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Auditor General

Victoria

Franchising Melbourne's train and tram system

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AUDITOR GENERAL
VICTORIA

The Hon. Monica Gould MP
President
Legislative Council
Parliament House
Melbourne

The Hon. Judy Maddigan MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my performance audit report on *Franchising Melbourne's train and tram system*.

Yours faithfully

JW CAMERON
Auditor-General

14 September 2005

Foreword

The lifeblood of any great city is its public transport system. For over 100 years, Victoria's train and tram system was provided by the state. In the late 1990s, the Victorian Government took the step of contracting the private sector to operate the train and tram system, in the form of franchises, for periods up to 15 years. In effect, the state paid private sector companies to provide an essential public service.

The franchises soon became untenable, forcing the government to quickly find a viable solution. The government had 3 credible options: renegotiate metropolitan train and tram franchises with remaining operators; retender franchises; or restore train and tram services to public sector ownership. The government chose the renegotiation path. Today, metropolitan train and tram services are provided by separate private sector train and tram operators, and regional train services are provided by the state.

This audit examined the renegotiation of the franchise arrangements and whether the issues that arose from the original arrangements were addressed. These arrangements were complex, significant to the state, and costly. I have used this audit as an opportunity to test the government's model for developing and establishing public-private partnerships. I believe that the lessons captured here will be useful for other similar transactions in the future, not the least of which is the importance of good recordkeeping as the platform for accountability.

I consider that the franchise renegotiations resulted in a good outcome for the state. There are some refinements in processes to be made, which should be addressed in future public-private ventures.



JW CAMERON
Auditor-General

14 September 2005

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1. Executive summary



1.1 Introduction

Any large city depends on its public transport system. It connects people to work, to services, and to each other. For these reasons, many governments are closely involved in public transport policy and operations in their jurisdictions.

In 1999, in pursuit of greater efficiency and service quality, the (then) Victorian Government split Melbourne's train and tram system into 5 franchises. It conducted a competitive tender for each franchise, and awarded them to 3 private sector franchisees for periods of between 12-15 years.

However, it soon became clear that some of the franchisees' revenue and cost targets had been unrealistic and were unsustainable. Several franchisees experienced various degrees of financial difficulty, which jeopardised their viability.

By December 2002, the franchisees' financial difficulties had become acute, and one (the National Express Group Australia) withdrew from its 3 franchises. The government immediately appointed receivers and managers to operate these 3 businesses. It also negotiated interim operating agreements with the 2 other original franchisees, while it considered its options for the whole system.

After a detailed process (the subject of this audit), the government restructured the metropolitan train and tram system into one train and one tram franchise, and awarded the 2 current franchises to: Connex Melbourne Pty Ltd (train franchise); and MetroLink Victoria Pty Ltd (tram franchise). Unlike in 1999, the government did not award the current franchises through a competitive tender process. Instead, it chose to negotiate bilaterally with Connex Melbourne Pty Ltd and MetroLink Victoria Pty Ltd. The franchisees are referred to as Connex and Yarra Trams for the remainder of the report.

The current franchise agreements commenced in April 2004 and will end in November 2008, with an option to extend the franchises till May 2010. The Department of Infrastructure (DoI) manages these franchise agreements for the government.

1.1.1 The audit

The objective of this audit was to determine if the 2004 franchising agreements for the metropolitan train and tram system represented value-for-money. In particular, the audit sought to determine whether:

- the responsible agencies effectively managed the process of developing the current franchise agreements, so as to ensure value-for-money, and
- the 2004 franchise agreements adequately took account of the lessons learnt from the 1999 franchise agreements.

We did not assess whether the franchisees had met the conditions of the current franchise agreements because at the time of the audit, it was too early to make this assessment. We also did not analyse why the 1999 franchise agreements led to the franchisees sustaining financial difficulties. The return of V/Line Passenger to state control was also outside the scope of the audit.

To assess value-for-money, we first considered whether the government received effective advice on which to base its decision to renegotiate with the franchisees. Second, we considered whether or not the government (through DoI) negotiated the franchise agreements for Melbourne's train and tram services for the best possible price.

As competitive tenders were not called, we assessed the range of other approaches available to DoI to achieve the best possible price through negotiations with the franchisees, and the effectiveness with which it applied these approaches. We also assessed whether the current franchise agreements were more likely to be sustainable, by considering whether DoI adequately addressed the difficulties with the 1999 franchise agreements.

1.2 Overall conclusion: Do the current franchise agreements provide value-for-money?

Our overall conclusion is that the current train and tram franchise agreements represent reasonable value-for-money (assuming that franchisee performance meets contracted levels). This conclusion is principally based on our assessment that the payments the government negotiated with the train and tram franchisees were close to the best possible prices it could have negotiated for the sustainable operation of the metropolitan train and tram system.

DoI's primary negotiation strategy was to develop and use train and tram public sector benchmarks to accurately identify realistic costs and revenues of Melbourne's train and tram franchises: in short, the benchmarks helped DoI (and the government) become a highly informed purchaser. The benchmarks are discussed further below, along with DoI's other, complementary negotiation strategies.

Having said this, DoI took a conservative approach to allocating risks in the current franchise agreements, resulting in several risks returning to the state. This was principally to ensure that the current agreements would be more sustainable than the original agreements. While this was an understandable reaction to the difficulties experienced in 1999, the approach undertaken to allocating risks in the 2004 agreements may diminish the benefits for government of outsourcing metropolitan public transport operations. In future arrangements for the metropolitan train and tram system, there may be an opportunity to increase value-for-money to the state by allocating some risks back to train and tram operators.

In addition, DoI put in place a range of mechanisms to ensure the sustainability of the current agreements. These are discussed further below. The most far-reaching of these measures is a comprehensive performance monitoring framework.

This transaction has served as a valuable test of the principles embodied in the government's approach to procuring services through public-private partnerships – in this case, for public transport services. The lessons learnt should be helpful for other similar transactions in the future. However, the government's generic guidelines for procuring services through such transactions may need to be tailored to reflect individual circumstances. It is, therefore, important that the guidelines are continuously reviewed to ensure they reflect past experiences, and to ensure their relevance in future transactions of this nature.

1.3 Our assessments in more detail

1.3.1 Effective advice to government

We consider that the Franchise Review Task Force's¹ early analysis of all of the options was not robust. However, the smaller number of preferred options taken forward was subject to additional analysis that led to the government's decision to negotiate with the existing franchisees. Our overall conclusion was that the task force's advice to government to renegotiate and not to immediately retender was reasonable, bearing in mind the task force's research which suggested low market interest.

1.3.2 Allocation of risks

As discussed in section 1.2, the state took a much more conservative approach to allocating risks to ensure that the current agreements would be sustainable. This meant that some of the risks allocated to franchisees in 1999 returned to the state in 2004. The allocation of risks was decided prior to the development of the public sector benchmarks. We consider that risks were appropriately allocated in the 2004 agreements. However, DoI should review most of the risks that have been resumed by the state to ensure that they are appropriately allocated in future arrangements.

One of the risks that have returned to the state is the risk that the condition of rail infrastructure would not be maintained appropriately. We support DoI's current work examining the condition of rail infrastructure. This work should be completed as a matter of urgency, so that DoI can adequately assess whether the infrastructure is fit for purpose and whether the franchisees' asset management plans will prevent the infrastructure from deteriorating over time. Until this is in place, the state will not effectively be managing this risk.

We also found that DoI did not quantify all risks retained by the state. This means that the state was not fully informed about the price it paid for accepting these unquantified risks. We have recommended that DoI, as part of its risk management practices, quantify all state-retained risks; and that it have strategies to mitigate them.

¹ The Franchise Review Task Force was established to, among other things, identify the main problems with the 1999 franchise agreements, and to provide advice to the government on the ways forward for the metropolitan train and tram system. The task force was chaired by the secretary of DoI, and comprised representatives of DoI, the Department of Treasury and Finance, and the Department of Premier and Cabinet.

Recommendations

The following 3 recommendations are considered to be the highest priority.

1. That DoI review the current allocation of risks, to ensure the allocation is appropriate for future metropolitan train and tram arrangements.
2. That DoI, as a matter of urgency, complete its work on the condition of rail infrastructure. This will help the state effectively manage infrastructure residual risk.
3. That DoI as part of its risk management practices:
 - quantify all risks retained by the state
 - have documented plans to mitigate the risks
 - regularly review and update the plans.

This will ensure that the state is a more informed decision-maker for future arrangements.

1.3.3 Public sector benchmarks

As discussed in section 1.2, DoI's main strategy to ensure the current agreements represented value-for-money was to develop and use a public sector benchmark for each of the metropolitan train and tram franchises. The benchmarks contained carefully considered and reliable estimates of the main items under negotiation: forecast fare revenue, costs and risks transferred to the franchisees. They did not include risks retained by the state.

As a result, DoI was able to enter the negotiations with the franchisees as a well-informed purchaser with tools to evaluate the reasonableness of the Connex and Yarra Trams offers. Using the benchmarks, DoI effectively negotiated Connex and Yarra Trams offers to within about 3 per cent of the relevant public sector benchmark (for trains - \$1 548 million and for trams - \$598 million)².

DoI also effectively used the benchmarks to test whether the franchisees' forecasts were realistic and, therefore, that their offers were financially sustainable.

² These figures are in net present value terms.

We did, however, identify some deficiencies in DoI's recordkeeping about the benchmark development process. For example, DoI did not adequately document the outcomes of risk review workshops, or endorse changes to the benchmarks during the process of evaluating and negotiating offers. We have recommended that DoI address these deficiencies, so as to maintain higher levels of accountability in future procurements.

Recommendation

4. **That DoI, when conducting future financial benchmarking exercises, ensure that it can demonstrate that:**
 - **all relevant risks have been identified, valued and reviewed, and**
 - **changes made to the financial benchmarks have been validated and endorsed.**

1.3.4 Other negotiation strategies

In addition to the public sector benchmarks, DoI used 8 other strategies to achieve acceptable prices with each franchisee. On the whole, DoI had adequate strategies to influence the prices of the franchisees' offers. Most importantly, DoI successfully negotiated for the government to share excessive profits made by the franchisees. It also simulated, as best as it could, the competitive pressures of an open tender process.

1.3.5 Probity and performance monitoring

During the audit, we also examined 2 matters that are fundamental to any good government procurement process: probity and performance monitoring.

We found no breaches of probity during the renegotiation process. However, there were aspects of DoI's probity process (particularly the breadth of involvement of the probity auditor) that should be addressed to minimise probity risks in future procurement exercises.

Recommendation

5. That DoI reviews its probity practices so that issues raised in this report are addressed for future significant transactions.

These issues include:

- ensuring probity plans fully meet all of the Victorian Government Purchasing Board's minimum requirements
- ensuring that probity auditors formally approve all probity documents
- documenting and communicating all changes to core documents, including probity plans and contracts
- setting out the specific duties of probity auditors in contracts, and documenting any changes
- managing contracts better, to ensure that processes for appointment of probity auditors are robust, and that probity auditors fulfill the requirements
- ensuring that formal probity sign-off of processes and documents meets agreed criteria and standards
- managing conflicts of interest better, by developing a conflicts of interest policy, and
- improving existing processes to ensure that all documents relating to conflicts of interest and confidentiality are accounted for.

The 2004 franchise agreements contained a comprehensive framework for DoI's monitoring of the franchisees' performance. The framework is designed to ensure that difficulties (such as the inability to conduct "open-book" examinations of franchisees financial affairs) in the 1999 franchise agreements are not repeated.

1.3.6 Did DoI adequately address difficulties arising from the 1999 franchise agreements in the 2004 franchise agreements?

Our assessment is that DoI adequately addressed the main problems with the 1999 franchise agreements in the current (2004) franchise agreements. Figure 1A outlines the problems DoI identified in the 1999 franchise agreements, and the action it took to addressing them in the 2004 franchise agreements.

