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Service contract management: key concepts and experiences at EU level

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Introduction

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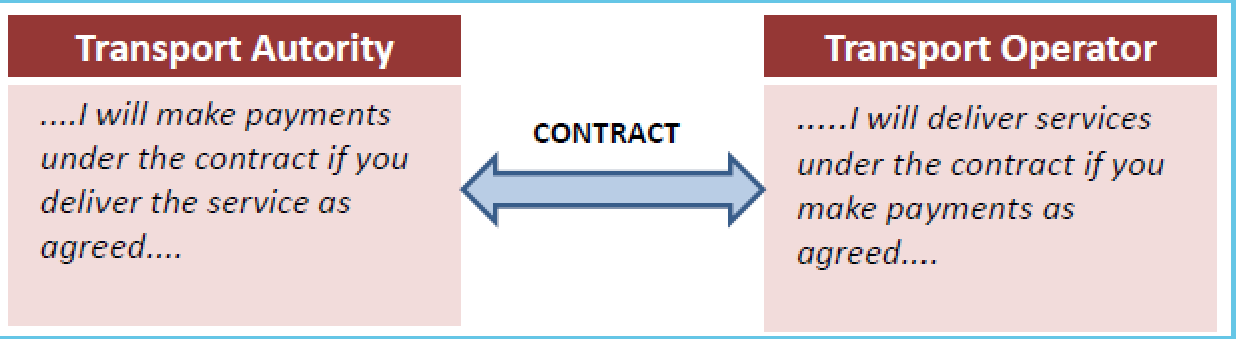
- This workshop is focussing on the management of public transport service contracts.
- My talk will highlight the key concepts associated with public service contracts and their management
- Illustrates lessons learnt through examples from a number of European countries.

Contract management

- The goal of an Authority is to efficiently deliver high quality PT services which meet user needs and policy aims.
- The contract is a tool for ensuring goals are met



- Management of the contract is about ensuring services are delivered as agreed and using the payment mechanism as a means of controlling this.

Contract management

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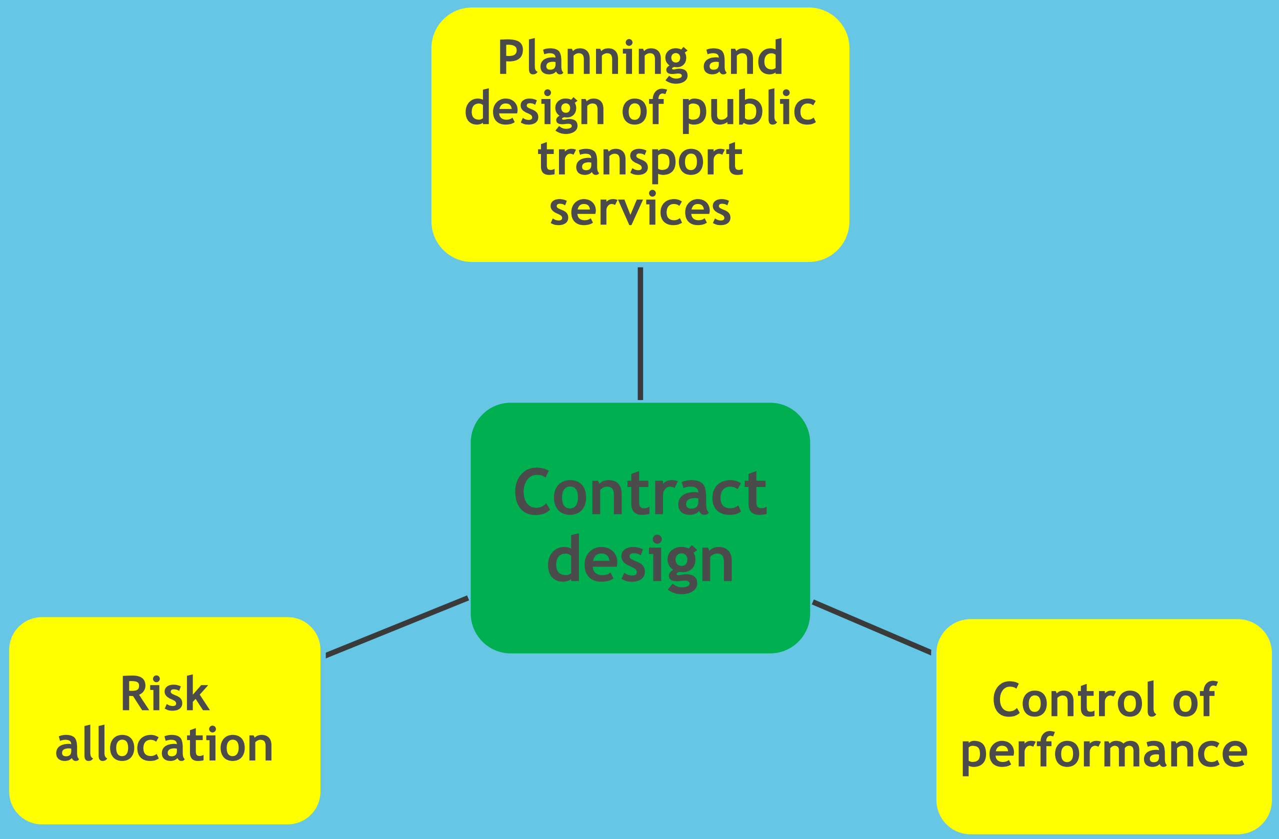
- **Management of all contracts requires some monitoring of service performance**

