



A case for negotiated performance-based contracting rather than competitive tendering in government public transport (bus) service procurement



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ABSTRACT

Australian federal and state governments have entered numerous free-trade agreements with other nations. A focus of these agreements and related policies is the requirement for participating governments to procure goods and services via public tender. While such tendering is purportedly to obtain 'value-for-money' solutions for governments, in practice, tendering is often aimed at procuring goods and services at the lowest possible price. Against this blanket approach there are circumstances in which alternatives to tendering can and should be utilised. This paper reviews academic research over the past decade, in particular research developed for and presented at Thredbo Series Conferences, which examines how public transport and particularly bus services should be procured in the context of a discussion about service cost and quality. It outlines the successful implementation of negotiated performance-based contracting (NPBC) in Victoria, Australia, in respect of its bus network, and concludes that there is no reason why competitive tendering should be viewed as the most appropriate method of procurement in each and every instance or even the 'default' position. Indeed, when there are existing private providers of such services, NPBC appears to be a better alternative to tendering.

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1. Introduction

There has been considerable ongoing debate about how public transport services, in particular, bus services, are best procured by government. Clearly, the best method for governments to procure any good or service is determined by numerous factors, such as the type of good or service being procured, the nature and sophistication of the market for the good or service, and the will of those making the procurement decisions. The worst thing that a government can do is to focus all its energy on applying one method of procurement at the expense of all others regardless of circumstances or context, yet this appears to have been the approach of the federal and state governments of Australia over the past few decades. Over this time, and particularly since the increased use of

free-trade agreements, Australian governments have demonstrated an almost singular focus on competitive tendering without considering the merits of other methods.

This paper will review academic research that has been published and discussed over the past decade, in particular at the Thredbo International Conference Series on Competition and Ownership in Land Passenger Transport, relating to the manner in which public transport services should be procured. The paper specifically focuses on the following:

- Australian free-trade agreements and competitive tendering
- the suitability of competitive tendering for the procurement of public transport services in respect of service cost and quality
- negotiated performance-based contracting (NPBC) as an alternative method for the procurement of public transport services
- the use of NPBC in Victoria, Australia

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- indicative performance outcomes and recent econometric research comparing the cost efficiency of procuring public transport (bus) services via competitive tendering versus negotiation.

The research demonstrates that NPBC can have measureable economic and social advantages over competitive tendering that should be considered by governments when engaged in contracting for public transport services. For example, advantages from NPBC are likely where there is an established existing privately operated bus network. While significant savings have been demonstrated from tendering publicly owned and operated public transport bus services, this is not true of competitively tendering contracts that are already in private hands. Rather, realistically negotiated contracting such as that used in Victoria is demonstrably more likely to result in improved service levels and quality while at the same time optimising the state's return on its investment.

2. Australian free-trade agreements and competitive tendering

Prevailing economic orthodoxy provides that the way to improve the economic welfare of a nation is for it to trade goods and services with other nations. The understanding is that with minimal levels of regulation, the market forces of supply and demand will ensure the resources of participating nations are directed to the areas of market activity in which they hold comparative advantage, leading to the most efficient use of resources and subsequent improvements in economic welfare. To give effect to this orthodoxy, there has been a plethora of free-trade agreements negotiated between nations. As a small open economy, Australia relies heavily on these agreements to open markets in other countries for its exporters. During recent decades, Australian governments have entered numerous free-trade agreements.¹ One of the most significant of these is the Australia – United States Free Trade Agreement (AUSFTA),² which came into force on 1 January 2005.

Chapter 15 of AUSFTA sets out the manner in which government procurement should proceed. It has had a major impact on how Australian Commonwealth Government departments and agencies procure goods and services, as well as on how the states and territories do so, including the State of Victoria. Soon after AUSTFA was executed, prescriptive policies for an extremely wide range of goods and services were developed by Australian governments to give effect to AUSFTA, including procurement value limits and appropriate methods of procurement relating to these limits.

From 1 January 2015 however, all departments and agencies of the State of Victoria have moved away from such a prescriptive approach. Among other changes, the new approach no longer has set value limits. According to the home page of the Victorian Government Procurement Board (VGPB) website, this change represents a shift for procurement 'from a financial threshold to a complexity and risk based model'.³ The Commonwealth has also recently revised its procurement law and principles,⁴ but its

approach remains very prescriptive and reflective of the requirements of Chapter 15.

For governments, the focus of free-trade agreements and related policies is for their departments and agencies to procure goods and services via competitive tendering. At the international level the rise of competitive tendering and privatisation has been based in the 'New Public Management' approach which seeks to introduce market-like disciplines into public sector decision-making. The claim is that this will improve service efficiency by reducing costs per unit of output, and effectiveness in responsiveness to consumer demands. Stanley et al. note that:

It is characterised by purchaser–provider splits, contracts defined by performance targets (with Key Performance Indicators [KPIs] embedded, directly influencing provider remuneration) and by politicians acting like corporate non-executive directors (e.g. removed from the decision-making process for delivery and contract management) (Stanley, Betts, & Lucas, 2005, p. 8).

While this tendering purportedly has the purpose of ensuring value-for-money solutions for participating governments, in practice it is often simply procuring goods and services for the lowest possible price as determined by the cost to the relevant government department or agency, rather than the best possible benefit for the society as a whole. In particular, the 1990s saw a noticeable increase in competitive tendering of a range of services that had previously been supplied by governments. This was mainly driven by pressures to reduce the budget cost impact of service provision (Hensher & Stanley, 2003a, p. 3).

