COMPETITION AND OWNERSHIP OF BUS AND COACH SERVICES

Report on workshop 3: The Bidding Process

by

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Introduction

The aim was to discuss the evidence on the best way to conduct competitive bidding for contracts for the supply of bus services. The evidence we considered was in the workshop papers and in the diverse practical experience of the workshop membership. Papers were presented to the workshop by Cox and Love; Glaister and Beesley; Teal; and Usher.

We identified the major issues raised by the workshop papers and those not raised. We assessed the nature of the evidence. We present our conclusions under three main headings: how much can one hope to save by competitive tendering compared to conventional methods of procurement? what are the general principles of the best and fairest ways of securing these savings? what are the detailed "do's and don'ts"?

First some general remarks.

We believe that our conclusions apply equally to the procurement of inputs, such as maintenance and cleaning services, as to outputs such as bus service. We frame our discussion here in terms of procurement of outputs.

Competitive tendering is not the same thing as deregulation. And neither of these is the same as public to private ownership transfer. One can have these three things in any combination, although there is a tendency in recent policy experience to link them in particular ways. Ownership transfer involves conversion from public sector ownership to ownership and control by private shareholders who are primarily motivated by pursuit of profit. This is not the same thing as "corporatisation" which is creation of transparent accounts within the public sector. Deregulation is the relaxation of legal restrictions on the terms under which companies may compete with one another. In England (excepting London) bus services have been both transferred to private ownership and deregulated. In Scotland they have been deregulated but the Scottish Bus Group initially remains in public ownership. In the UK, telecommunications are privately owned but not fully deregulated because only two

companies are granted licenses to supply. In the United States and Canada public transport services are publicly owned, but are increasingly provided through competitive tendering.

Competitive bidding for tenders has a role under any combination of these circumstances. It is a process whereby potential suppliers of a service bid against one another for a contract to supply. Depending on the circumstances the bids may be positive (the bidders are offering the "auctioneer" money in return for the contract) or, more usually in our context, negative (the bidders are to provide service to a governmental unit in exchange for money).

In our view the critical thing in determining outcomes is the presence or lack of effective competition, rather than the structure of ownership.

The workshop was keen to stress at the outset that if the process is to work successfully there must be clarity in the objectives of the tendering authority, of the responsible political authority and in the relationship between them.

The evidence on savings

There can be no doubt that the introduction of bidding processes must involve upheaval and administrative costs. Therefore, it is important to have clear evidence that there are benefits to justify these costs. The evidence we refer to here concerns the benefit of introducing competitively tendered service by private companies to situations where all provision was by the public sector: the workshop doubted whether large savings would be available where there had already been private sector involvement on a large scale, especially if all bidders were buying their inputs in the same markets on the same terms. Big gains are more likely to occur if bidding can facilitate a fundamental reduction in the cost of inputs (for labour, vehicles, land etc.).

Not surprisingly the documented experience has been variable. Cox and Love recount the US experience where public sector wage costs, sickness rates and labour productivity had all got out of control. They record that competitively tendered public transit services have exhibited average cost savings of 30% and ranged from 10% to 60%. In all cases the requisite reductions in employment have been achieved through the natural attrition rate of the labour force - there have been no compulsory redundancies.

Teal's findings, again from US evidence (some of it coinciding with Cox and Love's sources), is similar. He concludes that cost savings averaging about 25-30% have been achieved. These savings have been sustained or bettered in the long run. Extra

administrative and monitoring costs vary, but they are typically in the rage of 3-10% of contract cost, with most systems not exceeding 5-6%. For the case of London, Glaister and Beesley report average savings of 16% net of administrative and enforcement costs. The latter vary between 3 and 6% of savings. The conclusion would seem to be that on the evidence presented one can normally expect at least a 20% saving on cost from competitive tendering, gross of extra administrative costs of the order of 5%. Plainly, the actual saving will depend on the particular circumstances. In some cases it has been less than this but in many others it has been substantially more.

The savings appear to have been sustained in the long run. In isolated cases there have been transient problems in maintaining quality of service, but the general experience has been that quality has been maintained or improved, not least because of the extra supervision which is involved because of contract enforcement.

This experience is not inconsistent with other evidence from the non-London bus industry in the UK as reported to the conference in papers by Beesley, Higginson, White and Turner, and Gwilliam. Similar findings are reported by Domberger et al (1986, 1987) in respect of refuse disposal and hospital services in the UK, McDavid and Schick (1987) in respect of refuse disposal services in Canada and Savas (1982) in respect of various public services in the United States.

