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**Summary:**

## **Procurement and contracts for local bus services**

The main aim of this project has been to map different forms of purchases and contracts for local bus services. Of particular interest were the effects of tenders on production efficiency and subsidies, and the experiences with different forms of purchases and contracts.

The most important conclusions which can be drawn from the project are:

- The current competitive regime has up until now resulted in a development which has encouraged competition. Broadly speaking, the tender process works as intended.
- Exposure to competition has up to now contributed to cost effectiveness. This has made it possible to reduce subsidies.
- The difference between gross and net contracts is largely nominal and of lesser practical significance than was previously assumed.
- Counties that have chosen a regime with a mixture of tenders and negotiated contracts appear to have experienced a less favorable development than those that to a larger extent have chosen one over the other.

### **Background**

Since 1994 the county councils in Norway have been allowed to use competitive tenders for the procurement of local bus services. Tendering as a form of purchase has been adopted to varying degrees by the different counties. There is also reason to emphasise that the contracts play a central role in evaluating the effects of different forms of purchase, such as tenders. A purchase is no more effective than the contract allows. The contract between the purchaser and the operator is what controls the day-to-day relationship between them.

In order to obtain an overall view of the use of tenders in local bus services, the Ministry of Transport and Communications commissioned a project to map the status and development of procurement and contracts for local bus services. One of the aims of this project is to evaluate the effects on public budgets. In addition this will provide a platform of experience that will help the county councils in their development of purchase processes and the later development of contracts. This project was commissioned to the Institute of Transport Economics (TØI) in the summer of 2005.

TØI has answered the Ministry of Transport and Communications's questions through a three-part assessment:

1. *Mapping the degree of variation in the types of purchase regimes and forms of contract, their scope and development over time.*
2. *A quantitative analysis at both the macro and micro levels of the connections between purchasing regime, contract forms and production, market and social effectiveness.*
3. *A qualitative study where we obtain supplementary information through interviews with players at the county council level and analyse selected contracts and invitations to tender.*

The report contains both status and development characteristics as well as analyses of effects of different forms of purchase and contracts.

## Data quality

Some of the feedback from the county councils has indicated that the bus statistics are inaccurate. This suspicion is strengthened by the large, inexplicable variations from year to year. Nonetheless, we feel that the data we have collected provides a good starting point for carrying out analyses at a somewhat broader level, although analyses of individual counties are more problematic. This applies to data linked to all the aspects listed above. The data is further quality assured in that the counties have all had the opportunity to comment, explain and update the data which we have collected.

The sources of data which are used in this project are:

1. *Time series over central key figures for public transport in different counties, based on the historic bus service statistics, reported by the county councils.*
2. *Data from the counties linked to forms of purchase and contract types.*
3. *Information about completed invitations to tender has been obtained from all the counties which have used tenders.*
4. *Contracts and invitations to tender have been taken from a number of counties.*
5. *Interviews with central players have been carried out in a number of counties.*

## Analytical framework

Competitive tendering has long been the prevailing norm for new contracts for local bus services in Europe. *Competitive tendering* refers to a situation where the state allows other legal entities to compete for a service that the state has traditionally carried out itself (Lilli 2004). Competitive tendering thus differs significantly from free competition and does not necessarily imply privatisation of the business.

Both Denmark and Sweden were quick off the mark with competitive tendering for local bus services, creating the basis for what is often referred to as the Scandinavian model (van de Velde 2003). This means that the authorities are responsible for drawing up the public transport service, which is then purchased from private companies on behalf of public transport users. This is the form of competitive tendering upon which the public debate in Norway is usually based. However, this Scandinavian form of competitive tendering represents just one of many ways of opening up the industry to competition. On the basis of factors relating to the tendering procedures, four main forms of competitive tendering may be identified (figure S1).

