

## Melbourne's Public Transport Franchising: Lessons for PPPs

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### **Abstract**

The paper reviews the recent franchising of public transport services in Melbourne, Australia, to assess the extent to which the objectives of the franchising were achieved. The major franchisee has failed only a short time into the franchise period. Some financial benefits from franchising have been realised, largely at the expense of franchisee shareholders. These savings are not sustainable. Some aspects of service delivery have improved. Overall, however, franchising has fallen well short of government expectations. The paper asks what can be learnt from this experience to improve future public/private partnerships in public transport. It is critical of the franchising process, in terms of unrealistic expectations and an insufficiently critical acceptance of competitive tendering to deliver outcomes. Changes in the nature of the relationship between the regulator and service provider are proposed, to incorporate a stronger planning focus, closer partnership basis and a greater reliance on negotiated contracts, along lines used in some infrastructure PPPs.

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## 1. Scope

The last two decades has seen a number of major changes in the way public transport services are delivered. Whereas public monopolies long dominated service provision, with the roles of the regulator and service deliverer closely entwined, it is increasingly common to see the service delivery task passed to the private sector. This process is usually driven by expectations of (1) lower costs to government from more efficient service delivery by the private sector and (2) better service delivery outcomes from a service provider more attuned to meeting customer needs. The public sector purchases operations and/or infrastructure services, instead of delivering them itself, with the private sector taking on various risks associated with service provision and being rewarded in some way for so doing.

Great Britain led this process with its de-regulation of bus services outside of London in the mid 80s. Complete de-regulation is unusual, the most common change being to see public sector service provision replaced by private provision by a single operator, who receives a franchise or concession to deliver services in a specified area (or route) for a specified period, usually with nominated service standards to be achieved. Competitive tendering processes are commonly used to select the successful operator.

With the regulator focusing on outcomes while retaining control of key elements like minimum service standards (specified in contracts), fare levels and with performance monitoring and delivery being undertaken by the private operator, the process can be seen as a form of public private partnership, even though the emphasis is typically on operations rather than on infrastructure (although infrastructure improvement, including rolling stock, may be part of the contracting requirements).

This paper presents the views of two individuals who believe that opening public transport markets to greater competition is not the *only* path to delivering the two major intended outcomes of lower cost service provision and higher service quality through a public/private partnership. This view has been strongly reinforced by experience in Victoria, where a notable failure of a public transport franchisee has recently occurred.

The paper begins with a review of the recent franchising of train and tram services in Victoria, concluding that this has fallen well short of the expectations of those who drove the process. It then asks what lessons can be learnt from this failure and suggests areas in which efforts need to be focused to reduce the risks of repeat performances.

## 2. Train and Tram Franchising in Victoria, Australia

### 2.1 Context

Melbourne, a city of about 3.5 million people, was the first, and remains the only, Australian city to franchise both its passenger train and tram networks. The tram network is one of the most extensive in the world, comprising 240 kilometres of double track, about 80% of which operates on road space shared with motor traffic. There were about

526 vehicles in the fleet at the time of privatisation. The suburban rail network had 336 kilometres of route length, 197 stations and about 150 train sets at that time. Both the tram and train fleets were generally acknowledged as being in need of a significant upgrade at the time of franchising. Franchising also included the regional public transport system (V/Line passenger) then operated by the State. This included rail services operated on over 4,500 kilometres of track and some coach services. The current paper focuses on the metropolitan services, not on V/Line.

The franchise process was “competition for the market” and five businesses were offered: two metropolitan train services, two metropolitan tram services and one regional train/bus service. These five businesses grew out of the State-owned Public Transport Commission and they had been corporatised as separate entities prior to sale.

The franchising occurred in August 1999 and was expected to lead to:

- substantial reductions in government subsidies (forecast to fall by about \$160 million annually in real terms over a 15 year period, on average)<sup>1</sup>;
- significant upgrading of rolling stock; and
- service improvements (driven by incentive components in the franchisees’ remuneration packages).

Large patronage increases were also expected from franchising, with a patronage growth rate of 3.6% p.a. forecast for the 1999-2014 period, or 71% increase in total patronage (compared to 1.0% average annual increase achieved over the 1991-1999 period). This major increase in expected patronage growth rates was critical in the expected funding outcome, considered below.

## **2.2 Objectives**

Reducing the public transport call on the public purse was a primary motive for franchising, which was part of a much wider push by the Victorian (and other Australian Governments) at the time to introduce increased competition into the supply of goods and services that had previously been publicly provided (e.g. telecommunications, gas and electricity).

More generally, however, the then State Government set itself five goals when it began the franchising process:

1. to secure a progressive improvement in the quality of services available to public transport users in the State;
2. to secure a substantial and sustained increase in the number of passengers using the system;

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<sup>1</sup> Russell et al (2000), Table 4. This table shows \$1.82 billion expected savings over 4 metropolitan franchises and one regional franchise, presumably in 1999 prices (the price levels were not indicated in the report). Making an allowance for varying lengths of franchises, the expected annual saving would be of the order of \$160 million.

3. to minimise long term costs of public transport to the taxpayer;
4. to transfer risk to the private sector; and
5. to ensure that the highest safety standards were achieved.

These objectives mirror a balance between financial and service delivery outcomes. Sitting behind the service delivery outcome objectives was a belief that a shift in modal usage away from the private car and towards public transport was desirable, because of the unpriced external costs of car use.

