



Regulation, trust and contractual incentives around transport contracts – Is there anything bus operators can learn from public air service contracts?

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ABSTRACT

This paper compares recent experiences in contract negotiation and subsequent commitment in public air services with the bus industry. The heart of the paper is a survey of European and Australian regional airlines, which we mirror with revealed experiences of bus operators. We aim to identify a number of elements in the contracting regimes that have exposed ambiguity and significant gaps in what the principal (e.g., transport department) expected, and what the agent (airline or bus operator) believed they were obliged to deliver. Ultimately airline and bus services are similar in that public authorities procure transport services that are desirable for the society but would be unprofitable without government involvement. In both sectors (theoretically fairly similar) public transport contracts are used, and those usually include obligations and performance measurements. In terms of similarities, one of the surveyed contract details that had a perceived high clarity in both industries was “payment procedures” and amongst those with rather poor clarity was also in both industries “incentives to improve performance and grow patronage”. We also show differences between regional air services and bus operations with regard to performance measurement and pre-specified obligations. Because of the strong safety culture around air services we find that regulation and trusting partnerships are even more important to aviation than to the bus sector. Because of the high level of trust but also because of simpler and more complete contracts in aviation, there is much less (re-)negotiation going on compared to the bus operations.

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1. Introduction

Public transport in both remote and urban areas is often not commercially viable and hence ministries, public transport or regional authorities procure/subsidise such transport services. As a result there usually exists a contractual relationship between principals (transport authorities) and agents (operators). Unsurprisingly, these contracts differ substantially depending on local and/or national, environmental, regulatory and political circumstances. Some contracts strive for completeness and clarity; others are, often on purpose, very incomplete and unclear with various consequences for the principal–agent-relationship and the transport operation. The results of the different degrees of contract completeness and clarity will depend on the individual set up, and there are usually trade-offs between pre-specified incentives and room for innovation in contracts, between certainty of pre-specified minimum service level requirements and the benefits of

free markets (including further growth), but also between contract drafting cost and the level of transaction costs that arise from amendments and re-negotiation of weak contracts. Rail franchise contracts in Britain for example have been found to be very pre-specified (indicating completeness in the sense of ensuring value for money at least from the transport authorities perspective), thus leaving little room for train operators to become more efficient and provide better quality at lower prices through innovation (Merkert, 2010). On the positive side, contract completeness could have also resulted in lower transaction costs (which for other reasons, including the regulatory set up, has not happened in the UK rail market).

Despite local factors and regulatory differences influencing these trade-offs, there are also patterns across different regions/jurisdictions (e.g., Merkert & Hensher, 2011a) and we argue also across different modes of transport. One of the key similarities is that arising problems due to a lack in contract completeness and clarity are usually amplified when there is a discrepancy between the principal and the agents perceived understanding of contract obligations and other key contract details such as the measures that

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access the performance of the operator. Such discrepancies can result not only in undesired levels or quality of transport performance but also in disputes and hence, if no trusting relationships exist, in high level of transaction costs.

In a paper presented at the Thredbo 11 conference, [Hensher \(2010\)](#) revealed for a sample of 18 bus operators a number of contract attributes that were neither overly complete nor clear. He also showed what impact trust and partnerships had in reducing the barriers to establishing greater clarity of contract specification and obligations, and in recognition of the degree of contract completeness. In this paper we update Hensher's bus study and also apply his methodology to the context of air service contracts. The aim of the paper is to mirror the results and to compare air and bus operator's perceptions with regard to contract completeness/clarity and trust. This will enable us to reveal both differences and cross-modal similarities/trends to derive some lessons for both sectors. Our hypothesis is that in both air and bus transport, good relationships/trust can help reducing the costs/need of having to have and, perhaps more importantly, having to use/apply complete/clear contracts.

The analysed public air transport contracts are interesting as the specification of contracts plays a vital role in securing adequate (or pre-specified) levels of air services to remote and economically underdeveloped regions, particular in Australia and Europe. [Merkert and Williams \(2010\)](#) revealed not only substantial differences in the interpretation and use of public service obligation (PSO) air service contracts in Europe but also that specific contract details such as contract duration have a significant impact on the carriers' efficiency. Despite this heterogeneity, [Merkert and Hensher \(2011b\)](#) show that good relationships and trust help to overcome problems related to incomplete and unclear PSO contracts. In this paper we analyse how this experience compares with the perception of bus operators. As good relationships appear to play an important role, we study in addition to contract attributes the impact of asset specificity, size of firms (number of contracts), ownership and other factors on the perceived level of trust between operators and transport authorities.