FIGURE 1A: SUMMARY OF MAIN PROBLEMS WITH 1999 FRANCHISE AGREEMENTS, AND HOW THEY WERE ADDRESSED IN 2004 AGREEMENTS

Problem with 1999 franchise agreement	How the Department of Infrastructure (DoI) addressed the problem in the new agreements
<p>Passenger and revenue forecasting</p> <p>Inaccurate forecasting of passenger and revenue growth was the biggest factor affecting the financial viability of the franchisees.</p>	<p>DoI assessed the accuracy of franchisees' forecasts by comparing them with the forecasts DoI developed for the public sector benchmarks.</p>
<p>Risk allocation</p> <p>The original agreements provided for the franchisees to assume all revenue-related risks. Consequently, the franchisees had to bear the full burden when these risks eventuated, which resulted in growing losses.</p>	<p>DoI determined the party best able to manage each risk. Risks have either been wholly allocated to the state or to the franchisees, or are shared (such as revenue risk).</p>
<p>Fare evasion</p> <p>In the original bids, the franchisees forecast reductions in the levels of fare evasion. These reductions did not occur because of the poor performance of the ticketing system, variation in the rates of checking tickets and flawed coordination of revenue protection activities.</p>	<p>Franchisees must prepare and submit annual revenue protection plans to MetLink³, which develops a network-wide revenue protection plan. Franchisees must also employ a minimum number of authorised officers⁴.</p>
<p>Revenue allocation</p> <p>Under the original agreements, the Revenue Clearing House allocated revenue to the franchisees according to the results of usage surveys. The surveys turned out to be flawed. This led to survey results (and, therefore, the percentage of revenue paid to each franchisee) being volatile, and led to protracted disputes between the franchisees over revenue shares.</p>	<p>DoI fixed the share of revenue to each franchisee, which ended the volatility. Connex and Yarra Trams each receive 40 per cent of total fare revenue, with the remaining 20 per cent for buses.</p>
<p>Cost reduction forecasting</p> <p>In their original bids, the franchisees forecast reductions in operating costs. In the event, franchisees did not reduce costs, which increased their financial difficulties. Their situation was worsened by unplanned costs.</p>	<p>DoI assessed the accuracy of the franchisees' cost forecasts by comparing them with the forecasts used for the public sector benchmarks.</p>
<p>Financial shocks</p> <p>Franchisees incurred costs that were either not planned for, or exceeded original expectations (including costs related to the ticketing system).</p>	<p>DoI included safeguards in the new franchise agreements for events where the financial impacts are uncertain. Events include the 2006 Commonwealth Games and a new ticketing system.</p>
<p>Performance monitoring</p> <p>Flaws in the performance monitoring aspects of the franchise agreements affected the government's ability to foresee problems.</p>	<p>Franchisees must provide DoI with business plans, and monthly and quarterly performance reports. DoI can also instigate a viability review at any time to assess the franchisees' financial health.</p>

³ The entity created to market public transport and increase patronage. It is owned by Connex and Yarra Trams.

⁴ Authorised officers are mainly responsible for revenue protection, passenger information, and safety and security. Connex must employ a minimum of 290 full-time authorised officers, and Yarra Trams a minimum of 215 full-time authorised officers.

FIGURE 1A: SUMMARY OF MAIN PROBLEMS WITH 1999 FRANCHISE AGREEMENTS, AND HOW THEY WERE ADDRESSED IN 2004 AGREEMENTS - continued

Problem with 1999 franchise agreement	How the Department of Infrastructure (DoI) addressed the problem in the new agreements
<p>Co-ordination of public transport activities</p> <p>Franchisees did not effectively work together to coordinate activities. There was a “cultural and institutional” separateness between the 3 companies⁵ established to market public transport and increase patronage.</p>	<p>The government created MetLink to replace the 3 companies, to substantially increase patronage and fare revenue.</p>
<p>Contract length</p> <p>The 12-15 year length of the original agreements made it harder for franchisees to forecast costs, revenues and risks, and gave them greater exposure to longer-term macroeconomic factors.</p>	<p>The new franchise agreements are for 5 years, with an option to extend for a further 18 months.</p>
<p>Contract flaws</p> <p>There were ongoing disputes between the franchisees, and between the franchisees and the government. Disputes included the allocation of revenue, and claims for losses and costs associated with perceived flaws in the agreements.</p>	<p>Many of the disputes associated with the 1999 agreements were resolved in the steps above. The “one train, one tram” policy has also ensured that many inter-operator disputes have not recurred as of the time of the audit.</p>

Source: Information provided by Department of Infrastructure.

RESPONSE provided by Secretary, Department of Infrastructure

The Department welcomes your office’s review of the 2004 re-franchising arrangements and the positive findings in this matter.

The Report reflects both a well developed audit scope and the application of the Victorian Auditor-General’s Office’s (VAGO) professional expertise throughout the process.

The Report demonstrates the complex nature of the re-franchising transactions and also the extensive work undertaken by the wider Victorian Government re-franchising team.

The Department is pleased with the recognition the Report gives to the processes of Public Sector Benchmarking, risk allocation and strategies adopted to achieve best outcomes for the State of Victoria. This was achieved while managing minimal disruption to the travelling public’s metropolitan rail services.

Detailed comments on the Report’s recommendations are provided below.

⁵ The Revenue Clearing House, VicTrip and Melbourne Passenger Growth Incentive.

RESPONSE provided by Secretary, Department of Infrastructure - continued

Recommendation 1: Agree

The Report states that “the allocation of risks associated with the reduction in the franchise terms was appropriate”.

The Department intends to review the current allocation of risks as part of the future metropolitan train and tram arrangements. Factors to be taken into account include franchising history, the delivery of new rolling stock, implementation of the new ticketing system and the adoption of relevant contractual terms.

Recommendation 2: Agree

In the Report, the Auditor-General says that he “supports DoI’s current work on the condition of rail infrastructure”.

Following an independent report on the condition of Victoria’s metropolitan rail infrastructure, the Department is implementing a series of measures to improve the management of the network. In addition, the recently introduced PASS Assets system will eventually provide continuous up-to-date information on infrastructure configuration and condition to complement the implementation of the report findings.

Recommendation 3: Agree

It is clear from the Report that DoI quantified most risks associated with re-franchising. As part of the decision making process, it also made the Government aware of residual condition risks. As required under the Whole of Victorian Government Risk Framework, the Department is compliant with risk management practices. The compliant risk framework will be used in any future franchising arrangements managed by the Department.

Recommendation 4: Agree

The Department agrees with the “robustness” of the public sector benchmark findings made in the Report, particularly in relation to quality assurance.

The re-franchising team’s Benchmarking and Modelling Committee undertook work on the identification and valuation of risk. The Committee also reviewed and approved all relevant changes to the financial benchmarks. The Department will formally sign off appropriate changes to all future benchmarking exercises and reinforce the Department’s record management practices.

RESPONSE provided by Secretary, Department of Infrastructure - continued

Recommendation 5: Agree

In the Report, the Auditor-General found “no evidence that probity had been breached during the franchise renegotiations”.

The Department complies with the Victorian Government Purchasing Board (VGPB) policies that set minimum standards for procurement of non-construction goods and services. The Department is also compliant with the procurement process guide issued by the Department of Treasury and Finance (DTF).

The Department has established that the VGPB policy on probity is currently under review. It is understood that VGPB will drive the adoption of any necessary policy changes across the Victorian Government. The Department has provided input to DTF who are responsible for managing the process.

There is a strong recognition of the importance of probity across all Departmental programs, projects and transactions. Probity policies and procedures will be tightened to reflect Recommendation 5 in the Auditor-General’s Report and to ensure the primacy of probity practices in all future Departmental commercial transactions.



2. About the franchising of Melbourne's train and tram system



2.1 Recent history

Railways are vital to Victoria's economic growth. They link people to services, employment and each other. The provision of rail (train and tram) services is also a major financial commitment by the government.

Victoria's train and tram system has seen major changes in recent years. Before 1999, the Public Transport Corporation (a statutory body) provided passenger train and tram services across Victoria. In 1999, the (then) government awarded 5 separate franchises to private sector companies to operate trams and trains for periods of up to 15 years. The 5 franchise businesses were:

- M>Train (15 years)
- M>Tram (12 years)
- Connex (15 years)
- Yarra Trams (12 years), and
- V/Line Passenger (10 years).

Three of these businesses (M>Train, M>Tram and V/Line Passenger) were owned by National Express Group Australia.

The Department of Infrastructure (DoI) is the government agency with primary responsibility for public transport policy in Victoria.

2.1.1 The 1999 franchise agreements

The 1999 franchise agreements aimed to improve service quality, increase patronage, minimise long-term costs to the taxpayer, transfer risks to the private sector and maintain safety standards. The (then) government estimated that the franchising of passenger train and tram services (including V/Line Passenger) would cost \$161 million less per year over the 15-year franchise terms than would public provision of the services¹. It anticipated that these savings would result from competition among service providers, and from incentives for franchisees to pursue efficiencies.

¹ Department of Treasury and Finance 2000, *Passenger Rail Franchising in Victoria: An Overview*, Department of Treasury and Finance, Melbourne.

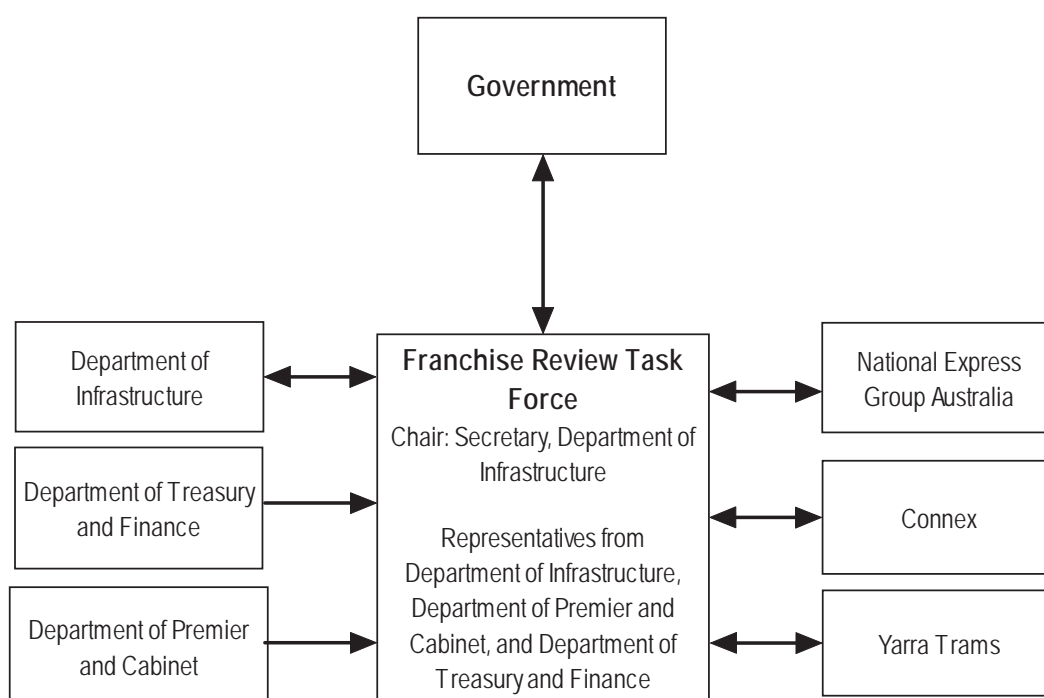
In the first 2 years of operation, the franchisees did not meet their passenger growth and cost reduction targets, which jeopardised their financial viability. Consequently, at the end of 2002, the government entered into 2 interim operating agreements with Connex and Yarra Trams. It did so to ensure the short-term viability of the businesses, to resolve contractual disputes and to restructure the industry. The National Express businesses also went into administration, and the government appointed receivers and managers to operate them.

Difficulties with the 1999 franchise agreements

In December 2001, the government established the Franchise Review Task Force to, among other things, identify the main problems with the 1999 franchise agreements, and to provide advice on the ways forward for the metropolitan train and tram system².

Figure 2A shows the structure and relationships of the task force.

FIGURE 2A: FRANCHISE REVIEW TASK FORCE AND ITS RELATIONSHIPS



Source: Victorian Auditor-General's Office.

² The role of the Franchise Review Task Force was to: minimise long-term risk adjusted costs to the state of passenger train and tram services by promoting patronage growth and improving the operational efficiency of the train and tram businesses; ensure that the full range of services continue to operate safely and without interruption; and to establish a clear, stable and lasting basis for the future provision of the services, broadly consistent with the structure of the existing franchises.

The main problems with the 1999 franchise agreements, as identified by the task force, were:

- inaccurate passenger and revenue growth forecasts by the franchisees
- inappropriate allocation of revenue risk
- fare evasion
- a flawed system of revenue allocation
- inaccurate franchisee cost forecasts
- financial shocks
- gaps in performance monitoring
- lack of coordination between franchisees, and
- contractual flaws.

