Delivering Value for Money to Government through Efficient and Effective Public Transit Service Continuity: Some Thoughts

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Editor’s Introduction

This thought piece was submitted by David Hensher for possible publication in Transport Reviews. It raises a series of fundamental issues concerning the structure of the contemporary public transport industry that are international in their scope and implications, particularly as they relate to different contracting regimes and asset ownership, the role of government, and the means by which effective partnership arrangements can be made to work effectively. Eight key international researchers have been invited to respond to the original paper, and David has been given the opportunity to respond to their views. This group of papers is the result of that process and we hope they will add to the richness of the debate about these important issues.

Delivering Value for Money to Government through Efficient and Effective Public Transit Service Continuity: Some Thoughts

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ABSTRACT This paper documents some thoughts on the reform agenda in public transit that is occurring throughout the world. The specific focus is on a growing commitment to competitive regulation through competitive tendering, and the efforts by a few governments (notably in Australia) to take control of the tangible assets used by private operators as a mechanism to exercise the opportunity, if so taken, to put services out to competitive tender. The paper reviews the theoretical arguments and empirical evidence on contracting regimes and asset ownership, and the role that government and the operator might play in a setting in which building trusting and collaborative partnerships has merit in delivering services that are in the main funded from the public purse.

Introduction

This paper documents some thoughts on the reform agenda in public transit that is occurring throughout the world. The specific focus is on the commitment to competitive regulation through competitive tendering, and the interest by a few governments to control the tangible assets used by private operators as a mechanism to exercise the opportunity, if so desired, to put previously private sector-protected services out to competitive tender. The views presented herein are in part based on knowledge of what ensued in the Metropolitan Reform process in Sydney, Australia, leading to the signing of contracts in 2005 and the focus of the 2006–07
reform program outside of the Sydney metropolitan area; and an appreciation of the evidence from around the world presented at the International Conference Series on Competition and Ownership of Land Passenger Transport, known as the Thredbo series (Hensher, 2005b), as many jurisdictions have undertaken wide-ranging reform of their public transport systems, especially bus and coach. The Thredbo series provides a rich array of real-world experiences as many countries test the full gamut of procurement and funding models (Norheim and Longva, 2005; Preston, 2005; Preston and Van de Velde, 2002; Viegas and Macario, 2001; Van de Velde, 2001; Van de Velde and Pruijmboom, 2003; Van de Velde et al., 2005).

Theoretical arguments and empirical evidence on contracting regimes and asset ownership are reviewed, as well as the role that government and the operator might play in a setting in which building trusting and collaborative partnerships, within the context of formal procurement contracts, has merit in delivering services that are in the main funded from the public purse. The focus on cost-efficiency and quality (or service effectiveness), and incentives to innovate as contractible and non-contractible elements, is key to the arguments.

The Indisputable Strategic Objective of Government on Behalf of Society

The broad objective(s) of government might best be summarized as follows: to provide a good quality, integrated and continually improving transit service for a fair price, with reasonable return to operators that gives value for money under a regime of continuity. From an operator’s point of view, there should be no argument with this, provided there is industry buy-in and confidence in the procurement and continuing funding procedures.

There are a lot of valuable signposts in this objective, focused on securing appropriate services for the community in the context of a trusting partnership between all stakeholders (especially the government and the service provider), mindful of the social and commercial imperatives that each stakeholder works towards, given each parties legally sanctioned contractual obligations. There is a strong recognition from the outset that the service provider (i.e. transit business) is a crucial input, but only one input, into the overall obligations of government to provide mobility and accessibility services to the community that are consistent with value for money per taxpayer dollar.

Given the requirements to meet social obligations, there is the risk that social obligation gets misinterpreted as either delivering value for money (a popular phrase, defined so often as doing more with less), rather than the preferred definition (globally) of maximizing accessibility or net social benefit per dollar of government funding. The latter is useful under all contractual arrangements since government still has substantial investment in the infrastructure and demand management of the system. Underlying this focus is recognition that 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. As far as one can tell, many jurisdictions have a way to go in connecting through a trust chain.

Trust, Cooperation and Collaboration

Trust is the expectation that arises within a community of regular, honest and cooperative behaviour, based on commonly shared norms, on the part of that...
community. There are two types of trust: thick and thin. Thick trust should be present when there is a set of complex intertwined relations covering many aspects of economic and social life. Thin trust involves more limited contractual relations; such as an exchange relationship in the market. Cooperation and collaboration are distinct levels of relationship (Golicic et al., 2003). Collaboration, which is a stronger magnitude than cooperation, involves decision-making in an active capacity whilst sharing key information. Collaboration requires trust, integrity and reliability, which can help lead the relationship to grow stronger over time.

Repetition leads to cooperation and collaboration and the by-product is trust. The evidence can be attributed to Professor Robert Oumann, a game theorist, who was awarded the 2005 Nobel Prize in Economics. Oumann showed in his writings that repeated games, compared with a single game, lead to greater cooperation. An interpretation of this in the transit context, given the focus on efficient and effective continuity in the context of incomplete contracts, is the growing of partnership by building on relationships; something that is arguably relatively limiting with competitive tendering (especially short-term contracts such as 5–7 years), but reinforcing through negotiated performance-based contracts (PBCs) with incumbents and rules for non-compliance. Another way of viewing this is to think of it as “ironing out the wrinkles” over time and moving forward with continuity in the delivery of efficient and effective services. Importantly, the trust-building paradigm must exist within a framework that has clarity on the obligations under legal contracts; however, it will be argued below that it is the incompleteness of such contracts that makes for the case for combining trust and legal contracting obligations, rather than promoting one or the other.

This links to the broader literature of transactions economics and costs, and property rights and the boundaries of a business offer ideas on a range of contractual mechanisms for buying transparency, efficiency and effectiveness.

Supporting Efficiency and Effectiveness Through the Life of a Contract (and Not at the Time of Tendering)

The focus of any reform process must be on (cost) efficiency and (service) effectiveness, promoting continuously uniform competitive pressure through the life of a contract, with competitive tendering only one of a number of options, but an appropriate instrument for non-compliance under all regimes. In presenting the arguments, it is important to recognize that some elements of the efficiency–effectiveness dyad will be contractible, but many may be non-contractible; and it is often through the non-contractible dimension that innovation and benefit are seen that are typically delivered better by private ownership than by government ownership of tangible and intangible assets.

Transaction cost economics (TCE) provides a relevant framework within which to develop the arguments for the roles of the market and governance which is so central to the reform process. A transaction occurs when one stage of activity finishes and another begins. With a well-working interface, these transfers occur smoothly. TCE supplants the usual preoccupation with technology and distribution costs, with an examination of the comparative costs of planning, adapting and monitoring task completion under alternative governance structures. It is as much about transactions within a single entity (e.g. one transit
operator, a regulator) as it is between entities. It pays special attention to information signalling and processing and its asymmetry throughout the system (i.e. where the expertise really resides), bounded rationality (i.e. the ability to process a limited amount of information), hazard, opportunism and asset specificity (Williamson, 1979).

Importantly for any ongoing reform process, transaction cost economics maintains that it is impossible to concentrate all of the relevant bargaining action at the ex-ante contracting stage (which is what competitive tendering essentially does; especially in the presence of inadequate ex-post monitoring). Instead, bargaining is pervasive, in which case the institutions of private ordering and the study of contracting in its entirety take on critical economic significance. PBCs, which can be negotiated under an unambiguous condition of expected performance, align with this view (Hensher and Houghton, 2004, 2005) since the market operates actively throughout the contract period under signals delivered through incentive payments and benchmarked efficiency—or what is known as yardstick competition. The behavioural attributes of human agents, whereby conditions of bounded rationality (‘doing what each party is best at’, i.e. specialization) and opportunism (e.g. ‘looking for appropriate opportunities to grow patronage’) are joined, and the complex attributes of transaction with special reference to the condition of asset specificity, are responsible for this condition (Williamson, 1987, p. 178). Alignment of incentives is central to efficient contracts and property rights. The latter emphasizes ownership matters, with rights of ownership of an asset (tangible and intangible assets) defined as the rights to use the asset, the right to appropriate returns from the asset, and the right to change the form and/or substance of an asset.

Transaction cost economics acknowledges merit in both monopoly and efficient risk-bearing approaches to contracting. It insists, however, that efficiency and effectiveness purposes are sometimes served by restraints on trade (Williamson, 1987, p. 188). This statement is crucial to the discussion because it puts forth the argument that examination of the underlying attributes of transactions discloses that restraints on trade can help to safeguard the integrity of transactions when transit operator-specific investments are at hazard, with downside consequences on service delivery.

Asset Ownership—A Key Issue Linked to the Boundaries of a Transit Operator’s Business

The relationship between asset ownership and incentives is an important kernel of the debate in some reform processes. What is being found in Sydney in particular, where assets are currently owned by private transit operators, is a position of progressively relinquishing ownership of tangible assets (vehicles in particular) through new financial arrangements when assets are being replaced, opening up in time (potentially) to competitive tendering. If an incumbent operator is cost-efficient and service quality-effective, what does this do to incentives to invest and grow the business? And what incentives are provided by competitively tendered management contracts, as, for example, in Adelaide and Perth in Australia (Hensher and Wallis, 2005), where one is starting with a ‘clean slate’ in the sense of no initial private incumbents?

Transaction cost economics (Williamson, 1985) can assist in addressing the question of what determines business boundaries. The basic tenets of the property
rights framework can be usefully discussed in terms of an arrangement between a principal (i.e. the government) and an agent (i.e. the transit operator) hired to accomplish some task. As principal–agent theory has long argued, appropriate incentives must be provided for the agent. In general, because the principal cannot directly measure the effort level of the agent, incentives need to be provided by making the agent’s remuneration partially contingent on benchmarked performance. An example is the incentive payment that a transit operator might receive from improved service quality. A basic conclusion of the theory is that agency problems can be mitigated, and sometimes even solved, by offering the agent a sufficient share of the output (i.e. rewards) produced, commensurate with the risks they take and an agreed margin.