This increase in competitive tendering raises an immediate question about how to properly judge and assess quality in tender responses. While it may be easy to identify and compare pricing of tender responses in respect of the procurement of some government goods and services, identifying assessment criteria and judging quality becomes extremely difficult for tenders relating to goods and services that need to be integrated with other government objectives as do public transport services.

A European Union (EU) Transport Research program in the late 1990s provided an early focus on public transport service quality through its *Quality Approach in Tendering Urban Public Transport Operations* (QUATTRO), part of the EU's 1998 *Fourth RTD Framework Program* project. The project's final report concluded that quality is one of the key dimensions in the provision of urban public transport deserving of more attention from authorities and operators in the future (EU, 1998, p. 7).

QUATTRO built on another EU research project, *Improved Structure and Organisation for Urban Transport Operations of Passengers in Europe* (ISOTOPE). The ISOTOPE project concluded that although 'the introduction of competition [via competitive tendering] usually led to significant efficiency improvements and, consequently, to lower subsidy requirements, its conclusion as to the impact of liberalisation on effectiveness [quality] was far more ambiguous' (EU, 1998, p. 8). Indeed, a major issue is that quality expectations can develop during the course of a contract, reflecting the need to recognise incomplete contracts and a process for regularly refreshing contractual provisions during the contract term. Those in favour of using negotiated contracts hold that this form of contracting is more suited to the relational approach that this adjustment process requires (Stanley, 2011, p. 10).

The relational approach is typically absent from the competitive tendering model in which contract payments are often tied to predetermined milestones that preclude mid-contract adjustments without escalating and unbudgeted costs. As a result, projects risk system redundancies in critical areas.

¹ For a complete list of the free-trade agreements Australia has made, see <http://www.dfat.gov.au/trade/agreements/pages/trade-agreements.aspx>. Last accessed 5.05.14.

² For the complete document, see <http://www.dfat.gov.au/trade/agreements/ausfta/Pages/australia-united-states-fta.aspx>. Last accessed 5.05.14.

³ See <http://www.procurement.vic.gov.au/About-the-VGPB>. Last accessed 5.05.14.

⁴ See <http://www.finance.gov.au/procurement/procurement-policy-and-guidance/commonwealth-procurement-rules/>. Last accessed 5.05.14.

3. The suitability of competitive tendering for the procurement of public transport services

This raises the question of the suitability of competitive tendering for government procurement of more complicated government or social services such as public transport services. While competitive tendering may be a sensible procurement method for a good or service which is standardised, or something for which there are easy off-the-shelf solutions, it cannot be assumed for the procurement of more complicated types of government or social services such as public transport services.

As far back as the EU's QUATTRO project, it has been evident that:

[Public] transport is more than a business. Its missions are so closely related to the quality of life and to the economic development of a town that its provision cannot always be driven by market forces alone; it sometimes seems appropriate for public authorities to intervene on or in [urban public transport] services in order to ensure their delivery in adequate conditions of quantity and quality. However, the need for public intervention depends heavily on local situations (EU, 1998, p. 17).

Given that it is accepted that passenger transport externalities (e.g. environmental effects, safety problems, congestion problems, well-being, regional development) cannot be adequately evaluated and dealt with at the level of the individual transport operator, it is only the implementation of more global policies by a city or regional authority, which in turn requires clear and consistent relationships between the relevant authorities on the one hand, and the operators on the other, which can 'significantly improve mobility conditions while reducing the negative externalities produced by transport operations in the city' (EU, 1998, pp. 153–154).

In response to criticisms of the New Public Management focus on cost reduction without properly understanding the true costs and benefits of increasing investment in public transport services, a new approach, Public Value Management (PVM), emerged. Public value provides a broader measure than is conventionally used within the new public management literature, covering outcomes, the means used to deliver them as well as trust and legitimacy. It also addresses issues like equity, ethos and accountability (Kelly, Mulgan, & Muers, 2002, p. 3).

Stanley et al note that the PVM approach recognises that public or social preferences may be different to private preferences and can encompass matters not revealed by the market place (e.g. public preferences for trustworthy government or for protecting the interests of future generations). The existence of such public preferences creates an argument for government action additional to more traditional 'market failure' reasons (Stanley et al., 2005, pp. 8–9).

The authors identified three key implications of PVM for the planning and delivery of public transport services in a privatised system:

- a need to include community engagement at all stages of the STO [Strategic, Tactical and Operational] framework, with attention on revealing social or public preferences, managing the engagement so as to ensure it supports more effective outcomes (rather than confusing and hindering delivery);
- less slavish adherence to the ideology of competitive tendering and a greater emphasis on alliance partnerships in pursuit of shared public interest outcomes; and
- greater focus on public accountability/transparency through the STO process, as part of the process of building trust (Stanley et al., 2005, p. 11, p. 11).

Public transport services must also be fully integrated with the achievement by governments of various policy imperatives such as proper land use and city planning, regional development, enhancing social inclusion of citizens, improving the environment, improving the efficiency of road travel and reducing congestion. However, numerous factors make implementing such policy extremely difficult.