The task force reported in detail on its analysis of these problems in submissions to government, and DoI made public a summary of its analysis in *Public Transport Partnerships - Passenger Rail Franchising in Victoria: An Overview*³.

2.1.2 The 2004 franchise agreements

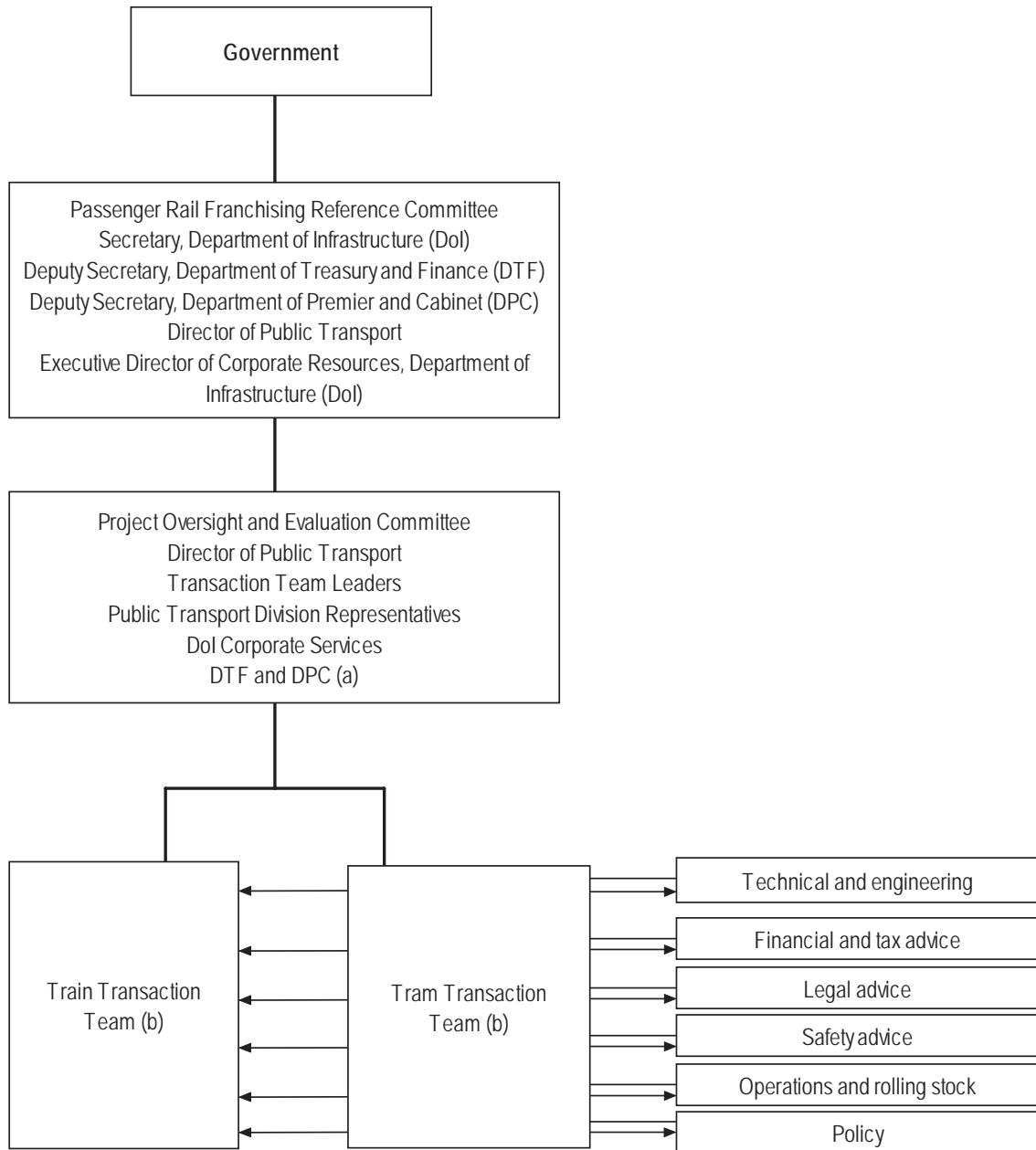
In July 2002, the government decided to restructure the metropolitan passenger train and tram system into one train and one tram franchise. In April 2003, the government decided to negotiate the single train and tram franchises with the remaining franchisees (Connex and Yarra Trams). A Refranchising Team⁴ was established within DoI to achieve a set of objectives established by the government for the new franchise agreements. The objectives are discussed later on in this section.

Figure 2B shows the structure of the renegotiation process.

³ Department of Infrastructure 2004.

⁴ The Refranchising Team comprised representatives from DoI's Public Transport Division and Corporate Finance group, and a number of expert external consultants.

FIGURE 2B: STRUCTURE FOR THE RENEGOTIATION PROCESS



(a) The role of the Project Oversight and Evaluation Committee was to ensure that the renegotiation process was delivered in accordance with agreed timelines and processes, and to consider the offer evaluation reports prepared by the Transaction Teams as a basis for advice to the government.

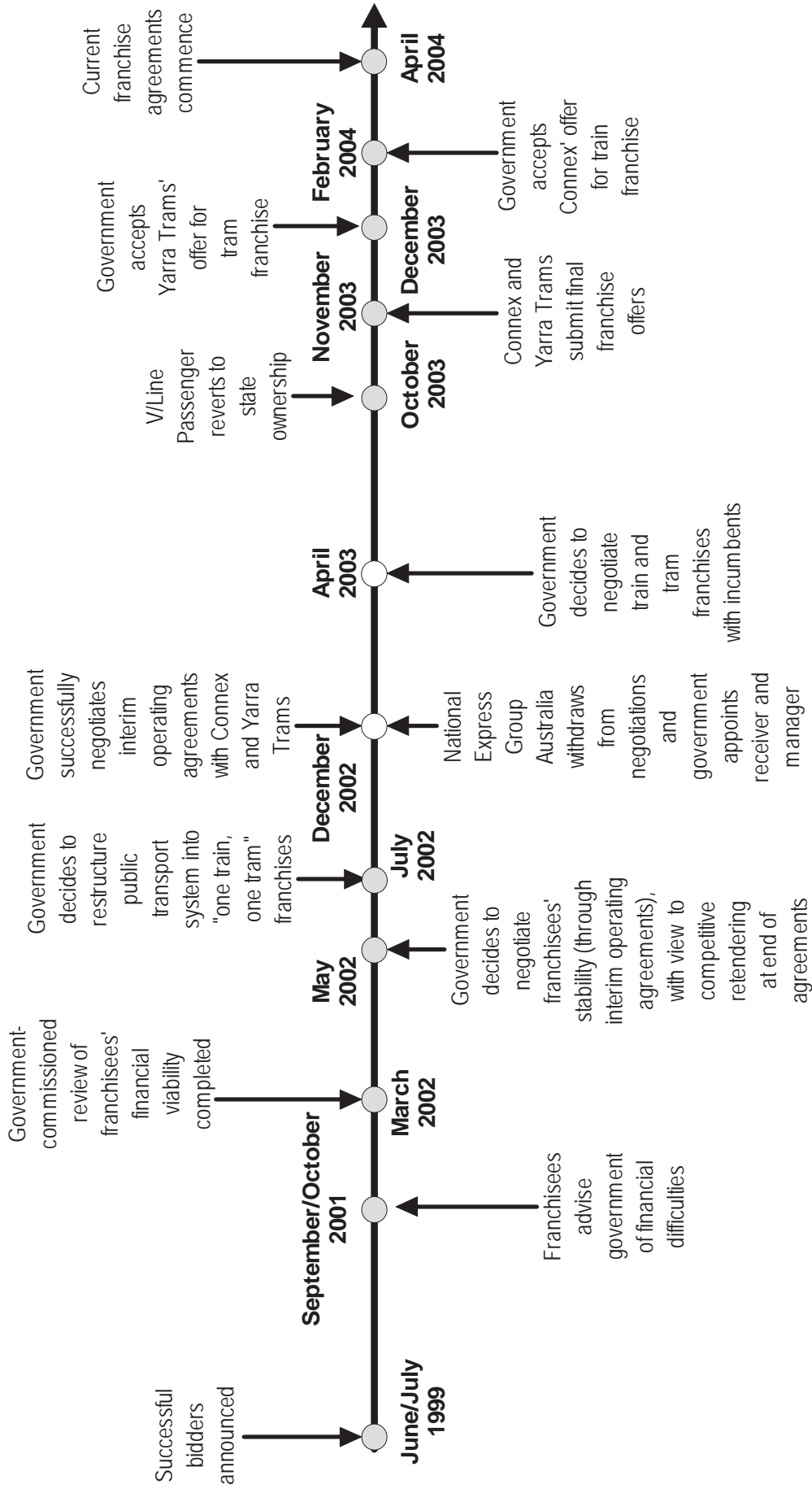
(b) The role of the Transaction Teams was to manage government interaction with franchisees during renegotiation process, and prepare offer evaluation reports for further consideration.

Source: Department of Infrastructure.

In February 2004, after extensive negotiations, the government awarded Connex the metropolitan passenger train franchise and Yarra Trams the metropolitan tram franchise, for the period 18 April 2004 to 30 November 2008 (with the option of extending this period for not less than 6 months and up to 31 May 2010). (The background to these decisions is discussed in full in Part 3 of this report.) Both immediately started operating under the new agreements. (Separate to the renegotiation process, the government also decided that V/Line Passenger would be transferred back to state control to assist in the delivery of a number of projects, such as the Spencer Street Station redevelopment).

Figure 2C summarises the major events affecting the Victorian public transport system since 1999.

FIGURE 2C: EVENTS IN MELBOURNE'S PUBLIC PASSENGER TRANSPORT SYSTEM SINCE 1999



Source: Victorian Auditor General's Office.

DoI manages the train and tram franchise agreements for government. DoI's Director of Public Transport signed the agreements, on behalf of the government.

Objectives of the 2004 franchise agreements

When deciding to restructure the metropolitan train and tram system into one train and one tram franchise, the government set the following objectives for the new franchise agreements. These were:

- to establish franchise arrangements which deliver rail services which are safe, operationally efficient and supported by convenient intermodal connections, and high quality passenger information
- to encourage and achieve innovation in the delivery of public transport services
- to establish stable and sustainable relationships with franchisees that offer proven managerial experience, and are committed to positive action, in key areas such as: operational safety; innovation; technology planning; operational planning and management; asset maintenance, renewal and improvement; marketing; project development and implementation; financial management; ticketing; revenue generation and protection, and industrial relations
- to establish franchises which are financially sustainable but which do not earn excessive profits
- to achieve value-for-money in the franchise contracts
- to secure acceptance by the franchisees of institutional reforms, contractual obligations and commercial risks which support the state's policy objectives for public transport, and
- to complete negotiations with incumbent franchisees by the end of 2003⁵.

These objectives were included in the criteria that DoI used to evaluate the franchisees' offers.

The government also settled on a set of specifications for the train and tram services that would realise its objectives⁶. The specifications were set out in a *Contract Design Guide*, which formed the basis of the requests for proposals from the franchisees, DoI's public sector benchmarks and offer templates used by the franchisees.

⁵ Department of Infrastructure 2004, *Public Transport Partnerships, Passenger Rail Franchising in Victoria - An Overview*, Public Transport Division, Department of Infrastructure, Melbourne.