“If you can’t measure it, you can’t control it
……….If you can’t control it, you can’t manage it
…………..…If you can’t manage it, you can’t improve it!!!”

The contract design and the items (service specifictions, minimum performance standards, rules for payments, etc.) included in a contract are therefore crucial elements of contract management.

When designing the contract three closely connected issues have to be addressed



Planning and design of services

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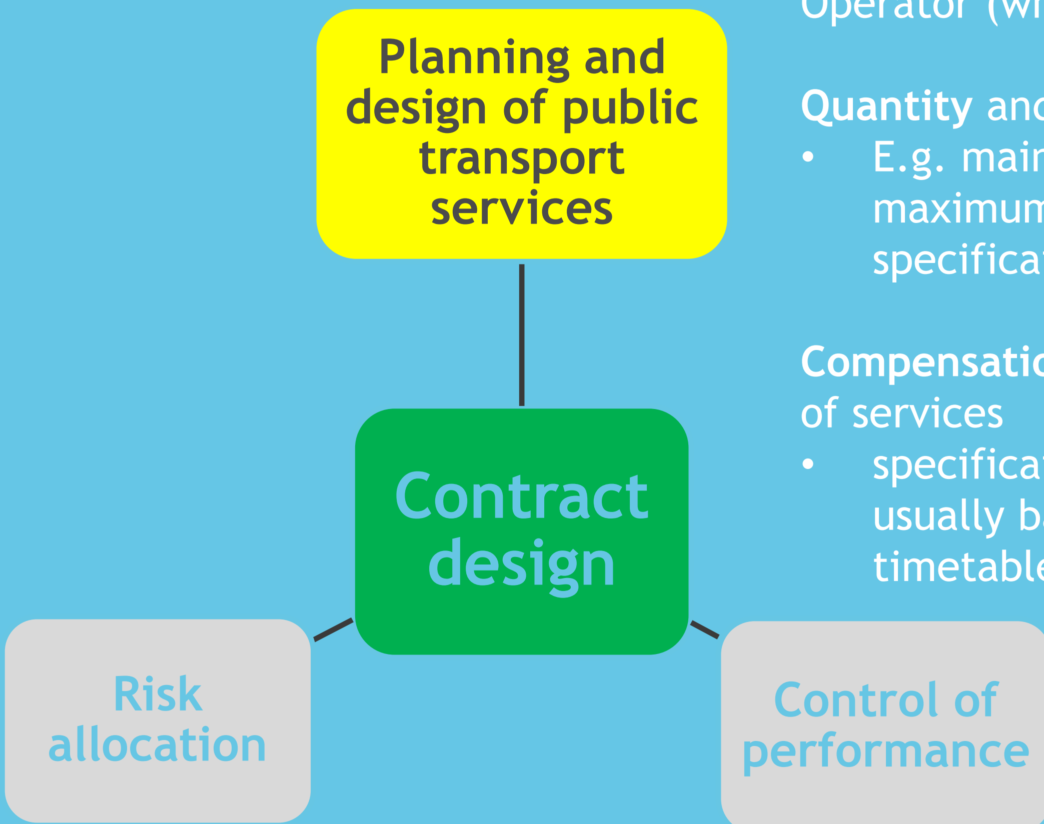

The **rights and obligations** of both Authority and Operator (who is responsible for what?)