However, problems arise when it is not possible to specify clear performance measures in advance (i.e. a poorly structured contract that does not build in clear performance benchmarks and agreed variations). For instance, the government may have insufficient information to prespecify the decision-making activities of the transit operator; after all, that’s presumably what they were hired to do. The solution prescribed by agency theory calls for a comprehensive contract that considers the marginal value of all possible activities of the transit operator and the marginal cost to the transit operator in all possible states of the world, such as innovative improvements, and the ability of government to commit to pay the appropriate compensation for each outcome (Hart and Holmstrom, 1987). Lacking such a comprehensive contract, incentives, and therefore production, will be sub-optimal.

Rich economic theory has emerged in recent years that combines the insights of transaction cost economics on the importance of bounded rationality and contracting costs with the rigour of agency theory. The theory focuses on the way different structures assign property rights to resolve the issues that arise when contracts are incomplete. This provides a basis for defining different organizational structures by the ownership and control of key assets. Grossman, Hart and Moore (GHM; Grossman and Hart, 1986; Hart and Moore, 1990) pioneered this approach, and its relationship to earlier approaches has been lucidly documented by Hart (1989).

A key tenet of the GHM approach is that, unlike the contracts typically analysed by agency theory, real-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. Schliefer (1998) broadly describes all non-contractible elements as “quality”, which in the transit case may include innovation, planning expertise, driver attitude and manners, vehicle cleanliness, etc. Incompleteness is a natural consequence of the bounded rationality of the parties.

Each of the parties will have certain rights under the contract, but its incompleteness means that there will remain some ‘residual rights’ that are not specified in the contract. When these rights pertain to the use of an asset, the institution that allocates these residual rights of control is referred to as property ownership. All rights to the asset not expressly assigned in the contract accrue to the person called the ‘owner’ of the asset. For example, if a bus purchase contract says nothing about its maintenance protocol, then it is the transit owner who retains the right to decide on the level of investment (which may not be optimal).
The allocation of the residual rights of control will have an important effect on the bargaining position of the parties to the contract after they have made investments in their relationship. In the absence of comprehensive contracts, property rights largely determine which ex-post bargaining positions will prevail. What is being found in Sydney is a very explicit allocation of property rights moving towards government. Is this likely to be a trend or has Sydney got it wrong? In particular, a party that owns at least some of the investment in the asset will be in a position to reap at least some of benefits from the relationship that were not explicitly allocated in the contract by threatening to withhold the assets otherwise. A party who does not control any assets must rely on the letter of the contract or the goodwill of the asset owner to share in the output. As a result, an agent who controls no assets risks going unpaid for all effort not explicitly described in a contract. In contrast, the agent who controls assets that are essential to the relationship can ‘veto’ any allocation of the residual rewards not considered sufficiently favourable. Thus, the ownership of assets and the receipt of any residual income stream go hand in hand.

Ownership matters when an organization makes specific investments (Williamson, 1975, 1985) and where contract incompleteness leads to distorted ex-ante investments (Grossman and Hart, 1986). Grossman and Hart show that the agent whose ex-ante investment is ‘essential’ to making the most productive use of an asset should own it. Hart and Moore (1990) suggest that an asset should be owned by an agent, or a coalition containing the agent, who is indispensable to the asset (i.e. without their participation the asset has no effect on the marginal benefit of others). They further argue that an agent who is dispensable should have no ownership rights over assets.

Efficient ownership would seem to depend both on where the investment is taking place and which is the indispensable party. Could there be a case for government ownership of the physical assets if government is either the party that undertakes all ‘essential’ investment (with operators therefore dispensable) or the party viewed as indispensable? Schliefer (1998, p. 137) point out that GMH theory does not model government participation specifically, and goes on to demonstrate that government ownership is rarely the most efficient at providing ‘essential’ investment in non-contractible elements. Public managers have relatively weak incentives to make ‘essential’ investments (particularly innovation) as they are not the owner and will receive only a fraction of the returns. Schliefer (1998, p. 138) argues that the question of ownership in the government context is rather one of whether high-powered (market) incentives are appropriate to the procurement context.

Schliefer outlines a small subset of cases where low-powered incentives (provided by government ownership), such as legal rules on compensation of bureaucrats, complexity of government objectives and public setting rules (which reduce the return to public managers), are more appropriate when private ownership would otherwise lead to excessive cost reduction, to the detriment of non-contractible quality. Private ownership is, however, generally considered superior even where there is strong incentive to sacrifice quality for cost savings for three reasons: gains from innovation through private ownership may outweigh the negative effects of cost pressures; where there is competition (especially with the car), demand influences quality as well as costs; and where there are repeat transactions the reputational effect tends to negate cost pressures. Schliefer does not consider public transit as a case requiring low-powered incentives through
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High-powered incentives embedded in PBCs (Hensher and Houghton, 2005) such as patronage and service incentives can provide the incentives for an efficient outcome.

Our focus has been on physical assets (e.g. vehicles) despite the fact that ‘essential’, specific investment in the transit industry is more likely to involve intangible human assets (e.g. information, experience, skills). Simon (1982, p. 21) has long argued for a greater emphasis on these intangible assets:

My central theme has been that the main productive resource in an economy are programs—skills, if you prefer—that in the past have been partly frozen into the design of machines, but largely stored in the minds of men.

Given the continuing information explosion, the role of ‘intellectual capital’ is becoming more significant. As Drucker (1992, p. 95) put it:

In this society, knowledge is the primary resource for individuals and for the economy overall. Land, labor and capital—the economist’s traditional factors of production—do not disappear, but they become secondary.

Hart and Moore (1990) show that control over a physical asset can lead indirectly to control over human assets, where the owner exercises their ability to exclude others from the use of that asset. The owners of the human assets are provided with incentive to act in the owner’s interest in order to make use of their asset-specific, human investment. Schliefer (1998) emphasizes, however, that government ownership of any kind of asset is usually inefficient. Given the interdependence between tangible and intangible assets across the full spectrum of contractible and non-contractible activity, if the ownership of contractible tangible assets is taken away from the private sector, one engenders higher risks of malfunctioning, especially where there is a sizeable amount of non-contractible quality.

In summary, a specific asset should be owned by the organization that can use it most productively. Importantly, it is the interaction of contractibility with the need to provide incentives via asset ownership that defines the costs and benefits of market coordination. Government ownership is rarely efficient, and private ownership with appropriate performance incentives can provide the least distortion to ex-ante investment incentives.

Conclusions

This paper offers some alternative perspectives on the role that government and the operator might play in the future in the delivery of transit services. In particular, the authors is of the view that efficient and effective services can be provided under a carefully crafted regulatory framework that provides appropriate competitive pressures which does not necessarily require competitive tendering to deliver the appropriate outcomes. This can be achieved under a strong continuing trusting partnership through negotiated performance-based partnerships that have strict rules on commercial relationships and deliverables. As part of a programme of reform to achieve these ideals, the matter of property rights and incentives form the backbone of establishing a framework capable of meeting the obligations of all parties.
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 recognize 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.

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References


Notes

1. The series was co-founded by David Hensher and the late Professor Michael Beesley, and is now recognized globally as the premier conference on competition and ownership of land passenger transport.

2. This phrasing avoids the ambiguity of subsidy since government is also investing in the system.

3. One is often told that the incumbent tends to win back the tendered contract. If this is the case, then why is tendering being undertaken instead of seeking out efficient solutions through negotiated performance-based contracts? (Hensher and Houghton, 2004, 2005).

4. It is true that there are plenty of examples of mistrust that lead to a loss of performance, e.g. aspects of the UK rail regulatory regime and the operator collusion that occurred in France (Yvrande-Billon, 2007)—the latter linked to a lack of expertise within the public authorities; however, this should not be read that the ‘solution’ lies in competitive tendering, but in a better aligned trust chain conditioned on clear contractual obligations, incentives and non-compliant conditions.

5. Often with assumed grandfather’s rights.

6. I am reminded of what happens when a private plumber as a service provider services one’s hot water system. One does not argue that the equipment he uses, which I am paying for in part, belongs to me. It is capitalized in the price charged and he keeps the equipment. So why should not the cost of a transit service provided by an operator be treated the same (as the cost of providing a service), with the service charged back to the government through a funding model? Indeed, even if one goes to competitive tendering, this should apply.

7. The Adelaide and Perth success under competitively tendered management contracts appears to be due in the main to the patronage and service incentive payment schemes and not tendering per se (except in the initial round of moving from public to private service provision). It is also noteworthy in a growing number of countries that the average number of bidders is declining. For example, the average number of bids per route tender in London is currently three but was 4.5 in the late 1990s. One would expect more interest in less risky route-based contracts. For area-wide contracts in New Zealand, the average number of bids is 1.2 with the incumbent winning nearly 90% of the contracts.

8. Operators in Sydney have to apply to the government for permission to purchase new vehicles, and the government will decide if this is supported. The operator will then offer quotes from suppliers, and the government will choose one and provide funding over the life of the asset. The asset life is government-determined, in contrast to allowing an operator to determine the write-off period according to the financial state of their business. A related matter that arises when determining the cost of capital is the opportunity that exists for either party to recognize ways in which one party might have a comparative advantage in the ability to raise capital to fund assets. This will depend on the performance rating of a specific government (AAA, etc.), the taxation regimes in place for private and public-sector loans, and interest rate cycles. Importantly, the source of funds can be treated in such a way that the party best placed to get the most attractive financial deal for the sector can then make the assets available to the operator (unless the operator is the best financier), at an agreed price, without having ownership transfer along the lines being implemented in Sydney.
9. Hart and Moore (1990) show that this provides incentives to act in the asset owner’s interests.
10. For example, when a private operator does not invest in service planning and employs lower quality tangible and intangible assets.
11. See note 8.

Response 1

Combining Competitive Tendering with Formal and Informal Ex-post Mechanisms: Evidence from the French Urban Transport Sector

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Since the seminal papers by Williamson (1976) and Goldberg (1976), problems associated with the competitive tendering of public services contracts have been largely described, particularly in the transaction cost literature (Crocker and Masten, 1996). According to the theory, these problems come from the contractual disabilities of the parties, i.e. from the existence of transaction costs. More specifically, the three main potential difficulties are that: (1) the initial award criterion is apt to be artificial or obscure since the service put out to tender may be complex and therefore difficult to describe; (2) execution problems leading to ex-post renegotiations are apt to develop since contracts are necessarily incomplete; and (3) bidding parity between the incumbent and its rivals at the contract renewal interval is unlikely to be realized because the former may benefit from first-mover advantages due to the presence of relationship-specific investments.