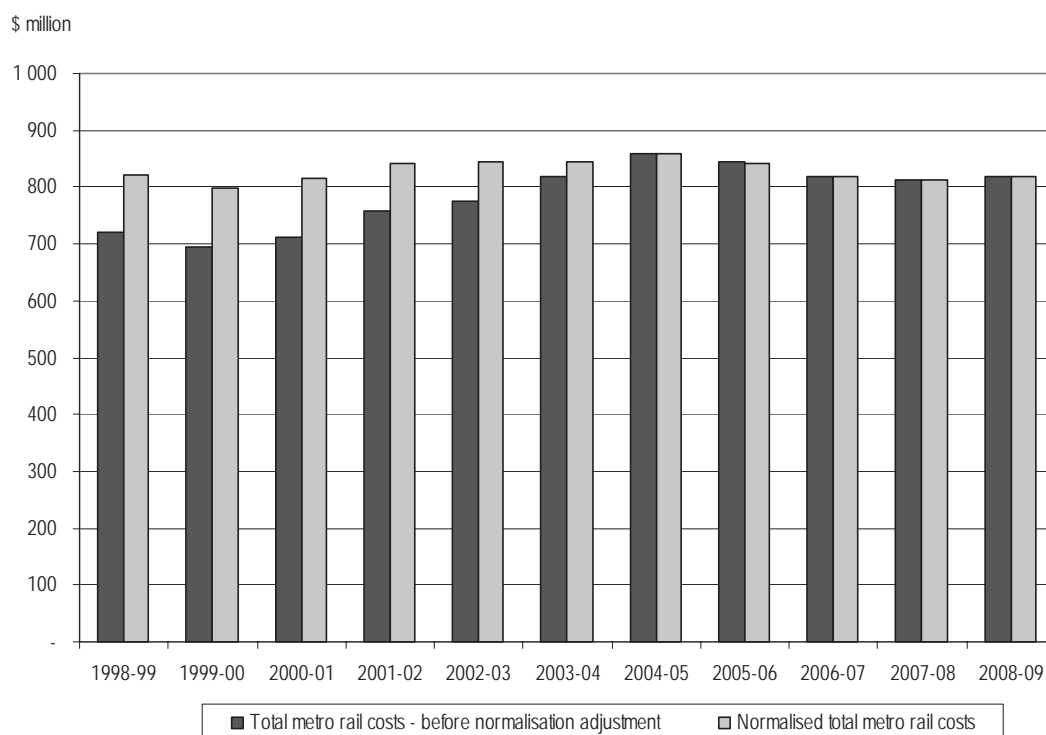
⁶ Department of Infrastructure 2003, *Passenger Rail Franchising in Victoria, Contract Design Guide*, Public Transport Division, Department of Infrastructure, Melbourne.

2.2 Costs of operating the metropolitan train and tram system

2.2.1 Total costs

Figure 2D shows the total cost of operating Melbourne's tram and train system. It shows that the cost has remained (and is expected to remain) relatively constant over time, with the exception of the costs of introducing the new rolling stock.

FIGURE 2D: TOTAL COST OF OPERATING MELBOURNE'S TRAINS AND TRAMS (\$MILLION PER YEAR)



Note: Normalised costs include adjustments made to present the results on a comparable basis. These mainly include constant investment in rolling stock. Figures are in net present value terms.

Source: Information provided by Department of Infrastructure.

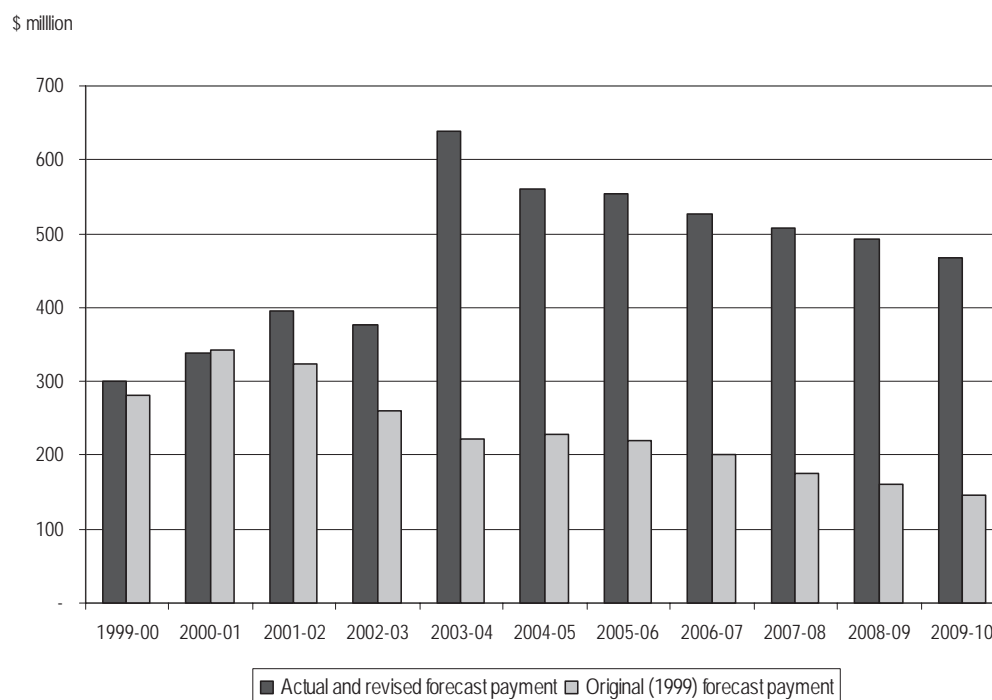
2.2.2 Government payments to franchisees

Melbourne's passenger railways depend on taxpayer funding to supplement fare revenues.

The 1999 franchise agreements were based on forecasts that total government payments would gradually decline, and that franchisees would become largely self-supporting, towards the later years of the 12-15 year franchise terms as revenue grew. Following the renegotiation of the franchises in 2004, government payments to the franchisees increased significantly. They are forecast to drop slightly over the 5 years of the franchises, mainly due to expected growth in fare revenues (which will decrease the payments needed to meet revenue shortfalls).

Figure 2E compares actual and projected payments under the original 1999 and the new 2004 franchising agreements.

FIGURE 2E: MELBOURNE'S TRAIN AND TRAM PAYMENT PROFILE (2004-05 REAL DOLLARS) – PAYMENTS TO FRANCHISEES



Note: Consumer price index (CPI) sourced from the Australian Bureau of Statistics for the period 1999-2004. Base year of 1999-2000 used (March 2000). Forecast CPI sourced from the 2005-06 state budget.

Based on 30 June figures.

Includes additional costs associated with running the metropolitan train and tram system that are paid to the franchisees (such as rolling stock adjustments, concession fare payments and other service costs). These differed slightly between 1999 and 2004.

Source: Information provided by Department of Infrastructure.

Under the renegotiated franchises, the payments to both franchisees increased by \$330 million a year to about \$560 million in 2004-05, and will be more than \$3 billion for the whole franchise term (2004-2010)⁷. About 85 per cent of each payment is a base payment, and a payment to fund the leasing costs of new rolling stock. This part of the payment is fixed. The balance is a variable amount to compensate for concession fares and various forecast adjustment payments that are subject to particular events occurring.

Of the \$330 million in extra payments to be provided each year, around 5 per cent is for requirements new to the revised agreements. These new requirements are for extra employees to check tickets, and for extra employees on trains and trams and in stations. In other words, almost all the extra payment is to secure the franchisees' operation over the franchise period.

1999 franchise agreement costs

Between the commencement of the franchise agreements in 1999 to the date of restructure (April 2004), a number of events took place that had or will have an impact on the government's finances above what was forecast. These events mainly resulted from government policy initiatives, the interim operating agreements and the withdrawal of National Express Group Australia.

Figure 2F shows these transactions.

⁷ All amounts are in 2004-05 dollars.

FIGURE 2F: OVERALL IMPACT ON THE STATE'S FINANCES (\$MILLION)

Transaction item	Total public transport system (a)		Metropolitan train and tram franchises only	
Policy initiatives -				
Employment of roving conductors and Safe Travel staff	37.7	37.7	37.7	37.7
Costs associated with the collapse of the 1999 franchise agreements -				
Settling outstanding claims and disputes with the franchisees	68.2		64.4	
Funding of December 2002 interim operating agreements by sharing franchisees' operating losses	55.0		55.0	
Fees for appointing a receiver and manager for the National Express Group Australia franchises	11.0		9.2	
Funding shortfalls of franchisees in receivership to ensure services continued to operate	257.6		244.8	
Net asset gain on National Express Group Australia rolling stock companies acquired by the state	(1.3)		0.0	
Less receipt of performance bond paid by National Express Group Australia	(135.0)	255.5	(90.0)	283.4
Costs subsequent to the collapse of the 1999 franchise agreements -				
Franchise Review Task Force and Refranchising Team costs (including consultants and in-house staff)	37.6		37.6	
Assumption of employee entitlements (b)	172.6		148.0	
Assets purchased from Connex and Yarra Trams following restructure	107.0		107.0	
Less value of old rolling stock returned to the state and revalued (c)	(568.0)	(250.8)	(448.0)	(155.4)
Net impact to the state		42.4		165.7

(a) Includes V/Line Passenger, but excludes buses.

(b) At the inception of the franchise agreements in 1999, accumulated employee entitlements (valued at around \$136 million) were assumed by the franchise operators. Under the 2004 franchise agreements, these obligations have been resumed by the government, along with the subsequent movement in the liability.

(c) The old rolling stock was originally provided to the franchisees for nominal consideration. Under the new franchise agreements, the old rolling stock is leased back to the franchisee for nominal consideration.

Note: Does not include any infrastructure renewals that may be attributable to a backlog of infrastructure maintenance over the original franchise term, which were being examined by DoI at the time of the audit. See Part 4 of this report for further discussion on infrastructure maintenance.

Some of the transactions listed in the above table are also accounted for in the payments made to the franchisees, as described earlier in Figure 2E.

Source: Information provided by Department of Infrastructure.

Other costs to government

Under the 2004 franchise agreements, the state assumed responsibility for some of the ongoing costs of operating the metropolitan train and tram system. This included insurance (estimated at \$16.6 million a year) and contributions towards MetLink's operations and marketing. The state also retained the costs of operating the current ticketing system (previously channelled through the franchisees), movements in CPI (payments are indexed to CPI) and the cost of introducing a new ticketing system.

In addition, the state has assumed the risks that:

- insurance premium may increase
- actual employee leave balances may be lower than balances forecast by the franchisees
- latent defects in the train infrastructure may be higher than the thresholds
- the new ticketing system may result in a fall in revenue (for example, if there are problems with its introduction)
- the works set out in asset management plans may not prevent the infrastructure from deteriorating over time, and
- actual revenue may be below thresholds set for each of the franchise years, in which case the government will cover 50 per cent of the shortfall for trains and 75 per cent of the shortfall for trams.

The key risks and other costs retained by the government include:

- providing additional services for the 2006 Commonwealth Games
- acquiring or leasing additional rolling stock to increase capacity, and
- guarantees over the condition of the new rolling stock, in the event that the franchisees do not meet condition targets.

Thus, in addition to the \$560 million annual payment provided to the franchisees, the government will also incur additional costs associated with assumed and retained risks.

2.2.3 Franchisees' costs

As Figure 2G shows, the franchisee's biggest operating costs are labour, maintenance (which also includes a major labour component) and new rolling stock lease payments.

FIGURE 2G: ESTIMATED OPERATING COSTS FOR METROPOLITAN TRAIN AND TRAM SYSTEM FOR 2004-2008 (\$MILLION)

Metropolitan service	Labour (excluding maintenance)	Maintenance (rolling stock and infrastructure)	New rolling stock lease payments	Other	Total operating expenditure
Tram	512	368	152	172	1 204
Trains	736	774	375	366	2 251
Total	1 248	1 142	527	538	3 455

Based on franchisee final offer price over the franchise term (in net present value terms).

Source: Final franchisee offers.

Labour (excluding maintenance)

Although each franchisee decides on the size and composition of its own labour force, the government has set minimum staffing levels for some of the franchisees operations to ensure the quality of services and to protect revenue. The government has also assumed the employee leave entitlement liability for most franchisee staff from the start of the new franchise agreements. This means that where the actual employee leave balance is greater than the balance the franchisees forecast, the franchisee is required to pay the difference to the state. Where the actual employee leave balance is lower than the forecast balance, the state must pay the difference to the franchisee. Employee leave entitlement liability is discussed further in Part 4 of this report.

Labour issues can also result in indirect costs for the franchisees. For example, the shortage of train drivers at the time of the audit resulted in more trains being cancelled, which in turn increased penalties for the train franchisee.

Maintenance (rolling stock and infrastructure)

The main maintenance items for franchisees are the rails, stations, signalling and traction power equipment. Victorian Rail Track (VicTrack - a state-owned entity) owns the infrastructure and leases it to the Director of Public Transport, who then leases it to the franchisees for nominal consideration.

Under the renegotiated agreements, franchisees must submit (and implement) an annual infrastructure works plan to keep the infrastructure operational and safe. The risks of residual asset condition (beyond the minimum work required by the annual plan) have returned to the state. The franchisees are also required to maintain the old and new (leased) rolling stock in specified conditions. The renegotiated agreements also provide that maintenance services are provided within and outside the franchisees structure.

New rolling stock lease payments

The original franchise agreements required franchisees to bring new rolling stock into service by specified dates, to replace existing rolling stock and to increase the capacity of the system.

Since the start of the original franchise agreements, over 95 new trams and 65 new metropolitan trains have been ordered. The average age of the stock has fallen, to around 12.9 years for trains and 15.5 years for trams (excluding the heritage W, Z1 and Z2 class trams).