The officials and consultants driving the franchising process tried to balance four objectives through the process:

- protecting system aspects that users valued highly, such as service levels, fare levels and multi-modal ticketing;
- encouraging innovation in service delivery and in responding to the marketplace;
- providing a degree of certainty to bidders; and
- providing incentives to drive service quality improvements and patronage growth.

Final criteria used to evaluate bids were:

- NPV of cash flows required from the State over the franchise period;
- quality and thoroughness of the business plan, as a demonstration of the bidder's ability to operate and manage the business in order to achieve the State's objectives;
- conformity of the transaction documents to the State's expectations;
- extent of risk transfer to the State;
- any conditions attached to the bid; and
- relevant experience.

It is noteworthy that these criteria suggest something of a shift in emphasis away from a balance between service outcomes and financial consequences and more towards financial consequences and commercial criteria as the key objectives of reform. This is probably a consequence of the reform process being centred in a Transport Reform Unit, established within the State Treasury, to manage the franchising process. It may also have been an unavoidable part of the process of moving from statements of intent to details of contract delivery. Service delivery aspects were essentially handled by the inclusion of an Operational Performance Regime in the franchisee remuneration package. A patronage incentive component was also used as a way to reward passenger growth.

### **2.3 Remuneration Components**

Franchisees receive three major fixed payment flows from the State:

- a base operating subsidy for provision of specified levels of services;
- rolling stock payments relating to lease costs for the purchase of new rolling stock;
- capital grants for the construction of infrastructure and rolling stock capital projects.

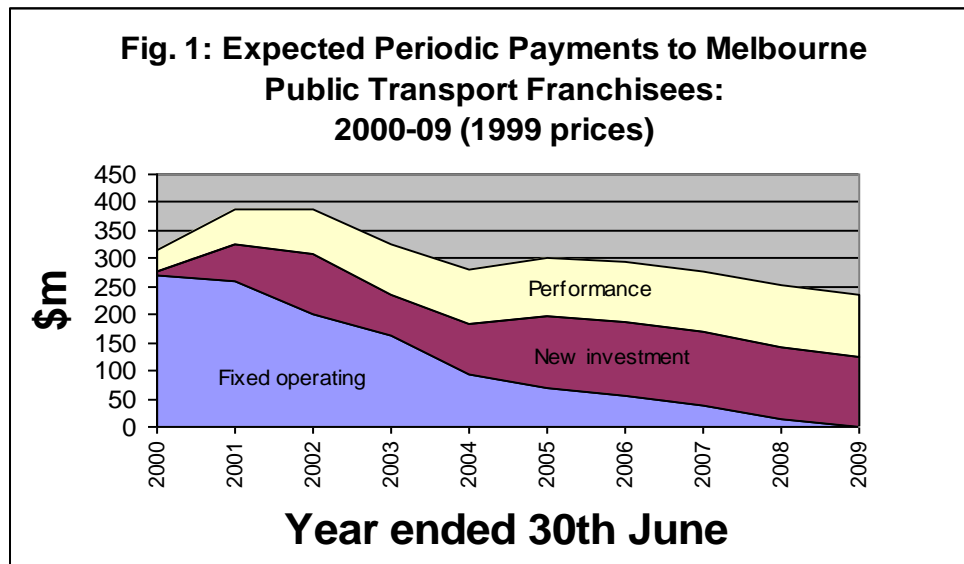
These fixed base operating subsidies were expected to reduce to zero by 2010 (Figure 1)<sup>2</sup>.

Franchisees also receive variable payments for:

- concession fares (topping up revenue from 50% to 75% of full fare for a concession passenger);
- a patronage growth incentive, equivalent to 50% of the real growth in fare revenue above a threshold, where that threshold reflected revenue gains that were thought to be easily achievable (by reducing fare evasion);
- operational performance bonuses/penalties for service reliability and punctuality.

From these various fixed and variable payments, franchisees need to pay the State for leases of infrastructure owned by the State, such as track, stations and tram stops, together with lease payments for commercial sites (e.g. depots).

Performance payments were projected by franchisees to grow from 12% of total payments in 1999/2000 to almost half the total payments by 2009, by which time operating subsidies were expected to be zero. By 2014, almost all payments were expected to be performance or investment based. Figure 1 (derived from Russell et. al 2000, Figure 2, p. 149) shows the major expected revenue flows, as seen at the start of the franchise period.



#### 2.4 Expected Outcomes from Franchising

In summary, the franchising process was expected to lead to:

<sup>2</sup> The “Fixed” payments in this figure include the net of fixed base operating subsidy, infrastructure lease payments and payments for commercial sites. “New investment” includes new investment in rolling stock and other capital grants. “Performance” payments include the variable elements of concession fare payments, patronage growth incentive, operational performance bonuses/penalties and other service payments.

1. a progressive improvement in service quality available to public transport users
  - service delays reduced by about 40% over 10 years
  - a planned 11% increase in services over 10 years
  - \$1.5 billion investment by the private sector in new/upgraded rolling stock
  - \$0.8 billion to renew existing infrastructure
2. a substantial and sustained increase in PT patronage
  - 71% over 15 years
3. much reduced long term costs of PT for the taxpayer
  - savings of over \$1.8 billion in real terms over 15 years, or about \$160 million annually;
4. risk transfer to the private sector
  - franchisees to assume revenue, operating and legal risk, except in limited circumstances
  - by 2009, performance-based payments to constitute almost half total payments to franchisees
5. ensuring the highest safety standards are maintained
  - operator accreditation required from the Public Transport Safety Directorate
  - all franchisees reputable international operators.