Viegas identified three central issues for policy implementation. First, there is an ever-widening set of objectives that transport decisions are expected to consider, the most commonly mentioned of which are safety, environmental quality, social equity, national competitiveness, economic development, technological leadership, human resource redistribution and social welfare (Viegas, 2005, p. 37). To these can be added community cohesion, which is specifically relevant in the Victorian case. Second, there are multiple perspectives and interests, all claiming legitimacy. Third, the institutional framework is complex with each transport problem engaging a large set of affected stakeholders. As Viegas (2005, p. 44) saw, 'this generates a high risk of cacophony, inconsistency, and high cost of the decision process with low effectiveness'.

When these matters are considered, the procurement of public transport services becomes a great deal more complex than simply purchasing an off-the-shelf solution. It is clear that the procurement of public transport services does not lend itself easily to a simple competitive tendering solution. More complex procurement models must be designed to achieve such a range of interconnected outcomes.

Importantly, while fair-trade agreements have an overriding preference for competitive tendering as the method of procurement, they do, in very specific and delineated circumstances, allow some flexibility for government procuring entities to undertake alternative methods of procurement; however, the alternatives are the exception rather than the rule. For example, there are times when it is possible to undertake a direct approach to the market to procure a good or service; however, this approach is generally adopted only after there has been a public tender and no contractors have responded to a request for tender.

Given the unique characteristics of a service such as public transport, it is arguable that free-trade agreements need to be amended to exclude the procurement of this service from their operation or, at the very least, that they should be modified to provide or permit a more suitable way of procuring public transport services. As noted, there has been a move in Victoria towards acknowledging that determining procurement methods based almost solely around dollar values, irrespective of the complexity of certain products, is not the best way to procure items. A 'root-and-branch' reform of VGPB policies has been occurring over recent years, and Victorian departments and agencies were required to transition to the new regime and policies by 1 January 2015.

The procurement *Reform statement* issued by the VGPB provides the following:

[Procurement] reform introduces a policy framework to support a more strategic and more efficient approach to procurement. It is underpinned by high standards of probity, accountability and flexibility with a strong focus on value for money, more interactive engagement with the market and productivity improvement. The reform will reposition procurement as a core business function. It places the onus on the buyer to understand how best to manage the procurement process, *engage the supplier market and align the skills required to manage the procurement (capability) with the requirements of the procurement activity (complexity)* (italics added).

The VGPB procurement reform has specifically removed the dollar thresholds and the prescriptive rules for approaching the market. It has also decreased the number of policies from 38 to five. These five policies are Governance, Complexity and Capability Assessment, Market Analysis and Review, Market Approach, and Contract Management and Contract Disclosure.⁵ When applying the policies, Victorian departments and agencies must ensure that all procurement activity meets the requirements of value for money, accountability, probity and scalability directives. Procurement can only proceed when an organisation determines it has the necessary capability to meet the complexity of the procurement activity.

In addition, VGPB produced a guide document⁶ to be read with the Complexity and Capability Assessment Policy. This guide makes it clear that a department or agency needs to assess the complexity of the procurement, which will generally mean placing it into one of four quadrants, and then deciding which procurement method is appropriate. If it is a 'focused' or 'strategic' procurement, the method can be a 'limited tender' (i.e. a direct approach to one or more potential suppliers without notification to the open market).⁷

However, it remains unclear how this new approach will play out on a practical level, or how the VGPB will manage obligations under the AUSFTA that include a global presumption for competitive tendering, certainly above prescribed dollar thresholds, which as it applies to the procurement of goods and services by the Victorian government is generally set at AU\$551,000.

Reform policies	Details
Governance Policy	<ul style="list-style-type: none"> • Governance structure embeds procurement across the organisation and ensures alignment with business planning • Greater focus on up-front strategic planning and transparency to provide consistency of market approach and better value-for-money procurement decisions
Complexity and Capability Assessment Policy	<ul style="list-style-type: none"> • Procurement decisions based on an assessment of complexity and the capability of the entity to conduct the procurement. Procurement can only proceed when an organisation determines it has the necessary capability to meet the complexity of the procurement activity
Market Analysis and Review Policy	<ul style="list-style-type: none"> • Market analysis determines the capacity of the market to supply, and the opportunities for market-based solutions. A review of requirements and processes in response to market analysis determines the most appropriate path to market
Market Approach Policy	<ul style="list-style-type: none"> • Applying a structured, measured approach to informing, evaluating and negotiating with suppliers
Contract Management and Contract Disclosure Policy	<ul style="list-style-type: none"> • Contract management is escalated to a high-level consideration early in the planning process to arrive at an integrated end-to-end procurement framework

⁶ <http://www.procurement.vic.gov.au/Buyers/Policies-Guides-and-Tools/Complexity-and-Capability-Assessment-Policy>. Last accessed 5.05.14.

⁷ See <http://www.procurement.vic.gov.au/Buyers/Policies-Guides-and-Tools/Complexity-and-Capability-Assessment-Policy>. Last accessed 5.05.14. (Pages 4 and 5 are the most relevant.)

4. Negotiated performance-based contracting as an alternative method for the procurement of public transport services

There are circumstances in which the procurement of public transport services falls within an express exemption to the rules of a fair-trade agreement (as they did for metropolitan route bus services in Melbourne in 2008).⁸ There are also circumstances in which public transport services are excised from these rules or the rules are modified to allow for more complex procurement methods. Under such circumstances it has been demonstrated in practice that another viable way for governments to procure such services and obtain better value-for-money solutions is through negotiated performance-based contracting.

