WHEN TO TENDER, WHEN TO NEGOTIATE? WHY ARE WE IGNORING THE ELEPHANTS IN THE ROOM?

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Governments have and will probably continue to opt for negotiated solutions with incumbent operators, rather than tender services in areas where operators control strategic assets. This paper attempts to offer guidance to cities facing the debate of whether to tender contracts, or negotiate, so as to achieve best value within their jurisdictions.

BACKGROUND

For over 20 years cities across the world have been occupied with the question of how to achieve sustainable best value for the public purse, with regard to how bus services are procured and delivered. Different nations, and different cities within a nation, have chosen different procurement paths in the belief that they represent the most efficient and effective way of meeting public transport objectives. Moving largely from a uniform base of government provision some cities, such as Adelaide and Perth, chose to pass operational risk to the private sector by tendering service contracts, but managed the risk of monopolies developing by retaining ownership of strategic assets. Others, including parts of the United Kingdom and New Zealand passed assets and revenue risk to the private sector through net cost contracts; furthermore it was in these two countries that some of the more extreme deregulatory measures took place – allowing the private sector to register services commercially whilst contracting subsidised services into the gaps.

Yet deregulatory measures have not been the only initiatives undertaken in the global bus sector in recent years. In both the UK (outside London) and New Zealand, concerns have arisen over the negative consequences of extreme deregulation – lack of integration and poor competition amongst them. In some Australian states and in New Zealand – the assertion of "grandfather rights" and/or the alleged tactical use of commercial registrations has raised increasing concern in the mind of Governments and regulatory agencies about competition, value for money, integrated transport planning and industry sustainability. This, in turn, has led to a desire to re-regulate (or at least regulate more closely) the bus industry in these jurisdictions.

Re-regulating the bus industry can, at a simplistic level, be seen as more contentious than deregulating. Under deregulation many responsibilities can be passed to the operators, along with a commensurate risk premium – for example, industrial relations, asset condition and revenue risk. Re-regulation entails taking back some of these elements, which operators now

perceive as “belonging” to them, and introducing a greater degree of transparency over profit margins, cost structures and operational practices.

For this reason, moving back to regulated markets, or moving to fully competitive markets, where previously contracts have been negotiated with incumbents can create significant friction between (incumbent) operators and the transport authorities.

PRESUMPTION OF TENDER

Whether the parties like it or not, there is a presumption (an expectation even) of competitive tender for service contracts with government – especially where millions of dollars are involved – this is usually the case with public transport contracts. This presumption arises all around the world, and is enshrined in many countries by competition legislation as well as procurement best practice guidelines, whether in the form of Free Trade Agreements, in European Competition Directives or in local procurement polices issued by national and state governments.

And yet negotiated solutions can achieve value for money outcomes. There are also circumstances where pursuing a tender makes no practical commercial sense – what ever the law may say. Pursuing a tender in such circumstances cannot represent value for money (we’ll consider this further later).

Ultimately, there is no “one size fits all” solution. The most suitable mechanism in each case will be determined by a variety of factors, including local competitive conditions, ownership of strategic assets and other potential barriers to entry, the prevailing political climate, the parameters of the contracts to be let, and whether or not the exercise is the first of its type.

PROCUREMENT THEORY

The various procurement policies promote the ideal of competition and therefore tender. However, most acknowledge there are (limited) circumstances where a tender may not be practical. To cite an example (which appears to reflect the principles of many other similar policy statements) here is an extract from the Commonwealth (of Australia) Procurement Guidelines1:

“Conditions for Direct Sourcing

An agency may only conduct procurement through direct sourcing in the following circumstances:

a. where, in response to an approach to the market:
    i. no submissions were received, [unlikely to apply to bus contracts unless <50 buses]
    ii. no submissions were received that conform to the minimum content and format of submission as stated in the request documentation [could apply to bus contracts if large numbers of buses and / or depot(S) required to be procured as part of tender and lead time is insufficient], or

1 Commonwealth Procurement Guidelines, January 2005 http://www.finance.gov.au/procurement/docs/CPGs_-_January_20051.pdf

iii. no potential suppliers satisfied the conditions for participation and the agency does not substantially modify the essential requirements of the procurement; [no applicable]

b. where, for reasons of extreme urgency brought about by events unforeseen by the agency, the property or services could not be obtained in time under open tendering procedures; [unlikely to apply to bus contracts]
c. for purchases made under exceptionally advantageous conditions that only arise in the very short term, such as from unusual disposals, unsolicited innovative proposals, liquidation, bankruptcy, or receivership and which are not routine purchases from regular suppliers; [unlikely to apply to bus contracts
d. where the property or services can only be supplied by a particular business and there is no reasonable alternative or substitute for the following reason:
    i. the requirement is for works of art; [not applicable]
    ii. the protection of patents, copyrights, or other exclusive rights, or proprietary information [depends on your view of grand father rights? – may be applicable]; or
    iii. due to an absence of competition for technical reasons; [unlikely to be applicable]
e. for additional deliveries of property or services by the original supplier or authorised representative that are intended either as replacement parts, extensions, or continuing services for existing equipment, software, services, or installations, where a change of supplier would compel the agency to procure property or services that do not meet requirements of compatibility with existing equipment or services; [not applicable]
f. for purchases on a commodity market; [not applicable]
g. where an agency procures a prototype or a first good or service that is intended for limited trial or that is developed at its request in the course of, and for, a particular contract for research, experiment, study, or original development [not applicable];
h. in the case of a contract awarded to the winner of a design contest provided that [not applicable]:

    i. the contest has been organised in a manner that is consistent with this Division, and
    ii. the contest is judged by an independent jury with a view to a design contract being awarded to the winner; or
i. for new construction services consisting of the repetition of similar construction services that conform to a basic project for which an initial contract was awarded following an open or select tender process, and where the initial approach to the market indicated that direct sourcing might be used for those subsequent construction services [not applicable]."

As indicated above, these generally sound principles seem unlikely to cover the circumstances in which many transport authorities find themselves, and they seem to ignore some fundamental realities of the public transport market – at least that which occurs in many parts of Australia and New Zealand.

While it is accepted that in theory competitive tenders could be pursued, and might be preferred "in an ideal world", in practice they are not pursued (or have not been to date)2. If we consider why this might be the case, a number of common significant factors can be identified, which make tender an understandably unattractive proposition for Government.

[2] Perth and Adelaide are noted exceptions amongst the large cities in the region

- Operators own all of (or almost all of) the strategic assets – buses and depots – which they may not agree to pass on to their successor, even for fair value;
- In New Zealand, operators control and operate registered commercial services, which generally sit within the network of uncommercial (subsidised / contracted services). In Australia, many operators also run charter and coach businesses from there "route and school" service depots. It can be hard to unbundled the potential extent of "cross-subsidy", or at least cost allocation, between these businesses;
- Incumbent operators have been running their businesses for many years (some more than 100 years) and they have become substantial and influential members of the local (and in some cases state and national) community. Supplanting them (or even putting them up to tender) may be very unpopular politically;
- Some incumbent operators (at least in NSW and Victoria) assert[3] equitable "legal" rights (colloquially known as "grand-father" rights) over the routes which they have been running for many years. Contesting these rights may be time-consuming and expensive; worse still, until tested the outcome is de facto uncertain;
- A disgruntled incumbent may simply walk away from their contract either before expiry of their current contract, or at the conclusion of it – before the successor is ready (many of the "old style" contracts have limited or no mechanisms – such as performance bonds – to address this issue; many simply do not address even the possibility of tender, they remain silent on the issue). While most operators would (will?) be affronted by the suggestion that they might abandon their businesses and their customers, and would never consider it in practice, unfortunately there have been a number of examples[4] of insolvency or premature departure (enough anyway) to create the perception in government circles that the continuity risk is real. In addition the "sabre rattling" articles in industry publications, do not help perceptions of potential outcomes. Assuring continuity of service is an imperative for governments; the prospect of school kids left waiting on the roadside is not politically appealing.

Note in response to item 4 above, the procurement "purists" may argue that any bid is worth having to establish a market for a competitive tender5, but in practice we question whether an incumbent will simply calculate the prevailing price premiums operating on potential new entrants and price their bid just below this level – rather than based on actual costs plus a reasonable margin.

We also suggest that in practice if only one bid is received (from the incumbent), this fact will not be lost on the incumbent when finalising the details of the new arrangement, or in re-negotiating future contract variations, which inevitably arise.

These significant factors seem to go largely ignored by most commentators – at least in published documents. To ignore the proverbial elephant in the room (or herd of them!), seems to somewhat undermine the value of the rest of the analysis.

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[3] "Assert" is used here on the basis the proposition has not been formally tested in the courts. The judgement in the Waverley Transit Case was based on estoppel and due process considerations – it did not rule on "grand father rights".

[4] "Commercial" services have been handed back in UK and New Zealand; King Bros' and Westbus' insolvencies in NSW; Harris Park's exit from the industry in NSW; experience with rail franchising in UK and Victoria (National Express).

[5] See item (a) of the Commonwealth Procurement Guidelines above

THE ELEPHANTS IN THE ROOM

In many situations the Government is faced with an incumbent monopoly (or oligopoly) which has provided services for many years. More important these incumbents own all of (or the majority of the strategic assets – depots and vehicles). The procurement theorists and best practice guidelines will suggest that these issues can be addressed by long lead times in a tender process.

To an extent this is true, but it appears to ignore several important factors.