One way to cope with these difficulties is to choose alternative devices such as bilateral negotiation (Bajari et al., 2003). However, recent developments have also proposed other solutions, which do not necessarily consist in repudiating competitive tendering. Instead, they advocate complementing this awarding mechanism with formal and informal devices aiming at supporting efficiency through the life of the contract. Auditing procedures, sanction and reward mechanisms relying on benchmarking methods or elaborate dispute resolution processes are examples of formal devices that can be used to improve ex-post coordination (Littlechild, 2002). Informal dimensions can also play a role. Thus, reputational concerns, perspectives of repeated transactions or, on the contrary, threats of vertical integration can help deterring ex-post opportunistic behaviours (Zupan, 1989; Chong et al., 2006). In a nutshell, these approaches highlight the need to consider hybrid governance modes, mixing formal and informal mechanisms, and encompassing ex-ante and ex-post coordination. This view is therefore similar to David Hensher’s: competitive tendering is not taken as a self-sufficient coordination mechanism so that the efficiency of the public services procurement models depends not only on the way auctions are
organized *ex-ante*, but also on the way contractual relationships are maintained and enforced *ex-post*.

The organization system of urban public transport in France provides an interesting case to illustrate this argument. Indeed, as argued in a previous article (Yvrande-Billon, 2006), the French model is characterized by an inadequacy of the regulatory framework within which competitive tendering is delivered and monitored. First, the attribution process lacks transparency as the selection criteria are not precisely defined *ex-ante* and the award of delegation contracts is partly guided by the ‘*intuitu personae*’ principle. Although some level of discretionary power from public authorities might be necessary to allow for flexibility in the attribution process, too much arbitrariness combined with a lack of verifiability of the selection criteria surely generate uncertainty for potential new entrants and lead to a semblance of competition, not to mention that the industry is highly concentrated and subject to collusive practices. Second, contract execution and adaptation are particularly problematic given the limited monitoring capabilities of local authorities.

Present regulation does not impose precise conditions to the operators concerning the supply of data on issues that are relevant in evaluating the quality of the service delivered and the extent to which promises of performance are being fulfilled. Moreover, local authorities rarely engage in comprehensive financial data collection and control monitoring. Qualitative appraisals and specific complaints investigations are not conducted and, whatever the performance indicator, there is no standardized reporting procedure and consequently no comparisons of the various networks. Thus, franchisors (i.e. local authorities) are in a weak position to sanction their franchisees (i.e. the operators) because they do not supervise them properly. Since the information collected by local authorities is disparate and unreliable, franchisees do not feel threatened and are not incited to improve performance, even though they are regulated by high-powered incentives-based contractual schemes. At last, despite the fact that investments in physical assets are, most of the time, made by the local authorities who own them, and although the regulation stipulates that, when a contract changes hands, staff should transfer on the same terms of employment, bidding parity at the time of recontracting is not insured. Due to the lack of expertise and control by local authorities, only incumbents can evaluate properly the depreciation of physical assets, which gives them a crucial advantage over potential entrants.

As demonstrated elsewhere (Roy and Yvrande-Billon, 2006; Yvrande-Billon, 2006), this inadequacy of the regulatory framework neutralizes the potentially beneficial effects of competitive tendering and explains, at least partly, the poor performance of the industry. As developed by transaction costs economics and argued by Hensher, introducing market mechanisms into utilities industries via competitive tendering does not guarantee better value for money. Such a coordination device must be completed by a credible regulatory scheme able to govern the procurement of public services *ex-post*.

References


Response 2

Value for Money in Public Transit: Who is Responsible?

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Scope of Discussion

The paper by Hensher provides a synthesis of the main concerns on the rationale underlying the trend observed in the last years of urban transit evolution. These are largely bounded by the following concepts (or pre-concepts) that one has build over the last decade: competitive pressure as performance leverage; barriers to market entry as a form of protection to incumbents versus the stabilization of supply; value for money in the provision of public services versus unbounded provision; the contribution of information systems to reduce transaction costs; and, last but not least, governments’ strategic objectives in urban mobility. What does all this mean if strategy is in fact about winning?

The extension of this comment does not allow one to cover all these issues. However, two examples in Europe can be given as the aggregated result of the conflicting options offered by these evolving concepts. This is specially so in countries of Napoleonic conduct (or influence), as defined by Hensher and Macário (2001). In the first example, there is a reduced willingness of local authorities to accommodate the political risk of seeing their own firms thrown out of the market if they provide a lower efficiency than potential entrants. In the second example, there are the social (direct and indirect) effects accruing
from potential unemployment as the public transit firm developed strong X-inefficiency effects over their years of incumbency. The convergence of interests (and thus, collaboration) among European countries is also self-evident through the ‘emptiness’ process observed along the many iterations (from 1998 to today) suffered in the attempt to revise European Union Regulation 1191/69 on awards for public service obligations in land passenger transport that was brought to an ‘almost final’ halt by the Court of Justice’ decision on the Altmark case law.

**Industrial Organization Underlying Public Transit**

Trust, cooperation and collaboration in public transit occur in the framework of industrial organization of urban mobility. Bain (1968, p. 25) defined industrial organization as the decomposition of the market into three parts: structure, conduct and performance. Market structure covers the way sellers interact between themselves, with buyers and with potential new competing entrants. Market conduct means the way firms behave in a given market structure, that is how firms determine their strategies and their policies. Market performance includes the welfare outcome of market interaction, and to assess performance one must measure whether the market interaction leads to a desired outcome, or whether a failure occurs in which case regulatory intervention is needed. The legal structure that rules and supervises market behaviour is usually designated as antitrust laws, and the definition of market structure represents the specification of the rules of the game that will be played by agents in the course of their short- and long-term relationships within a market. Setting these rules means describing agents entitled to play it, a finite action set available to each player, as well as specifying the elements that define the end of the game (e.g. time period, outcomes, effects, results, etc.). Market contestability is thus conditioned by these structural frameworks that model short- and long-term relationships between productive agents and regulatory and planning agencies.

In urban mobility systems, it is the regulatory and organizational framework that provides the legal and institutional background configurations where markets develop, and the market supervision goes beyond the anti-trust function, since there are many rules defined by authorities that limit the action of operating companies. These include rules related with network stability (even in the UK), and to administrative price setting. In the last decades we have observed substantial changes in market structure for urban mobility. In urban mobility systems, the trend is to move from production based on public capital monopolies to a limited competition situation where competitive pressure is ensured through contracts and other instruments. In most countries the change has transformed markets, where typically one local monopolistic company operated in a more competitive environment, and where global companies are able to operate either directly (in the UK) or enter the market through capital ownership of local operators. These changes raise a number of questions that are usually approached in studies of industrial organization, and that should be upstream of the decision on which regulatory regime should be selected for a given service in a determined city:

- What is the market’s optimal dimension in order to divide the network in such a way that minimizes costs?
Does the market produce a socially optimal number of services adequate to consumer’s preferences and diversity?

Are companies dynamically efficient and are investments carried out in order to ensure the adequate amount of resources to develop new technologies for current and future generations?

Contracts as Performance-effective Devices

Today there is a strong awareness that contractual completeness is impossible to achieve, as this implies that at the outset of the relationship all possible contingencies that may affect the agreement are foreseen. As stated by (Hart, 1995, p. 1), at the root of contract formulation one must understand that in an ideal world contracts would not be needed, since partners simply trust each other and rely on everybody behaving fairly with no aim to jeopardize the other parts in the relationship. The less trust exists the more we need contracts. Also when one of the parties is a State agency, a contract is needed, not least because of the inherent rotation of the persons occupying the position, as it is the case in Urban Mobility Systems. As Loasby puts it: “firms provide contracts for future options, whereas markets provide options for future contracts” (Loasby, 1994, cited in Foss, 1996, p. 2).

The work of (Guasch, 2001, p. 2) is especially relevant for present purposes, where a detailed analysis was developed of 1000 contracts for utilities and transport signed during the 1990s and which found out that renegotiation happened in around 50% of the cases, suggesting that the likelihood of renegotiation is highest when the auction criteria is driven by objectives of minimization of average prices paid by the users of the services submitted to bidding procedures. In his study, one of the main pitfalls identified was the low effort put in the assessment of the factors influencing fluctuation of demand. Preceding Guasch’s studies, Tirole (1999, p. 779) presented a set of theoretical reasons that can justify contract incompleteness, such as the following:

- Unforeseen contingencies that may arise during the execution of the contract.
- Even if there is prospective capacity to anticipate all possible contingencies, the cost of doing it would be a reason not to proceed.
- Contracts can only be contingent upon variables that can be verified by a third party, otherwise the contract is non-enforceable.

For this author, these reasons justify the preference for an incomplete contract as opposed to a complete one with a high probably of being renegotiated in the near future. This preference lies on the fact that renegotiation of contracts is not without risk since the parties are not symmetrically informed, nor are the contingencies fully foreseeable. In addition, the loss of bargaining flexibility by all partners and the increasing potential for collusion and/or corruption between the firm and the public administration in charge of the renegotiations are also among the factors that contribute to increased risks associated with renegotiations. Therefore, reduction of the probability of renegotiation may well be a variable to consider when selecting a firm in a competitive procedure.

As observed by Hart (2003, pp. C70-C71), both approaches encompassed in the theories of the firm and of privatization are concerned about whether it is better to regulate a principal–agent relationship via an arm’s length contract or via a transfer of ownership.14
However, these two theories did not develop along similar lines. In the theory of the firm, focus on vertical integration leads one to formulate the relationship-specific investment between two firms along two main options: the existence of an arm's length contract with the two firms remaining as independent; or the two firms will merge and carry out the transaction within a single firm. In the theory of privatization, the same question receives a different treatment. Assume that firm A represents the government, which has to deliver a service to society, and firm B represents a firm supplying the government with that service, in the present case mobility services, or more specifically public transport. The options open for this relationship are: the two entities have a contract, with the supplier (agent) remaining as a private firm; or the government (acting as principal) can buy (nationalize) the supplying firm.