Under the original agreements, rolling stock leasing companies contracted with manufacturers to build new trains and trams, and leased them to the franchisees to operate. The rolling stock leasing companies funded the purchase of the new stock, and the franchisees paid them leasing charges out of the government's payment. The government provided a number of guarantees to the rolling stock leasing companies and had wide-ranging step-in rights, as well as the option to acquire the rolling stock.

These arrangements are the same under the renegotiated agreements except that the lease agreements are assigned to the relevant franchisee, and the government now pays the insurance on the rolling stock.

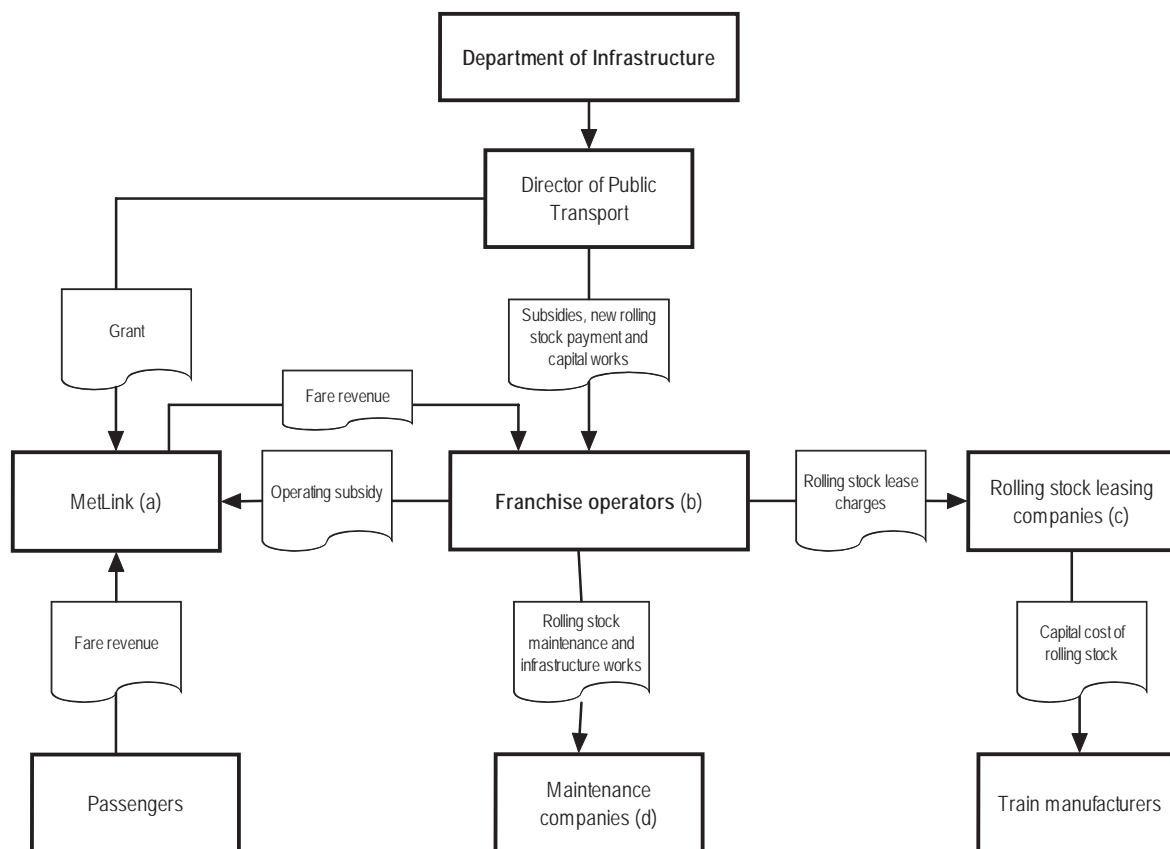
The government will fund all (or almost all) of the rolling stock's fair value through the new rolling stock payments to the franchisees (which the franchisees then pays to the rolling stock leasing companies) over the 15-year lease term. If the state elects to acquire the new leased rolling stock at the end of the lease term, it will make a final termination payment, which DoI estimates will be about \$100.8 million⁸ for all the new leased metropolitan trams and trains.

2.2.4 Money flows for the metropolitan train and tram system

The major money flows for the metropolitan train and tram system in 2004 are shown in Figure 2H.

⁸ Amount is in net present value terms.

FIGURE 2H: TAXPAYER AND PASSENGER FUNDING OF MELBOURNE'S TRAIN AND TRAM SYSTEM IN 2004



- (a) MetLink is wholly-owned by the franchisees and is responsible for fare revenue allocation, customer information and marketing.
- (b) The franchise operators are Connex and Yarra Trams.
- (c) Rolling stock leasing companies responsible for the acquisition and lease of the new rolling stock.
- (d) Yarra Trams does most of these functions in-house and Connex Trams has a 30 per cent equity in the company responsible for maintenance of infrastructure and most rolling stock.

Source: Victorian Auditor-General's Office.

2.3 Audit objective and scope

The objective of this audit was to determine whether the 2004 metropolitan tram and train franchise agreements represent value-for-money. In particular, the audit examined whether:

- the responsible agencies effectively managed the process of developing the current franchise agreements, with due regard to ensuring value-for-money, and
- the 2004 franchise agreements adequately took account of the lessons learnt from the 1999 franchise agreements.

The scope of the audit was the renegotiation of the 1999 franchise agreements to establish the 2004 agreements, and the essential events preceding the process. We did not examine the government's decision to return control of V/Line Passenger to the state. We did not assess whether franchisees are meeting the conditions of the franchise agreements as, at the time of the audit, it was too early to make this assessment. From some of the franchisees' perspective, however, the current agreements provide qualitative benefits, such as a clearer understanding by the franchisees of the state's expectations. We also did not analyse why the 1999 franchise agreements led to the franchisees sustaining financial difficulties.

2.4 Audit method and report structure

2.4.1 Assessing value-for-money

For the purposes of this audit, we defined the question of value-for-money in 2 ways.

First, we considered whether the government received effective advice on which to base its decision to renegotiate with the franchisees (examined in Part 3 of this report).

Second, we considered whether or not the government (through DoI) negotiated the franchise agreements for Melbourne's train and tram services for the best possible price.

Best possible price comprises 2 components:

- the *price* the government paid for the train and tram services – in this case, as the government payment to the franchisees for operating the train and tram services, and
- whether this price was the *best possible*.

Our preliminary research for the audit told us that DoI would have obtained the best possible price if it:

- distributed risks between the government and the franchisees according to who was best able to mitigate them, and paid franchisees an appropriate premium for the risks they were taking on (examined in Part 4)
- accurately identified the costs of providing the train and tram services, and realistically forecast fare revenue, to determine the lowest level of payment the government would need to provide to franchisees. DoI brought this information together in 2 financial models, one for trains and one for trams, called public sector benchmarks (examined in Part 5)

- ensured that the final offers DoI accepted from Connex and Yarra Trams were comparable to the public sector benchmarks (examined in Part 5), and
- used any other available means (such as strategies to share excessive profits) to negotiate prices (examined in Part 6).

The audit also examined 2 other matters that are fundamental to any procurement process:

- whether probity requirements were observed (examined in Part 7), and
- whether DoI built adequate performance monitoring arrangements into the new agreements (examined in Part 8).

Examining DoI's response to difficulties with the 1999 franchise agreements

The value-for-money picture is not complete without an examination of the difficulties associated with the 1999 franchises. Although the 1999 agreements may have appeared at the time to represent value-for-money, they were ultimately unsustainable.

An essential part of our value-for-money assessment was, therefore, whether DoI took account of the difficulties with the 1999 franchise agreements. With the government intent on new franchise agreements, it was crucial that DoI identified the problems that caused the difficulties, and ensured that these problems did not recur in any new agreement.

Figure 2I shows how we examined whether DoI addressed these difficulties with the 2004 franchise agreements.

FIGURE 2I: OUR APPROACH TO EXAMINING DOI'S RESPONSE TO THE DIFFICULTIES IN THE 1999 FRANCHISE AGREEMENTS

Assessing value-for-money	Examining whether DoI addressed difficulties with the 1999 franchise agreements
Public sector benchmarks	⇒ Did DoI ensure that franchisees' fare revenue forecasts were realistic? Did DoI ensure that franchisees' costs estimates were accurate?
Risk allocation	⇒ Did DoI reallocate risks, particularly fare revenue risks, to the party best able to mitigate them? Did DoI limit the volatility in franchisees' fare revenue flows? Did DoI adopt the most appropriate contract length?
Performance monitoring	⇒ Did DoI establish performance monitoring arrangements that will enable it to identify if the same difficulties are emerging again? In particular: <ul style="list-style-type: none"> • Did DoI establish arrangements to ensure that franchisees reduce fare evasion? • Did DoI establish arrangements to monitor franchisees' financial viability?

Source: Victorian Auditor-General's Office.

A consolidated summary of the difficulties with the 1999 franchise agreements, and the ways in which they were addressed in the 2004 agreements, is provided at Appendix A of this report.

2.4.2 Conduct of the audit

We conducted detailed audit fieldwork, addressing all these areas of interest including:

- document reviews (such as reviews of the franchise agreements, and submissions to government)
- interviews with DoI and Department of Treasury and Finance (DTF) personnel and representatives of Connex and Yarra Trams, and
- analysis of the financial models used by DoI during the renegotiation process.

The audit team used Partnerships Victoria guidance⁹ as a guide during the audit. However, we recognise that the franchise agreements for Melbourne's trains and trams are not, strictly speaking, subject to this guidance.

The audit was performed in accordance with the Australian auditing standards applicable to performance audits. The cost of the audit was \$1 040 000. This cost includes staff time, overheads, expert advice and printing.

We thank staff from DoI, DTF, Connex, Yarra Trams and members of the audit reference group for their assistance with the audit. We would also like to thank consultants from Frontier Economics Pty Ltd and Ove Arup Pty Ltd for their assistance.

⁹ Department of Treasury and Finance 2001, *Partnerships Victoria Guidance Material*, Department of Treasury and Finance, Melbourne.



3. Did the responsible agencies provide effective advice to government?



3.1 Background

In late 2001, the (then) franchisees began to signal to government that they were experiencing financial difficulties. These difficulties put the ongoing operation of the metropolitan train and tram services in jeopardy. This risk continued, in different ways, over the next 3 years.

In the face of these difficult and constantly changing circumstances, the government's first need was for advice about its options for ensuring that the metropolitan train and tram services continued to operate.

The government established the Franchise Review Task Force to provide this advice. All submissions to the government on franchising were submitted via the task force. This arrangement supported a series of sequential government decisions, responding to the deteriorating franchisee circumstances.

3.2 Did the responsible agencies provide effective advice to government?

3.2.1 Criteria

In assessing whether the responsible agencies¹ provided effective advice to government, we examined if the responsible agencies:

- identified the main issues affecting the ongoing operation of the public transport system, as summarised in DoI's analysis of causes of difficulties in the 1999 franchise agreements²
- identified options for addressing those issues, and
- analysed the cost-effectiveness of each option³.

When examining the task force's cost-effectiveness analysis, we considered whether it included evidence about:

¹ Department of Infrastructure, Department of Treasury and Finance, and Department of Premier and Cabinet.

² Department of Infrastructure 2004, *Public Transport Partnerships – Passenger Rail Franchising in Victoria: An Overview*, Department of Infrastructure, Melbourne.

³ In *The Australian Policy Handbook* 2003, P Bridgman and G Davis identify a commonly accepted model of policy development. We used this model as the basis of our audit criteria. Cost-effectiveness analysis compares the cost of various options for achieving a specific outcome. Since the need for the government to provide train and tram services in Melbourne was never at issue, this was the most relevant model for analysing the government's options.

- costs of delivering train and tram services under each option, and the transaction costs associated with each option
- extraordinary costs peculiar to the option of renegotiating the franchise agreements with the incumbents, and
- any uncertainty about costs, so as to enable government to take this into account when making decisions.

As identified in Part 2 of this report, DoI, DTF and the Department of Premier and Cabinet (DPC) provided their advice through the Franchise Review Task Force. It was not possible to distinguish between the departments' advice and the task force's advice. For the purposes of the audit, we have therefore examined the task force's advice.

The audit covered the period between late 2001 and April 2003 (when the task force provided final advice about options to the government). We distinguished between 2 phases of option development. These were before and after December 2002, the month that National Express Group Australia withdrew from all 3 of its franchises.