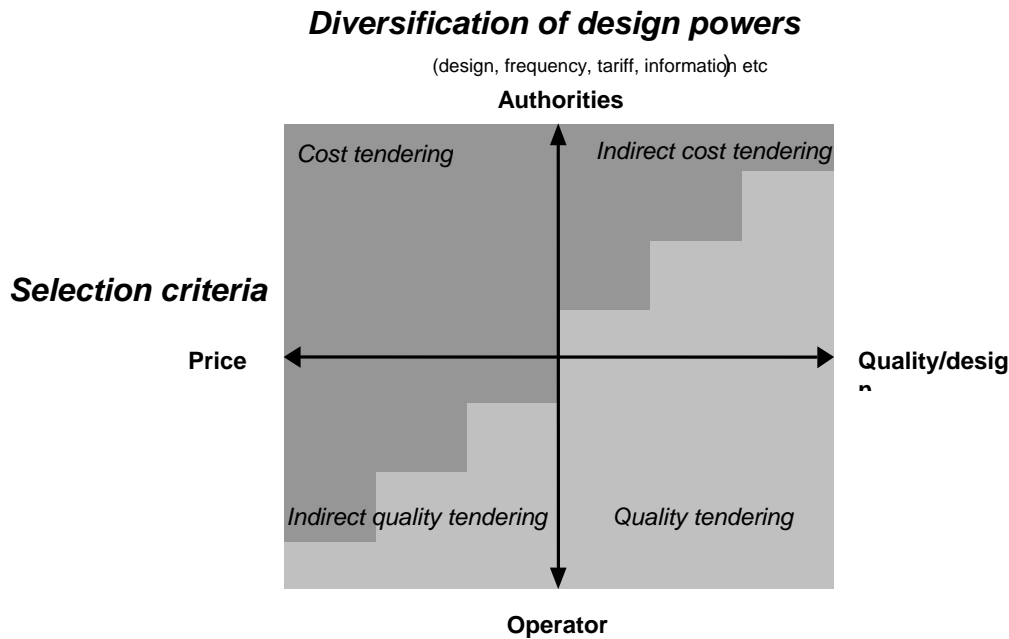


Figure S.1: Main forms of competitive tendering based on selection criteria and design freedom for the operator (Source: Longva and Osland et al 2005)

In the upper left corner of the figure, the service-design is pre-defined by the authorities and the operating costs remain the sole criterion for the choice of operator (“cost tendering”, paralleling “The Scandinavian Model” referred to above). The opposite extremity of the cost tendering model is found in the lower right corner of the figure, named as *quality tendering*. Quality tendering means that the service design and proposed quality is totally or partially decisive in the choice of operator. The operator is furthermore given greater opportunities to develop the content of the service provision within a given geographical area (this is mainly found in the Netherlands). Both cost tendering and quality tendering models have their mixture forms, defined as indirect quality tendering on the lower left side of the figure and indirect cost tendering on the upper right side.

The distinction between cost and quality tendering may be further nuanced by introducing issues related to the contractual period (Table S.1).

Table S.1: Different forms of contracts (source: Longva and Osland et al 2005)

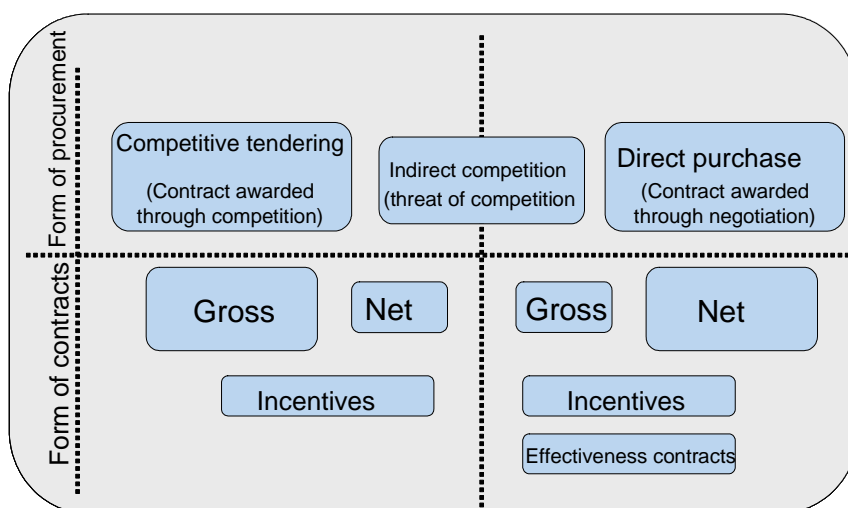
Who has revenue risks?	Are there incentives beyond risk diversification?	
	No	Yes
The authorities	1. Gross cost contract	2. Extended gross cost contract
The operator	3. Net cost contract	4. Extended net cost contract