The two situations are of course different in some of the implicated elements. If it is assumed that firm B is a mobility provider, this entity will have a direct relation with clients, irrespective of the option taken for the relation with government, and also with other service providers, since mobility is a chain service provision. Consequently, the contract with the government will represent an attempt to regulate the company’s relation with its own customer and with its own partners and suppliers, which does not happen in the case of a strictly economic decision such as vertical integration, as opposed to the previous one that is a political decision.

In much of the literature on these issues, as reported by Laffont (1947/2002), Holstrom and Milgrom (1991), Hart (1995), Schmidt (1996), Schliefer (1998), King and Pitchford (2001), and others, the supporters of the theory of the firm take the incomplete contract perspective but consider that inefficiencies arise because it is difficult (and in some cases even impossible) to foresee some of the contract variables. Supporters of the privatization stream take the complete contract perspective and consider that the reason for imperfection lies on the moral hazard of asymmetry of information, which implicitly leads to the conclusion that organizational form (that entails ownership and firm boundaries) is not relevant. In this perspective, the owner has no special rights once everything that can ever be specified is included in the contract. At the opposite, ownership is of utmost importance when contracts are incomplete, so that the owner of an asset or firm can take all decisions that are not included in the original contract.

The main idea brought forward by Hart (1995, p. 4) was that contractual incompleteness and power can be used to understand a number of economic institutions and arrangements. In fact, several theories have addressed the problem of contracts before but never associating it to power as this is not a standard feature of economic theory. For example, in general equilibrium theory it is assumed that every agent abides by the terms of any transaction entered into, making power an irrelevant aspect, while in game theory the market power concept is put forward. However, this concept says nothing about how to allocate power within the relationship and one should emphasize that an institutional arrangement is always an instrument designated to allocate power among the agents. However, it is only the theory of the firm that raises the discussion on power, based on the idea that firm boundaries are chosen to allocate power optimally among the various parties of a transaction.

According to Hart (1995, p. 29), ownership is a source of power when contracts are incomplete. In fact, ownership gives privileged information, especially through the access to the accounting system. The owner chooses which depreciation method he wants to use and has the capacity to distort transfer prices. For some authors (Grossman and Hart, 1986, p. 705), this privileged access to information is
not the type of right that can be contracted to some outsider; it is rather a residual right of control that is tied together with ownership. It is worth referring that these authors ignore the effects of information access inside the firms and the impact of the internal structures of power in that process, which stands on both sides of the relation that is internal to the agent and internal to the principal, and may have significant interference in the external relations of the firm.\

Conclusions

Observation of reality in urban mobility systems (TIS.PT et al., 2001, MARETOPE, D3) provides evidence that interaction between agents—conflicts, alliances, negotiation, cooperation and even exercise of power—indeed occurs within the constraints and opportunities offered by existing structures. But it is simultaneously the interaction between agents that forms the movement for restructuring and changing the system, as well as external factors that are outside the control or even influence of any of the agents in the system. This means that structures are expected to have a dual role as they constrain some actions, but should also enable those evolutionary processes. Thus, the evidence of a permanent co-evolution between agents, structures and contracts is a major reason to write incomplete contracts.

An incomplete contract will have gaps, missing provisions and/or ambiguities that will create situations in which some aspects related with the use of non-human assets will not be specified in the contract. According to Hart (1995, pp. 23–25), missing usages will fall into the logic of a property rights approach, according to which it is the owner of the asset who has residual control rights over that asset, that is residual control rights are themselves the virtual definition of ownership.

In organizational economics incompleteness means there is room for alignment of incentives. In this field adaptation to unforeseen contingencies is a key issue and contingencies are seen as a possible problem outcome. Consequently, an open-ended structure has the virtue of flexibility to adjust to a problem-solving framework and the learning that accrues from the multiple iterative flows between successful and unsuccessful approach to problems. Therefore, problem-solving and consequent learning are activities of contingent character that cannot cope with the rigidity of a closed (complete) contract, which leaves no other option than entering into a renegotiation process to face any unforeseen occurrence or simply the natural strategic drifting of the different agents and consequent misalignment regarding a previous stage of stability.

Given all the arguments expressed above, it can be concluded that rather than being a deficient instrument for the management of public transit, incomplete contracts do represent an essential adjustment instrument as it provides room to develop a dynamic learning process for systemic interactions, while accumulating essential knowledge to devise more effective incentives. In urban mobility systems, it is precisely the incompleteness of contracts that allows the market, with several levels of interactive processes between agents, to function as an adaptive, cognitive system, as long as feedback mechanisms are established to enable the creation of an effective information system that will feed all agents in their process of development of knowledge and innovation.

References

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Notes

13. Market is herewith understood as the virtual arena where producers place their products or services to attract the same set of consumers.

14. Hart uses car manufacturer and electricity supply to illustrate his reasoning, but the rational and arguments are largely valid for urban mobility systems and are what enable us to establish the parallel between Hart’s formulation and our urban mobility problem.

15. This problem is extensively developed in the field of psycho sociology of organizations, but falls beyond the borders defined for this work, which is the reason why we limit ourselves to point out the importance of enclosing it within the factors affecting the contractual dynamics between agents.

Response 3

Competitive Tendering and Collaborative Partnerships in Bus and Rail Transport: Some Reflections

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This response to David Hensher’s think-piece is informed by the author’s extensive research on tendering and franchising in public transport (e.g. Preston, 2005),
his recent experience as a special adviser to the House of Commons Transport Committee, which has recently completed an inquiry into passenger rail franchising in the UK (HC1354, 2006), and the proceedings of a recent ECMT workshop on rail tendering (e.g. Thompson, 2006).

Hensher is right to start his discussion with problems concerning defining the objectives of competitive tendering or franchising. This has been highlighted recently as a problem for passenger rail services in Britain. There are a number of dimensions to this problem. Governments are reluctant to define clear objectives against which their policies can be judged, although the quantification of government (Best Value Reviews, Public Service Agreements, Target Setting, etc.) is overcoming this to some extent. Governments are also reluctant to set specific objectives that can be easily changed by an incoming administration, but are also wary of specific long-term commitments that extend past their term of office. But perhaps most crucially, governments are wary of clearly specifying objectives when they are conflicting. In public transport, there are clear conflicts between commercial and social objectives (Preston et al., 2005). For economists, the answer is easy: public transport organizations should have an objective of maximizing net social benefit subject to a budget constraint. However, economists have difficulties in making this definition operational, particularly if quality as well as price and quantity are taken into consideration and the market is suitably segmented. Moreover, the economists’ jargon does not translate well into lay language and can easily be reinterpreted by politicians (and sometimes planners) as maximizing output (bus-miles, train-miles) subject to existing subsidy levels. It is well known that this will lead to suboptimal results (Nash, 1978).

However, when considering objectives, it is worth distinguishing between gross-cost and net-cost contracts. In gross-cost contracts, the authority tries to determine the fares, quantity and quality mix that maximize net social benefit subject to a given budget. It has responsibility for social objectives and for revenue. The commercial operator is left to focus on cost minimization—something which it can do very effectively. However, this all assumes that the authority can act in an allocatively and dynamically efficient manner—but it may not be incentivized to behave in this manner (Preston, 2006). However, with net cost contracts the split between social and commercial objectives can be fuzzy—operators will usually have more responsibility for setting fare levels and structures (albeit in the case of rail in Britain in a situation in which almost one half of fares are regulated). For long-distance public transport services this may have some merit. The more heterogeneous (and more elastic) nature of the market may give operators greater scope to grow the market, whilst first-best (the Mohring effect) and second-best (congestion, environment, accidents) arguments for social subsidy may be less material than for urban public transport. In long-distance passenger transport markets there may not be a too great discord between social and commercial objectives and net cost contracts may be appropriate. For urban public transport, they may be more problematic. Some of the alleged generic problems with competitive tendering may in fact be just examples of applying the wrong kind of competitive tender to the wrong market.

Rather than competitive tendering to sort out these problems, Hensher has a faith in trust, cooperation and collaboration, a view consistent with his predilection for performance-based contracts. In public transport industries which have complex intertwined relationships such as rail, Hensher highlights the importance of thick trust. The experience of Britain’s railways in the post-privatization
era suggests that such trust is difficult to engender. Although Integrated Control Centres and other forms of virtual integration between Network Rail and train operators do suggest that some form of cooperation is emerging, it could be argued that this is based on mutual distrust. In any event, a reading of transaction cost economics would suggest that such trust might be best engendered by vertical integration (Preston, 2002). Furthermore, although Oumann has shown how repetition can engender trust, one could also argue that in certain circumstances it may engender mistrust. It has long been established that in situations of asymmetry and repeated games, predatory behaviour becomes a credible threat (Roberts, 1986). In the bus industry, more limited contractual relations are the norm and hence one might expect thin trust to be prevalent. The preponderance of voluntary quality partnerships in the bus industry in Britain might be argued to support this notion (although repetition does not seem to be a factor here), but the failure of statutory quality partnerships and quality contracts to take-off may reflect deep mistrust between operators and authorities (Preston et al., 2005).

A further point that needs to be addressed is the role of incumbency advantages in competitive tendering. Hensher asserts that there is a tendency for the incumbent to win back re-tendered contracts—in effect becoming a de-facto negotiation. Although there is a need for empirical work on this, my impression is that the rate of churn in tenders in Britain (at least) remains high. My estimate is that of 17 rail franchises in Britain that have been re-franchised to date only five have been held by incumbents, although incumbents have been more successful in the most recent rounds. Where there is a clear concern about incumbency advantage is with re-negotiation.

Another area where empirical work is needed is an examination of the efficacy of negotiated contracts as compared with competitive contracts. Interesting comparison could be made with, for example, inter-city rail operations in Britain and the Netherlands. It is not clear a priori where the advantage is but Van Dijk (2006) cites cost savings of 20–50% on competed franchises by comparison with savings of zero to 10% on negotiated franchises in the Netherlands. A further issue surrounding negotiated contracts is the reliance on incentives, although this is also an issue with incomplete competitive tenders. Practical experience with respect to incentives in Britain’s railways is that it is often difficult to align incentives. An example is the performance regime. In the early stages of this regime it seems that Railtrack was more incentivized than the train operators to improve punctuality, although not to the extent that it would ensure the appropriate level of control of contracted-out track maintenance. Train operators, by contrast, were more incentivized to increase output, which in turn could lead to reductions in performance. Another more recent example is the cap-and-collar regime designed to share risk between the franchising authority and franchisees and thus forestall the mid-franchise renegotiations that characterized around half the first round of rail franchises in Britain (Knowles, 2004; Nash and Smith, 2006). There is a suspicion that this has led to a form of moral hazard in that bidders (incumbents in particular) are prepared to engage in riskier behaviour than would have otherwise been the case and submitted overzealous bids. The extent to which second-best Vickery auctions or Brazilian-style public auctions might curb these excesses is worth considering.

