


VIEWPOINT

Good procurement: rewarding deliverability, rather than excessive risk

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The headline 'DfT's procurement practice praised' (*LTT* 28 Sep) made us chuckle in light of the Department's admission that it was having to cancel the West Coast franchise competition "following the discovery of significant technical flaws in the way the franchise process was conducted" (*LTT* 12 Oct). The headline referred to a report that Oxera and RBconsult recently completed for the Australian Department of Infrastructure and Transport, which set out recommendations for avoiding overbidding for toll road concessions.

Despite our amusement, however, this is serious stuff. Many Australian toll road concessions opened and operate with traffic numbers vastly below the forecast incorporated in the winning bidder's submissions (see table, below). This has led to considerable losses for investors, including many individuals in Australia who bought into initial public offerings, and led to litigation.

Does this matter? If government gets a large cheque and its asset built, should we be worried if investors paid too much in the first place (especially if you're not on the hook to renegotiate, which is the firm position of the Australian Government)?

Arguably, yes. The purpose of government contracting with the private sector – instead of delivering services itself – is to benefit from the specialisation of companies that devote themselves to providing those services. In theory, competition between these companies for delivering into the transport market should improve outcomes – lower prices for users and better-quality services, for less taxpayer money and risk. But, instead of government getting the most innovative, efficient provider, there is a danger that it awards a contract to the bidder willing to take the most risk.

So what has gone wrong in the Australian cases? It seems as though the incentives throughout the procurement process in Australia have combined to deliver over-optimistic bids.

• First, a lack of checks and balances in government has led to schemes being approved with inflated traffic forecasts in the first place, in order to meet political aspirations.

• Second, as the concessions have been put to market, competition has focused on maximising the payments made to government – so typically the riskiest (as opposed to the most efficient and innovative) bid has won.

• Third, extensive use of success fee arrangements has affected the incentives of advisers to the bid teams, who are themselves heavily motivated to win.

• And, finally, the penalty for getting it wrong (loss of money for investors) has not necessarily reflected the social, as well as the private, cost of failure – while the Australian Government has (we think rightly) not renegotiated any of the deals, the consequence of the recent losses for investors is a considerable lack of confidence in similar transactions in future.

Our recommendations to the Australian Government focused on making sure that, in the future, it aims to receive the most accurate – as opposed to the highest – bids. In this context, the practice of the UK's DfT is noteworthy (West Coast notwithstanding):

• The use of a value for money assessment framework that explicitly recognises there is scope for bias in scheme selection, and considerable uncertainty about whether that scheme can deliver expected outcomes.

• A package of measures designed to minimise the risk of overbidding for rail franchises – making default costly for bidders, and placing considerable weight on the 'deliverability' of bids, such that price is not the only decision variable when selecting bidders.

Both of these initiatives offer improvements over the Australian experience, and form part of the Oxera/RBconsult recommendations to the Government. However, a change in the West Coast evaluation (which came after our report was finalised) seemed to us to be a retrograde step. We think the use of bidder deposits and increasing losses in the event of default is a good thing. However, instead of bid Net Present Values being reduced on the basis of a submission being judged less deliverable (as was the case in previous franchise competitions), the DfT asked bidders to offer a Subordinated Loan Facility (SLF) on which it could call in the event of default.

This changes the bidding game substantially, with more risky bids having a greater likelihood of winning (if banks can be found to underwrite the SLF). Arguably less onus was placed on deliverability as a consequence. And what is clear from the Australian experience is that relying on capital markets to price risk when incentives are skewed is not sufficient to avoid overbidding.

Furthermore, while the move to longer franchises is likely to give operators a stronger incentive to invest in the business, it should be clear that this contributes to 'deal scarcity' (there are likely to be strong incentives for overbidding if a company knows that a current competition is their only chance of a 'win' for several years); increasing the uncertainty about the nature and extent of risk implicit in bid submissions.

Not all of our recommendations related to DfT practice. We interviewed public private partnership market participants from across the world and reviewed procurement practices in a number of countries. Importantly we revisited the fundamental concept of demand risk allocation and concluded that appropriately-designed transactions, incentive mechanisms and reward structures could continue to support the efficient transfer of traffic risk to the private sector; a key policy consideration for governments perhaps wishing to strengthen the commercialisation of their roads sector.

Reflecting on recent events – and looking forward – many of the lessons from our international procurement review for the Australians would seem to be highly pertinent in a UK context. LTT

Australian toll road traffic performance: openings since 2000

Australian Toll Road Traffic Performance: Openings Since 2000

Project	City	Opened	Latest Reported Performance Against Traffic Forecast	Comments (currency = AUD)
CityLink	Melbourne	December 2000	+10% (*September 2012*)	• Road took 7 years to reach forecasts.
Cross City Tunnel	Sydney	August 2005	-56% (*February 2011*)	• Receivers appointed in December 2006. • Sold to ABN AMRO/Leighton for \$700m in June 2007 (cost \$1bn).
Westlink M7	Sydney	December 2005	-40% (*September 2012*)	• Road underperformed in terms of trips, but compensated in terms of trip distance (restoring vehicle kilometres travelled).
Lane Cove Tunnel	Sydney	March 2007	-60% (*September 2012*)	• Receivers appointed in January 2010. • Sold to Transurban for \$630m in May 2010 (cost \$1.1bn). • \$160m legal action launched against traffic forecasters in September 2009.
EastLink	Melbourne	June 2008	-39% (*September 2011*)	• Shares slumped from \$1 to 45c. • Delisted and sold to CP2 for \$2.2bn in October 2011 (cost \$2.5bn).
CLEM7	Brisbane	March 2010	-76% (*September 2012*)	• Shares initially dropped to 20% of value. Now worth \$0. • Receivers appointed in February 2011. • \$150m class action lawsuit launched against traffic forecasters in May 2012. • \$2bn legal action launched against traffic forecasters by receivers in May 2012.
New Gateway Bridge	Brisbane	May 2010	n/a	
Go Between Bridge	Brisbane	July 2010	-49% (*June 2012*)	• Toll tariffs have been 25% - 45% below anticipated levels, so revenue underperformance exceeds traffic underperformance.
Airport Link	Brisbane	July 2012	-45% (*September 2012*)	• Road has been operating toll-free. • Underperformance prompts operator to revise toll introduction, now with (unanticipated) discounted rates for the first 6 months.
Average			**-44%**	• **On average, actual traffic usage has been 44% below forecasts.**

Source: Various investor presentations, ASX releases, inquiry proceedings, committee reports and media articles.

Andrew Meaney is head of transport at Oxera. Robert Bain runs RBconsult. The views expressed in this article are those of the authors alone. Copies of their report, *Disincentivising over-bidding for toll road concessions*, are available online from Oxera's website (www.oxera.com).