It should be noted that the savings figures quoted above do not include any credit for any consequential effects of competitive tendering on the rest of an organisation. If tendering only applies to a part of a public sector's activities, as is often the case, then it may well succeed in putting efficiency pressures on the whole organisation because of the incentive to win some of the contracts. Glaister and Beesley provide an illustration of this effect which shows that it can be a substantial one, while Cox and Love refer to similar experience in San Diego.

In most of the cases that we have considered the savings have come from readily identifiable changes, such as market based wage and benefit rates, improved labour productivity and streamlined management. The competitive market controls the costs of these important inputs.

We were not able to detect any reliable indication as to how long it generally takes for all costs to "shake out", though the cost savings referenced occurred within the first year of operation under competitive tendering.

The evidence on the relative safety performance is not definitive. Whilst the workshop members recognise that safety is an important consideration they felt that even if there were evidence of inferior

safety performance, it would not justify an argument against competitive tendering: rather, it would justify an argument for more effective safety regulation.

General principles

In this section we set out the workshop's view of the principles to be followed in conducting a competitive tendering exercise if it is to be fair and effective.

(1) The tendering authority must

(a) keep control of the process and have proper regard to its policy objectives. Often it must be accountable for public funds. All this implies a commensurate level and quality of staffing.

(b) recognise that competition is the important consideration, not ownership per se

(c) recognise that the operators are likely to possess skills, knowledge and experience which the tendering authority may not have. If possible use should be made of these.

(2) This implies that it is important to talk and negotiate with the industry before and during the formal contract awarding process. It is probably a mistake for the authority simply to write a rigid contract specification in vacuo and blindly accept the lowest compliant bid.

(3) In turn, this implies a good bidder pre-qualification process, because the authority must have a clear idea of who it does and does not wish to deal with.

(4) There must be absolute clarity and transparency of process. On balance the workshop favoured the full publication of all bids after the award of contract. There must be a strict divorce of the tendering authority from any operating or other interest. Particular problems are liable to arise if, as often happens, the tendering authority has an "in-house" production capability. Personnel involved in constructing in-house bids should be forbidden from involvement in bid evaluation.

(5) A cheap, efficient and respected means of settling disputes is necessary. Provision for arbitration should be made in order to reduce the risks of expensive litigation.

(6) It will of course always be necessary to make and enforce proper arrangements for regulation of safety. However, great care should be taken to ensure that these are not allowed to become (or remain) vehicles for economic regulation or special pleading for particular interests. In practice this is difficult to achieve; there are many examples of severe economic regulation round the world which were originally

conceived as safety regulations.

(7) It is important to foster active competition for contracts. It follows that it is necessary to be aware of the problems and strategies seen from the bidder's point of view. Nothing should be done inadvertently to discourage potential bidders. For instance it is likely to be administratively convenient and cheap to let large tranches of service in a single contract. But this may create unacceptable risks for the small potential newcomer who, having no track record, has imperfect access to sources of finance. It may also give a sophisticated and experienced bidder scope to adopt subtle strategies which are hard for the authorities to assess and for the opposition to compete against.

(8) Different kinds of contract create different kinds of incentive. While reasonable penalties can ensure consistent service, excessive penalties for under-performance tend to increase costs for both the provider and the tendering authority. These costs are passed on to riders and taxpayers. So far as possible the aim should be to create incentives which make the contracts self-enforcing. We drew the inference from this that one should seek to give the operators every opportunity to express their entrepreneurial abilities. Where appropriate they should be given control over their revenues. This inclined us towards favouring "bottom line" over "cost" contracts. "Bottom line" contracts require tenders for a net subsidy - cost net of fare revenues - while "cost" contracts require tenders for the full cost of service, with the public agency retaining revenues. However, we did not come to a final view on this and we noted that there are many possible "half way houses" in which the operator retains an interest in at least a proportion of the revenue that he generates. In some cases it may not be appropriate for operators to retain an interest in the revenues. There are at least two critical factors that favour "cost" contracts: (1) where ridership cannot be substantially influenced by the operator (at least upwardly), and (2) where a public authority provides services both in-house and through contracts and is charged with the delivery of an integrated public transport system, determining fares, routes, schedules, etc.. Where passenger usage is particularly low, such as in the United States, or where public policy dictates that public agencies specify services (operated in-house and through tenders) in an integrated network, such as in Canada and the United States, "bottom line" contracts are often less appropriate.