Hensher is right to highlight concerns about maintaining competition in competitively tendered markets, but London’s three bids per tender is still likely
to be better than the maximum of one involved in negotiations. Time-series evidence on bus tendering in Merseyside indicated that real bid prices are reducing (net subsidy increasing) over time, whilst the winning bid increased (net subsidy reduced) with the number of bids. This may indicate either an independent private value auction or a common auction in which the winner’s curse operates (Every et al., 2004). An issue in rail franchising is the high cost of bidding. In Britain, it is estimated that bidders are currently spending between £3 million and £5 million each per bid, but in evidence to the Transport Committee these operators tended to see this as a worthwhile investment and did not wish their expenditure to be curtailed. There are fears that these high costs are limiting entry and one recent rail franchise (West Midlands) elicited only two short-listed bidders. However, in a negotiated regime, it is easy to imagine similar budgets would be spent on re-negotiation. Public–private partnerships in Britain (and elsewhere) have proved problematic partly because the private sector is better placed to invest in negotiation skills than the public sector, a situation which has become apparent with London Underground (Glaister, 2004). The problems that have emerged in France with re-negotiations cannot easily be dismissed as due to a lack of expertise on the part of public authorities—there are likely to be powerful structural reasons why such a lack of expertise is endemic.

Hensher raises some further concerns with respect to asset ownership, which seem to be informed by events in Sydney where private transit operators are progressively relinquishing ownership of tangible assets (vehicles in particular) through new financial arrangements when assets are being replaced. However, there may be sound economic reasons for vehicles to be provided by a third party. Small operators have neither access to cheap capital nor the purchasing power to obtain bulk discounts on new vehicles. This may result in existing vehicles being used for longer than is optimal. Second-hand markets may be imperfect (particularly in thinly populated markets) or, in the case of rail, virtually non-existent (hence, the creation of the ROSCOs in Britain). In Sweden, collections of authorities have combined to provide vehicles for firms that compete for management contracts. Similar arrangements exist in a number of other European countries. There have been concerns that this can lead to overcapitalization as a result of over specifying vehicle requirements, but it has not been as politically sensitive as appears to be the case in Sydney because the separation of ownership and operation has not been accompanied by a transfer of assets from the private to the public sector. In Sweden, vehicles have remained in public ownership, whilst for rail in Britain vehicles have been transferred from the public to the private sector. It is well known that unregulated public monopolies are inefficient. If vertical separation is to be pursued, the emphasis in Sydney should be on establishing competitive input markets. In the rail industry in Britain, ownership of infrastructure remains contentious. In evidence to the Transport Committee, Merseytravel argued that vertical integration of the local rail network would lead to material cost savings, but this was disputed by Network Rail, a company that defies a simple public/private classification.

If sectors are to be successfully competitively tendered, they should exhibit a number of desirable features. These include that: service requirements should be easy to define and reasonably stable; the technology should be well understood; sunk costs should not be too high; the initial costs of defining and letting the contracts should be low; and monitoring of service delivery/quality should be feasible. Experience from around the world, including London and Copenhagen, suggests that the local bus industry meets these criteria, although that is not to say
that competitive tendering is unproblematic. There are challenges to maintain competitive pressures and raise service quality. Rail is a less obvious candidate for competitive tendering. *Ex-ante* structural reforms are need to overcome the sunk cost problems associated with infrastructure, rolling stock and human capital (and, as Hensher rightly notes, the latter is often neglected). A more complex (but less flexible) technology, the greater importance of network benefits, the greater indivisibility of supply, and the longer asset lives makes rail more difficult to tender than bus, but it is clearly not impossible. Perhaps the most crucial factor is rail’s permanence. Governments seem unable to withdraw rail services with the ease that they can withdraw bus services. Bidders are aware of this and can engage in strategic bidding with a view to renegotiations. Moreover, the larger size of rail contracts (typically area based) compared with bus contracts (typically route based) mean that in the case of failure the threat of sanctions or rebidding is not credible because the full costs of imposing the potential sanctions would be higher than renegotiating. This has been a major problem with competitive tendering in Britain and Australia (Kain, 2006). A further problem, particularly in Britain, has been a tendency for a one-size-fits-all approach to be adopted to rail franchising. Following Thompson (2006), there may be some merit in gross cost, relatively short-term (5–7 years), near complete contracts for the more socially oriented urban, suburban and inter-regional networks and net cost, longer term (15 years, but with appropriate break points), more incomplete contracts for more commercial inter-city and regional services. The latter may have some similar features to Hensher’s preference for negotiated contracts, including sophisticated incentive structures. Empirical evidence is needed to complement the theory, but on the available evidence it seems that exploring ways of improving competitive contracts might be more fruitful than promoting negotiated contracts and holding back competitive tendering as a last resort. Of course, for competitive tendering to work well this will require trust and cooperation between authorities, operators and other stakeholders.

References


The issues raised by David Hensher are illustrated in many recent developments and current problems faced in Britain. As is well known, the deregulation of bus services from 1986, and subsequent privatization of rail services from 1996, has created a situation in which very extensive experience has been obtained both of commercial operation and services contracted to public authorities—recent developments in the bus and coach sector are reviewed in White (2005) and issues relate to competition and tendering in both bus and rail sectors in White (2006).

The issue of asset ownership being retained (or transferred to) in the public sector does not generally arise with respect to rolling stock, unlike some cases Hensher discusses. Apart from a few cases where authorities have provided buses to operators, the general practice is that the operator owns (or leases) the rolling stock, the cost of this (depreciation and interest, or leasing charges) being reflected in total costs covered either from passenger revenue (in the case of commercial services), or within the contract price. For example, a very modern bus fleet is now operated in London (98% of buses below 10 years by the end of 2005, average age around 4 years) as a result of specifications in contracts for Transport for London (TfL), but it is the operators’ responsibility to provide the vehicles. Clearly, higher costs are incurred, which will be reflected in the contract price (TfL, 2005, p. 290). The national rail fleet is largely provided through leasing from rolling stock companies, although the market set-up for this purpose at the time from privatization was somewhat artificial (especially in charges made for older stock) and only recently has a more competitive market developed.

A more critical issue is the ownership of infrastructure. The privatization of the national rail system involved the transfer of infrastructure (track, signalling, stations, etc.) to a private company (Railtrack plc). Following its demise, a semi-public body, Network Rail, now controls such assets (its debt has been classified as ‘public’ by the Office of National Statistics, given government guarantees that exist). However, this remains as a monopoly supplier.
In the case of privatization of the bus subsidiaries of London Transport, depots as well as vehicles were sold off. This may have given incumbents a substantial advantage, given the difficulty that newcomers face in acquiring land and planning permission for new operating bases. A more competitive market might have been secured by retaining depots in public ownership, making their use open to newcomers as well as incumbents. Currently, in the London area 86 depots are owned by operators, and eight by TfL (TfL, 2005, p. 40), but TfL is now seeking to build 15 new depots which will assist newcomers to enter the market (Transit, 2006, p. 7).

Hensher rightly raises the issue of quality of service in contracts, given the shift in emphasis from the simple cost-minimization approach in the first phase of competition and privatization. In the case of rail services, a fairly strict quality regime has been in place from the outset, with monitoring of train performance through data derived from the control system, and attribution of delays between service operators and the infrastructure provider. Incentive and penalty payments are linked to this. Monitoring of performance in the case of local bus service (especially commercially registered routes) has been more difficult, but in the London network a shift to ‘Quality Incentive Contracts’ (QICs) recently has produced substantial improvements in performance, linked with a set of incentive and penalty payments additional to the basic contract (London Assembly Transport Committee, 2006). For example, rather than setting the minimum running time, operators may now set a more realistic schedule to reflect variability in running times. This may involve more resources being used, but produces a higher quality of service for the users.

However, the Public Private Partnership (PPP) for the London Underground highlights some of the difficulties Hensher mentions. Its very long duration (30 years, with a periodic review every 7.5 years) makes it difficult to remove a contractor whose performance is unsatisfactory. It is also questionable whether penalty payments are sufficiently large to incentivize the infrastructure companies to minimize delays to passengers (e.g. where weekend engineering work overruns). A particular dissatisfaction has been expressed about performance of Metronet, a company holding two of the three contracts (Office of the PPP Arbitrator, 2006).

The issue of trust between operators and authorities is illustrated in the case of commercial local bus services. Quality can be improved both through action by operators (e.g. better staff training) and by local authorities (e.g. greater provision of bus priorities). This can be seen in the ‘quality partnership’ (QP) concept. However, trust between partners can be poor. For example, transferring road space from private cars to buses is politically difficult, yet the local authority receives no guarantees of service frequency or fares from the operator when such changes are introduced. The ‘quality contract’ (QC) concept, introduced in law under the Transport Act 2000 (but yet to be applied in practice), would create a situation similar to that in London in which authorities would be able to specify service and fares levels, but is opposed by the operating industry. Its ‘ownership’ of profitable commercial services would be affected by such changes (since the incumbent operator would be in the same position as other bidders), leading to questions of possible compensation. A less strict application of competition laws would assist in enabling competing operators to coordinate their services, and could form part of a ‘third way’ between QPs and QCs now being considered (DfT, 2006).
D. A. Hensher et al.

References


Notes

1. The PPP (public private partnership) is a means by which responsibility for maintenance and renewal of the infrastructure and rolling stock of London Underground was transferred to three private sector ‘infracos’ over a thirty-year period from 2003 (while direct operations remain in the public sector). In practice, only two companies—Metronet (controlling two infracos) and Tube Lines—were successful in bidding. The contracts run for a thirty-year period, with reviews every seven and a half years. While a long-term approach to renewal investment is thus made possible, there is virtually no scope for competitive bidding (other than work sub-contracted by the infracos) once the contract period has commenced.

