Pitfalls in competitive tendering:

Addressing the risks revealed by experience in Australia and Britain

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ECMT workshop: Competitive tendering of rail passenger services

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Outline

- Introduction
- Overview of Australian experience
- Overview of British experience
- What went wrong
- Pitfalls in franchising
- Avoiding the major pitfalls
Introduction

Why undertake competitive tendering?

“The principal argument for competitive tendering is that it permits the preservation of an integrated network of services, subsidised where necessary, whilst still introducing competitive pressures, leading to incentives to reduce costs and (depending on who bears the revenue risk and what other incentives are in place) improve quality of service.”

CEMT/CM(2005)18
Introduction

Features of Australian and British Franchises

Common features:
• Net cost contracts (*aim* to transfer *both* cost and revenue risk)
• First price, sealed bids
• Industrial disputation risk transferred
• Staff transferred to new operator
• Leased rolling stock

Differences:
• Integrated railway franchises in Australia; above-rail franchises in Britain
• Contract lengths of 15 years in Australia and (typically) 7 years in Britain
Overview of Australian experience

- Rail operations were split into five: two heavy-railway and two light-railway urban TOCs in Melbourne and a non-urban above-rail operation
- Franchising competition, 1997-99
  - National Express won one heavy rail TOC; Connex the other TOC
  - Gross savings of A$1.8 billion anticipated (5 franchises)
- Franchises began, August 1999
Overview of Australian experience

Kennett transport plan a quiet achiever
Overview of Australian experience

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Overview of Australian experience

Wednesday 27 February 2002
THE AGE
STATE AID FOR TRANSPORT GIANTS

Friday 9 August 2002
Herald Sun
TRANSPORT FIRMS CAN DEAL

Tuesday 20 August 2002
THE AGE
MINISTRY STANDS BY PRIVATISERS
Overview of Australian experience

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• Interim additional subsidy provided, February 2002
• National Express walked away from its operations, December 2002
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Wednesday 18 December 2002

THE AUSTRALIAN

BRITISH OPERATOR LOSES $380M TO ESCAPE "CONTRACT FROM HELL"
Overview of Australian experience
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• Government “refranchised” the heavy-rail operations Connex in 2004, re-integrating the two rail operations but not using competitive tendering
Overview of British experience

- British Rail operations were split into 25 TOCs
- Franchising competition, 1995-97
- Over the first 7 years, subsidies were due to fall to less than one-half of the 1996-97 level
- Franchises began operation 1996-97
- By 2002-03, around one-half of the TOCs were receiving additional subsidy and/or operating on a cost-based management contract
- Three markedly different stances to franchising policy and refranchising structures, notably
  - tightening service specification
  - oscillation over contract length
  - adoption of risk sharing (government explicitly assuming more risk)
What went wrong

Over-optimistic patronage projections and unrealistic cost saving assumptions

Bid assumptions made—Australia

<table>
<thead>
<tr>
<th>Melbourne heavy rail franchise patronage assumptions*</th>
<th>Patronage growth assumptions</th>
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<tbody>
<tr>
<td>Franchise</td>
<td>Year 1</td>
</tr>
<tr>
<td>Bayside Trains (National Express)</td>
<td>+15.5%</td>
</tr>
<tr>
<td>Hillside Trains (Connex)</td>
<td>+15.8%</td>
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</tbody>
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Bids apparently included significant cost savings—despite government conclusion that there were minimal savings to be made.

Public transport was “… an industry that was already relatively efficient after five years of down-sizing and offered only limited scope for further cost reductions”.