(9) Ideas and innovations will generally come from the operators themselves. Hence it is desirable to keep the channels for this open. This can be achieved by encouraging bidders to offer variations on the given specification and by encouraging interaction among operators at pre-bid meetings.

(10) Proper contract management, monitoring and audit trails will be necessary. This cost must be properly budgeted for. However, this may have the benefit (in the past unanticipated) of improving quality of service simply because of the extra attention being given.

(11) It is important for tendering organisations to obtain quality service. Bidders should be required to demonstrate their technical and financial ability to provide the service according to specification. Contracts should be awarded to the lowest responsible and responsive bidder.

(12) A special situation arises when competitive tendering is proposed to replace a system of private ownership (as in some cases in Australia). The workshop spent some time discussing the issues raised by "goodwill" and "property rights" of companies already holding franchises to operate particular services. There was some confusion as to what was meant by these terms. It was generally agreed that no real difficulties of principle were presented by a situation where a particular set of individuals are able to command a return to a good reputation, experience, particular skills etc. This should be correctly reflected in a market value for the enterprise. If action is taken to damage this then, the principle of appropriate compensation is clear. However, situations can and do arise where tradeable assets have acquired a value (which the present owner may or may not have paid for) because of privilege conferred by existing regulations. A familiar example is the value of a licence for a taxi or bus route, where the quantity of licences on issue is limited. The workshop thought it important to recognise such situations and to deal with them equitably, whilst it acknowledged that this is often easier said than done. We felt that the difficulties of these situations should not be allowed to become excuses for inaction.

The existence of these rights should not be accepted too readily: the burden of proof should lie on the claimant. These situations are much easier to create than to remove, so it is important to take great care to avoid creating new such situations. Because competitive tendering in the United Kingdom, the United States, New Zealand and Canada is occurring or will generally occur in an environment of public rather than private ownership there are fewer property rights consideration in those countries.

Details: Do's and Don'ts

Most of the items on the following detailed list are intended to provide correct incentives and to generally "oil the wheels" of the tendering process.

Contracts should not be on a "cost plus"

basis but should be fixed price, possibly indexed to suitable input prices. Contracts should not be subject to price negotiation after execution.

It was noted that sometimes a new technological advance or a new method of working can be used as an opportunity to rapidly "shake out" excess costs. An example was the way in which the introduction of small buses in the UK became identified with different labour contracts, which may not entirely have been ascribable to differences in the vehicles themselves.

The workshop discussed financial guarantees, bid bonds and performance bonds and concluded that when used, such instruments should be for no more than the tendering organisation's probable loss in the event of invocation. Bonds whose face value exceeds possible loss unnecessarily increase bidders' costs and, ultimately increase the price of competitively bid service.

It is common for there to be an "in-house" or direct labour bidder which is not independent of the tendering authority. If this situation is unavoidable then the in-house operator must be bound by the same terms and conditions in constructing his bid as other bidders, and the in-house bid must reflect the extra cost to him incurred in meeting the contract in full.

In many cases a suitable contract term has been found to be three years, possibly with an option to extend by a further two years. This is a compromise between the need to give the winner a period of stability, the administrative convenience of infrequent reletting of contracts and the risk of giving the winner a protected position for too long. It is important that contracts be fully retendered at expiry. There is a temptation to negotiate an extension with the incumbent. But if this becomes common practice the market will come to know it and the forces of competition will be weakened, resulting in unnecessarily higher prices - inevitably the authority will be "captured" by the incumbent.

There is a good case for the authority to provide as much accurate information as it can to bidders and, possibly, to give positive assistance with bid preparation. At the least it should make preparation as easy as possible, perhaps by supplying standard forms for some of the information so that bidders know what is required of them.

We have already noted that large contracts may have disadvantages. Contract size must clearly depend upon the circumstances but the workshop thought it better to err on the small side. Arguments that there are economies of scale should not be accepted unquestioningly in the bus industry. On the other hand one should be aware of the danger of damaging markets by creating passenger confusion through letting too

many contracts. As a rule of thumb a single contract should not normally involve more than 25 vehicles. Very exceptionally should it be as much as 75 vehicles.