### 3. Antecedents

Before reviewing the early outcomes of the franchising process, it is instructive to understand the context against which that process occurred. Prior to franchising, the Victorian Auditor General reported that on-going annual savings of at least \$245 million had been delivered by a transport reform program implemented earlier in the 1990s in provision of train and tram services, against a cash appropriation of \$565 million in 1991/92<sup>3</sup>. The major part of these savings resulted from labour shedding, with numbers falling from 18,000 by about 9,600 between 1992 and 1997. In 1998-99, the State cash cost of providing passenger rail services was \$450 million, with the true economic cost assessed at about \$850 million.

The Auditor General noted that sustaining these financial benefits through a franchising process would require<sup>4</sup>:

*...that effective action is taken in two key areas, namely, successful implementation of the automatic ticketing system and development of a strategy to control and accurately monitor fare evasion within the automated ticketing environment.*

The Auditor General concluded that the 1990s transport reform program, in addition to reducing the call of public transport on the Victorian taxpayer, had:

<sup>3</sup> Victorian Auditor General, Public Transport Reforms: Moving from a Service to a System, Report No. 5, May, 1998, p. 1. Capital outlays of \$332 million were also incurred, together with a cost for accelerated superannuation of \$453 million.

<sup>4</sup> Victorian Auditor General 1998, p. 1.

- improved service reliability, with the notable exception of the peak period reliability of the suburban train fleet, with its aged rolling stock;
- improved punctuality, but that more needed to be done to achieve world class standards;
- reversed declining patronage trends; and
- improved service availability (e.g. a 23% increase in train suburban kilometres between 1991-92 and 1996-97).

In short, reforms were on the right track before the franchising process began, in terms of governmental objectives, and had already delivered substantial gains, especially in the financial area.

Interestingly, the Auditor General also noted that<sup>5</sup>:

*After 6 years of cost-cutting and rationalisation of operations, there appears to be limited scope for further large savings to be achieved in an environment where a substantial proportion of existing rolling stock will need replacement over the next few years.*

This judgement did not deter the privatisers from seeking further substantial economies!

The Auditor General confirmed the need for the approaching franchised system to contain contractual requirements that included suitably stringent performance standards and incentives and penalties for operators to increase patronage and improve services.

## **4. Outcomes from Franchising**

### **4.1 The High Profile Outcome**

It is now over three years into the franchise process, time enough to form a view on its early achievements.

The most publicised outcome of the franchise process has been the financial failure of the National Express Group (NEX), the largest operator among the new franchisees. NEX won the right to provide one of the two metropolitan train services, one of the two metropolitan tram services and the regional passenger service. NEX ceased operations in late 2002, only three years into the franchise process. Outstanding creditors are owed at least \$70 million, with a likelihood of receiving about 40 cents in the dollar, or less. NEX has forfeited its performance bond of \$135 million, which the State Government has indicated it is using to help meet the increased costs of future replacement services. At the same time, the contractual arrangements with the remaining two franchise operators are shifting more towards *management contracts* and away from the strongly incentive-based arrangements that characterised the initial deal.

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<sup>5</sup> Victorian Auditor General 1998, p. 8.

At a more detailed level, the Victorian Department of Infrastructure (DOI) and the Victorian State Budget report various Key Performance Indicators of the Melbourne public transport system. These enable some comments about emerging patterns in performance, compared to the outcomes that were expected from the franchise process (as outlined above).

#### **4.2 Financial Outcomes to the State**

State payments to franchisees totalled \$301 million in (part of) 1999/2000, about \$30-40 million less than had been forecast for that year (in current prices) and \$349 million in 2000/01, about \$75 million less than had been forecast for that year (in current prices). This latter shortfall was mainly due to capital grants about \$30 million less than expected and the base plus incentive payments being each about \$18 million short of expectations. The shortcoming in the capital grants area is probably a reflection of the financial troubles being experienced by franchisees at this early stage, troubles senior officials in the franchise companies were prepared to admit in private.

The 2001/02 payment figures were broadly in line with the expected figure for that year, although incentive payments as an individual component were only about half the expected number, particularly due to shortfalls in the patronage incentive. Patronage numbers were not growing as quickly as required or forecast.

Within total payments to franchisees over the 2000-02 years inclusive, the franchises operated by NEX received over 60% of total franchisee payments from the State, these NEX payments averaging about \$240-250 million annually. Nonetheless, NEX was unable to continue its operations. Press comment at the time the franchise was handed back suggested National Express was facing a write-off of over \$300 million on its Victorian franchise investments.<sup>6</sup>

The failure of one of the franchisees was not unexpected. In February, 2002, the State Government committed an additional \$105 million to the franchisees, with \$68m. payable in the short term. This was widely interpreted at the time as a bail-out, although part of the payments were described as “settling outstanding contractual disputes from the time of franchising”.

The Victorian State Budget for 2003/04 continued the process of upping the financial commitment to the franchised services. The Budget Papers suggest that an additional \$1 billion over the next five years will be needed to sustain these public transport services, increasing the cost of the franchises from \$1.75 billion to \$2.75 billion over that period. This is an increase of well over 50% for the period in question.