Gross cost contracts implies that the operator leaves the fare revenue to the public authorities, i.e. that the operator assumes risks only related to costs. Public authorities have the responsibility for all planning, marketing and information during the contract period. Extended gross cost contracts implies that although public authorities still use gross cost contracts, these include relatively large economic incentives as bonus for quality and/or passenger improvements. Net cost contracts implies that the operator

carries the revenue risk, keeping the fare revenue, whereas extended net cost contracts implies that the contract also has incentives for further improvements in quality or patronage. The latter one is often called indirect quality tendering.

The different forms of contract are often defined using different collective terms. One example of this is *result dependent subsidy contracts* which is a collective term for extended gross contracts and extended net contracts. Common to these contracts is that part or all of the subsidy is paid on the basis of production, patronage and/or quality dependent results, irrespectively of them being based on a gross or net contract. Another collective term which is often used for contracts with different incentives is *quality contracts*.

The nuances in operational contracts apply no matter how the authorities make their choice of operator, and thus can be used in both competitive tendering and in negotiations. The combination of purchase and contract forms is shown in figure S.2. Taken together, these form the alternatives faced by the individual counties as they choose between competitive tendering and direct purchase.



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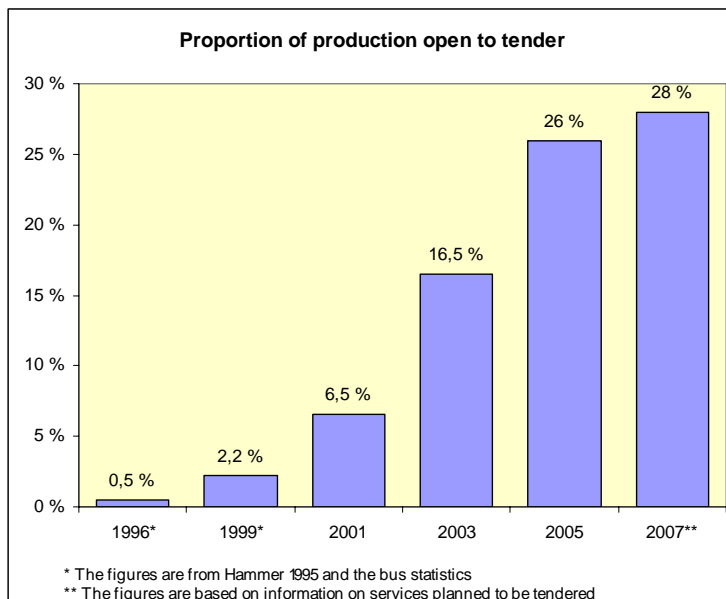
Figure S.2: Forms of purchase and contracts

The dividing lines between the figure's different elements are moveable. Few county councils have put all bus operations out to competitive tender, while at the same time a threat of competition has been established in a number of counties. This threat can be experienced as more or less realistic based on the extent to which the county production is open to tender, and on how explicitly or implicitly the authorities indicate that other work will be open to tender if they do not achieve specified results. The threat of competition can for example be built directly into the various contracts, something which will often be the case of quality contracts or effectiveness contracts. This means that the contract with the existing operator will be exposed to the threat of competition if specified quality or effectiveness targets are not met. The purchase therefore goes ahead without competition at the outset, but with an inbuilt contractual threat of competition.