As long ago as 2003, Hensher and Stanley argued that negotiated contractual agreements, based on achieving designated performance objectives reflected, for example, in KPIs and incentive regimes, hold the best prospect of delivering better value for money in terms of meeting multiple objectives of the type aimed at meeting community service obligations by rewarding initiatives that increase user benefits and rewarding externality reduction (Hensher and Stanley (2003a, 2003b)).

The theory and practice of NPBC as an alternative to competitive tendering as means to award the right to provide service has been a continuous focus of the Thredbo conferences for over a decade.⁹ Negotiation is a process through which parties perceive one or more incompatibilities between them and work to find a mutually acceptable solution. This is in direct contrast to competitive tendering which functions more like an auction. Where the result of an auction *determines* the value of a product or service, negotiation is designed to *create* that value. As such, the opportunity to negotiate adds potential benefits that are denied through tendering (Hensher & Stanley, 2007, pp. 1145–46).

Tendering will necessarily be problematic in complex projects where contractual design is incomplete. This is of particular importance in the consideration of area-wide contracts in bus and rail given that:

[R]eal world contracts are almost always 'incomplete', in the sense that there are inevitably some circumstances or contingencies that are left out of the contract, because they were either unforeseen or simply too complex and/or expensive to enumerate in sufficient detail. [Non-contractible elements in transit] may include innovation, planning expertise, driver attitude and manners, vehicle cleanliness, etc. 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 (Hensher & Stanley, 2007, p. 1148).

A series of studies has shown that competitive tendering stifles communication between buyers (i.e., the government agency) and

⁸ An exemption from having to tender was allowed due to exceptional circumstances, that is, when circumstances support an alternative approach to the market, and it is not used for the purpose of avoiding competition.

⁹ Stanley (2005, p. 427) noted four areas of concern central to the debate at Thredbo 8 about competitive tendering versus NPBC as a means of awarding rights to provide public transport services: First, service specification can be difficult for complex service tenders, making comparison of alternative bids difficult and creating uncertainty that can discourage bidders. Opportunistic bidding with a view to re-negotiating more favourable contractual terms after winning a bid can be encouraged by difficulties with specification. (Alternatively, the 'winner's curse' may be an outcome of poor service specification.) Second, collusion between bidders reduces the effectiveness of a competitive tendering process. Third, the lack of any clear evidence of service quality improvement may be partly due to poor authority performance. Fourth, the clear advantage enjoyed by an incumbent when it comes to re-tendering, for reasons such as information availability (e.g. over asset quality, demand characteristics, etc), can be a major disincentive to alternative bids.

sellers (i.e., the service provider), preventing the buyer from utilising the contractor's expertise when designing complex public transport projects (Hensher & Houghton, 2004; Hensher & Stanley, 2003a, 2003b; Stanley, 2009; Stanley et al. 2005).

Rather, value for money is more likely to be demonstrated through the implementation of a credible results-based regulatory scheme able, as Hensher observed, to govern the procurement of public services *ex-post*. This would necessarily require the development of trusting partnerships and (incomplete) commercial contracts with unambiguous incentive and penalty structures throughout the life of a contract. Market mechanisms such as competitive tendering would still be present as a way forward should operators fail to comply with their contract obligations (Hensher, 2015, pp. 139–40).

The transaction costs of re-tendering through competitive processes (which is essentially an *ex ante* competitive process) are very high and such processes are typically incomplete, causing *ex post* adaptation to become an important feature of the transaction. Properly structured, transparent and performance-based negotiated arrangements are able to avoid this problem and protect the provision of service, while meeting other important government service objectives (Hensher & Stanley, 2007, p. 1150).

Some proponents of NPBC argue that this procurement form is most likely to support a trusting partnership between purchaser and provider and that, given scarce skills on both sides, that such a relationship is more likely to maximise goal achievement through service provision than an awarding mechanism based on competitive tendering. Trusting partnerships are particularly important because of the problems posed by incomplete contracts. As has been noted, changing market environments make the precise specification of contractual obligations extremely difficult (Stanley et al., 2005; Stanley & Hensher, 2011). Since public transport contracts typically extend between 7 and 10 years, such changes are inevitable.

Stanley proposed a number of requirements for purchaser—provider partnering, largely irrespective of the functional setting in which the partnership is based.¹⁰ These emphasise the importance of trust and mutual commitment to the successful implementation of long-term high quality service provision.

This notion of a trusting partnership has further evolved through recent Thredbo conferences as being grounded in 'five Cs'. The five Cs are:

1. **common** core objectives that are tied to public-policy purposes
2. **consistency** of behaviour and direction
3. **confidence** in the partner's capacity to deliver
4. respect for the **competencies** of each party
5. **commitment** that demonstrates good faith in making and keeping arrangements and in principled behaviour (Stanley & Hensher, 2011, p. 13).

¹⁰ These requirements can be summarised as follows (Stanley, 2005, p. 428):

- common objectives tied to public policy purposes.
- agreed governance arrangements.
- trust—this was seen to be based on a number of factors, including:
 - selection of the right partners.
 - confidence in a partner's capacity to deliver.
 - demonstrated good faith.
 - accountability/transparency—which can aid in supporting trusting relationships between partners but is likely to be particularly important in conveying to the wider community that a trusting partnership is not merely another form of regulatory capture by the service provider.
 - written agreements/contract incorporating the above principles. Stanley noted that this emphasis on the pre-contractual environment, and on principled behaviour, provided a major focus for the Workshop at Thredbo 8.