3.2.2 Pre-December 2002

Identification of issues

Soon after the task force was established in December 2001, it agreed with franchisees on a timetable for a review of the franchise agreements (which the task force would oversee).

From early 2002 to April 2003, the task force:

- commissioned advisors to provide independent reports on the franchisees' financial situations and on operational matters
- separately collected their own financial and operational data about the franchisees
- researched public transport policy and operational issues in Victoria, to help them develop options for government
- conducted workshops for ministers and their staff on a potential public transport policy agenda for the next 5 years, to develop the context for the issues they were trying to resolve, and
- made more than 20 submissions to government on options, and financial and contractual matters.

The task force identified that by the beginning of 2002, all 3 franchisees were no longer financially viable. The task force's April 2002 advice to government attributed this mainly to "deal fever" among the franchisees in 1999, which resulted in over-optimistic revenue forecasting. The task force also advised that fare evasion and ticket machine problems had also reduced franchisees' revenues below their forecasts.

The task force also identified that the franchisees' financial positions were unlikely to improve because of:

- franchisees having little room for productivity improvements, as most of the possible cost-cutting and restructuring had been done before the 1999 franchises were awarded
- franchisees not working together effectively to promote public transport and to minimise fare evasion, which dampened patronage and revenue, and
- disputes between DoI and the franchisees about how the condition of the system's infrastructure should be measured which, in turn, had affected franchisees' abilities to plan and allocate infrastructure spending.

On the positive side, the task force identified that franchisees had improved the timeliness of services; that customer satisfaction had markedly increased; and that new rolling stock purchases were on time and on budget⁴.

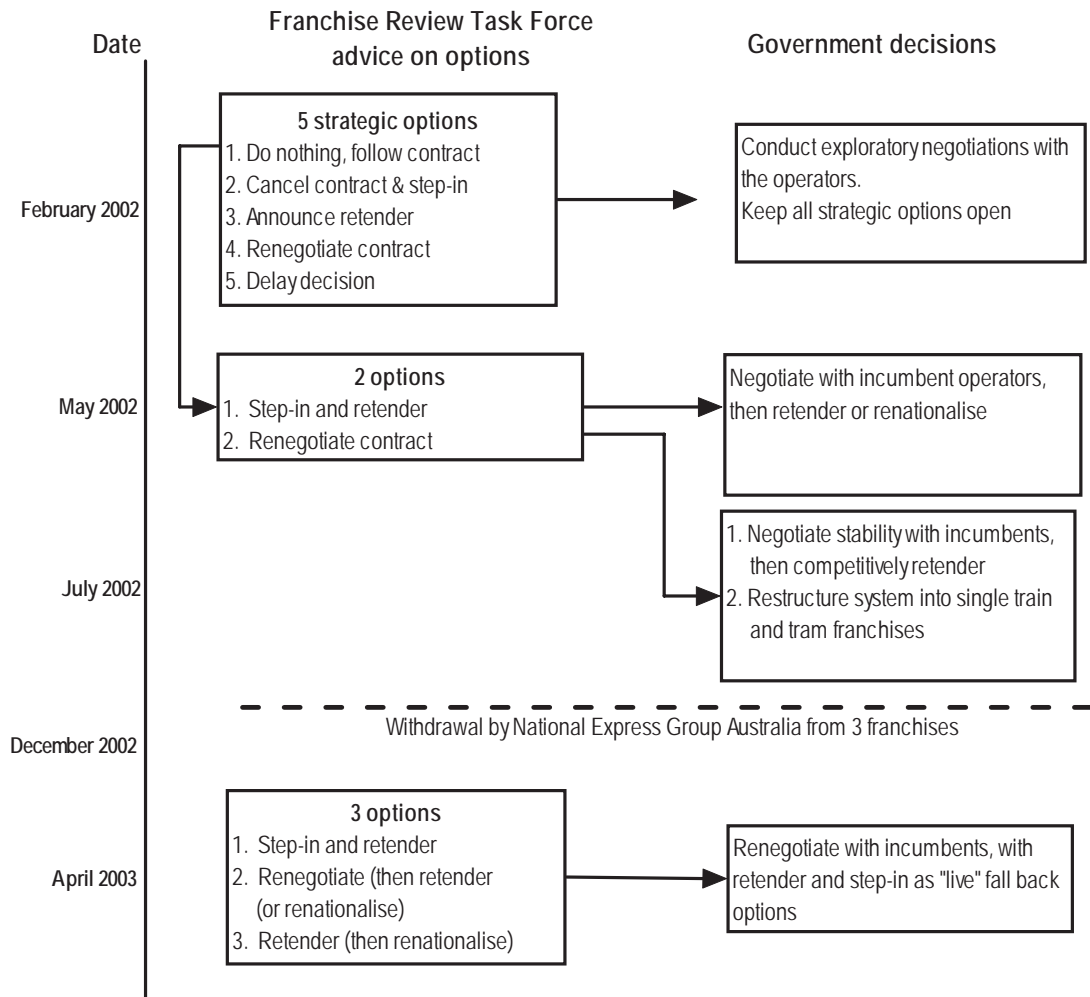
The issues that the task force identified at this early stage were the main issues affecting the ongoing operation of the public transport system.

Identification of options

Figure 3A below shows the options that the task force developed and submitted to the government, in response to the issues facing the franchisees.

⁴ Department of Infrastructure 2004, *Public Transport Partnerships – Passenger Rail Franchising in Victoria: An Overview*, Department of Infrastructure, Melbourne.

FIGURE 3A: OPTIONS PUT BY FRANCHISE REVIEW TASK FORCE, AND GOVERNMENT DECISION



Source: Based on submissions to government.

In April 2002, the task force proposed 5 options. They were:

1. Do nothing, other than strictly enforce the 1999 franchise agreements: the task force anticipated that this option would force the franchisees into insolvency.
2. Use the "step-in"⁵ provisions of the contract for the state to assume control of the franchises.
3. Announce that the franchises would be retendered.
4. Seek to renegotiate the franchise agreements with the franchisees, or
5. Defer action for an indeterminate period of time to allow the situation to resolve itself (via insolvency, merger, acquisition or an injection of funds by a parent company).

⁵ The "step-in" provisions were designed to allow the Director of Public Transport to deal with major default in specific or broad areas by the franchisees, or to appoint a receiver/manager if a franchisee became insolvent.

In April 2002, the government decided to conduct exploratory negotiations with the franchisees to modify existing contracts to resolve their difficulties. This effectively removed options 1 and 5 from further consideration. By May 2002, the task force had distilled the 3 remaining options to 2:

1. Step in and retender the services (that is, the task force integrated the April options 2 and 3), or
2. Renegotiate the franchise agreements with the incumbents.

The government initially approved option 2 by deciding to negotiate in good faith with incumbent franchisees, while leaving open the option for the government to retender or renationalise.

However, in July 2002, the task force expressed concerns that the franchisees might seek more funding from the government during the negotiations. The government decided on a different approach: first, ensure the franchisees' financial and operational stability (through interim operating agreements, or IOAs); and then, start an orderly process to competitively retender the franchises. At the same time, the government also confirmed its desire to establish a "one-train, one-tram" system, principally to address the lack of coordination between franchisees.

In December 2002, the task force successfully negotiated an IOA with both Connex and Yarra Trams. These replaced the 1999 franchise agreements. The task force was also very close to finalising an IOA with National Express Group Australia, but it was not approved by its UK parent company, which withdrew support from its Australian subsidiary. When this happened, the government adopted its only real option in the circumstances, and exercised its authority under the franchise agreements, by appointing a receiver and manager to run the 3 National Express Group Australia franchises.

Analysis of options

The task force's April 2002 advice to government was accompanied by indicative whole-of-franchise costs for⁶:

- retendering franchises: \$1 050 million (for the remainder of the 1999 franchise terms)
- renegotiating with incumbents: \$635 million (for the remainder of the 1999 franchise terms)
- restoring public sector operation, at \$1 470 million⁷ (for the remainder of the 1999 franchise terms).

⁶ These 3 figures are in net present value terms and allow for the franchisees' performance bonds of \$190 million. The task force originally advised government that under any of the 3 options, the franchisees would forfeit these bonds, which the state could use to reduce its costs.

These costs essentially covered all 5 options. The task force's advice also covered potential contract design and risk allocation issues.

The main reason that the indicative cost of retendering the franchises was higher than the cost of renegotiation was that the cost of retendering included an indicative profit margin and a risk premium of \$500 million, while the cost of renegotiating included no profit margin and a risk premium of only \$100 million.

We found no further analysis to support the task force's assertion that retendering the franchises would be significantly more costly than renegotiating with the franchisees. At the time of the audit, DoI and DTF advised that in the case of renegotiations, they had assumed that the possibility of paying performance bonds, and thus giving up operation of the franchises, would have encouraged the incumbent operators to accept a lower profit margin and risk premium.

We would have expected that the estimated costs to government of both options would be the same, regardless of the negotiation model used (e.g. bilateral negotiations versus retendering). This is because the franchisees' profit margins, which are based on their costs, revenues and risk allocations, are unlikely to vary greatly between the 2 options. More realistic cost estimates were developed in May 2002.

The task force, in May 2002, increased its cost estimates for⁸:

- retendering franchises, by \$450-650 million to \$1 500-1 700 million (for the remainder of the 1999 franchise terms)
- renegotiating with the franchisees, by \$565-765 million to \$1 200-1 400 million (for the remainder of the 1999 franchise terms), and
- restoring public sector operation, by \$130 million to \$1 600 million (for the remainder of the 1999 franchise terms).

The main reasons for these increases were the deduction of the performance bonds from all 3 options (the task force changed its advice that the bonds would be forfeited under any option, to advise that bonds would only be forfeited if a franchisee defaulted on its contract), a change in fare revenue assumptions, and a more realistic estimate of the likely government payment required.

⁷ DoI first attempted to estimate the updated costs of efficient public sector delivery in April 2002. At this time, it used the public sector comparator used for the 1999 tender, adjusted to reflect CPI and other known cost increases to 2002 values.

⁸ The 3 figures are in net present value terms.

During the audit, DoI and DTF advised us that these indicative costs were only provided to demonstrate the broad financial consequences of a particular course of action. This is supported by our observations that, in the April and May 2002 task force advice, many costs were followed by warnings that they were not, at that time, reliable financial forecasts. The indicative costs developed in May 2002 were updated in the post-December 2002 options put to government. These are discussed below.

In its May 2002 advice to government, the task force estimated the transaction costs of either retendering or renegotiating with the franchisees to be \$20 million for either option. This estimate did not include the costs of running the task force and the Refranchising Team. We found that the total costs for running the task force and the Refranchising Team alone were \$37.6 million⁹. Therefore, the costs for the renegotiation of the franchises were significantly in excess of the \$20 million that was originally estimated.

The task force's analysis of options pre-December 2002 was not robust, particularly the lack of evidence to support its assertion that the cost of retendering would have been significantly greater than the cost of renegotiating.

3.2.3 Post-December 2002

Identification of issues

The withdrawal of National Express Group Australia from the metropolitan train and tram system changed the issues facing the government. About two-thirds of the metropolitan tram and train system was now in the hands of government-appointed receivers and managers, and the 2 remaining operators (Connex and Yarra Trams) had signed IOAs and were committed to contract renegotiations with the government.

Added to this, in March 2003, the task force also advised the government that there might not be enough market interest to attract a field of bidders, if the government decided to retender the franchises. This advice was based on the task force's research into the potential market for bidders that would be prepared to enter into a new tendering process:

- a preliminary investigation conducted by the task force's executive director of the United Kingdom transport market in February 2002

⁹ This amount includes the cost of running the Franchise Review Task Force and the Refranchising Team in 2002-03 (\$16.6 million) and in 2003-04 (\$21 million). These amounts have been audited.

- a research tour undertaken by DoI and DTF officials to the United Kingdom and Europe, and further desktop research of other potential bidders¹⁰
- a wider study of the transport market by an external consultant
- updated advice from a consultant on market interest
- an analysis of transport operator profit margins by a consultant¹¹, and
- advice on likely market interest from a consultant in the United Kingdom.

Identification of options

In April 2003, the task force provided the government with 3 final options, which reflected its research into the potential franchise market. They were:

1. Cancel the IOAs, return the system to public sector operation and then re-tender the franchises at some later stage.
2. Renegotiate with the franchisees and, if agreement could not be reached, retender the franchises or return them to public sector operation, or
3. Retender the franchises and, if a satisfactory bid was not forthcoming, return them to public sector operation for a period of time to allow the market to improve¹².