Quantity and **quality** of services delivered

- E.g. main nodes served, frequency, size of vehicle, maximum permitted fare paid and/or other specifications related to service and quality.

Compensation payments to the operator for delivering of services

- specification of minimum performance standards - usually based on vehicle mileage and adherence to timetable

Planning and design of public transport services

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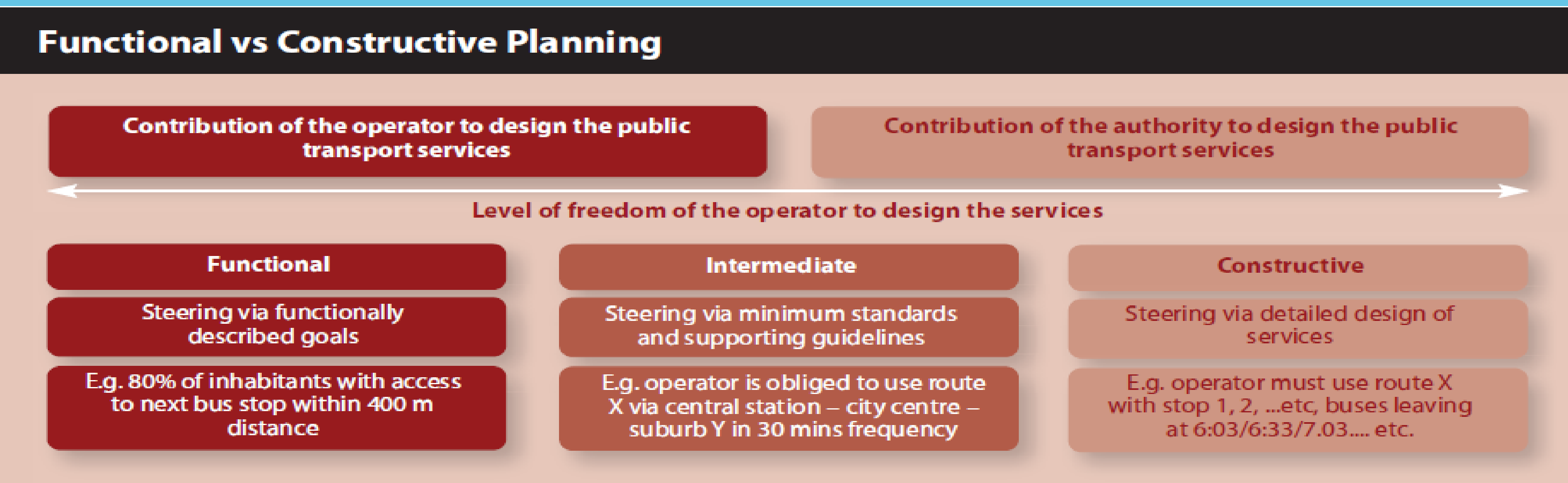
- **Constructive planning**
  - PT services are mainly designed by the authority and the contract contains detailed service descriptions in order to steer the operator.
- **Functional planning**
  - authority gives operator a high degree of freedom in service design
  - less need to describe every aspect of service provision in detail
  - but requires adequate contractual incentives inducing the operator to serve passenger demand and realise public transport policy objectives.