Problems with the introduction of the automatic ticketing system and with levels of fare evasion (argued to cost about \$50 million annually in terms of foregone revenue) have

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<sup>6</sup> The Australian Financial Review (18/12/2002, p. 54) suggested a figure of about \$335 million, other press comment suggesting even higher figures.



contributed to all franchisees' financial problems, as the Auditor General had previously warned. For example, almost 30% of ticketing machines on the train system were out-of-service early in the franchise period (run under a separate contract to the franchise contracts). Also, fares increased by 14% in six months, following the introduction of a new Commonwealth Government Goods and Services Tax (at 10%) and fare indexation. This fare increase and the associated problems with the ticketing system are thought to have led to increased fare evasion, contributing to a fall in real total system fare revenue available to operators in 2000-01, even though revenue had increased 11% in the first year after franchising. This real revenue reduction was a blow to the franchisees.

While recognising ticketing and fare evasion problems, there is little doubt that over-optimistic bidding was a fundamental problem in the National Express failure, with cost savings being harder to deliver than anticipated and significant patronage gains being hard to realise. The *Australian Financial Review* expressed it this way (AFR, 18<sup>th</sup> December 2002, p. 54):

*...the bidders were responsible for a large share of their problems. They were supremely arrogant in their belief that they could replicate the patronage increases and cost savings achieved in Britain, and made commitments they couldn't keep...*

The additional \$200 million required annually from the State Government compares quite closely with the \$160 million or so annual savings projected through the lives of the franchises, once allowance is made for inflation. Thus, while the franchising process seems to have delivered financial savings in the three years to date, largely courtesy of the shareholders of the franchisees, it seems highly likely that these savings are unsustainable and that Victorian taxpayers will see no long term financial savings from the franchising process. Most of the financial gains were delivered prior to franchising and the Auditor General seems to have got it right when he predicted in 1998 that further financial savings would be hard to deliver.

One irony of this financial outcome is that the Victorian State Government has recently changed its mind in favour of imposing tolls on a proposed \$1.8 billion new freeway project, citing the public transport funding shortfall as a major reason for this policy change. The public transport sector will push for this pricing switch on tolling to be generalised towards a more comprehensive program of reform in land transport pricing.

### **4.3 Service Quality**

Improvements in service quality were a central rationale for the franchising process. What has been achieved? A small number of service quality indicators are measured and reported by the Victorian Department of Infrastructure, enabling some conclusions on trends in these areas to be drawn.

Figure 2 shows that there have been improvements in on-time running, with three of the four metropolitan train/tram franchises showing improved performance.<sup>7</sup> Traffic congestion on shared rights-of-way is posing major concerns for the tram franchisee whose performance deteriorated. The franchising target was for 40% reduction in service delays within ten years. The on-time running data suggests that three of the four businesses are on track, or better, in this regard.

Data for the first quarter of 2003 (later than that shown in Figure 2), shows that since the demise of NEX and the taking back of these services by the State Government, the on-time running performance of the train and tram businesses the group had operated has deteriorated. This confirms the suggestion from Figure 2 that franchising has helped to improve service punctuality.

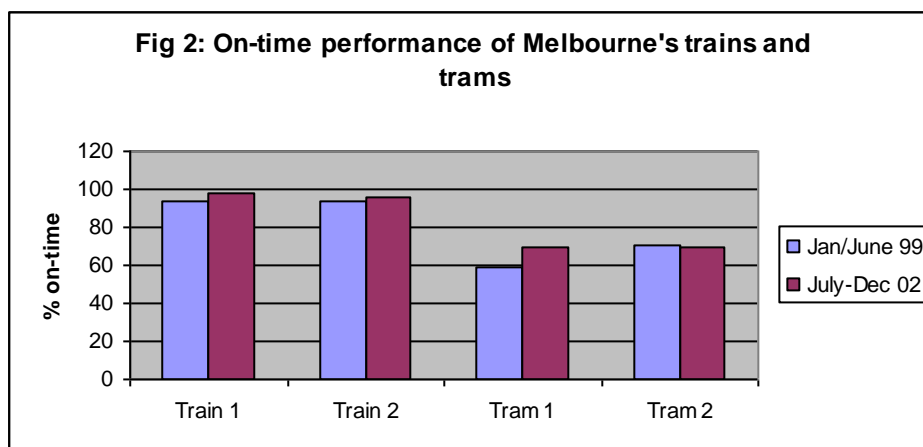
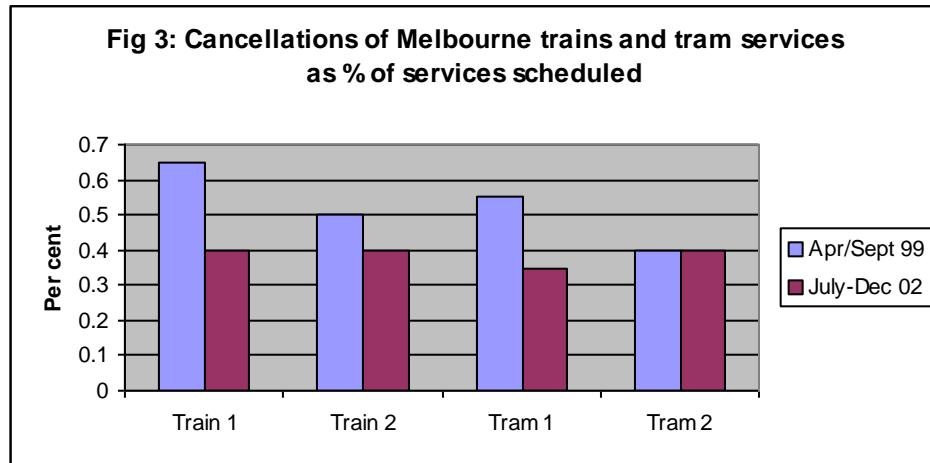


Figure 3 shows service cancellations on metropolitan train and tram services, as an indicator of reliability.<sup>8</sup> These show a similar pattern to the on-time running results, with the two train services and one tram service showing improvement but the other tram service marking time.