Analysis of options

By the time it provided its April 2003 advice, the task force had a better understanding of the actual costs of running the train and tram system. These were used as the basis for the task force's advice. The task force drew on historical financial data from the Public Transport Corporation, financial documents lodged in the 1999 data room, its experience in operating the former National Express Group Australia franchises (under receivers and managers), and detailed financial data provided by Connex and Yarra Trams when they signed the IOAs. This information was captured in early versions of the public sector benchmarks, which had been under development since June 2002.

¹⁰ Department of Infrastructure and Department of Treasury and Finance 2003, *Passenger rail franchising in Victoria - Report on likely market interest in metropolitan franchises*, Department of Infrastructure and Department of Treasury and Finance, Melbourne.

¹¹ Department of Infrastructure 2003, *Passenger Rail Franchising in Victoria - Offer Evaluation Report - Tram, Appendix L*, Department of Infrastructure, Melbourne.

¹² Subsequently, the government also agreed to establish MetLink to overcome the lack of coordination of public transport promotional activities, and fare allocation disputes. In October 2003, the government also decided that V/Line Passenger would be transferred back to government control.

While the task force mainly evaluated the options on the basis of this cost information, it also argued for immediate renegotiation (option 2) on the basis that it promoted short-term stability, while still reserving the right to the other options, if renegotiations failed. Immediate retendering (option 3) was not supported by the task force's market research. We also note that immediate renationalising (option 1) was not supported by the task force's early observations that operational performance had improved since franchising, and that difficulties with the 1999 agreements were mainly attributable to contracting flaws, rather than the fundamental proposition to franchise the system. We observed that various elements of this analysis was included in the task force's advice, but in a piecemeal way, and not explicitly linked to detailed analysis of the costs of each option.

In April 2003, the government decided on option 2 - that DoI should renegotiate the franchise agreements with the incumbents to operate a "one train, one tram" system in Melbourne, while still enabling recourse to the other options, if the renegotiations failed.

The task force's analysis of options post-December 2002 was robust.



A new low-floor tram, the Citadis tram, operated by Yarra Trams.

3.2.4 Cost estimates for the renegotiation option

In general, it is in the government's interest to have as many potential bidders as possible to create competition. Ultimately, the research activities discussed earlier identified that market interest was weak and that it was unlikely that a new tendering process would attract enough bidders to introduce the necessary competitive tension. The task force put this conclusion to the government in April 2003. It did not provide a quantitative or qualitative estimate of the cost of this lack of competitive tension. However, DoI subsequently took steps during the renegotiation process to simulate competitive tension. These steps were appropriate, and made up for the lack of initial analysis by the task force. These are discussed in detail in Part 6 of this report.

3.2.5 Uncertainty about costs

In its April 2002 advice, the task force identified some areas of uncertainty that would affect the accuracy of its costs estimates, if the renegotiation option failed. These were uncertainty about the profit that a franchisee would seek, the value of potential damage to franchisees' reputation and the size of the franchisees' risk premiums.

We consider the task force's analysis to be adequate.

3.3 Conclusion

DoI, DTF and DPC, through the Franchise Review Task Force effectively:

- identified the issues affecting the continued operation of the metropolitan train and tram system, and
- identified options for addressing these issues.

In relation to the task force's overall cost-effectiveness analysis, it was not robust. In particular:

- we found no evidence to support the task force's assertion that retendering the franchises would be significantly more costly than renegotiating with the franchisees. We consider that the estimated costs of both options would have been the same
- the estimated transaction costs did not include costs associated with running the task force and the Refranchising Team (and ultimately were substantially exceeded)

- the task force did not analyse the costs of a lack of competitive tension, which arose from the renegotiation option. We acknowledge, however, that DoI subsequently put steps in place to simulate competitive tension, and
- the task force did adequately identify uncertainty about its cost estimates.

The task force's overall advice to government to renegotiate, rather than immediately retender, was reasonable, particularly the task force's research which showed low levels of market interest in a retender.



4. Did DoI allocate risks effectively?



4.1 Background

Effective risk transfer is central to achieving value-for-money in public-private partnerships¹. In the case of the renegotiated franchises, there are many events and influences that could put financial viability, on-time performance or service quality of the metropolitan train and tram system at risk. To avoid these risks, the government and the franchisees needed to identify, analyse, allocate and manage them.

In public-private partnerships, the public sector is able to transfer significant risks to the private sector, if it is better placed to manage them. However, if the private sector is unable to manage the transferred risks, or expects to encounter difficulty in doing so, there is great potential for problems. One of the risks that the state cannot transfer is the risk of service failure. That is, if the private sector partner fails to deliver the service), the state is still responsible for delivering the public service. This was the case with the withdrawal of the National Express Group Australia from its 3 franchises.

The 1999 franchise agreements transferred many of the significant risks of running the metropolitan train and tram system to the franchisees. The main transferred risks were revenue risks (that projected increases in total fare revenue, and decreases in fare evasion, would not be achieved) and expenditure risks (that actual costs would be greater than projected costs). The 2004 franchise agreements reassessed the allocation of risks and transferred a number of risks back to the state. This allocation occurred prior to the development of DoI's public sector benchmarks (PSBs).

Figure 4A shows the allocation of risks to the state in the 1999 franchise agreements and compares them to the 2004 franchise agreements, as identified by DoI. Risks to the franchisees in the 2004 agreements are discussed further in Part 5 of this report.

¹ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure, Final Report to the Treasurer*, Department of Treasury and Finance, Government of Victoria, Melbourne, 2004.

FIGURE 4A: ALLOCATION OF RISKS TO THE STATE IN THE 1999 AND 2004 FRANCHISE AGREEMENTS²

Risk	Nature of risk	Allocation under 1999 agreements	Allocation under 2004 agreements	Rationale for allocation under 2004 agreements and mitigation
Insurance costs	Upside and downside	Franchisee	State	Rationale: State able to secure better value by procuring insurance on behalf of whole industry rather than leaving to individual operators. Mitigation: DoI to manage with Victorian Managed Insurance Authority. Budget cover (plus contingencies) already allocated.
Franchisee employee entitlement liabilities	Neutral	Franchisee	State	Rationale: Original obligation on franchisee to pay out employee entitlements in full at franchise expiry was unsustainable and would have led to significant additional funding requirements. Mitigation: Franchise agreement defines expected future scale of liability, with franchisee required to make or receive payments in respect of any variation from forecast.
Revenue risk: Sharing shortfalls in franchisee revenue	Downside	Franchisee	State/Franchisee	Rationale: Lower risk premiums in franchise payments; reflects limited ability of franchisees to control patronage and revenue; improves franchise sustainability. Mitigation: Modelling suggests additional risk to the state will be modest; covered in state budget contingencies.
Revenue risk: One-off concession payments for Commonwealth Games/new ticketing system	Upside and downside	Franchisee	State	Rationale: Lower risk premiums in franchise payments; provides state with free hand to manage implementation without risk of claims for revenue forgone. Mitigation: State will need to take into account revenue and cost impacts of projects as it plans their implementation.
Revenue risk: State clawback for real fare increases	Upside	State	State	Rationale: Enables state to reduce cost of franchises by increasing user contribution to cost of public transport operations. Mitigation: Upside risk only.
Overpayment to franchisee (funding higher than required)	Downside	State	State	Mitigation: Profit sharing mechanism now provides safeguard against excess profits pursuant to "single source" negotiation.

² Department of Infrastructure August 2004, *Public Transport Partnerships, Passenger Rail Franchising in Victoria – An Overview*, pp. 110-113.

FIGURE 4A: ALLOCATION OF RISKS TO THE STATE IN THE 1999 AND 2004 FRANCHISE AGREEMENTS - continued

Risk	Nature of risk	Allocation under 1999 agreements	Allocation under 2004 agreements	Rationale for allocation under 2004 agreements and mitigation
Franchisee or franchise entity insolvency	Downside	State	State	Rationale: Insolvency intrinsically awkward, given scope for operational disruption and claims from creditors. Mitigation: \$100 million performance bonds as security for performance of franchisees' obligations. While state and franchisee both affected, contractual arrangements have been tightened to maximise capacity for proactive response by state.
Inflation rate	Upside and downside	State	State	Rationale: Facilitates forecasting by franchisees; lower risk premiums in franchise payments. Mitigation: Budget contingency already allocated.
Capacity: Overcrowding in trains and trams	Downside	State	State	Rationale: Costs of additional vehicles or infrastructure capacity likely to be prohibitive for franchisee with 5-year contract. Mitigation: State under no obligation to fund additional capacity if overcrowding occurs. Franchisee required to use all reasonable endeavours to cure overcrowding.
Long-term asset condition (Infrastructure, vehicles, etc.)	Upside and downside	State	State	Rationale: Unavoidable: inherent function of contract length. Mitigation: Detailed strategies must be developed by the franchisee and approved by the state, prior to implementation by the franchisee.
State-managed projects: Cost/timing	Upside and downside	State	State	Rationale: State should bear risk on projects which it manages. Mitigation: State will take into account revenue and cost impacts of projects as it plans their implementation.
State-managed projects: Operational, operating cost and revenue impacts	Downside	State	State	Rationale: Franchisee should not be penalised for disruption caused by state-initiated projects over which it has no control. Mitigation: State will take into account operational impacts of projects as it plans their implementation. Operating Performance Regime is budget-neutral in any case.
Commissioning/introduction of new Siemens trains	Downside	State	State	Rationale: Connex very reluctant to assume full risks as per original rolling stock supply agreements, given difficulties previously experienced by M> Train and lack on operational track record of Siemens trains at franchise commencement. Mitigation: State's exposure capped in terms of timing and vehicle operating hours.

FIGURE 4A: ALLOCATION OF RISKS TO THE STATE IN THE 1999 AND 2004 FRANCHISE AGREEMENTS -

Risk	Nature of risk	Allocation under 1999 agreements	Allocation under 2004 agreements	Rationale for allocation under 2004 agreements and mitigation
Latent defects	Downside	State, but more so now	State	Rationale: Franchisee should not bear risk on defects which, by definition, it could not have anticipated or prevented. Reduces risk premiums in franchise payments. Mitigation: Franchisee must bear rectification cost up to \$3.5 million (to prevent large numbers of claims against the state for trivial defects) and otherwise mitigate impacts.
Pre-existing contamination	Downside	State	State	Rationale: Franchisee should not bear risk on contamination which, by definition, it could not have anticipated or prevented. Mitigation: Costs only arise if clean-up notice issued by Environment Protection Authority. Costs managed as part of VicTrack budget.
Disability Discrimination Act exemptions	Downside	State	State	Rationale: Future status of exemptions uncertain. Major cost implications for the industry. Natural role for state government in negotiations with Commonwealth. Substantially reduces risk premiums in franchise payments. Mitigation: For state government to negotiate with Commonwealth.
Force majeure events	Downside	State	State	Rationale: Franchisee should not bear risk on events which, by definition, it could not have anticipated or prevented. Reduces risk premiums in franchise payments and improves franchise sustainability. Mitigation: Franchisee contractually required to mitigate impacts of force majeure event in order to earn relief from obligations.
Changes in state government law aimed at public transport	Upside and downside	State	State	Rationale: Cannot be managed by franchisee; reduces risk premiums in franchise payments. Mitigation: Risk clearly manageable by state government: needs to assess cost implications for industry before introducing laws.
State-initiated contract variations	Downside	State	State	Rationale: Variations cannot be forecast by franchisee. Reduces risk premiums in franchise payment. Mitigation: Risk clearly manageable by state government. Clearer framework mitigates risk.

Source: Department of Infrastructure.

4.2 Did DoI allocate risks effectively?

In assessing whether DoI effectively allocated risks in the 2004 franchise agreements, we considered whether the risks returning to the state were allocated appropriately, taking into account experiences with the original franchise agreements, national and international experience.

We also considered whether DoI quantified all risks retained to the state, and used that information to make key decisions.

4.2.1 Were the risks returned to the state in the 2004 franchise agreements allocated appropriately?

Figure 4B shows our assessment of the key risks that the state resumed under the 2004 franchise agreements. It also shows whether the risks assumed by the state were allocated appropriately, and whether the allocation should be reassessed for future arrangements.