It is important to not permit any company to obtain monopoly power through competitive tendering. Market share limitations should be considered, especially where large amounts of service are subject to competitive tenders.

Where multiple contracts are administered by a public authority, it is useful to rotate contract expiration dates. This reduces administrative burden and expense and is likely to increase competition for the contracts.

Contracts should contain break clauses on both sides to be exercised in extremis. This is standard procedure in this kind of contract and no special difficulty was anticipated, providing all sides were clear about the arrangements from the outset.

The authority should seek to dissipate inflexibilities which cause risk to bidders. For instance, the existence of an active market for second hand vehicles, or well established vehicle leasing arrangements mean that the bidder does not have to bear a risk of being landed with excess vehicles should he not win the contract again when it expires. Vehicle leasing is common in road haulage and aviation and would be confidently expected to develop if a need were created by sufficient tendering activity. However, the experience is that when tendering is first introduced the services are slow to develop and bidders do sometimes construct their bids on the basis of writing off the whole of the new cost of vehicles over the life of the contract. In such circumstances it may be worthwhile for the tendering authority itself to become owner of the vehicles. In this way it can pool certain of the bidders' risks. London Regional Transport has done this in isolated cases.

Similar considerations apply to land required. If town planning restrictions make it difficult for new enterprises to secure land for depots etc. then it may be sensible for the authority to hold land and offer it as part of the contract. The workshop did not see land availability as a particular problem, providing the land market is working reasonably well. However, it did note the need to guard against those who happen to hold particularly attractive terminals and stops from using them in an anti-competitive way.

Similarly, equitable access to sources of finance will remove a potential barrier to entry - although it is unclear to what extent the authority should get into the business of overriding the judgement of the financial markets by such devices as providing financial guarantees.

Labour law can impose important

inflexibilities and therefore risks on bidders - a liability to redundancy pay, non-transferability of pension rights etc. Tendering organisations should impose no labour requirements of its own, beyond adherence to applicable labour laws.

Concessionary fares schemes, integrated ticketing, travel cards etc. are becoming more common. They have undoubted popular and political appeal and some real operating advantages. However, they all have the feature that they blur the relationship between the cash taken and the actual journeys made. They therefore tend to obscure the incentives to operators which, we have argued, it is desirable to preserve. For instance, if a large proportion of income is allocated from off-bus sources then it makes it harder to operate bottom line contracts. Stored value systems can overcome many of the problems. In any case new ticketing systems should be designed with an eye to the implications for competition generally and competitive tendering in particular. In this connection the workshop spent some time discussing the merits of user-side subsidy as an alternative to concessionary fares. It was felt worthy of further consideration, but no conclusions were reached.

If fares are to be specified they should relate directly to costs of supply. And if subsidy is to be paid (as with concessionary travel) then payments to operators should relate to trips actually made.

On the timescales for the tendering process, it was not found possible to make concrete suggestions. It was considered a matter of being reasonable. Sufficient time must be allowed for bid preparation and negotiation. But delays must not be so long as to introduce undue uncertainty or costs to bidders. This suggests months rather than weeks or years, from the first announcements and consultations to service commencement. Timescales should be shorter rather than longer.

From the point of view of the vehicle supply industry, the programme of tendering should be designed to avoid sudden fluctuations in the demands for new vehicles.

In certain cases it may be necessary to recognise that in the past certain operators have saddled themselves with operating liabilities at the behest of the authorities. Similarly, legal requirements on conditions of employment, not of the employers' choosing, may have created liabilities. In the interests of fair competition it may be necessary to "buy out" such liabilities.

The view was strongly held that primary responsibility for publicity should lie with the operator of the route rather than with the authority in situations where the operator has the potential to impact ridership. He would have the incentive to make sure that it is done properly. It was

acknowledged that the authority would have a secondary role in coordinating information and performing system-wide marketing.

Future research

Competitive bidding is in its infancy in the bus industry and it is an activity which is likely to grow. Many different schemes have been and will be tried, so there will be plenty of scope for research into how the different schemes work.

There will be many opportunities for commercial research and consultancy, to both bidders and authorities who will find it to their commercial advantage to understand the strategic nature of the bidding process, and to have well constructed bids. This has become well established in the oil and construction industries.

More needs to be known about the rate of cost escapement achieved under competitive bidding, the effects on service quality, effects on safety etc.

Finally, a strategic view of the future of all public transport markets in the country concerned is required.

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