## Development tendencies

The development in competitive tendering is closely connected to changes in the framework conditions for local public transport. In April 1994 directives came into force

which permitted the use of tendering for local public transport eligible for subsidy. At the same time the state transfer of funds for transport and communications purposes in the period 1995-1999 were reduced on the grounds that the counties could use tenders or other forms of effectiveness in the purchase of public transport services (Carlquist and Fearnley 2001). In addition, the EU's desire for more liberalisation within the area of public transport and the ongoing revision of decree 1191/61 have meant that some countries, including Norway, have adapted to the proposed legislation. All these aspects point towards an increased use of competitive tendering. This is also happening in practice.

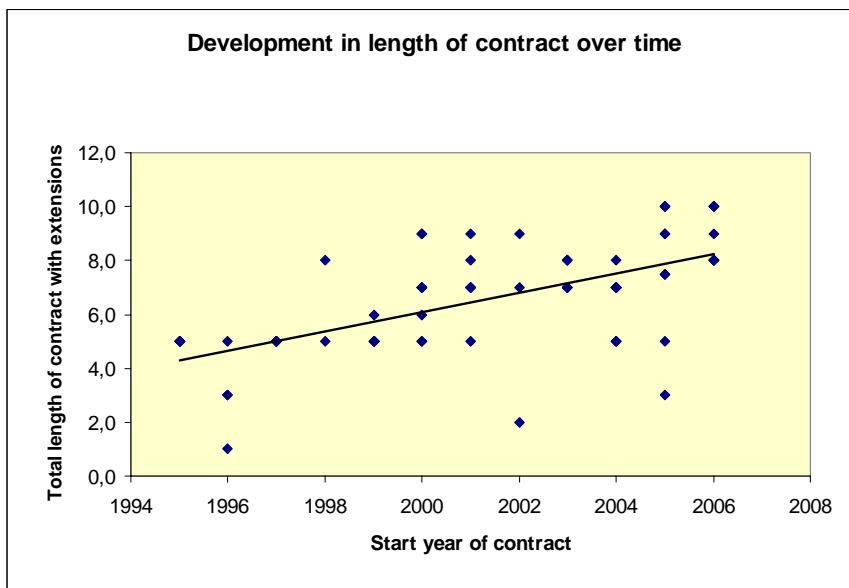


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*Figure S.3: Developments in tendering.*

Both in competitive tendering and in direct purchases, the length of contracts has increased. The average length of a tendered contract is now five years. In addition to this there is an average option for an extension of the contract of a further two years. The maximum total contract length observed is ten years, which must be regarded as a very long time perspective as applied to bus operations. The content of the contract is therefore becoming more and more important.

The same development towards longer contracts can be seen in the use of direct purchase and negotiations. While earlier negotiated contracts were annual, with a common implicit agreement on extensions, more recent pre-negotiated contracts often define increasingly longer contract periods on a formal basis. The report looks at a more recent prenegotiated contract with a formal duration of four years. There is also reason to point out that the increase in formal contract length under a pre-negotiated regime does not necessarily mean that the players' actual investment and planning horizons have become longer than they were previously. The one-year agreement's implicit understanding of an extension may, for example, have provided a basis for longer time perspectives than was the case with four-year agreements and the threat of tenders.