The five Cs reflect the approach taken by the parties in the last round of negotiated Melbourne bus contracts in 2008.

A question arises relating to concerns about overly expensive contracts or regulatory capture. Stanley and Hensher note that Australian experience suggests that under NPBCs, transparency and accountability in this regard 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; KPIs and the threat of competition (through competitive tendering), in the event of inadequate performance, assists the maintenance of competitive pressure and efficient performance—the relevant association is best placed to represent the bus industry in setting up a benchmarking process.
2. an open-book approach to costs, with a third-party auditor to verify the data
3. appointment of a probity auditor to oversee the negotiation process
4. public disclosure of the contract (Stanley & Hensher, 2011, p. 8).

It will be seen in the next section that these exacting requirements have been successfully implemented in the Victorian bus industry.

5. The use of negotiated performance-based contracting in Victoria

NPBC, including relevant KPIs, has been the predominate model of procurement of privately operated bus-route services in Victoria. Since 1982, many Victorian state governments (of all persuasions) have agreed to separate the treatment of existing bus services and new bus services, and negotiate with the industry representative body, Bus Association Victoria, for the procurement of existing bus services in the context of working together to address relevant policy imperatives. Increasingly sophisticated processes have been developed and agreed over this time to ensure, as far as practically possible, that the procurement of public transport bus services is open, transparent and presents a value-for-money option for the state.

In Victorian practice, state governments have provided funding support for approximately four decades. The Victorian experience thus offers a significant case study of NPBC in action. Service provision is based on exclusive franchise areas for particular operators, with Melbourne contracts reflecting benchmarked costs for the service levels provided. (These are termed 'gross cost contracts'.) In the years leading up to 2008, Melbourne route bus operators and the Victorian Government supported a trusting partnership approach, encompassing both the tactical and operational stages. The process was completed in July 2008 when new route bus contracts came into effect, reflecting the matters agreed through the trusting partnership relationship.

In addition to the goal of pursuing a trusting partnership relationship, Stanley (2009, pp. 102–103) provides a summary of the following goals agreed by the parties as the basis for the negotiations leading up to the entering of the contracts:

For government

- value for money—with the reform process outlined below indicating some of the ways realisation of this goal will be achieved
- flexibility and continuity in service provision are achieved by the new contract provisions
- accountability and transparency are achieved by the contract-negotiation process

For operators

- business continuity is achieved for at least ten years, subject to performance that meets contract KPIs
- fair contract remuneration is achieved through the contract-negotiation process
- clear operating guidelines are achieved through the contracts and through associated practice notes, which add interpretation to some matters that will evolve during the course of the contract—the trusting partnership allows such measures to be used to handle some key areas where change will be required, setting out how the change process will be managed.

This trusting partnership approach has delivered an effective, stable and economically viable delivery of services which at the same time allowed sufficient flexibility to negotiate changes proposed by either of the parties within the contract term.

Key elements in the agreement between the government and the bus industry included an accountable costing process in setting gross contract prices for NPBCs and use of benchmarked efficient costs in setting contract rates. This process includes cost substantiation for perceived high costs, to demonstrate that service provision is efficient, with a reduction in payments where such substantiation is judged to be inadequate, subject to agreed appeal processes. A process of comprehensive service reviews ensures that funding is allocated to best effect in terms of government service provision goals, public availability of the route bus contracts, and the implementation of patronage, operational performance and service quality incentives in contracts subject to caps on scale of approximately 2 per cent of contract value, which as Stanley (2009, p. 103) noted is consistent with much international practice.

Contract negotiations were focused on agreement on the commercial principles¹¹ and subsequent contractual detail that would facilitate the achievement of these objectives throughout the term of the contract. Again, the trusting partnership approach was primary. In Victoria, both parties agreed to a set of procedures to be followed in a compilation of costs during the negotiation process, and the Department of Transport agreed to a negotiation process. It

¹¹ Stanley (2009, p. 103) notes that these commercial principles included:

- length of contract = seven years plus a roll-over for another three, subject to satisfactory performance against KPIs—the contract is silent about what happens at the end of the ten year period, a matter for subsequent discussion and negotiation.
- security—a performance bond, set at a level agreed as being fair and reasonable.
- access to assets are to be owned by the operator but with government right to access in the event of termination.
- dealings with assets the operator must notify the Director of Public Transport in relation to dealings with depots and buses but not other assets.
- service continuity—the contract contains defined breach, cure, step-in and termination regimes.
- service variation/flexibility—an agreed process is specified, including a future option for an operator to have some flexibility in which kilometres are provided (linked to agreement for a patronage incentive).
- Greenfields services to be tendered in an open market.
- Orbital SmartBus services to be tendered in an open market.
- Non-Orbital SmartBus services (i.e. premium trunk services that are not orbital) = a process has been agreed for selective tender among materially affected operators.
- financial transparency an agreed cost template was completed by operators and a review process agreed, whereby 'high costs' require justification and may be trimmed and 'low costs' may be argued as a basis for increased payments.
- performance-based contract with a patronage incentive, operational performance incentive and qualitative performance incentive regimes.
- bus-replacement program—program agreed across the full set of operators (26) and contract years.
- funding model—covering such matters as how remuneration will change over time, beyond the starting agreed payment (and including how the KPIs will work).

felt the negotiation process proposed by the Director of Transport offered the following opportunities for operators:

- to negotiate exclusively with the Director for the award of a new service contract
- to commit to a process that is designed to ensure that both the operator and the Director negotiate and enter into a new service contract
- to make an offer to the Director that demonstrates the value for money the service delivers to the state
- to work with the Director to achieve the service objectives and support the state's substantial commitment to the metropolitan bus industry through the implementation of the government's transport policy of the time entitled '*Meeting Our Transport Challenges*'.