Response 5

A UK Local Bus Perspective

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David Hensher’s paper is largely based on Australian experience, but, in my view, it has a number of important lessons for the UK, especially in the field of urban public transport. For the past 20 years local buses outside London have been deregulated. Commercial companies that decide routes, timetables and fares provide them. Local authorities can step in to ‘top up’ commercial provision to meet any transport requirements that the market is not providing for. They do this by contracting with an operator for the provision of a service and fares specified by the authority, following a competitive tendering process.

Even where this results in a large number of services provided under contract, there are two significant differences from the model on which Hensher’s paper is based: the contracts are for a maximum of 5 years and typically for 1 or 2 years; and they are for individual services not networks.

However, despite this, the UK bus contracting market supports many of Hensher’s arguments especially in respect of the following:

● There are high transaction costs resulting from the small size of the contracts and the number of contracts.

● The contracts are typically short-term and give the operator little scope for developing the service or for investing in it.
Assets (buses, garages) are owned by the operator.

There should be little surprise that this model rarely leads to trust, cooperation and collaboration. However, there is a growing body of opinion amongst transport authorities, government and operators that trust, cooperation and collaboration are essential for the future development of bus transport in the UK. In a number of areas, including Greater Manchester, a degree of partnership and trust has been developed outside a formal contractual framework. This was achieved because there was a high-level commitment on the part of the transport authority and operators to develop an integrated network. This has had a number of notable successes including integrated all operator and multi-modal travelcards and integrated passenger information services funded jointly by the authority and the operators. This indicates that trust and cooperation can deliver and supports Hensher’s conclusions. However, this has no contractual base and is always a fragile relationship. Furthermore, operators are subject to competition legislation that can make it difficult or impossible for them to collaborate with one another or with a local authority.

In the late 1990s there were demands from local authorities to be given powers to contract for all bus services in their areas. These were granted in the Transport Act 2000, which enables a transport authority to request the Secretary of State (Minister) to allow it to implement a Quality Contract in the whole or part of its area. This would allow the authority to specify the services it requires together with fares, performance standards and measures. This could cover many of the areas that Hensher discusses.

Issues such as ownership of assets are still to be determined. So far, no applications have been made, although some authorities are now actively developing them. However, all of this would still be subject to competitive tendering with a 5- or possibly 10-year contract term with an operator. It therefore remains to be seen whether this approach would lead to “strong continuing trusting partnership through negotiated performance-based partnerships” that Hensher advocates. However, his arguments and findings should help to inform the debate over the form of future partnerships and contracts in the UK bus market.

Response 6

Efficient and Effective Public Transport Services: A Comment from a European Perspective

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Competitive Tendering Dogma

The usage of competitive tendering in local and regional public transport has spread across Europe during the last two decades. Contracting between transport
authorities and transport operators was not absent from the public transport scene before this, but three main facts stimulated the growth of more formalized competitive tendering procedures.

The first is the introduction of competitive tendering in the procurement of bus services in London in 1984. This competitive tendering regime gained high credits in many Continental countries. This was helped by the booming London economy which generated substantial autonomous ridership growth and by service integration which characterizes the London system. Market-based deregulation introduced elsewhere in Britain under severe subsidy caps imposed upon Labour-led metropolitan governments by the Conservative government received, on the contrary, a rather bad reputation, despite local successes. The London example was then copied extensively in other countries, Copenhagen (Denmark) started and the rest of Denmark and Sweden soon followed suit to such an extent that this organizational form subsequently even came to be known as the ‘Scandinavian model’. Essential in this regime is the gradual transformation of the former public operator into a planning/procuring agency and the (gradual) privatization of the former operating divisions. This regime is currently spreading further across the Continent (e.g. in the Oslo, Norway, and Frankfurt, Germany, areas), be it with substantial variation in transition speed and sizing of (route) contracts. A common feature is that services are tightly specified by the procuring agency, while operators have mostly no say on service design and fares.

The second main impulse is the usage of competitive tendering in public transport in France, championed by the internationally expanding French transport groups. Successive legal amendments in France in 1981 and 1994 introduced more rigorous contracting and tendering practices upon an already well-established private-sector contracting practice. A particularity of the French regime is the much wider scope for negotiations and choice of operator by the tendering authority. Operators also have at least some say on service design within this regime. Although it must be said that contracts are often very restrictive, too restrictive perhaps, and that operators have often not much more than the right to suggest modifications to the services.

The third main influence is the European Commission’s endeavour to develop legislation favouring competitive tendering as the basic regime in public transport. Initiated in the 1990s, this controversial legislative process was stranded until very recently. Parliament approval is now expected in 2007. The perspective of this legislation, and especially the threat of tendering that came with it, influenced some countries—together with the spirit of time—to introduce their own reforms towards competitive tendering of exclusive rights. This can be seen in the Netherlands. An argument put forward by the Commission in favour of this legislation was the development of an international market, exemplified by the appearance of international transport operators, mainly from Britain and France. The French groups in particular, who have concentrated their business models around the French network contracting practice, proved to be strong proponents of the generalization of this organizational form all over Europe through European legislation.

Alternatives and the European Legislative Process

An alternative to the competitive tendering dogma would have been to (re)juvenile organizational forms based upon free-market initiative, but then in combina-
Delivering Value for Money to Government

Reaction to Hensher on the Functioning of Competitive Tendering in Europe

Transport operators are often heard requesting more freedom to make use of their professionalism in designing transport services. Yet, they are often restricted to being producers of bus-km. This criticism is essentially against the so-called ‘Scandinavian model’. Several countries do, however, develop alternatives. The French practice is one illustration; current developments in the Netherlands and to some extent in Germany and Norway provide other interesting extensions where operators are requested to design services while tendering and/or during the contractual period. Various incentives (such as passenger growth, revenue growth, quality, passenger satisfaction, etc.) are given but, differently from the performance-based contracts (PBCs) advocated by Hensher, yardstick competition is not used. The fundamental remains competitive tendering, perhaps regrettably for longer-term entrepreneurship and commitment.

In agreement with Hensher, “the solution is not CT, but a better aligned trust chain conditioned on clear contractual obligations, incentives and non-compliant conditions”. One should also stress the importance of the contract
period versus the tendering period. Contract life is important, especially as the environment changes. A closer look at European practices reveals that the problem is the legal, procedural and contractual stiffness that comes with the compulsory usage of competitive tendering. While this may be the result of a misguided interpretation of some of the legal, procedural or contractual requirements by tendering authorities, the result is more static a product than what is probably needed.

Although Hensher mentions quite strongly the issue of the ownership of the rolling stock in the bus sector, one has, however, to observe that operators are and remain the owner of their vehicles within most recent European competitive tendering practices in the bus and train sector. The main exceptions are the French urban public transport contracts, especially where dedicated metro and tram infrastructures make public ownership reasonable.

Response 7

Delivering Value for Money to Government through Efficient and Effective Public Transit Service
Continuity: A Comment

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Introduction

David Hensher further opens the debate on the role of governments in public transport, in particular on the tendering procedures. He proposes and discusses some alternative perspectives on the role that government and operators might play in the future in the delivery of transit services. He argues that efficient and effective services can be provided under a carefully crafted regulatory framework that provides appropriate competitive pressures which does not necessarily require competitive tendering to deliver the appropriate outcomes. This paper is a brief response to the ideas of Hensher, which are certainly defendable. I will, therefore, not discuss them in detail, but elaborate on the broader context of the role of the government in public transport policy.

What to do with the Ideas?

I consider current developments in the roles between government and private parties with respect to public transport as a learning process, and to a large extent as a set of experiments, worldwide. Theories, including transaction costs economics, mainstream economics, auction theory, and agency theory, and methods such as gaming are helpful to obtain a first idea about the pros and cons of possible roles of the government versus private parties, but it is very difficult to predict successfully the outcomes. Unfortunately, there is not a recipe for success. I
therefore recommend experimenting with the ideas of Hensher, and carefully evaluating the results including crucial success and failure factors, and reporting them to a wide audience. I think the results depend to a large extent on a large set of determinants not explicitly included in the theories and concepts used. One can think of the thrust wordiness of key actors (see Hensher’s paper for the importance of the concept of trust), the quality of the employees operating the service, the role of the media, and responses to media of crucial actors, etc. Besides, cultural aspects, traditions, tacit knowledge and some other context factors that are difficult to catch in a theory can have a big impact on the results. And to make it even more complicated: the devil is in the detail. Therefore, it is difficult to draw general conclusions on different roles between private and public parties, without investigating what is going on in detail. Therefore, methods such as meta-analyses are unfortunately difficult to apply for research into the success of these roles. To understand better the impacts of more general determinants, in my opinion evolutionary economy can be helpful in understanding (but not predicting) what happens, but unfortunately is not very useful for forecasting.

**Which Results Should be Obtained?**

What strikes me in Hensher’s paper, as well as in most of the literature on this subject, is that it is not made explicit what the government wants to be the result of its interventions. Hensher explicitly elaborates on efficiency and effectiveness, but efficiency and effectiveness with respect to what? And how should it be measured? One of the general arguments not to leave public transport to the market (only) is because of external effects related to the environment, safety, congestion/accessibility, and the land-use system, other arguments being access and accessibility of some categories of users, often referred to as the social role of public transport. I argue that the government should much more explicitly (compared with current practice) measure the impacts of alternative roles, contract forms, tendering procedures, etc. on the final goals. What is the impact on environmental indicators; to what extent is the social role of public transport fulfilled; what is the impact on accessibility/the functioning of (urban) systems, etc?

With respect to these final goals, a spatial distinction can be made between urban and rural areas. In (remote) rural areas the social dimension will be dominant, but in urban regions the impact on the functioning of the urban system, accessibility of central urban areas, and maybe congestion are more important.