As with on-time running, data for the first quarter of 2003 shows that service cancellations on the prior NEX services have increased since these services were taken back by the State Government, reinforcing the conclusion that franchising tended to improve service quality.

<sup>7</sup> Source: Department of Infrastructure, Track Record, Numbers 3 (2000) and 13 (2003).

<sup>8</sup> Department of Infrastructure, Track Record, Numbers 3 (2000) and 13 (2003).



#### 4.4 New Vehicles

A major objective of the franchising process was to see rolling stock upgraded, because of the expected impact this would have on patronage. To date, 36 new Citidas trams have been brought into service and 59 new Combino trams will have been delivered by December 2004. In addition, over 300 trams will have been refurbished by December 2003. The upgrading of the tram fleet is probably the most visible outcome of the privatisation process, representing a significant lift in quality. Upgrading the train fleet has been slower.

Overall, the rolling stock upgrade program appears to have been delivered on-time and on-budget, with few operational performance problems. It is likely that the new vehicles would not be there if there had not been the prospect of substantial cost savings from franchising. The sustainability of the upgrade program, under higher cost structures, becomes more problematic.

#### 4.5 Increases in Services

Over the three years from 1999/2000 to 2002/03, total kilometres operated by trains and trams on the Melbourne network increased by almost 5%, most of this increase in kilometres being on the train system (+1.3 million vkms, or +8.4%, in a total increase of 1.8mvkms). This was a lower rate of overall increase than over the period immediately prior to franchising (see “Antecedents” section above) but is in line with the expectation that services would increase by about 11% over 10 years.

Service frequency and coverage and speed/reliability are generally agreed to be the major drivers of growth in public transport patronage in Melbourne. It is difficult to see how the franchisees could ever meet their patronage forecasts with only very modest targets for growth in services. In short, franchising has met its expectation in terms of early growth in services but this expectation seems far too low to be consistent with achieving the patronage growth forecast.

#### **4.6 Patronage**

Patronage increases have been achieved. Total patronage on the metropolitan train and tram system was 257.3 million passengers in 2000/01, increasing to 270.9 million in 2002/03, an increase of 5.3% over two years. This is a good result, by comparison with the recent past, but is about 1% per annum less than was expected from the franchise bids. This shortfall is not unexpected in terms of the modest growth in service kilometres.

Tram patronage increased by 6.2%, faster than the rate of growth in train patronage of 4.4% over this period. With the growth in train service kilometres being much faster than that in tram kilometres, the likelihood is that improvements in the tram fleet have driven increases in tram patronage.

#### **4.7 Risk Transfer**

The financial changes that have occurred over the past 18 months suggest that not a great deal of lasting risk transfer from the public to the private sector has been achieved!!! Additional payments have been made to franchisees and one franchisee has failed financially. This will result in a need to increase payments from government to sustain services. The major expected recipients of the increased payments are the surviving train and tram operators, who are likely to see their franchises expanded in spatial coverage and shortened in time span. A more appropriate risk management philosophy is emerging. Rather than simply seeking to transfer risk from the public to the private sector, as in the initial franchise process, the new contracts will seek to assign risk to the party most able to manage it. This reflects a trend towards more of a partnership relationship.

#### **4.8 Safety Outcomes**

Improvements in safety were one of the objectives of the franchising process. There is no published data available to suggest whether or not this has been achieved and anecdotal evidence is mixed. Some franchisees have achieved significant improvements but this experience is apparently not the rule. Conclusion = no conclusion at present!

#### **4.9 Customer satisfaction**

Regular measurement and reporting of customer satisfaction has existed for many years on the Victorian public transport services. These surveys show no significant trends over the period of franchising. Satisfaction levels rose for one tram operator around the time new vehicles were introduced into its fleet but have drifted back since, to be marginally above levels at the start of the franchise. Satisfaction with the other tram franchise has fluctuated around the starting level. Satisfaction with the two train operators has shown similar patterns. In short, customers are reporting no significant shift in satisfaction levels either up or down (although a Ministerial Press Release of 24<sup>th</sup> October 2003 is

more positive, reporting increased satisfaction levels in the latest survey, which was not published at the time of writing this paper).

Market research conducted for the private operators suggests that dissatisfaction with the ticketing system and concerns about perceived security around rail stations may be the main reasons why customer satisfaction levels are not rising, even though there is hard evidence of improvements in some aspects of service quality. Marketing efforts are seeking to communicate these improvements to customers and deal with perceived concerns.

## **5. Overview**

This review of the recent public transport franchising experience in Victoria indicates that the objective of reducing the call on the public purse has not been met and was, in reality, never likely to be met. Significant cost savings were achieved prior to franchising, when large reductions in the public transport workforce were achieved, and delivering further large cost savings was always going to be difficult in the extreme, as the Auditor General predicted.

Franchising has seen an improvement in the quality of tram rollingstock, in particular, and improvements in a number of service quality indicators, such as on-time running. However, growth in service kilometres has been slower than in the period prior to franchising. Patronage increases have accelerated compared to the period prior to franchising but by less than the franchisees' forecast. Risk transfer to the private sector has not been anywhere near as much as intended. Customer satisfaction levels are not showing any marked recognition of franchising having been beneficial to users.