The Director consulted extensively with Bus Association Victoria in developing this negotiation process, and sought to create a transparent, accountable and fair process. It began with the Director Invitation to Negotiate (ITN) documents sent to each operator, setting out the terms of the negotiation. The ITN documents covered the Director's commercial, technical and legal requirements for the negotiation. To accept the Director's ITN, the operator was required to sign a formal and enforceable Commitment Deed, which included an Acknowledgement Letter. By doing so, the operator and the Director committed to certain obligations, and the negotiation process began. Operators were not obliged to accept the Director's invitation. If they did not wish to do so, they did not sign the Commitment Deed. Some key aspects of the documents are summarised below.

5.1. ITN documents

The main purposes of the ITN documents were:

- to invite operators to submit an offer to perform services from the expiration of the operators current contract (if applicable as extended under the Commitment Deed) under a new service contract
- to detail the process to be followed in submitting the offer
- to detail the documents and information to be submitted with the offer
- to identify key deadlines for deliverables
- to summarise the basis on which the offer would be evaluated.

The ITN did not form part of any subsequent contract, nor was it an offer to contract.

5.2. Commitment Deed

The main purposes of the Commitment Deed were:

- to require the operator to commit to certain rules (e.g. confidentiality) with which the state usually requires the private sector to comply when the state is procuring services
- to record the operator's commitment to provide accurate and complete information with the offer and to comply with the ITN documents
- to record the operator's and the Director's binding commitment:
- to negotiate in good faith to enter into a new service contract
 - to agree to a process for negotiating pricing-specific aspects of the offer
 - to resolving any differences that may arise between the operator and the Director during the negotiation so that a new service contract can be entered into.

The Commitment Deed was a binding contract between the operator and the Director. Negotiations could not begin until the operator and the Director signed the Commitment Deed and the Acknowledgement Letter. If necessary, to facilitate the ITN process under the Commitment Deed, the Director had an option to enter into a new interim service contract with an operator on substantially the same terms as its current contract (including the same contract payments) for a term of three months.

5.3. Financial Template and the Financial Template instructions

The main purposes of the Financial Template and the Financial Template Instructions were to provide a template to document the operator's financial offer, to provide details of the financial information the Director needed to assess the offer, and to establish procedures for how the Director intended to evaluate this financial information. It was critical for the financial information to be accurate and complete. The Director was not obliged to start negotiations, or indeed, could end them, if the information was not provided.

To accept the Director's invitation and to submit a valid offer, operators were required to submit the signed unamended Commitment Deed and the Acknowledgement Letter together with other offer documents, completed in all respects and in accordance with the ITN documents, to the Director by the due dates.

Each of the offer documents and their purpose are summarised below.

5.4. Offer details

The Offer Details document summarises the operator's offer. It was required to include details of the operator's background in the industry, corporate and financial structure, including entity type (e.g. company or trust), ownership interests, financial overview, related entities, subsidiaries and parent companies, including relationships between the operator's group and bus operations, and a brief overview of the offer, including key financial components and value-for-money propositions.

5.5. Operator's service plan

This document was to be completed in the form of the Operational Service Plan Template provided by the Director and in accordance with the passenger service requirements (PSR).¹²

¹² PSR refers to the Director's requirements for local services specified in the document set out in Part B of Schedule 1 (as revised and reissued) including information on the following matters:

- the origin and destination of each route.
- the stops that must be served along each route.
- the latest acceptable time for the first departure and the earliest acceptable time for the last departure (in each direction on each route).
- the minimum service levels (per hour) during the day (in each direction on each route).
- the maximum allowable journey time (in each direction on each route).
- additional short runs (i.e. those not running the full length of the route) that are designed to enhance peak services by alleviating vehicle overcrowding at key locations.
- service deviations that may be required to service schools in the morning and afternoons only.
- points along each route where services should be coordinated with train, tram or other passenger services.
- school services, major services and any other special services.
- flexible services.
- any other similar requirements notified to the operator in writing.

5.6. Completed Financial Template

The Completed Financial Template formed the basis of the financial components of the offer. Where there were inconsistencies about financial details between the Completed Financial Template and other offer documents, the financial information in the Completed Financial Template prevailed. The Completed Financial Template was required to be completed in accordance with the Financial Template and Financial Template Instructions. All relevant sections were required to be completed.

5.7. Statement of Key Financial Assumptions

This document was a summary of the key financial assumptions used in the process of completing the commercial bid items contained within the Completed Financial Template. The main purposes of the Statement of Key Financial Assumptions were to outline the basis of calculation of the items in the Completed Financial Template, to identify any material items of estimation contained in the Completed Financial Template, and to explain and substantiate any financial assumptions upon which the Completed Financial Template was based.

