

# **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
- \* Innovation often tied to individual GM skills and future ambitions

# Primary Organizational Schemes in the U.S.

## 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**
- \* **Large UK holding companies less interested in these contracts (slow growth)**

# Primary Organizational Schemes in the U.S.

## 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

# Services Typically Contracted

- **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**

# Services Typically Contracted

- **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

# Two Types of Service Contracts

## 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 (10-15%)**
- **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”**

# Contract Management/ Contractual Relationships

- **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**

# Case Study 1: New Suburban Fixed-Route Bus Services

- **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**