Overall, this form of competitive tendering has not delivered many of the forecast benefits for Victorians.

## **6. Why Has The Process Failed to Deliver?**

### **Operator Motivations and Governmental Reform Ideology**

A seasoned transport planner looking at the franchisees' forecasts of patronage growth and growth in service kilometres would almost certainly conclude they simply did not add up. Going further, when the period of cost-cutting that was undertaken during the 90s is recognised, one must wonder where franchisees expected to achieve major additional cost savings. This leads to two key questions.

*1. What were the franchisees' motivations?* Did they think they could achieve cost levels well below what had hitherto been possible? Perhaps their international networks might open up economies of scope and scale that were not available locally. This seems unlikely and the State Auditor General did not expect to see major new cost reductions, as indicated previously.

Were they engaged in buying market share, with a view to subsequent upwards contract price adjustments? Possibly. We call this playing “capture the regulator”, a phenomenon commented on by other observers of franchising processes, such as Alexanderson and Hulten (2003) in their analysis of competitive tenders in Swedish public transport. The argument goes along the line that, with a financially troubled franchisee in place, it is easier for a government to increase payments to that operator to continue service than to face the political odium of major service disruptions. The additional payments made by the Victorian Government during 2002 give some credence to this view, being widely seen as a bail-out in the local media at the time.

Were the successful franchisees victims of what some more charitably call the “winner’s curse”? In other words, did they simply get it wrong on the numbers, due to carelessness or ignorance. Possibly but this is a very charitable view, given the vast international experience of the franchisees! It might explain part of the outcome, given the extent of fare evasion that has been taking place on the system. However, the revenue estimated to be foregone because of fare evasion is about \$50 million, only one-quarter the additional annual amount the State Treasurer has indicated will be required to keep the services going.

**2. What about those managing the franchise process?** Why did they accept bids that, to a seasoned transport planner, were unsustainable? Ideology is the likely answer. The whole process was grounded in a strongly held political view at the time that the private sector would do it better and that competitive tendering would deliver the result. Privatisation across a whole range of fields, where provision was previously in the hands of government agencies, was being undertaken during this time.

While “before and after” (or public sector comparator) assessments were undertaken as part of the analysis of franchisee bids, we know of no evidence to show that those managing the franchise process undertook benchmarking analyses with comparable public transport services overseas. Any such benchmarking would have shown, for example, that sustaining patronage increases of the order forecast by franchisees is exceptional, especially given small projected increases in service kilometres, and that major reduction in subsidy requirements, as forecast, is uncommon if the start point is after a major program of labour shedding has been undertaken. The franchise process seems to be partly guilty, at least, of being too caught up in the hype of promoting competition as an end in itself! Ideology, it seems, triumphed over understanding.

For the latter situation to have developed, a major gap at the **tactical level** in the public transport planning and service delivery process in the State must be recognised as a significant contributory factor. Following Macario (2001), we identify three elements in the configuration of an urban public transport system (as part of the wider urban transport/land use system):

- **the strategic level (S)** = government outcome goals for public transport, typically covering matters such as access, safety, economic and environmental dimensions.

This is the level at which political trade-offs take place to define answers to meeting stakeholder needs subject to constrained budgets;

- **the tactical level (T)** = design of the transport system/service, including the roles to be performed by the respective modes, detailing of the policy means of translating the strategic outcome goals into operational specifications and drawing the boundaries between the roles of the regulator and the operator. This stage is normally the regulator's domain, as it is in Melbourne (although there is increasing international interest in the private sector pushing into this level). A common problem at the tactical level is the absence of adequate system definition, with individual operators left to pursue their own interests in a manner that misses broader opportunities for economies of scale and scope. Grey areas include the boundaries between the regulator and the operator in system design and development. The tactical stage is widely recognised internationally as a major gap in the public transport planning/delivery system and Melbourne is no exception. 10-15 year service delivery contracts will always struggle when there are no intact system-wide planning/delivery frameworks to match. Our personal view is that the Victorian Government during the late 1990s lost sight of its public transport **system** as it focused on franchising **separate services**. The subsequent Victorian Government is attempting to fill this tactical gap at present but is in recovery mode in so doing and will always struggle with the short term Treasury influence dominating budget processes, on which public transport is so dependent;
- **the operational level (O)** = production and consumption of transport services. If the strategic and tactical levels are well developed, this should be relatively easy!

Franchising in Melbourne essentially involved moving from public to private operators at the operational level, with little content at the strategic level, a weak tactical level and a team managing the franchising process who seemed to lack deep understanding of public transport economics. Again, ideology is no substitute for clear goals, a clear systemic view of how these will be achieved and a bit of knowledge about what will work and within what bounds. Franchising was doomed to failure in such an environment.