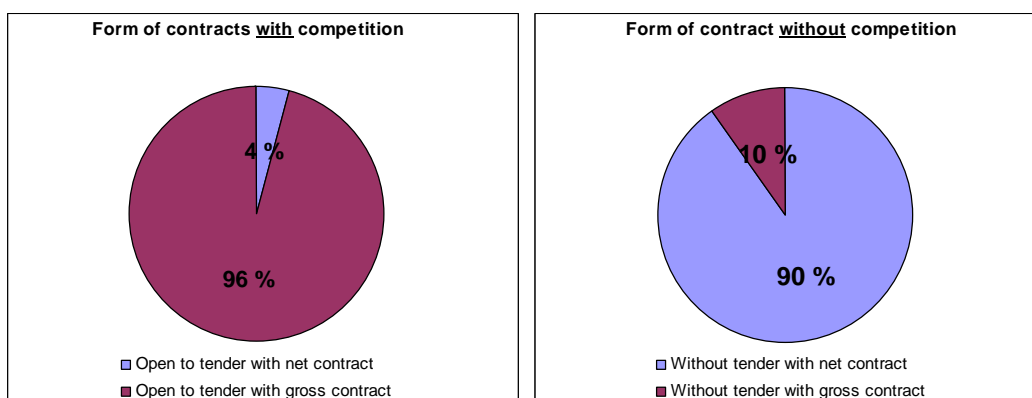


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Figure S.4: Development in length of contracts from start of tender

With regard to the form of the contract, the mapping shows that gross contracts are more or less universal for services which are exposed to competition. With competition, a total of 96% of the contracts are gross contracts, while for services which are not exposed to competition, 90% are net contracts. (see figure S.5). This is the most important driver behind the changes towards an increased use of gross contracts in recent years.

An analysis of the actual contract contents shows that the gross contracts which are used for tender competitions are to a large extent supplemented with financial incentives, which are production, patronage or quality dependent. The counties which have used tenders to the greatest extent are moving away from pure gross contracts towards an increased focus on extended gross contracts with increased income risks and incentives for operators. This is in entirely in line with the developments we see internationally (Longva and Osland et al 2005).



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Figure S.5: Contract form with and without competition

The analysis of the content of the contracts show furthermore that the negotiated net contracts often contain limitations on the operators' income incentives, including the use of threshold values before renegotiation of the annual contracts. The actual difference in the operators' income risks and incentives when transferring from negotiated net

agreements to the use of newer forms of tendered gross agreements is thus not necessarily large. The contractual exchange therefore primarily contains changes in the division of market risk between the authorities and the operators.

## **Main Conclusions**

### **Experiences with rounds of tenders are generally good**

The fact that there are more and more tenders should not come as a surprise. In the report we present some information to consider whether competition work as intended or not. Our most interesting findings in that respect are:

- **The length of contracts has increased**

With regard to the developments in the length of contracts, the data we have collected show that the newer contracts are on the whole longer than the earlier contracts. The standard is now around five years plus supplements, while previously the average length was around three years unless there were clauses regarding extensions.

- **The tenders have become larger in scope**

The tenders have in general become larger in scope. Part of this development can be explained by new counties starting to use the tendering process. Important counties such as Oslo, Akershus and Rogaland have such large service production that their entering the arena would clearly inflate the average size of the tenders. Larger tenders is an important real trend.

- **The number of bids has stabilized**

Our data indicate the interest for the various tenders. The average number of bids, over the entire period from 1994, are around five. There has been a development in the number of tenderers from the earlier rounds with large variations in numbers, to a more stable situation today. The number of bids for the various tenders has remained between three and five in recent years in the majority of cases. Further reduction may indicate a change towards monopolisation, or that the players are dividing up the country between them and should be a core focus in the future.

- **There is less difference between the tenders**

There is a very clear trend towards less difference between the tenders. While at the outset the difference between the winning tender and the second best could be as high as 40%, today this difference is down to well below 10%. The average difference has been around 8%. A more detailed analysis shows that for 70% of the 34 tenders for which we have details, the difference between the best and second best tenders was less than 10%. In addition the difference for 7 of the 34 tenders was less than 2 % of the winning tender. The difference between the highest and lowest tender also shows a clear downward trend.