**Who is the Client?**

Depending on the incentives of the government, public transport companies often see the authority that provides the money (or that gives other incentives, e.g. related to the assets) as the client, but not the user. A challenge is to combine both. If the (potential) user is satisfied, but the tax money does not result in a contribution to public goals, then the legitimacy is absent. This, for example, can be the result if incentives stimulate long-distance travel for higher-income groups. Due to the effect of a generation of travel (-induced demand), the environmental benefits might be negative, and the impact on congestion very limited. And the social role is not fulfilled, since there is no reason to subsidize such trips for higher-income groups. On the other hand, if the authority is satisfied but the client is not, then there also is a problem. Note that, as Hensher emphasizes, it is very difficult to specify
contracts that cover all relevant aspects. What theoretically is a ‘good’ contract, in
the sense that it includes all reasons for governments to intervene in the public
transport market in an economically first best way, might be a much too compli-
cated contract form. The result can also be that there is a lack of knowledge at public
transport companies to write a good proposal. If no companies would tender, the
system does not work. And if only one or two companies tender, the price can easily
be too high, as is often shown by research based on the auction theory.

Role of Innovations

As in most of the literature on this subject, Hensher also does not include the role
of innovations. The public transport sector does not have the reputation of being
innovative. Innovations often start with small companies, sometimes even outsid-
ers in the market under consideration. I would like to see, much more than
currently, incentives for innovations to be explicitly included in the debate on
public and private parties with respect to public transport.

Conclusions

Hensher’s paper certainly adds to the debate on the role of governments in public
transport, in particular on the tendering procedures. But I think the debate is
broader than included in his paper. For me the most important additional aspect
is the public goals public transport should contribute to. These should be made
much more explicit and included in an evaluation framework for options on the
roles of the government.

Response 8

Delivering Value for Money to Government through
Efficient and Effective Public Transit Service
Continuity: A Comment

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It is an honour for us to have been invited to comment on a paper by Professor
David Hensher on the reform agenda for the public transit industry. As is known
by the wider public, Hensher has been very active in bringing in new ideas for
improving contract design between transit authorities and operators, and in
developing comprehensive conceptual frameworks on this issue. His paper
presents us with the themes of trust building and of the creative use of asset
ownership regulation as an innovative incentive for quality and performance. We
regard it as our main duty here to test his proposals on the basis of the Latin American, especially Brazilian, experience.

The first issue highlighted by the paper is about trust building between the contracting authorities and the contracted operators, which is a recurrent theme in Hensher’s recent research. In some cases, as the author argues, the insistence on organizing competitive tendering procedures, which are expensive, would not be as constructive as assuring a good relationship built on trust between the partners which would free the contracted operator to add value to service beyond the terms of the contract, especially to incentive him to innovate in a manner not foreseeable by any imaginably comprehensive contract. The contracts, the author says, would be necessarily incomplete, and voluntary innovative contributions from the operators would be mainly ‘non-contractible’.

This approach indeed seems to be very prospective. The Latin American reality offers, however, some insights that may be useful for its further development. Generally, urban transit in most of the Latin American cities is in dire straits, except for the celebrated examples of Porto Alegre, Curitiba, Santiago de Chile, and Bogotá. The main reason would be that public transit is simply not on the policy agenda of local governments, which are, moreover, driven by the mobility needs of the middle classes. Continuous investment in urban roads shows that the main problem is not a lack of financial resources.

Thus, treated as a service for the poor, the service is either delivered by the informal sector (deregulation strategy, even if unofficial) or by groups of stronger incumbent operators which have largely succeeded in capturing regulation and in avoiding at least really competitive procurement procedures. The truth is that these operators have not been willing to bring forward relevant innovations either in vehicle technology or in operational quality, the only initiative by and large being over investment in fleet renewal (the Averch-Johnson effect). In the contract-relevant operation, receipt and cost data are firmly controlled by the operators, and users are not even informed at the stops on schedules and itineraries.

In this context, where the insistence on grandfathers’ right is the common cultural ground, the trust building rhetoric is put forward by some officials who are at ease with ‘their operators’ and unwilling to go through a politically risky procurement procedure, especially when newcomers are not expected as a consequence of a nationwide unwritten compromise between the operators’ syndicates. By consequence, the transit authority diminishes and actually extinguishes itself, which opens the door to illegal operators, whose services gain in popularity as the users do not trust anymore the services of the ‘official’ operators.

We may then conclude that trust building must not be limited to the relationship between contracting authority and contracted operator: trust has to be established primarily with the user and with society as a whole, who are the very principals, as both the authorities and operators are mere agents! The lack of legally and morally sound contracting rules produces legal insecurity which may even bring economic losses to the industry: for years, especially during the profusion phase of illegal operation, the operators in São Paulo did not have incentives to renewal their fleet. Only the organization of a procurement procedure, by which the authority regained actual power, was able to reassure them, as it empowered the authorities politically to repress the illegal operators and gave back a legally sound status for the operating enterprises recognized by both the courts and financiers.
With respect to the theoretical issue put forward here, we would stress that procurement cannot be regarded only as a proxy competition tool to be eventually opted out when other alternatives such as long-term contracts on the basis of a solid trust building are available. Procurement is a main instrument to assure fairness in the distribution between the competent economic agents of a society, of the opportunities to contract with its administration. As the different agents agree and comply with this rule, its winning beneficiaries can at last earn respect from the others and—bringing the discussion back to economics—are free to invest as they need not to be afraid of legal and illegal challenges.

The second major theme of the paper discusses asset ownership on the background of a recent experience in Sydney, where the authorities are gaining property rights on fleet. On the basis of transaction cost economics and a broader concept definition of asset ownership, the author analyses the rationality of this and other asset ownership policies.

Discussing once again the Latin America reality, fleet ownership has not been an issue for a decade: most of the public operators have been dismantled and the contracting procedures start from the principle that the acquisition of a fleet is within the duty of the operator. In the Brazilian bus industry there was one experience in Curitiba in the 1980s when the major acquired a lot of ‘public vehicles’ and put them to be operated by the private firms. As this innovation did not happen at the moment where contracts were put to tender or at least renewed, the operators were not willing and they did not even feel themselves duty-bound to maintain the imposed public fleet properly, especially because fleet ownership was considered the basis of their capturing powers; the experience was dropped at the end of the legislature period. Another reason for their resistance was the fact that the selling out of the relatively new used vehicles in the strong second-hand market is an important second revenue source for the firms. And acquiring permanently new vehicles assures them additionally high parcels for the amortization in the cost tables which are used for the fixing of fare prices. On the other side, public administration owns the rolling stock of privatized rail services, as the respective investment is regarded to be too risky for the operators which are rather contracted on the basis of O&M contracts.

But if we enlarge the analysis beyond the fleet ownership and include—going along with the argument put forward by the author—other assets, especially the intangible ones, it should be remembered that in a regulated transit industry the regulatory powers of the administration are the decisive asset (albeit intangible), and a big issue is their boundaries to the eventual planning playroom of the operators. In Code Law ruled countries, this is put forward more clearly as soon transit is established as a ‘public service’ whose titular is the public administration, which may opt to execute it directly, otherwise to delegate it to a private operator by means of a concession contract preceded by an obligatory procurement procedure (i.e. Art. 175 of the Brazilian Constitution). In this legal system, the rights of the contracted parties over the physical assets are also limited as they are considered as ‘reversible assets’, that is, they may be automatically transferred into public hands once the contract is put to an end (obviously, this plays a role in infrastructure property and is hardly applied to vehicle property). In countries with different legal clothing, the regulatory regimes ensure the administration broad powers to establish itineraries, schedules and fare prices. At last, the ever present step-in-rights of the authority turn the power of the physical asset owner even more relatively.
Of course, ownership of the physical assets, mainly of the fleet, may have important effects on the performance behaviour of the operators. But the analysis of the role of this category of asset ownership may be troubled when the fleet is acquired by third parties, e.g. leasing firms, as already happens in the airline industry. Even in a current bank-lending procedure, the bank may take the financed asset as a guarantee. (It should be remembered that the asset of the business mainly considered by the bank is the contracted cash flow!) In some cases, the administration may assume itself some back-guarantee responsibilities, which make the ownership status even more obscure.

These comments are, of course, intended to enlarge the scope of the analysis proposed by the author. On this opportunity we wish to bring in other elements that may be useful for this challenging issue.

First, the introduction of risk management into the contract design debate seems to be fruitful. A proper assignment of risk responsibilities between the authorities and the operators could enhance efficiency, e.g. if the risks of cost variation of the vehicles and respective components as well of labour are entirely transferred to the operator, in substitution for the traditional use of cost tables (common in the cost-plus strategy) which has systematically transferred them to the fare price. Precise risk management measures foreseen in the risk clauses of the contract could foster mutual trust when they include shared responsibility to communicate previous conflicts and dangers.

Second, good regulatory reform policies need strong constituencies. Therefore, a respective advocacy building, including the analysis of the involved stakeholders, seems to be an important issue. In general, regulatory reforms, procurement procedures and contract design seem to the users as issues that are distant to their day-to-day needs. And when the users, which may be relevant voters, do not insist on this theme, politicians, who so far have not even recognized transit as a relevant issue during elections, will see no point in putting forward politically risky reforms, especially if operators are generous election funders. Again, bringing transit back to the governmental agenda is the first challenge to be accomplished in order to give a chance to reasonable regulatory reforms, especially when the staff of the transit authorities have not enough effective decision autonomy to counterattack the strong capturing power of the operators (as is the case in many developing countries).

Comments of the Responding Contributors

DAVID HENSHER

The eight responses to my paper have provided a wide-ranging commentary, broadly distinguished by theoretical argument and practical experiences in particular countries that have been exposed to institutional reforms in the role of markets and ownership in the delivery of public transport services. I have ordered the comments more or less according to the focus on theory and evidence. At the outset I am impressed with the general support for the thrust of my arguments and the need to monitor theory and practice continuously to ensure that we learn from past practices, and gain insights from theory that needs
empirical confirmation. One message is clear: institutional settings differ between countries and cultures which can be quite constraining, but we can learn from each other and avoid many of the pitfalls that might be generic to good process and outcome. My response is an attempt to synthesize the positions of the eight respondents in the context of the key themes of my paper.