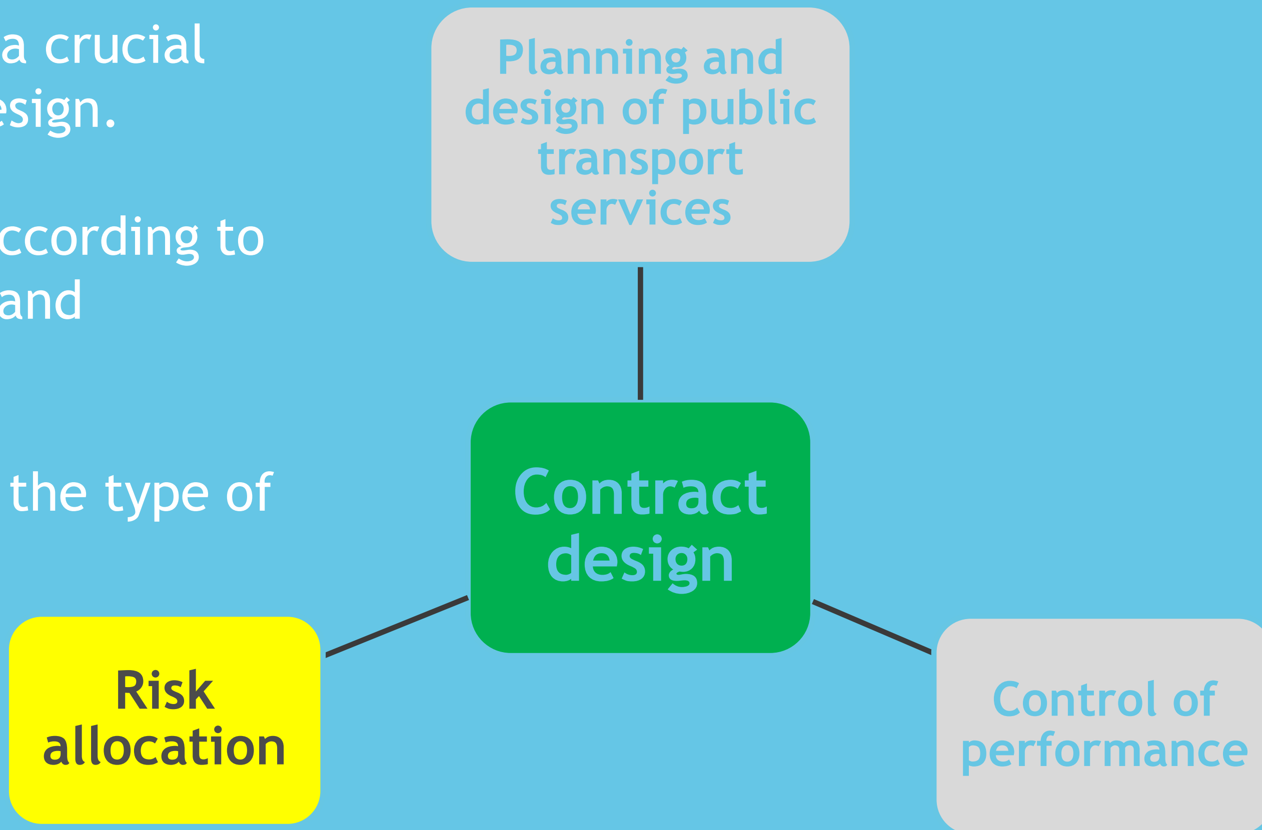


Risk Allocation

The share of risks is a crucial factor in contract design.

This share is made according to local circumstances and considerations.

It influences heavily the type of contract chosen.