Based on the results shown above, it appears that the current competitive regime has so far resulted in a development which has encouraged competition. Broadly speaking, the tendering process is functioning as intended.

### **Tenders have reduced costs and subsidies**

We have calculated models for total costs, costs per fleet kilometre and subsidies. The models have used the proportion of route production which is open to competition as explanatory factor.

Two effects stand out in our analyses. Tenders contribute to a reduction in both costs and subsidies. Our calculations show that a 1 per cent increase in route production which is open to competition reduces costs by 0.1 per cent and the need for subsidies by 0.7 per cent. Given that the subsidies only cover a small part of the costs and that the county councils have good opportunities to reap the majority of the cost benefits in connection with tenders, then tenders have a greater effect on the level of subsidies than on costs. This means that tenders have resulted in more cost effective production, and also that the savings have been taken out in the form reduced subsidies, rather than enhanced level of service. In addition the level of fares has increased, contributing further to a reduction in the subsidies.

### **Gross contracts do not necessarily result in a poorer market adaptation**

The analysis carried out makes it necessary to cast a critical glance at earlier conclusions that the introduction of tendering has resulted in a contract regime with fewer incentives for quality improvement, as compared to the earlier pre-negotiated regime. This is partly due to the fact that the actual passenger incentives in the pre-negotiated contracts are smaller than has been assumed. Moreover, the most recent gross tendered contracts appear to include an increasingly high proportion of income incentives and risks.

When the new tender contracts are increasingly supplemented with patronage-dependent incentives and associated risks, while being of a significantly longer duration, the differences in the actual income, risk and investment structures become less. Thus this can help explain the nuance of how large (or small) effects can be expected from the introduction of tenders in each individual county.

At the same time, effects and challenges experienced by the counties in the transition from a direct purchase regime to competitive tendering will vary from county to county - from one context to another. This is partly due to the fact that the forms of competition and contracts which are introduced under the new regime will vary between counties according to the degree of exposure to competition and also because the form of the contracts which they are giving up will vary from county to county. It seems right to state that the incentive and risk changes for operators are perhaps not as strong as has often been assumed in the research literature.

### **Half-way solutions can create unclear situations for both parties**

The analysis of the counties' costs and subsidy developments suggest that counties which have chosen a regime with a mixture of tenders and pre-negotiated contracts have experienced a somewhat poorer development than those which have to a greater extent preferred one over the other. We assume that this is connected with the fact that the introduction of tenders reduces the reliability of dialogue in pre-negotiated contracts, so that the operators adapt to a competitive situation even though their contract is not immediately exposed to competition. Moreover, it is also the case that the areas with the greatest potential for cost reductions are first put out to tender.

The threat of competitive tenders thus has two effects which partly work against each other. On the one hand, the threat creates pressure to make the business more effective. This is clearly apparent through the effectiveness agreements, which have largely come about as a result of the threat of tenders. The negative effect is that the trust relationship between operator and purchaser is weakened. The operator will keep to the terms of the contract to a greater extent and will not have a horizon which goes beyond this. With annual negotiations this results in a very shortsighted focus on costs.



## **Other effects of tenders**

This evaluation has taken little account of tendering effects for:

- organisation of purchase bodies (separate purchase body, private legal companies or others),
- employees' wages and employment conditions (salaries, pension rights, shift supplements and similar),
- future competition in the bus sector (the development towards larger actors through mergers and acquisitions)

These are conditions which may greatly affect the final evaluation of competitive tendering as a tool in local bus services, but that have not been the object of much research and evaluation in the past, either in Norway or internationally. For example, we know little about current practice in invitations to tender in Norway with regard to requirements for tariff coverage, transfer of business or other aspects which might be regarded as safeguarding employees' interests. In the same way, we know little about the challenges connected to setting up a separate professional purchase body in a region, or about the consequences this may have for the selection of the form of contract and purchase and the final service production.