The paper is structured as follows: Section 2 introduces briefly the theory, whilst Section 3 presents the methodology and data used in this paper. The results are discussed in Section 4, and Section 5 offers some conclusions.

2. Theoretical background

Transport contracts, particularly those awarded on the basis of competitive tendering, are often incomplete in the sense of their inability to verify all the relevant obligations (to achieve welfare maximisation) and to account for all external factors that may have an impact on the provision of the services (e.g., severe weather conditions impact on airline operation). Similar to public transport bus operations, air public service obligations (PSO) are a form of service of general interest in which a state or public transport authority can subsidize an air connection for social or economic reasons. Such contracts are applied in Europe, and in a slightly different form also in Australia, Canada, the US and India. Whenever this paper refers to air services, it means these "air-bus" operations, as the aim of the paper is to analyse how these services compare with surface bus operations. In general, good transport contracts can, if they are well drafted, support transport authorities in stretching budgets as far as possible, and in making sure that good quality and at least minimum service level requirements are delivered (achieving value for money). However, if a contract is unclear, it is very likely to create uncertainty, and in the worst case, results in a lack of interest from airlines or bus operators when tendered out (according to the European Commission, in late 2009,

for more than 60 out of 257 PSO routes no airline had put a bid in). Contrary, too pre-specified contracts can also weaken the interest of bidders, and can also suppress any form of innovation in the provision of the service.

In terms of a theoretical framework, New Institutional Theory and in particular its two streams of transaction cost economics and agency theory can assist in addressing the questions related to completeness and clarity of contracts. [Williamson's \(2002\)](#) transaction cost economics suggest that transaction cost will be high if the chosen or imposed safeguarding governance structure is not aligned with the transactions, which differ in their attributes. The main hypothesis of his "organizational failures framework" is that problems of small-numbers exchange relationships, an unsatisfying trading atmosphere (lack of trust and partnerships), high asset specificity, complex environments, frequent exchanges, and uncertainty, push firms to internalise (vertically integrate) stages of the production process. Because of their strong incentives, spot markets are initially seen as most efficient. Depending on the transaction attributes, hybrid modes of governance like franchises or long-term contracts become more efficient ([Ménard, 2004](#)). Continuing this argument, [Williamson \(1998, 2010\)](#) focuses on three dimensions of transaction attributes: uncertainty (including complexity), frequency and asset specificity. Asset specificity is seen as most important as transactions that are supported by investments in transaction specific assets will, as a result of incompleteness, experience weak coordination and hence inefficient results ([Williamson, 2010](#)). Asset specificity, or in other words sunk costs, may also be a driver of trust and an incentive for good/long-term relationships between the transaction parties.

In the light of transaction cost economics, we argue that weakly drafted contracts may result in disputes and a hence high level of transaction costs. In line with [Coase \(1960\)](#) and [Merkert, Smith, and Nash \(in press\)](#), we consider all costs associated with preparing, negotiating, utilising, enforcing and monitoring of air service contracts to be transaction costs. Whilst contractual incompleteness can be seen as the result of the transacting parties' willingness to save transaction costs, we argue that later negotiation could also result in similar if not higher transaction costs. We suggest, even further, that attempts to burden the contract with complexity, instead of recognising boundaries for an incomplete contract that allow for negotiation, may often not be a preferred strategy. [Hensher, Mulley, and Smith \(2011\)](#) suggest that incompleteness and negotiation give both parties the opportunity to propose changes (or variations) that move towards efficient and effective delivery, in contrast to overly complex contracts leading to ambiguity in translation, and operators focussing on such compliance with a diminished interest in exercising a commitment to continuous improvement in the service (through risk sharing outside of the contract).

Since competition in transport service provision is economically sensible and politically desired, internal production by transport authorities is not an option. However, because of the reportedly high asset specificity of some aircraft and bus depots, uncertainty related to demand and external factors, time lags in replacing poor performing or failing operators and the desire to operate a stable timetable over a period of at least a few months, spot markets are also no alternative. Hence, contracts are the norm and most sensible governance structure for the provision of air and bus public transport.

Given our focus on contracts, the concept of bounded rationality is of particular importance, as its key hypothesis is that contracts are never complete. Although some find motivational issues for this rationality (e.g., [Selten, 1990](#)), [Williamson \(2010, p.219\)](#) concludes that stakeholders "are neither hyperrational nor irrational but are attempting effectively to cope with complex contracts that are

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