Allocation of Risks

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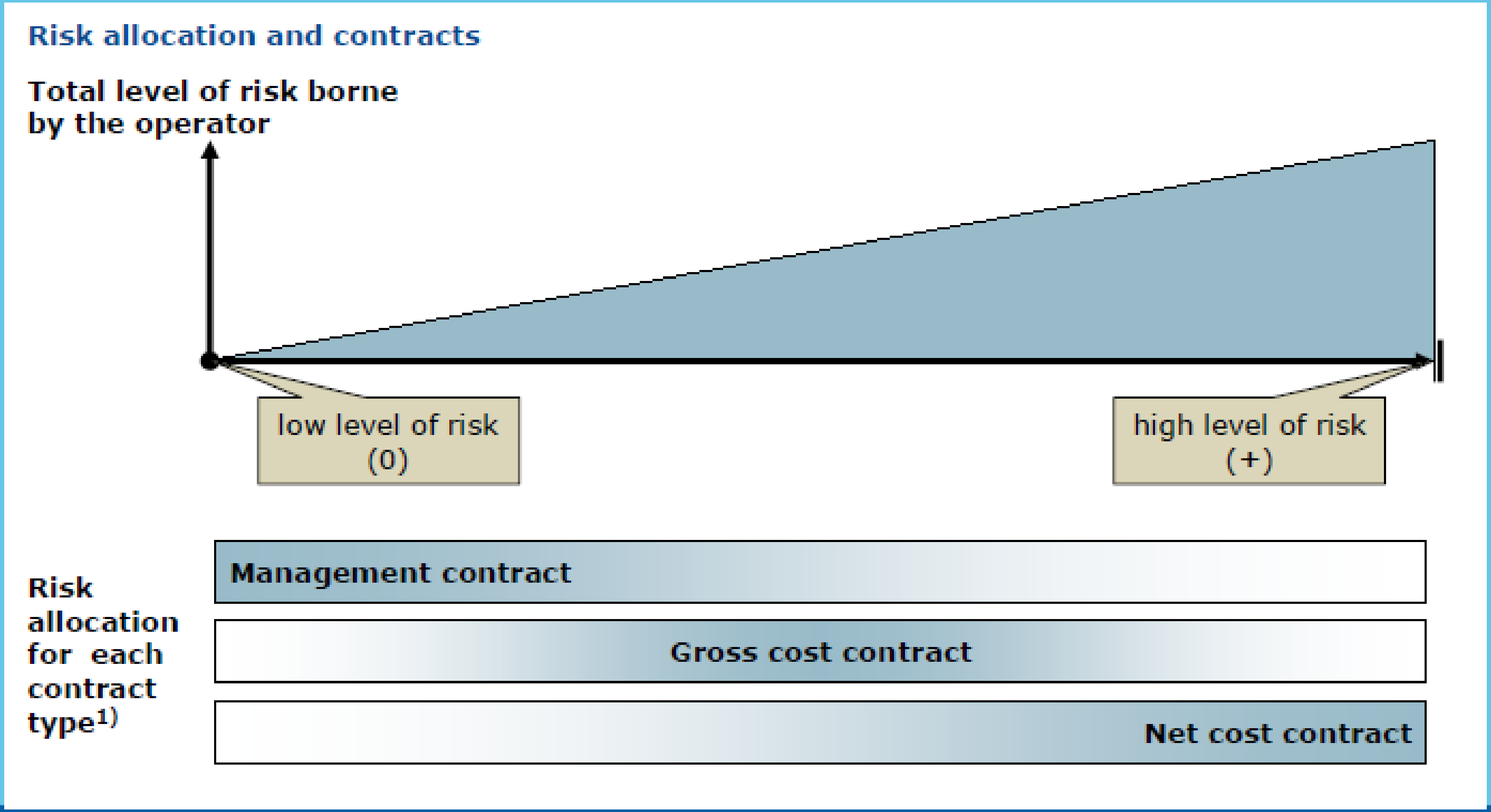
- There are two categories of risks: the industrial risk in terms of operating and investment costs and the commercial risk in terms of (fare) revenues.
- According to their allocation between authority and operator, three main types of contracts can be distinguished.

	operating costs are incurred and revenues received by the authority - operator manages the services on behalf of the authority for a fee.		operator bids for the full operating costs, and all revenue goes to the authority		the operator will be granted all revenue, and will bid only for the necessary difference between fare revenue and that needed to make the desired profit	
Contract	Management Contract		Gross Cost Contract		Net Cost Contract	
Risk borne by	Transport Authority	Operator	Transport Authority	Operator	Transport Authority	Operator
Industrial risk (costs)	✓			✓		✓
Commercial risk (revenues)	✓		✓			✓

