

Contracting regimes for bus services: what have we learnt after 20 years?

John Stanley and David A. Hensher
Institute of Transport and Logistics Studies
Faculty of Economics and Business
University of Sydney, NSW 2006 Australia
J.Stanley@itls.usyd.edu.au
D.Hensher@itls.usyd.edu.au

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Abstract

This paper reviews a number of themes that have played a crucial role in the debate on alternative contracting regimes for the provision of urban bus services. We have selected four crucial issues to reflect on: (i) contractual regimes (in particular competitive tendering as compared to negotiated performance based contracts, as means to award the rights to provide service; (ii) contract completeness (focussing on *ex ante* and *ex post* elements); (iii) building trust through partnership; and (iv) tactical or system level planning for bus services. Experience in these areas suggests that competitive tendering has frequently not lived up to expectations and that negotiation is likely in many circumstances to deliver better value for money. This finding is likely to have much wider applicability across governmental service areas.

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Background

The provision of route bus services in many developed economies has changed considerably over the years. Following an initial situation that often involved private sector provision until about the 1970s, as is still common among developing economies, public sector monopolies became the norm. A substantial swing back to private sector service provision then began in the 1980s, largely driven by a desire to reduce the growing call of services on the public purse and to provide scope for private sector innovation, which was thought likely to improve customer services and reduce costs.

In the UK outside London and in New Zealand, economic deregulation was the major way in which private sector involvement was achieved. In most other locations, the rights to provide service were put to competitive tender. Competitive tendering was also used in some parts of Norway, where existing services were provided by private operators under negotiated contracts.

The enthusiasm for private delivery of route bus services has varied between countries, but Australia has always had a significant private sector presence in bus service provision (for example, in Melbourne and parts of Sydney), and the role of the

private sector was increased through tendering out of services in Adelaide and Perth in the 90s.

Changes in ownership, and their impacts, have been of such interest to various stakeholders, that a biennial international conference has been established to review progress, problems and achievements and suggest directions for improvement. This is the Thredbo Conference series, Competition and Ownership in Land Passenger Transport, which has been held every second year for the past two decades (<http://www.thredbo.itls.usyd.edu.au>). This Series is now in its 20th year, having held 11 very influential meetings throughout the world.ⁱ This paper draws on findings from the past eleven Thredbo Conferences to suggest ways forward for bus planning and contracting regimes. Many of the lessons from bus service contracting are also relevant to planning and contracting of service provision in other sectors.

We have selected four crucial issues to reflect on: (i) contractual regimes (in particular competitive tendering as compared to negotiated performance based contracts, as means to award the rights to provide service; (ii) contract completeness (focussing on *ex ante* and *ex post* elements); (iii) building trust through partnership; and, (iv) tactical or system level planning for bus services.

Contract Regimes: the case for negotiation

The present authors believe that, for public transport services:

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

International experience with competitive tendering of previously government-provided bus services is summarised in Wallis and Hensher (2007). They conclude that, in most cases, competitive tendering reduced the cost of services by 10-50%, the scale of saving depending on the efficiency of the previous monopoly operator, a range of factors relating to the design and management of the tendering process and whether or not a strong market of potential bidders existed. In subsequent re-tendering, Wallis and Hensher note the tendency for cost increases, sometimes due to unsustainably low initial tender prices and/or to a shortage of bidders.

A key expectation in the use of competitive tendering was that it would drive operator innovation and improve customer service. The Dutch have been strong advocates of the competitive tendering approach for this reason but are reporting that results have frequently fallen short of expectations (van de Velde (2007). Eerdmanns et al (2009) attribute this disappointment to three reasons:

1. contractual reasons: the contract provided too little freedom and/or effective incentives for the operator;
2. market reasons: the development potential of the concession was too small for development;
3. organisational reasons: cultural differences between authorities and operators, and/or operator incompetence.

Van de Velde (2007) adds that Dutch authorities are now frequently seeking more of a relationship-based approach with operators, which is difficult with competitive tendering (and has been difficult under European law, which restricted negotiation with potential bidders).