The Statement of Key Financial Assumptions was required to explain the manner in which the Financial Template line items had been calculated and at least ensure the following:

- detail the basis for calculating depot rent for any depot owned by the operator or a related party—supporting documentation should also be provided with this (e.g. recent valuations based on existing use and site plans identifying the size of area used for depot purposes and any surplus area)
- identify any forecast actual increase in operating costs relating to specific contract obligations that could not be met by the activities currently undertaken by the operator
- detail the basis for calculating the fuel consumption rate used in the Completed Financial Template, including the actual average fuel consumption rate for the year ended 30 June 2006
- detail any other financial assumptions material to the operator's offer or the Director's consideration of it.

5.8. Formal letter of offer

This document is the letter of offer. Its purpose was to confirm that the operator had submitted all of the Offer Documents and that they were correct and complete, and that the offer was open for acceptance by the Director for the required period.

5.9. Acknowledgement Letter, Variance and Contractual Binding

This document had to be submitted at the same time as the Commitment Deed. Its purpose was to confirm that the operator understood and would comply with the transparent financial review process outlined in the ITN documents. Alternative offers were acceptable under very specific requirements and subject to the Director's discretion. Operators could vary their offer documents after submission, or make a supplemental offer, only if invited by the Director to do so. The offer was required to be binding on the operator and capable of acceptance by the Director for the period required in the Commitment Deed. An operator was able to withdraw their offer after submission only if agreed by the Director.

5.10. Financial review process

The Director intended to achieve the service objectives of financial sustainability and value for money through a transparent financial review. This review included the following:

- operators being required to apply the detailed Agreed Upon Procedures (as described below) in compiling annualised operating costs in the Financial Template
- operators submitting a Completed Financial Template and Statement of Key Financial Assumptions
- an independent audit of the performance of each operator's Member in Public Practice in compiling the Completed Financial Template in accordance with the Agreed Upon Procedures, the Financial Template Instructions and the other relevant requirements of the ITN documents
- each operator substantiating their offer, if it was identified as an outlier (outside certain financial parameters), including any increase in contract payments compared to the amount received under the existing service contract (adjusted for indexation).

This process was developed in consultation with Bus Association Victoria and was agreed to be an appropriate process for compiling and analysing the financial information to be submitted with operator offers.

5.11. Agreed Upon Procedures

Operators were required to appoint a Member in Public Practice to compile the Completed Financial Template using the Agreed Upon Procedures. They were required to provide a letter of acknowledgement to the Member in Public Practice and to the Director that outlined the basis of preparation and correctness and completeness of the information provided to the Member in Public Practice for use in compiling the Completed Financial Template.

The Agreed Upon Procedures detail the manner in which the operator's actual operating costs reported in their financial statements for the year ended 30 June 2006 (and associated operating data) were to be adjusted to meet the requirements of the Financial Template. The Agreed Upon Procedures specified the manner in which the following adjustments would be made to derive annualised actual operating costs as at 30 June 2006:

- removal of any capital-related costs, amortisations and payments to shareholders
- allocation of costs to non-contract commercial activities such as charter
- allocation of costs across multiple contracts (where applicable)
- treatment of related party transactions, including the allocation of any costs of corporate head office
- one-off and ongoing service changes during the 2006 financial year
- other significant one-off factors impacting the cost structure during the 2006 financial year
- treatment of cost inflation.

Where operators identified additional costs (e.g. new costs that they believed arose from the new contract), these were not part of the baseline established by the Agreed Upon Procedures. Such items were required to be identified separately in the Statement of Key Financial Assumptions and in the fields provided for in the Financial Template. In addition, operators were required to identify and substantiate the link between the contract obligation and the additional cost. The specific sections of the Financial Template to be completed by applying the Agreed Upon Procedures

included annualised operating costs, operating data, and new services.

The Member in Public Practice was required to provide a report to the Director on their factual findings of applying the Agreed Upon Procedures and prepare a detailed working paper file. The report by the Member in Public Practice was required to include a statement outlining whether during the course of applying the Agreed Upon Procedures anything came to the Member in Public Practice's attention that would lead them to conclude that the information compiled in the Completed Financial Template was materially incorrect or misleading. The Director appointed an independent accountant to audit the process of the application of the Agreed Upon Procedures by the operators' selected Member in Public Practice and reported the findings to the Director. The independent accountant's report was not to contain any information specifically concerning particular bus operators.

The Agreed Upon Procedures did not cover the preparation of any commercial bid items, such as margin, rent for owned depots, and forecast cost adjustments for any change in resources required to comply with the new contract. These commercial bid items were required to be prepared separately by the operators and documented in the Statement of Key Financial Assumptions. They were also required to be separately identified in the Financial Template and added to the operating costs derived using the Agreed Upon Procedures for the purposes of determining the contract price submitted in the offer. There was a specific input table provided in the Financial Template. The overall costs (including any new costs) would be used for outlier analysis as described.

As can be seen, the process was designed to both protect and advance the interests of both parties to the contract. This is quite distinct from a competitive tender process whereby tenderers historically attempt to win business by satisfying only the minimum specified deliverable requirements. Indeed, for this and a series of related reasons some have called for the abolition of competitive tendering as a means of procurement (M. Stanley, 2011). Certainly NPBC offers a valid alternative to the prevalent approach of competitive tender.

6. Indicative performance outcomes and recent econometric research

In examining the merits of government procuring public transport services via competitive tender versus negotiation, a final question may be whether there is evidence for any discernible difference in performance between bus operators who have acquired their interest in their bus routes historically and via a negotiated process with the state and those who have done so via a competitive tender.