Allocation of Risks



Allocation of Risks

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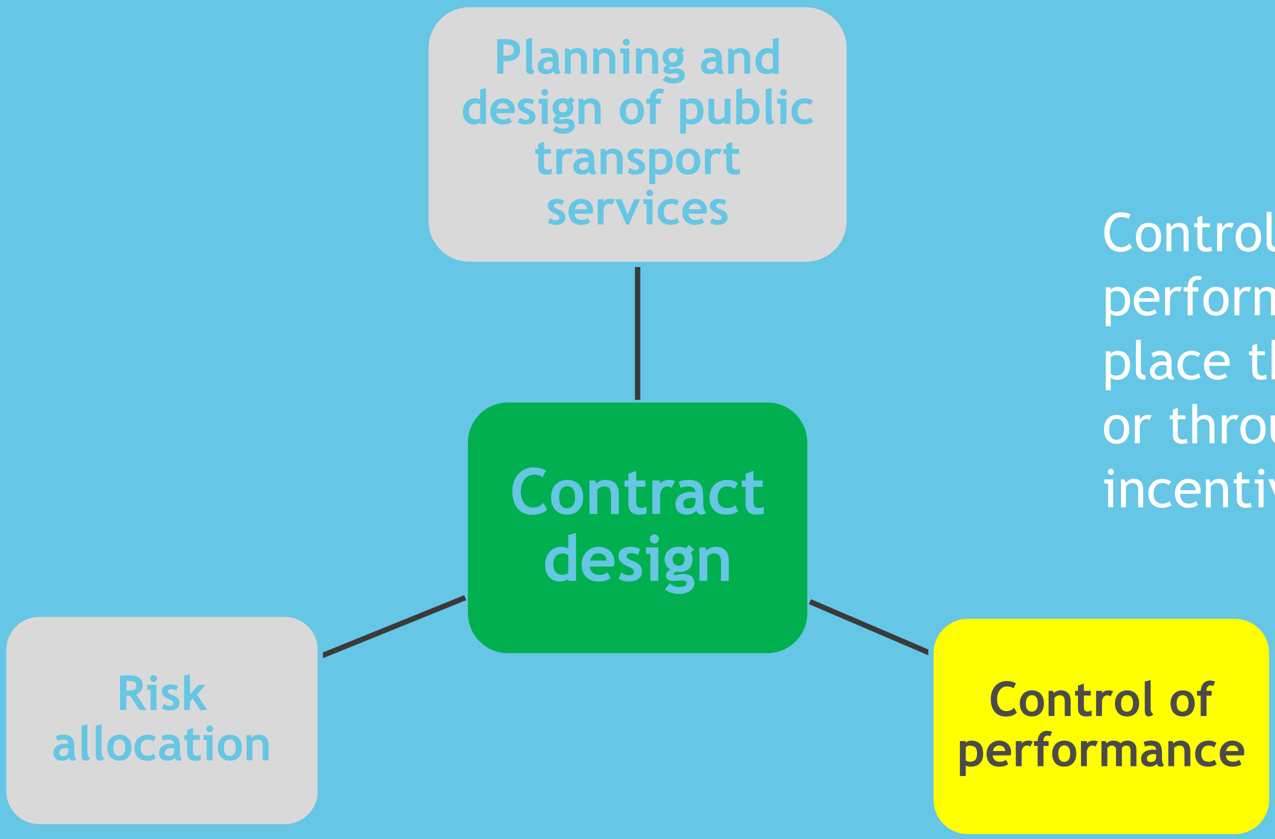
Although authorities might be tempted to transfer a maximum of risks to the operators this may bring a number of negative side effects:

- The operator will calculate a risk premium for the higher risk (increasing compensation payments). Especially if it is risk without opportunity!
- A very high level of risk may result in insolvency of the operator.
- The higher the risk the lower the number of bidders (risk can be a barrier to market entry

But from the operator side, higher risk net cost contracts encourage more entrepreneurial behaviour and put the onus on operators to run high quality services which attract maximum numbers of users.

Control of Performance



Control of the operator's performance can take place through monitoring or through use of incentives.

Monitoring

- **Independent of the contract type, authorities need to check whether the obligations stated in the contract are fulfilled.**

- **Monitoring is therefore an unavoidable part of contract management.**
  - The monitoring regime needs to be set out in the service contract.
  - The measurements must be transparent and verifiable for both parties.
  - Each performance target needs to be clear and measurable.

Who conducts the monitoring?

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- **Authorities can monitor services themselves - costly**

- **Alternatively, the contract can allocate the responsibility of data collection with the operator.**
  - In practice, however, the operator might not be prepared to provide information which may show underperformance or even lead to a penalty payment.

- **A combination of the two is usually adopted.**
  - Where operators are responsible then authority spot checks recommended.

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Monitoring

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Certain performance indicators need to be constantly collected in order to control the fulfilment of the contract.

