approach to greater dialogue will also ensure that established benchmarks, that entitle an operator to re-negotiation of a performance-based contract, will send the right signals to both operators and regulators that compliance and non-compliance are increasingly less ambiguous, and the terms of playing the field, are increasingly transparent and clear.

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