Acquiring such evidence would require a great deal of detailed research; however, it can be observed that the latest tender winner/bus operator in Melbourne, which operates approximately 30 per cent of the Melbourne metropolitan bus routes, appears to be experiencing great difficulties in meeting the requirements of the state. For example:

- The on-time operation of its buses (as at November 2014), both at the destination and at timing points, is worse than when that operator took over responsibility for the services in August 2013, and well below that of the other larger (comparable) existing operators.
- It is clear from the number of customer complaints that the customer experience of that operator's passengers has deteriorated compared to when the previous operator had the contract.

The number of complaints from passengers (39) using its buses for the six months ended 30 June 2014 is almost equal to the number of complaints against all other metropolitan bus operators combined (51).

- There are examples of the latest operator failing in its obligations to consult properly with the community regarding alterations to various bus routes in Melbourne (e.g. in the Maroondah District), which meant the relevant minister of the time and the government authority had to become involved and reinstate at least one service. This mistake had cost implications for the authority and the state.
- Further, given the difficulties that operator experienced with its one localised set of route changes, it is questionable how it is going to recommend and deliver an entire set of new 'Greenfield' routes as its contract with the authority envisages.

Interestingly, a different multinational operator of these services in the late 1990s and early 2000s withdrew from its multimodal contractual obligations in 2003, which demonstrates what can happen when firms aggressively bid for contracts (i.e. when prices are set below minimum market-acceptable commercial requirements). The original bid for the services is understood to have been significantly under the prevailing industry benchmarks in terms of margin (National Institute of Economic and Industry Research, July 2011). The state government then awarded the operating rights to these services to two local family-firm bus operators for ten years, but when the authority tendered the services again in 2012, they awarded the operating rights to these services to the incumbent multinational operator with a 2013 commencement. Clearly the competitive tendering model in itself is no guarantee of satisfactory performance.

Further, in April 2012 in South Australia, reports emerged that an operator that was appointed in July 2011 to run approximately half of Adelaide's route bus network was 'bleeding' as a result of the competitive tender process because of unexpected costs. It was suggested by some that government made a short-sighted decision in awarding the tender to the operator with the cheapest price. The operator subsequently faced fines (*Indaily* 12 April and 22 April 2013, *Australasian Bus and Coach* May 2013, *Mannix* 26 November 2013) and lost some of its services, which the South Australian government then returned to the previous operator (Lowe, 2016, p. 175).

These examples demonstrate that services and quality can decline when a government or authority simply award a service contract to the cheapest bidder. This phenomenon does not occur only locally in Australia. In Canada in 2012, small family-owned companies that had operated school buses for generations were going out of business due to being outbid by a multinational enterprise operator. The Canadian Education Minister was quoted as saying 'you can have a multinational company in at maybe a little bit cheaper of a price, but what happens to that community for so many years? [You] can be penny-wise and pound foolish when it comes to some of these decisions' (*The Canadian Press* 27 February 2012).

In an Australian context, once such small multigenerational firms are lost there are also irreplaceable losses to the communities they service, both in community cohesion and economically in the loss of regional incomes to centralized and possibly multinational non-regional fleet operators (Lowe, 2016). The social cost of such regional devastation is of no concern to the narrowly economic focus of the proponents of competitive tendering.

In comparing NPBC and competitive tendering across Australia, recent econometric research found that NPBC, even before benchmarked targets are implemented through the negotiation process, offers a three percentage points gain in cost efficiency (Hensher,

2015, p. 144). This shows it is simply wrong to assume that competitive tendering will ensure greater cost efficiency than (pre-benchmarked) NPBC where there is an existing network of privately operated buses. Further, NPBC does not attract the additional costs of administering a competitive tendering process, and removes the risk of service loss that may occur with repeated rounds of competitive tendering when the incumbents are not public operators.

Concomitantly, Hensher's data suggests that the gains from competitive tendering are generally illusory or overstated, that is, outside of the situation of an incumbent public operator. While there is evidence that when moving from an historically entrenched, publicly operated public transport service, competitive tendering has resulted in savings of up to 20–30%, at least in the first round of such tendering, there is also evidence that such savings progressively diminish in subsequent rounds and present a risk to service quality. Hensher argues on the evidence that testing the market for value for money through competitive tendering, in situations where incumbent contract holders are from the private sector, is not consistent with a widely held view that such a procurement plan is looking after the interests of society, compared to benchmarked actioned NPBC (Hensher, 2015, pp. 134, 147).

7. Conclusion

Perhaps the final comment as to whether or not NPBC deserves greater consideration by governments as a means of public transport procurement could be that of the Victorian Auditor General, who in his report on bus contracting in 2009 concluded that 'the department succeeded in negotiating new contracts that are likely to improve value for money' (Victorian Auditor-General's Office, 2009, p. 2). This is exactly the position of Bus Association Victoria in seeking the further renewal of NPBC which reflects that negotiated contracts have successfully operated in Victoria since 1982.

There is no reason why competitive tendering should be viewed as the most appropriate method of procurement in each and every instance or even the 'default' position. From the academic and empirical evidence reviewed in this paper it appears that negotiated performance-based contracts should always be considered as a viable alternative to tendering, particularly where the incumbents are not public operators. In this circumstance, the Victorian experience demonstrates that NPBC can achieve as good as, or better, improvement in cost efficiency alone, compared to competitive tendering.

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