- Especially relevant for pure gross cost contracts where the operator has no revenue risk…… incentives need to be implemented in order to achieve sufficient focus on fare collection and customer satisfaction.

Where performance indicators are not met, the authority must be able to impose fines, withhold part of the subsidy, arrange for compensation or deny extension/renewal options

Service indicator	Penalty	Paying/Receiver	Reporting
Cancelled trips	200 EUR/Trip	Company/City	Company
Cancelled trips not reported to the City	500 EUR/Trip	Company/City	City (random inspections)
Deviations from the requirement for clean buses (interior and exterior)	200 EUR/bus and day	Company/City	City (random inspections)
98% of passengers traveling with valid ticket	50% of the lost revenues	Company	City (random inspections)
Delays >3 minutes from departure provided the bus has arrived in time at terminus.	100 EUR/Trip	Company/City	City (random inspections)
Absence of line and/or destination sign on the front of the bus	100 EUR per bus per day	Company/City	City (random inspections)
Absence of timetables and route maps on bus and trolleybus stops	100 EUR/ bus stop and day	City/Company	City (random inspections)

Incentives

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- **Net cost contracts provide a market incentive for operators to perform well**
  - better quality services result in more fare revenues

  => requires less authority monitoring.

- **But remember……**
  - the more risk which is placed on the operator the more costly will be the cost of the tender, and possibly the lower the number of bidders.

Incentives

- **Incentives can also be used in contracts to achieve other goals.**
  - But the more details an authority specifies in the tender the higher the cost of the tenders. Limit detail to ensure main policy objectives and customer needs are met.

- **Authorities also have to be aware that incentives may introduce potential negative effects.**
  - For instance punctuality incentives might tempt the driver to speed to meet punctuality targets or the operator might relax his timetables (with longer travel times for passengers).

Experiences from Europe

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- **In most European Countries, local authorities have traditionally provided urban public transport, either directly or through associated companies.**
  - Often with no formal contract which enables proper monitoring and management.

- **EU Regulation 1370/2007 is changing this.**
  - By 2019, if awarding exclusive operating rights or exclusive financial compensation then a contract is mandatory and, in most cases, contracts will be required to be awarded following a competitive procedure.
  - Transition period for implementation 2009-2019

- **Look at some experiences where contracts have been awarded under competitive procedures for some time.**

Lessons from London: Use of Incentives

- 700 routes competitively tendered on gross cost basis: 68% more passengers since 1999!
- Extensive use of incentives to improve quality.
  - Each month 75% of operating cost payments are made to operators.
  - Remaining 25% paid 1 month later IF minimum performance standards (MPS) relating to bus reliability (vehicle mileage and punctuality) are achieved. Deductions made of not.
  - Added bonus incentives of up to 15% of base cost can be 'won' if MPS is surpassed.
  - Roadside surveys of 5% sample for reliability assessment (being replaced by vehicle tracking technology)
- Further incentives introduced relating to customer satisfaction, quality of vehicles and driver quality.
  - Passenger surveys, depot inspections (17,000 vehicle inspections p.a.), mystery traveller inspections (33,000 p.a.), driver quality assessments (6,500p.a.).
- Added incentive of a 2 year extension to contract duration if operator meets or exceeds target reliability criteria.
- Strong authority monitoring. Heavy management input.
  - Only justifiable on higher demand routes.
  - Lighter touch management on low demand routes, often adopting net cost contracts.

Lessons from London: Revenue Collection

- With gross cost contracts, enforcing fare collection is an issue (from passengers to operator and from operator to authority)

- Operator collects fares but does not retain them. Little interest that passengers are paying correct fares.

- Need for authority to provide revenue protection measures (e.g. employ ticket inspectors).