(Department of Infrastructure 2005) – also Auditor-General’s report in 1998.
What went wrong

Poor cost management and over-optimistic patronage projections

Franchisee performance—Britain

<table>
<thead>
<tr>
<th>Operating cost performance, 1997-98 to 2001-02</th>
<th></th>
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<tbody>
<tr>
<td>1. Change in operating revenue (tickets + subsidy)</td>
<td>-0.6%</td>
</tr>
<tr>
<td>2. Change in operating costs excluding access charges</td>
<td>+21.4%</td>
</tr>
<tr>
<td>3. Change in staff numbers</td>
<td>+8.3%</td>
</tr>
</tbody>
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Traffic and revenue projections also seriously flawed—saved only by unanticipated economic growth

... while the bid-projected decline in staff numbers was 10.9%
Franchise failures largely caused by acceptance of implausible bids

- unrealistic patronage/revenue *levels* and *pace of growth*
- unrealistic cost-saving assumptions
Pitfalls in franchising

Three key conclusions:

1. Franchise assessments have failed to separate the unrealistic from the robust
2. Commercial risk has not been successfully transferred
3. We might conclude that the franchising in Britain and Australia in general has resulted in an overall adverse financial outcome due to:
   - the cost inflation of a number of British TOCs
   - extra transaction and co-ordination costs and
   - considerable franchising costs
Avoiding the major pitfalls

What to do:

1. Adopt gross-cost contracts—risk assessments are easier (no uncertainty in revenue to consider) and more transparent (less “Beauty Contest” element)
   But, if adopting a net-cost contract…
2. Aim to set large service bundles that minimise loss of network economies (where “large” will depend on the network)
3. Make bid assessment criteria explicit. This:
   a) avoids firms bidding “blind”
   b) assists transparency in awarding contracts
   c) encourages incumbents to comply with their contracts if good and/or bad performance is applied to assessment weights
4. Ensure that barriers to entry are low—rolling stock leased (and the lease could be with government), mandated access to the track, staff transferred to successful bidder
Avoiding the major pitfalls

What to do (continued):

5. Permit state-owned TOCs to bid, if propriety can be assured and cross-subsidisation can be prevented. The TOC provides a useful reality check (especially in “shadow” mode) though if its bid differs markedly from “shadow” then it, too, is bidding tactically.

6. Tightly define service specification to protect public interest and to ensure network economics are not undermined by incompatible unilateral services.

7. Set “high” performance bonds to facilitate enforcement and encourage serious operators (even if it raises barriers to entry); bonds help defray disruption and re-franchising costs if TOC fails.

8. Set “short” contracts to maintain contestability. Highly-specified contracts with minimal “Beauty Contest” elements should keep competition costs down. Short contracts encourage compliance and evidence suggests investment is not dampened.

9. Because contracts are short, aim for “complete” contracts.
Avoiding the major pitfalls

What to do (continued):

10. Adopt risk-averse scepticism in bid assessments—the franchisor needs to adopt the same risk-averseness at the assessment stage as later, when valiantly trying to prevent the franchise failing:

   a) assume optimism bias (poor management) and tactical behaviour is at work
   b) assume something is wrong if bids are dispersed

So…

   a) predict outcomes before the competition
   b) use industry specialists to review
   c) specify link between subsidy and economic (“exogenous”) growth
   d) check bids for vulnerability to adverse outcomes (robustness)
   e) check that capacity is available—proposed services fit onto the network and there is sufficient rolling stock

—reward only that increase in patronage that is due to the efforts of the franchisee—“endogenous” growth

Australian Bureau of Transport & Regional Economics
Avoiding the major pitfalls

What to do (continued):

11. Allow risk to be borne with the party who is best placed to manage that risk:
   a) transfer cost risk and “endogenous” revenue risk;
   b) retain “exogenous” growth risk—economic growth and, perhaps, fuel prices—by indexing subsidy/premium payments.

... and what not to do...
Avoiding the major pitfalls

1. Avoid putting all your eggs in one basket—do not cluster franchise competitions
2. Avoid regulatory capture—there is a fine line between this and developing good business relationships
3. Do not pervert the incentives—beware of contracts where bidders do not have to deliver what they bid on
4. Do not bank on the risks staying with those rewarded to carry those risks.

Successful franchising depends on a fair competition: this extends to the fair execution of the contract. Rescuing franchises undermines the fairness and, probably, the integrity of the original competition. So…

5. Avoid rescuing franchises!
Thank you