

Contracting with Private Providers by the Public Transportation Industry

Outline

- Organizational Schemes
- Types of Transit Contracts
- Contract Economics
- Contracting Issues and Practices
- Contract Structure and Management
- Case Studies

Primary Organizational Schemes in the U.S.

1. Standard Public Ownership & Operations

- * Simplest structure
- * Theoretically has maximum accountability and control
- * Political and labor issues may introduce inefficiencies

2. Contract Management

- * Mostly in smaller areas
- * Provides expertise and/or experience via a manager or team who are not available locally
- * 3-5 year contract duration typical—usually fixed fee
- * Employees either public employees or hired by a locally- incorporated private entity
- * Implementation can be flawed; few incentives for private managers; very similar to first model

3. Service Contracting

- * Various components of service can be contracted out
- * Provision of actual bus or paratransit service most common
- * Vehicles and equipment may or may not be included in contractor-provided services
- * Objectives of public agencies key to determining type of procurement and contract

Services Typically Contracted

- Ancillary or support services: cleaning, advertising, real estate, etc.
 - * relatively straightforward and easy to define & administer
- Maintenance of way and vehicles
 - * limited examples in U.S.
 - * labor issues can be tricky
 - * more examples in the private sector
- Fixed route bus and rail services
 - * limited examples but increasing—Denver, Dallas, Southern California, San Juan, D.C. suburban services
 - * generally has been proposed to reduce costs and/or to provide new services
 - * since market is relatively small, # of bidders usually low
 - * rail market just starting—quality of service seems to be the emphasis here
- Paratransit (i.e., demand-responsive) services
 - * contracting much more prevalent here with a range of outcomes
 - * small portion of public agency budget often consumes a disproportionate amount of management attention and public scrutiny
 - * transition difficulties are frequent, especially in areas with only one provider
 - * technology plays an important role

Contract Economics: Basic Principles

- Deals with situation of asymmetric information:
 - important information available to only one of parties
 - important information cannot be independently verified
- Basic question: how can the party (the principal) with limited information:
 - (a) create a mechanism (contract) and
 - (b) behave, such that a party (the agent) with desired traits:
 - i) wants to enter into the contract and
 - ii) then wants to behave as desired by the principal

Difficulties in Applying Contract Economics

- Complexity of agent's task is great, simple incentives are risky
- The principal may have difficulty utility function
- A great deal of information is required of both parties
- Outcomes generally are not under the agent's control
- Resulting contracts may be unfeasibly complex
- The more possible actions, possible outcomes, and uncertainty between the action and the outcome, the more difficult the problem.
- There are limits to contract complexity in practice -- they are difficult and costly to design and enforce.

Applications to Transit Service Contracting

Traditional approaches to contract design:

- identify desirable performance by contractor
- define measures for performance
- devise incentives/penalties based on measures

Obstacles to applying contract economics:

- agency has multiple objectives for contracting
- contractors have a great range of actions to choose from
- contractors also have multiple objectives

Two Types of Service Contracts

1. “Cost Plus” (~ 20%)

- * provider is reimbursed for all costs (usually up to a “ceiling”) plus a negotiated profit
- * contractor generally cannot suffer a loss
- * thought to provide little inducement to keep costs low
- * often associated with quality of service objective

2. “Fixed Price” (~ 80%)

- * ~ 60% based on service provided (vehicle hours or miles)
 - revenue versus non-revenue
 - can result in less emphasis on quality
- * ~ 20% based on service consumed (passenger trips or miles)
 - short trips versus long trips
 - measurement becomes a critical item
- * shifts much more risk to contractor and various mechanisms have been used to reduce this risk
 - “floors” on service or passenger units
 - combination of fixed and variable payments

Fundamental Contracting Issues

- Maximize competition
- Understand the potential contractors
- Consider risk premiums
- Consider implications of fixed and variable costs
- Performance standards, incentives, and penalties
- Be concerned with misallocation of resources
- Compensation provisions (startup costs and cash flow)
- Provision of equipment and facilities
- Contract length

US Transit Agency Contracting Practices

- Contracting is growing, but still small share of all service (15%)
- Increasing use of competitive selection processes
- Structuring bids to minimize contractor's risk can increase competition
- Incentives and penalties are often included in contracts, but enforced much less frequently
- Contract extension/renewal a common implicit incentive
- Impact on reputation is a major factor

Specific Issues in US Contract Structure

- Contractor power to change the contract after it is in place
- Competition (multiple operators)
- Size and complexity of contract
- Compensation (minimize risk)
- Enforcement of incentives and penalties
- Contract management

Contract Management/ Contractual Relationships

- Key to success is competent management on both sides
- Mutual respect and fair dealings most important aspects of relationship
- Regular reporting by contractor, thorough review by agency necessary
- Hands-on, frequent interaction reduces “games”
- Incentives more important than penalties except in extreme cases
- Reputation/recommendation more important than minor financial incentives
- “Cost-plus” form of contract with revenue/cost savings sharing may be cheapest in the long run

Case Study 1: New Suburban Fixed-Route Bus Services

- 5-year fixed-price for new services (compensation based on revenue-hours)
- Low-bid selected (a penny an hour difference!)
- Vehicles purchased by public agency and maintenance-facility provided midway through contract
- Contract economics change drastically as service expands and vehicles age
- Drivers hired by public agency
- No interest within agency in renegotiating terms
- Penalties and incentives were insignificant
- Major loss could cripple small company
- New operator with substantially increased costs

Case Study 2: State-Sponsored Paratransit/Medicaid Transportation

- Competition for each county or groups of counties every 3-5 years
- Public, private-not-for-profit and private-for-profit companies compete
- Compensation on basis of price per passenger-mile with COL adjustments
- Quality of service initially an explicit factor; later reduced to a “qualification”
- Private providers pushed out due to public cross-subsidies

Case Study 3: Paratransit Brokerage

- One of longest-running private contracts in U.S. for one of the largest ADA/elderly paratransit programs
- Private broker has a “cost-plus” contract with public agency and in-turn contracts on a vehicle-hour basis with 6-12 private providers (by region)
- Significant incentive for productivity; small penalties for poor service
- Year-to-year semi-formal cost-based renegotiations of rates and adjustments of service areas
- Proven result-lower costs per passenger and per-hour and excellent service quality