- Authority is reducing the number of cash transactions on buses -
  - Oyster Card (smartcard payment system)
  - Roadside ticket machines
  - A number of busiest routes now have cashless boarding

Lessons from Copenhagen: Ensuring competition

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- **1990 - Competitive tendering of routes to private rather than public operators produced initial improvements in first 5 years**
  - highly competitive, 20-30% cost savings, higher quality, increased patronage

- **By 2002 90% of services provided by a small number of large international operators.**
  - less for the road competition – bids per tender very small.
  - the choice of operators at a network level is limited
  - incumbent operator often has unique access to strategic resources such as bus garages or specialised vehicles – especially in city centre where bus depots are scarce
  - Tender prices started to rise

- **Important to arrange tenders and contracts in such a way that they promote competition and encourage new entrants into the local supply market.**

Lessons from Copenhagen: Ensuring competition

- **Need to consider:**
  - the scale of the service contracts that are tendered: smaller contracts may well appeal to smaller, local operators. In Copenhagen all tenders are made on the basis of individual routes or small packages of routes.
  - the ownership of strategic assets: if the ownership of assets such as garages or special vehicles is transferred as a result of privatisation, a barrier to enter the local market is created. Experience shows that retaining some bus depots in the public sector may be a good way to ensure the entrance of potential new-comers.
  - vehicle procurement: A “buy-back guarantee” can be established by the authority in case the operator loses the tender. A “buy-back guarantee” may lead to lower contract prices, since part of the insecurity for the operator is removed.

Lessons from Sweden: Gross cost vs Net cost

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- **98% of services in Sweden have been subject to competitive tender for over 10 years.**
  - A lot of experience in management of different forms of contracts.
- **They have examined - on what basis should net contracts replace gross contracts?**

- **With net cost contracts**
  - there has to be possibilities for the operator to capture new market share to generate extra profit.
  - authorities have to let go their exclusive right to decide level of fares, frequency and routes. Otherwise the operator can only make peripheral decisions – without the right to control the financial bottom line.
  - E.g. in Stockholm the Authority identifies only the main nodes to be served –the operator is responsible for route design, frequency and timings.

- **If these factors are not possible then instead of net contracts, it is better to use gross contracts but to include incentives which share more of the risk/opportunities.**
  - E.g. split revenues from increased fares between authority and operator.

Lessons from Scotland:
Low demand and ‘other’ services

Strathclyde Passenger Transport is the PTA for Greater Glasgow.

Operates in deregulated free market. 85% of services are commercial without contract.

- Currently has 140 public service bus contracts for non commercially viable routes,
- 12 contracts for demand responsive services for elderly and disabled passengers,
- 1,430 school transport contracts (more than 17.9 million pupil journeys annually).

Lessons:

- Coordinate contract expiry dates to enable a network approach to tendered services
- Integrate school and public service tenders whenever practicable
- Progressively strengthen default conditions, so that an operator who fails to provide satisfactory services can be removed and in extreme cases can be liable for the cost of providing replacement services
- Require contracted operators to accept engineering+service quality inspections by SPT staff
- Use contracts accelerate the introduction of accessible vehicles
- “Nurse” small operators in order to maintain the market for tenders and encourage them to increase the scope of their operations - i.e. don’t always choose least cost bid!

Lessons from Flanders Region (Belgium): Public-Private partnership model

- **Flemish government has a management contract for all of its public transport activities with the public operator VVM ("De Lijn").**
- **VVM split the network into 79 PT packages which are subject to competitive tendering.**
  - The object being to avoid private oligopolies, resulting from operators having a far too substantial market share.
- **Packages are tailored to the rather modest size of the Flemish private operators.**
  - Theoretically, a private operator should never have > 5% market share.
- **Public-Private partnership model.**
  - half the network being operated by small private operators under contract to VVM.
  - VVM provide the remainder.

Benefits:

- **Retains high levels of competition while also allowing benchmarking performance of the remaining VVM public services with private ones.**
  - Has dramatically improved efficiency and performance of public operations
  - The public bus operator presence keeps private operator prices lower.

Summary

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- **Management of contracts requires constant monitoring and control**
- **Incentives are crucial to successful management**
- **Incentives should be used to ensure services are delivered to high standards in economically efficient manner.**
  - Goals should be tough, but realistic
  - Incentives should be reassessed on yearly basis
  - New goals established each year based on rolling increasing benchmark
  - Rewards continual improvement
- **Net cost contracts can be used to allocate more risk to operators**
  - In theory, the market provides the incentive to run high quality services
  - influences the level of authority monitoring and control needed.
- **Contract duration typically 4 to 5 year - but with option for 2 year extension for good performance.**
- **Important to ensure sufficient competition still exists in the market between contract rounds.**

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