### **Competitive Tendering versus Negotiated (Performance Based) Contracts**

Competitive Tendering (CT) as a means of selecting franchisees (part of the ideology of the process) has some inherent problems that were not recognised adequately in the franchise process. After a decade or so during which CT experienced something of a honeymoon, there are now several areas of concern, such as:

- a tendency to focus too heavily on cost minimisation, at the expense of service quality, an issue highlighted many times in the THREDBO series of conferences on Competition and Ownership in Public Transport;
- open to the prospect of predatory pricing, as outlined by Alexandersson and Hulten (2003), although this is possibly less of an issue with longer term contracts, such as applied in Melbourne's franchises, except where it is part of a strategy to "capture the regulator";

- open to the risk of franchisees playing capture the regulator, as discussed above;
- as a process for selecting several franchisees, it is not compatible with social welfare optimisation across the entire system (Hensher and Stanley, 2003), unless there are add-on negotiations at the system level between the regulator and set of operators; and
- it focuses on ex ante bidding positions rather than negotiated adjustments over time. In fact, the more that negotiated adjustments are used over time, to deal with changing circumstances, the weaker is the appeal of CT in terms of transparency (one of its main advantages).

These concerns do not rule out competitive tendering as a process but they weaken its appeal and suggest, for example, that it may have little advantage over **negotiated (performance based) contracts** if there are incumbent operators with good track records, provided those proven performers face the threat of competition if they stop performing. Service/cost benchmarking (“virtual competition”) can assist this process of helping to ensure cost effective service delivery with negotiated contracts. This is the approach the Victorian Government is taking to re-franchising, an approach that is supported by the present authors.

The requirement for clear outcome goals and a well developed Tactical level must, of course, complement improved franchising processes at the operational level. This approach is consistent with the emerging trend in construction and other major project contracting towards **project alliancing**, where negotiated agreements and sharing of risks and rewards in an uncertain operational environment are features, with competitive tendering taking more of a back seat.<sup>9</sup>

If negotiated contracts are to play a larger role, how should remuneration be structured? The aim should be to line up key elements of operator remuneration with governmental outcome objectives from service provision. Governments typically support public transport because of:

- its capacity to meet social obligations (e.g. provision of transport options for transport disadvantaged groups); and
- its capacity to reduce the (unpriced) external costs of private car use for all sources of intra- and inter-sectoral externality, while providing benefits to public transport users.

Contractual remuneration systems should thus seek to separately reward service providers with respect to:

- the community service obligations (CSO) of government in public transport service provision, through payment for provision of minimum service levels (MSLs, where these MSLs will probably be expressed in high level terms such as vehicle kilometres of service per geographic area) at efficient cost levels (achieved through best-practice

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<sup>9</sup> See, for example, Ross (2003).



benchmarking). Key performance indicators (KPIs) can be used to reward/penalize operators for their performance in delivering against these CSOs, such KPIs relating (for example) to on-time running, safety, environmental performance, etc; and,

- incentive components related to (1) the creation of public transport user benefits and (2) additional external benefits from attracting passengers from private cars to public transport, both these incentive components flowing from service improvements.<sup>10</sup> The public transport user benefit component is an important ingredient since, under the regulated fare environments that characterize many public transport service contracts, operators are constrained in their ability to be rewarded for user benefits that flow from their service initiatives. The external cost component is vital because of the scale of these costs from road use, assessed nationally at about three times the scale of road user tax/charge payments for road use in Australia (BIC 2001), and the urgency to take action to reduce the costs, as part of the development of more sustainable land transport systems.

The idea of PBCs in public transport is not new and has received strong and growing support in Europe, especially in Scandinavian countries (Carlquist 2001, Johansen et al 2001), where several Regional Authorities in Norway have rejected competitive tendering except as a last resort strategy (i.e. non-compliance under PBC's).

Competitive tendering might still be used, of course, to develop a short-list of parties with whom negotiations would take place to select a preferred supplier for a new service or for a service where the incumbent is not meeting expectations.

### **Area Agreements/Quality Partnerships**

In a multi-operator environment, how can social welfare optimisation across the system be achieved? This requires a mechanism for negotiating outcomes across the set of relevant operators and the regulator. This is an important element of service delivery at the system level because of:

- potential cost efficiencies and service quality improvements that are achievable if operators work in partnership to deliver services that cross modes and/or service franchises (e.g. system marketing; service connectivity);
- the scope for operators to deliver cost savings if governments are prepared to commit to forward programs of service delivery enhancements, such as on-road priority treatments for trams and buses and forward funding commitments for improved MSLs (which may create opportunities for service rationalisation to achieve economies).

Quality Partnerships have been developed in the UK as a means of encouraging such system synergies. These are specific to the needs of the somewhat unique UK regulatory environment within which public transport operates but the general idea of having a

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<sup>10</sup> A paper by Wallis and Gale (2001) to the Thredbo 7 Conference in Norway illustrated the application of an approach along the latter lines.

formal mechanism to encourage partnerships or co-operation between groups of operators and the regulator is laudable.

The regulatory environment for metropolitan bus operation in Australia is different to that in the UK but the idea of using an agreement of some form between government and the set of bus operators in Melbourne to meet government transport objectives is being promoted by the Victorian bus industry as a means of contributing to service enhancement and more sustainable transport systems. Bus Association Victoria has proposed to the Victorian State Government that the industry and government sign off on an agreement that includes jointly agreed objectives. This would require the government to:

- make a minimum five year forward commitment to funding bus services at an increased level and to specifying a development plan that reflects these commitments (prepared in partnership with the industry and local government);
- commit to a five year program of bus priority and related infrastructure and enforcement measures (again prepared in consultation with the industry and local government); and
- commit to a number of other procedural matters (e.g. relating to contract renewals).

The agreement then commits the bus industry (under such a quality partnership) to:

- ensuring that service efficiencies released by the government's commitments are converted to improved services at marginal cost;
- negotiating changes in franchise areas where this is needed to improve service effectiveness;
- opening up some service areas to competitive tendering (e.g. new cross-town services);<sup>11</sup>
- ensuring that all operators and their vehicles meet modern safety and environmental standards;
- meeting best-practice cost levels for service provision; and
- working co-operatively with the State and local governments on service development planning, contract reviews, etc.