The comments by Anne Yvrande-Billon and Rosario Macario are useful overviews of principal-agent relationships, ownership, and the incompleteness of contracts. Their emphasis, consistent with mine, is on the promotion of awarding mechanisms with formal and informal devices aimed at supporting economic efficiency through the life of the contract, i.e. *ex-ante* and *ex-post* coordination. Building on growing arguments to support negotiations instead of auctions, Bajari *et al.* (2002) suggest that auctions perform poorly when projects are complex and contractual design is incomplete. Areawide contracts in bus and rail appear to fit this circumstance in contrast to somewhat simple and relatively unambiguous bus route contracts. Furthermore, they argue theoretically and empirically that auctions (i.e. competitive tendering) stifle communication between buyers (i.e. the regulator) and sellers (i.e. the service provider), preventing the buyer from utilizing the contractor’s expertise when designing the project, a theme that has echoes of the British rail problems post ‘privatization’. Yvrande-Billon, drawing on the French experience, promotes the case for greater emphasis on establishing a credible regulatory scheme able to govern the procurement of public services *ex-post* and that focusing on introducing market mechanisms via competitive tendering per se 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.

Macario emphasizes the need to place the reform agenda within the broader context of urban mobility, which I view more generally as accessibility. Macario also states that “The less trust exists the more we need contracts”. I would argue that it is not a matter of either/or but of the creation and maintenance of a trusting partnership in the context of incomplete (commercial or non-commercial) contracts that are designed in the main as legal obligation documents, with a recognition of variance given the uncertainty of the context in which public transport services are provided. As Macario points out so lucidly, the evidence of a permanent co-evolution between agents, structures and contracts is a major reason to write incomplete contracts and, hence, by implication, the dependence of each party on each other to build the efficient system. In the words of Macario, it “provides room to develop a dynamic learning process for systemic interactions, while accumulating essential knowledge to devise more effective incentives”. Given the high transactions costs of putting this relationship to the competitive tender test every so often, especially where the contracts deliver a small number of bidders, something we increasingly see, at least in the bus context, where regulators prefer areawide contracts in contrast to route-based tenders, the partnership route with performance-based negotiated contracts grows in appeal. Indeed, 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 maximizing net social benefit per dollar of subsidy as recognized by John Preston to a disproportional over-zealous focus of cost containment. I would argue,
contrary to Preston, that the issue is not “applying the wrong kind of competitive tender to the wrong market” but the inappropriateness of any form of competitive tender where the transactions cost are so high as to nullify any financial gains (the exception typically being a first-round tender when moving from an historically entrenchant publicly provided public transport service which always deliver huge windfall financial gains) at the expense of relative neglect on broader social obligations which place as much on benefits as on costs.

Preston’s comment that Hensher has “faith in trust, cooperation and collaboration” has to be placed in context, recognizing the elements of incomplete contracts and limited financial gains and growing transaction costs from re-tendering. Importantly, the building of trust must be accompanied by an appropriate incentive scheme including tendering as a result of non-compliance. It does, however, require commitment from all parties in reporting performance and recognizing benchmarks throughout the contract period. The discussion by Preston on trust and mistrust, thick and thin trust is very illuminating and recognizes the heterogeneity of prevailing circumstances; however, it should, in my view, offer up an opportunity to continue to research the central question of this debate, namely negotiation versus tendering and the potential gains. What does one gain after periods of re-tendering from a high rate of churn in tenders? We need evidence on the costs and benefits in the British Rail context, given the presumably very high transactions costs and investment uncertainties, which I would argue are lower under re-negotiation, or indeed continuity subject to performance, which negates the need for re-negotiation. The evidence promoted by Preston on Dutch rail franchises appears to be first-round tenders where we always expect substantial windfall gains in cost reductions. The important issue to me is the gains and losses through re-tendering compared with negotiation? Preston suggests that the winner’s curse is evolving in the Merseyside contracts, which supports my position to some extent.

The point by Preston about the establishment of competitive input markets under vertical integration is a an excellent one; however, they already exist in many settings including Sydney for buses per se; what is in dispute is the extent to which centralized control of bus purchases, which may deliver cost economies (although we are not seeing it to date with over 1000 new purchases across five main manufacturers and distributors) more than outweighs the flexibility that operators have through ownership to grow their services unencumbered by permissions to do so in terms of requests and approvals of additional vehicle capacity.

Peter White raises the thorny issue of depot ownership, which more than any other type of asset buys substantial property rights and market entry deterrents to others. I agree that a mechanism needs to be found to ensure that if a performance-based negotiated contract regime fails, that the depot must be available to other operators or some other arrangements must be allowed to enable a depot to be established. This may well highlight a positive element of building partnerships to ensure that operations can be and will be separated out in the event of incumbency transfer for whatever reason. White’s brief reference to Public Private Partnerships (PPPs) is somewhat terse to appreciate, but the logical response is to craft the legal and risk-sharing obligations more carefully (to learn from the past experience), and to pick up poor performance along the way—certainly more often than 7.5 years, and impose penalties that really have the effect of resolving the concerns. It may be that existing practices are linked with somewhat blunt sanctions?
Bill Tyson makes the important point about the concerns of building trusting relationship outside of the formal (legal) contract that smacks of anti-competitive or colluding practice. I see this as a crucial element of the reform process and the need to have clarity of the argument that if such practices are deemed anti-competitive (under the law) but that it can shown that the social benefits more than outweigh the costs, then there should be merit in their progression. Unfortunately, in most competition policy frameworks this has to be proven and not taken as assumed.

Didier van de Velde gives a brief but informative snapshot of reform developments in Europe and notes that under competitive tendering “services are tightly specified by the procuring agency, while operators have mostly no say on service design and fares”. The exception is France where negotiation is an option that can be and is exercised by the tendering authority. There is a real concern about the French approach because it has produced collusion and subsequent legal action and fines; and as far as we can tell there is little evidence in the process that can be described as performance-based contracting with non-compliant re-tendering. Such examples unfortunately give the intent of negotiated performance-based contracts a poor reputation, yet this is, in my view, no grounds for a carte blanche move to fully fledged competitive tendering, for the reasons given in my paper and in the respondents’ comments above. There are no absolutes in this debate, but there are approaches that show signs of positive outcomes given the overall social and commercial obligations of the participating agents.

The negotiated performance-based contract (PBC) regime being promoted in my paper recognizes the continuous role of markets and the need to use competitive processes if they can deliver the most efficient and effective outcomes. Incentives built into a negotiated contract conditioned on market-linked benchmarks and the ultimate sanction of tendering if non-compliant enable the incumbent at least to prove their worth initially and then, provided the regulator does their job (which in many ways is the Achilles’ heel of the entire reform process), 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 economic deregulation, competitive tendering or negotiation. Van de Velde’s comments on vested interests and maintenance of the status quo are insightful, but a careful read of the statements and other related papers suggest to me that the negotiated PBCs can support these biases within a framework that respects the ideals of competition policy and clearly sends a signal to incumbents of their efficiency and effectiveness obligations. This may be controversial in the sense that some pundits simply do not understand the subtleties of mechanisms available to comply with competition policy outside of competitive tendering and economic deregulation. Van de Velde’s comment that “The fundamental remains competitive tendering, perhaps regrettably for longer-term entrepreneurship and commitment” is a powerful message that should be taken very seriously, and especially where the grounds for sharing the expertise in service design at the tactical level in the strategic-tactical-operations (STO) framework is but one example of why the approach I promote has some sensible values.

Bert van Wee indicates general acceptance of my arguments and chooses to build beyond them by focusing on broader public transport policy issues. The statement that we are still experimenting and learning globally and should continue to do so but to provide more detailed documentation of the experiences is strongly supported, and is indeed the impetus for the Thredbo series that I began in 1989
with the late Professor Michael Beesley (see http://www.itls.usyd.edu.au/thredbo10/). The questioning of government real interest in a particular intervention process is illuminating, and I agree that we need to flesh out some more the real meaning of efficiency and effectiveness; although I suggest it is broadly linked to notions of cost-efficiency, social effectiveness and what we might broadly represent through the maximization of net social benefit (including relevant internalized externalities such as environmental costs and benefits) per dollar of intervention support.

The suggestion by Van Wee that the contract process must integrate the ultimate user—the public—is important and indeed my appreciation of negotiated PBCs requires tracking the feedback from the public (including users) of their satisfaction with services. The reference at the end of Van Wee’s comments on innovation is powerful and must be linked to the nature of incentives to grow services and patronage, and it sends a message to government to be prepared to commit financially to incentive schemes that can support this. However, it can also be argued that there is also much financial gain to operators to be innovative regardless of government support. I am unfortunately sceptical about this given that most bus and rail operators are not sufficiently artistic in the way they think about markets and opportunities to grow their business. There are exceptions, but it seems that the best success stories are in the context of trusting partnerships, many of which exist in Latin America.

The final contribution by Joaquim José Guilherme de Aragão, Enilson Medeiros dos Santos and Rômulo Dante Orrico Filho (ASF) provides insights into the challenges that Brazil and similar countries face where corruption is high and, in the case of Brazil, operators in the official sector tend to be buyers and sellers of buses (keeping them as long as necessary until maintenance is due, etc. and selling them across the border). My idea of building trust and partnership is positioned within a contractual setting that still requires commitment to efficiency and effectiveness within a structured set of service and patronage incentives and non-compliant sanctions. This is clearly different to the Brazilian experience and has to some extent guided reforms in Australia (notably NSW, Queensland and Victoria) and possibly New Zealand in line with recommendations now with the New Zealand Minister of Transport that grandfather rights are essentially dead and the new agenda is very much driven by the privilege of being an incumbent subject to performance. Along similar lines to the comments of Van Wee, ASF correctly point out that “trust building must not be limited to the relationship between contracting authority and contracted operator: trust has to be established primarily with the user and with society as a whole” indicating that the efficient and effective relationship between regulator and operator is a necessary but not a sufficient condition to achieve the societal objectives.

The commentary from most authors, together with my initial contribution, contains a strong message that it is even more important to recognize the high transactions costs of re-tendering through competitive processes (which is essentially an ex-ante competitive process), which is typically incomplete causing ex-post adaptation to become an important feature of the transaction. Properly structured transparent and performance-based negotiated arrangements protect the continuity of service, since the need to re-tender when there are variations (under the usual rules of tendering) is circumvented in the interest of service delivery to the ultimate consumer. We admit, however, that there remains a significant challenge in progressing this perspective: does the regulator have the skill set to design a set
of objective rules for awarding negotiated contracts (to the incumbent of another provider), and the operators the appreciation of ‘give and take’ that minimizes transaction costs and secures continuity under a relevant set of rules, but that are not easily subject to manipulation, corruption or blatant favouritism? We encourage the debate to continue and the evidence to be forthcoming!

References