The evidence that savings from competitive tendering (CT) diminish beyond first round tenders, together with dissatisfaction with what competitive tendering has delivered for service improvements in some jurisdictions, has encouraged the search for alternative awarding mechanisms that can sustain performance pressure (Wallis and Hensher 2005). An important development over the past four Thredbo Conferences has been the focus on the theory and practice of negotiated performance-based contracts (NPBCs), particularly as an alternative to competitive tendering, as a means to award the right to provide service (see, for example, Hensher and Stanley 2003, Hensher and Houghton 2005, Stanley et. al. 2005, Yvrande-Billon 2007, Hensher and Stanley 2009).

A common rationale for NPBCs is to deal with the inevitable uncertainty that creates difficulty for *ex ante* contract specification and tender bidding, by adopting an awarding mechanism that can be adaptive and sustain performance pressure *during the course of the contract*. These areas of uncertainty relate, in particular, to questions that relate to service quality, which have proven to be much more difficult to specify in tender requirements than price but are increasingly recognised as the key to desired policy outcomes. By focusing on performance pressure during the contract, NPBCs reflect alliance contracting as used in such areas as building and construction and

infrastructure Public Private Partnerships more broadly. CT remains a fall-back mechanism in the event that service providers operating under NPBCs do not measure up adequately against their key performance indicators.

A further important rationale seen by some proponents of NPBCs is the belief that this contract form is most likely to support a trusting partnership between purchaser and provider, particularly for system planning, and that, given scarce skills on both sides, such a relationship is more likely to maximise goal achievement through service provision than an awarding mechanism based on CT (Stanley et al. 2007). 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 approachⁱⁱ.

Wallis et al. (2009) review the Adelaide experience with three rounds of tendering bus services 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 can not only reduce transactions costs (associated with tendering) but also offers the opportunity to work closely with efficient incumbents to grow trust and build patronage (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.

Dutch experience in this regard was noted above but similar experiences have arisen elsewhere.

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 solutionⁱⁱⁱ. 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)^{iv}, 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 remuneration^v. 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.

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. This result underlines the importance of negotiation as an alternative approach.

Under a negotiated approach, benchmarking plays an important role, 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 (Hensher and Wallis (2005); Wallis and Hensher (2007)).

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. Route bus 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.

To illustrate this issue, 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 bus operators (or contract region service provider) in Sydney metropolitan bus

services contracts (Hensher 2009). Hensher found 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.

Attempts to burden a route bus service 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 contract 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.

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 system design 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 (which requires that operators and the regulator/government do not behave opportunistically), 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). The trusting relationship has seen agreement about system development directions, service improvement and the strongest bus patronage growth in decades (28 per cent growth in patronage over four years, during which service kilometres increased 26 per cent).

Hensher (2009) in the context of Sydney metropolitan route bus 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”. This empirical evidence confirms in a systematic way, the somewhat ‘obvious’ belief in trust as an important lever in the institutional reform of the land passenger transport sector.

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.

Tactical level planning: the foundation for unleashing value for money

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 communities. Ultimate responsibility for system planning will remain with government, but bus operators can add considerable value to system planning, often working through an 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.

Conclusions

A successful contractual setting must align with the following Strategic and Tactical Level Commitments. At the Strategic (or policy) 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 (or system design) 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 vital. 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 providers 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 are 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 including performance-based rollover provisions. The latter is also relevant to improving outcomes under a tendering regime.

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**: Specific, Measureable, Achievable, the Responsibility of the party being assessed, and Timely. These indicators should be linked to performance consequences (which should include possibilities of contract roll-over where the provider's performance has been of a high order).

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 acceptance of boundaries on the degree of contract 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.

ⁱ As joint founder and convenor of the Thredbo series, the second author is well placed to distil the experiences around the world. The first author is an active member of the Thredbo series, helping to guide its focus.

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

ⁱⁱⁱ 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.

^{iv} 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.

^v 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.

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