- Requiring participants in a tender to make provision for replacement assets in their tender – rather than providing access to existing assets – means they must either assume they will be able do a deal with the [unsuccessful] incumbent, or they must make firm pricing arrangements with an alternate supplier. Under the first scenario, they create the risk of being unable to do a deal at the expected price (or may be held to ransom)[6], or under the second scenario, they must arrange to buy new assets. New assets (of appropriate quality) must be more expensive than the existing fleet[7], and furthermore the (new) operator then takes on the risk of procurement in time for the start of the contract. Given the size of some of the contracts (more than 100 and even 200 buses in some cases), acquiring an appropriate replacement fleet could take several years (based on the normal order and delivery times in the Australian bus market; and taking in to account the existing capacity of the bus body suppliers).
- As indicated above acquiring a large (>50) fleet would be hard, but for depots the impediments in most cities are even worse. These could include identifying land available land in relevant areas, price premiums for alternative use, difficulty in getting local councils to agree to new depots ("not in my back yard"), planning approvals, environmental impacts assessments, potential increases in dead running etc. All these create significant barriers to entry for potential market entrants and therefore for governments wishing to conduct a competitive tender.
- Having to include these risks in a tender price (on top of other general barriers to entry, for example incumbents have better data and other local knowledge) may either discourage bidders altogether[8] or render their prices uncompetitive.
- Once the winner is announced, what is to ensure the "losing" operator will remain, or if they do remain, that they will co-operate in the transition and will continue to maintain the previous level of service, once they know they will no longer be the future beneficiary of the brand or customer loyalty? In some cases incumbents have argued for substantial termination payments to transfer staff and other "intellectual property" to any successor.

In the face of these stark risks and potential costs, governments have opted to re-negotiate rather than tender. We would argue this is the prudent step. Tender processes are time-consuming and expensive (for governments and bidders alike). Negotiations are not cost free, but both parties' risks are reduced, assuming bona fides on both sides.

Other benefits of negotiation are well-documented – not least by industry luminaries such as Hensher, Stanley and Wallis in this august forum9.

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[6] As experienced when Harris Park left the NSW industry. STA stepped in when Westbus could not acquire the vehicles on an acceptable basis.

[7] New assets are likely to be required because there is no substantial second-hand market in (low floor) route buses and even if there were, acquiring a fleet of identical vehicles is unlikely – so a mixed fleet of different vehicles would result.

[8] See transcript of submissions from potential tenderers to the judge in New Zealand Commerce Commission v NZ Bus, July 2006

We note that the re-negotiation of rail franchise contracts in Victoria in 2003 received favourable comment from the Victorian Auditor General in his report of September 2005 (p154). However, given one of the relevant factors noted by the Auditor General in reaching his conclusions was the apparently low level of market interest in a tender, the specific circumstances in that case may not always apply. The bi-lateral negotiations of metropolitan bus contracts in NSW were also successfully accomplished, using open-book financial evaluation of prior years and benchmarking techniques.

In each of these circumstances it is always impossible to say whether the counter-factual scenario (i.e. competitive tender) would have resulted in better or the same (or worse) "value for money" outcomes. However, what one can say is that substantial changes were agreed and implemented on an industry-wide basis without any interruption to passenger services. In addition one can point to ancillary benefits to passengers, such as fare harmonization in Sydney and the development of the Metlink transport marketing, information and advocacy entity in Melbourne.

What can be established by a negotiated process10 – by reference to competitive markets and similar service industry and public transport service contracts – is that "appropriate margins" have been included in the price and that a reasonable estimate of actual costs and relevant risks has been included in the price.

In practice governments (Treasuries at least!) will always have a preference for tender, if it is possible – it is generally the most "defensible" approach. Nor do we conclude that negotiation should be the preferred method for bus contracts, but rather we suggest that it is possible to achieve value for money from this approach, and that it may be the only realistic procurement avenue in some circumstances. It is for each transport authority (or its government) to determine which approaches are feasible and which may yield the best results.

Negotiated contracts may therefore continue to present a reasonable and sustainable option for governments, alongside the "default" position of competitive tender. There are also substantial relationship benefits in pursuing a partnering approach with the industry. But this depends on trust in both directions; a lack of information (from industry) creates substantial suspicion in government. If the industry resists proper open book processes, or attempts to justify margins outside clearly demonstrable "appropriate and relevant" benchmarks, or demands unsubstantiated termination ("goodwill") payments, then it seems increasingly likely that resolving the major perceived impediments to tender – the "elephants in the room" (including resolving the legal question of "grand-father rights", and acquiring their own portfolios of strategic assets) – will become increasingly attractive to government, and the application of competitive tenders will become more compelling in these circumstances.

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[9] See the following articles on negotiation versus competition: *"Performance-Based Quality contracts in Bus Service Provision"[9] (31 July 2002)* Authors: David A Hensher (Professor, University of Sydney, Institute of Transport Studies) and John Stanley (Executive Director, Bus Association of Victoria);

"Competitive Tendering as a Contracting Mechanism for Subsiding Transport"[9] – Journal of Transport Economics and Policy. (September 2005,) Authors: David A Hensher (Professor, University of Sydney, Institute of Transport Studies) and Ian Wallis (Booz Allan Hamilton, New Zealand)

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[10] This assumes financial transparency and "open book" processes are adopted

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