Additional commitments are nominated for local government at the area level. Individual bus contracts would then reflect this overarching strategic framework.

While this approach has not been agreed at this time by the State Government, the Victorian bus industry is convinced that a partnership approach along such lines will lead to less expensive, more effective service provision at the metropolitan level. It will assist in breaking down the "them and us" approach that typically characterises regulator-

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<sup>11</sup> Because most bus services in Melbourne were started by private operators and run for many years from the farebox, the bus industry has long argued that operators have a legitimate equity interest in the bus routes they initiated, even though government now subsidises service provision. This position has been successfully defended in the court system in the past.

provider service contracts and associated relationships, encourage operators to price services taking into account government program commitments, and protect the interests of the Victorian public, particularly because of the benchmarking approach. Most importantly, it will help to fill out the content of that most difficult tactical level within the service delivery framework.

### **Risk Sharing**

While the intent of the franchise process was risk transfer to the private sector, the subsequent additional funding commitments by the State government indicate that the process failed miserably on this front. Subsequent thinking is to move from a process that simply seeks to transfer risk to the private sector to one that locates risk with the party most able to manage it.

Production risk is widely agreed to be a matter for the operator to manage. Revenue risk is more problematic, since it is influenced by some aspects of service delivery that are under operator control and by other things beyond operator control. For example, traffic congestion is affected by government road and traffic management programs, including parking programs, as well as by serendipity (e.g. traffic accidents due to bad weather). Traffic congestion affects the on-road performance of trams and buses and influences patronage levels. A government might expect a franchise bidder to make estimates of how this will impact on performance but, at the end of the day, it is a pretty hard ask in the absence of clear government intentions about its future road programs on specific links. Some means of risk sharing on the revenue side is thus more likely to be a fair approach to contracts than simply expecting the operator to make educated guesses and build these into bids.

It is noteworthy that, in tenders for public transport services, there are few net cost contracts. Net cost contracts expose the operator to both production and revenue (including patronage) risk. Gross cost contracts remove the revenue side risk. These are far more common in public transport. Gross cost contracts (e.g. covering minimum service levels, as argued previously), with additional elements that reward an operator for building patronage and delivering additional service (e.g. of benefit to existing users) are tending to be the approach adopted in Australia.

## **7. Melbourne's Emerging New Arrangements**

The franchising of public transport in Victoria in 1999, as reviewed earlier in this paper, used competitive tendering processes to select franchisees. Following the failure of the National Express Group franchises and financial stresses on the remaining franchisees, the State Government is preparing replacement arrangements for the franchised services. These replacement arrangements seem likely to involve:

- one train and one tram franchise for Melbourne;

- centralised metropolitan network functions (e.g. marketing, revenue distribution from the common ticketing system) handled by a separate organisation whose shareholders will be the public transport franchisees;
- shorter franchise periods;
- an opportunity for the parties to negotiate a contract extension at the end of the (shorter) franchise, as an alternative to re-tendering; and
- remuneration arrangements that include an operational performance regime (with KPIs), a service quality incentive and a service growth incentive, the latter two elements being similar in intent to the user benefit and externality components of remuneration proposed by Hensher and Stanley (2003).

This approach is very much in line with the performance based approach and a significant move away from the blind adherence to competitive tendering that characterised the earlier process.

## 9. Concluding Comments

Franchising of public transport in Victoria provides a recent clear example of the need for realistic expectations in regulator-provider relationships. The Victorian experience suggests that competitive tendering is no substitute for a hard-nosed assessment of what is possible in terms of service delivery and service costs. Franchising in Victoria, Mark II, will look different, relying more heavily on a (performance-linked) negotiated outcome with existing service providers who have survived the carnage from the first round of franchising.

The paper argues that, once private sector public transport service providers are in place, negotiated contracts may provide the best opportunity to move closer to a social optimum in service provision than competitively tendered contracts. The threat of tendering is always available to encourage performance compliance but the Victorian experience is that competitive tendering can encourage excessively optimistic forecasts that are, in essence, undeliverable. The recent compelling evidence by Flyvbjerg et al (2003) that large infrastructure projects in all sectors investigated (predominantly transportation) exhibit substantial cost overruns provides further supporting evidence to the Victorian Franchise experience.<sup>12</sup> Negotiated contracts may provide more sustainable service outcomes, with mechanisms such as benchmarking and open book accounting practices available to assure public accountability.

At the same time, successful public-private partnerships in public transport demand a well developed Tactical level, where system planning work takes place. This area needs improvement in Australia. Public transport reform has tended to focus on the service

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<sup>12</sup> Although the levels vary widely, the great majority of cost overruns are in the 10-40% band but some notable exceptions are well above this range, such as Boston's artery/tunnel project (196%), the Humber Bridge (UK) (175%), the Shinkansen Joetsu rail line (100%), the Channel tunnel (80%), the Paris-Auber-Nanterre rail line (60%) to name but a few examples.

provider. It is not time to shift the focus on to the regulator, where change has been far less than at service delivery level.

In a geographic area where there are multiple operators, with their own exclusive operating areas, the paper argues for government and the set of operators to agree a service development framework that includes major commitments from each side and where the emphasis is on partnering in the pursuit of service objectives.

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