FIGURE 4B: KEY RISKS ASSUMED BY THE STATE IN 2004 FRANCHISE AGREEMENTS

Risk assumed by the state	Was the reallocation appropriate?	Should it be reassessed for future arrangements?
Contract length	Yes	Yes
Residual infrastructure asset condition	Yes	Yes
Employee leave entitlements	Yes	Yes
Forecasting revenue	Yes	Yes
Insurance premiums	Yes	Yes
Residual risks associated with the old rolling stock	Yes	Not necessary
Liability for latent defects in rolling stock	Yes	Not necessary
Expansion of the definition for force majeure	Yes	Not necessary

Source: Victorian Auditor-General's Office.

Contract length

The 1999 franchise agreements comprised 5 train and tram franchises, with terms ranging from 12-15 years. The 2004 franchise agreements have reduced the franchise terms to about 5 years, with an option to extend.

As discussed in Part 2 of this report, inaccuracies in the 1999 franchisees' long-term forecasting contributed significantly to their difficulties, particularly their financial viability. The shorter terms for the 2004 agreements reduce the risks to the franchisees that result from their long-term forecasts being inaccurate, and were intended to reduce the uncertainty surrounding the introduction of the smartcard ticketing system in 2007. However, the shorter terms increase the risk to the state that the franchisees may address issues (such as infrastructure maintenance) with quick fixes, rather than invest in quality and efficiency improvements, if it will take longer than the franchise term to recoup the investment.

The allocation of risks associated with the reduction in the franchise term was appropriate. The experiences of the 1999 franchises clearly show the major risks to all parties that arise if longer-term forecasts are inaccurate.

Infrastructure residual risk

Infrastructure includes all major assets except rolling stock (such as tracks, stations and signalling equipment) and is owned by the state via VicTrack. Infrastructure usually has a life of 20-50 years and needs long-term maintenance plans to meet this lifespan, to maintain it to specified standards and to support desired levels of service delivery.

Under the 1999 franchise agreements, the franchisees were required to maintain the infrastructure in accordance with a condition index³. In December 2002, following ongoing disputes with the franchisees about the methodology for calculating the condition index, the state waived its right to commission a survey to assess the condition of rail infrastructure. This released the franchisees from potential obligations to maintain the infrastructure.

In response to the problems with the 1999 franchise agreements and to the infrastructure maintenance risks that are inherent in shorter franchise terms, DoI moved to "input-based" maintenance and renewal arrangements. These require the franchisees to prepare an annual work plan that details the specific works they will undertake to keep the infrastructure operating and safe. The "input-based" arrangements also mean that if, at the end of the franchise period, there are shortcomings in how the infrastructure has been maintained, the state would be obligated to pay for this to be rectified.

³ This index specifies the condition in which infrastructure should be maintained, taking into account the different ages of different items of infrastructure.

“Input-based” arrangements require the state to have high-quality data about the condition of assets, past expenditure and how it affected the condition of the infrastructure. At the time of negotiating the 2004 franchise agreements, DoI did not have comprehensive data on the condition of its infrastructure. However, at the time of the audit, DoI was finalising an external review of the condition of metropolitan train infrastructure⁴. The review examined a sample of infrastructure assets, representing between 5 and 10 per cent of all train infrastructure and on the basis of this sample, found that they were generally “fit for purpose” for current levels of operation. The review recommended that DoI develop a long-term strategy for maintaining and renewing the infrastructure.

We have not examined the external review’s outcomes as part of this audit. However, DoI’s maintenance of train infrastructure will be the subject of a separate future performance audit by our Office.

In the absence of comprehensive data on the condition of its infrastructure and its inability to reach agreement with the previous franchisees on the methodology for calculating the condition index, the “input-based” approach was DoI’s best alternative option under the circumstances. We support DoI’s current work on the condition of rail infrastructure. This needs to be completed as a matter of urgency. Otherwise, DoI will not be in a position to adequately assess whether the infrastructure is fit for purpose, and adequately assess the annual work plans submitted by the franchisees. Until this is in place, the state will not effectively be managing this risk.

Leave entitlements

Under the 1999 agreements, the franchisees were liable for employees’ leave entitlements. In December 2002, the state assumed liability for all accumulated entitlements under the terms of the interim operating agreements. It also assumed the liability for employees of the 3 National Express Group Australia franchises. The government resumed ownership of this risk because it recognised that in the event of the franchisees becoming insolvent or withdrawing from the franchise operations, the state may have been ultimately required to pick up the employees’ entitlements, as it did with the former National Express Group Australia franchisees.

⁴ Scott Wilson 2004, *Melbourne Metropolitan Rail (Train) Infrastructure Review*, Scott Wilson, Melbourne.

If the state did not assume the liability, the franchisee would have increased its offer by a similar amount. Under the 2004 agreements, franchisees are required to forecast the annual balances of their employees' entitlements. Where the actual employee leave balance is greater than the benchmark, the franchisee is required to pay the difference to the state. Where the actual employee leave balance is lower than the benchmark, the state must pay the difference to the franchisee.

Although the state's ownership of the accumulated leave entitlements provides security for the workforce, it may not encourage the franchisees to actively control the accumulation of annual and other leave entitlements as it reduces staff costs (the number of staff required, reduces training etc).

While we consider this allocation of risk appropriate for the current arrangements, DoI should, at the end of the current arrangements, review this allocation to ensure that the state's exposure to this risk is minimised.

Forecasting revenue

In the original franchise agreements, the franchisees assumed all revenue-related risks. This was despite the franchisees not being the best placed to assume all revenue-related risks: the state controlled some factors affecting fare revenue (such as price).

When the Franchise Review Task Force reviewed the allocation of risks between the state and the franchisees, it recognised that neither party was best able to manage all revenue risks. For example, under the 1999 agreements, a Revenue Clearing House had been established to allocate revenue to the franchisees according to the results of quarterly surveys of passenger ticket usage across the public transport system. Although DoI and the franchisees expected these surveys to be accurate, it turned out that they were flawed because the surveys used a small sample size and they were subjectively reported. This led to survey results (and, therefore, the percentage of revenue paid to each franchisee) being volatile. This system of revenue allocation also led to protracted disputes between the franchisees over their shares of revenue.

The new franchise agreements aim to provide the franchisees with more certain revenue flows. DoI has fixed the shares of revenue to each franchisee: Connex and Yarra Trams each receive 40 per cent of total fare revenue, and the bus franchisees receive the remaining 20 per cent. DoI chose this action to reduce the volatility in each franchisee's revenue flow, and create incentives for Yarra Trams to reduce fare evasion by increasing their exposure to fare revenue risk⁵.

⁵ Public Transport Division, Department of Infrastructure 2004, *Public Transport Partnerships, Passenger Rail Franchising in Victoria – An Overview*, Department of Infrastructure, Melbourne.

The new agreements also commit the state to contributing each year a percentage of the shortfall between the actual revenue received by franchisees and a pre-determined threshold level. These thresholds are 40 per cent of EBIDTA⁶ for Connex and 20 per cent of EBITDA for Yarra Trams. If total fare revenue in any year falls below the thresholds, the government will pay 50 per cent of the shortfall for trains and 75 per cent of the shortfall for trams.

Our research showed that the current UK public transport franchise arrangements take the position that the franchisee is in the best position to manage revenue risk in the short-term. However, the UK Government considers it better value-for-money to assume some downside revenue risk from the fourth year of a franchise term.

Both the franchisees and the state influence the factors that affect fare revenue, and to a certain extent, increase patronage. The franchisees largely control operational performance, fare evasion measures and marketing; the state controls the capacity of the network (that is, it has the ability to add new routes and rolling stock).

Taking into account the state's objective of securing the viability of franchisees for the full franchise term, the allocation of this risk was reasonable. However, we believe that DoI needs to conduct further work to determine the optimum allocation of revenue risks for future arrangements.



Yarra Trams operates the City Circle tram, which provides free, unrestricted travel around Melbourne's Central Business District.

⁶ Earnings before interest, depreciation, tax and amortisation.

Insurance premium risk

Under the 2004 agreements, the state is required to arrange insurance against property damage (including rolling stock) and to arrange public liability insurance on behalf of the franchisees over the franchise period. The premium is paid by the state, and franchisees are liable for specified amounts in the event of a successful claim.

The reallocation of the insurance premium risk to the state followed a period of uncertainty and change in the insurance industry, nationally and internationally. Had the franchisees been required to assume this cost, their offers would have reflected the assumption of this risk. It was reasonable for the state to assume this risk in the new franchise agreements because the state has also assumed the risks associated with the infrastructure. In addition, it was in the best position to manage the implications from the uncertainty in the insurance industry.

The current agreements also require franchisees to bear the full costs resulting from incidents up to a specific insurable excess amount (e.g. for trains, \$5 million). It is important that DoI monitor these incidents to ensure that blowouts in insurance premiums are limited.

Residual risks associated with old rolling stock

Under the new franchise agreements, the state has taken back ownership of all of the old rolling stock from the National Express Group Australia, and of the Comeng rolling stock from Connex.

There is a residual risk to the state if the old rolling stock has not been properly maintained. However, given the various controls in place under the franchise agreements, including the rolling stock condition index⁷, we do not consider this to be a significant risk to the state.

We consider the allocation of this risk to be appropriate.

Latent defects in infrastructure

The new agreement with Connex lowered the level at which the state bears the cost of a latent defect in infrastructure (that is, a defect not known at the start of the franchise term) from \$7 million to \$3.5 million. If the state decides that the latent defect requires rectification, it will pay for costs over and above the agreed level. If it doesn't, neither the state nor the franchisees pay anything. There was no change in the level agreed with Yarra Trams for the tram infrastructure.

⁷ This index specifies the condition that the rolling stock should be in, taking into account different ages.

The allocation of this risk in the new arrangements is reasonable from a value-for-money perspective: they reduce the unknown risks to the franchisees, who would have sought a premium to accept these risks.

Force majeure

Force majeure is defined, in the context of the franchise agreements, as an event outside the control of the state or the franchisees (such as natural catastrophes). The new agreements expanded the definition of force majeure to include failure of the ageing Metrol system⁸ and latent defects above a defined threshold. The allocation of this risk in the new arrangements is reasonable from a value-for-money perspective, for the same reason as the previous point.

4.2.2 Did DoI quantify risks retained to the state, and use this to inform decision-making?

Almost all Partnerships Victoria projects use a public sector comparator to identify, quantify and cost all project risks. As explained in Part 5 of this report, DoI developed 2 PSBs. These were similar to a comparator, but it did not identify, quantify or cost risks to the state.

In a separate exercise from the PSBs, DoI quantified some risks retained by the state. These included insurance premiums, revenue downside and some other minor risks, priced at about \$15 million a year. However, this exercise was not comprehensive.

We found no evidence that DoI quantified all risks retained by the state.

The value of risks associated with the ongoing maintenance and renewals of infrastructure, in particular, could be very high. As part of a separate performance audit on DoI's maintenance of rail infrastructure, we will further examine the potential costs to the state of risks associated with the maintenance and renewals of rail infrastructure.

It was important that DoI quantified all risks to the state. In the absence of this, the state does not know the price it has paid for accepting these risks. It is, therefore, even more important for DoI, as part of its risk management practices, to quantify all state-retained risks and to have strategies to mitigate them.

⁸ Metrol is the facility responsible for managing and controlling train movements throughout the Melbourne metropolitan area.

4.3 Conclusion and recommendations

Generally speaking, the risk pendulum has swung towards the state in the new franchise agreements. While this has increased the state's financial exposure, had franchisees borne more risks, they would have increased their bids by similar amounts.

We consider the allocation of risks in the current franchise agreements to be appropriate. However, DoI should review this allocation to ensure it is appropriate for future metropolitan train and tram arrangements. DoI should also complete its current work on the condition of rail infrastructure, so that infrastructure residual risk is more effectively managed.

We also found that DoI did not quantify all risks retained by the state. This means that the state does not know the price it has paid for accepting these unquantified risks. As part of its risk management practices, DoI should quantify all state-retained risks and to have strategies to mitigate them.

Recommendations

1. **That DoI review the current allocation of risks, to ensure the allocation is appropriate for future metropolitan train and tram arrangements.**
2. **That DoI, as a matter of urgency, complete its work on the condition of rail infrastructure. This will help the state effectively manage infrastructure residual risk.**
3. **That DoI as part of its risk management practices:**
 - **quantify all risks retained by the state**
 - **have documented plans to mitigate the risks**
 - **regularly review and update the plans.**

This will ensure that the state is a more informed decision-maker for future arrangements.



5. Were public sector benchmarks developed and used effectively during the negotiation process?



5.1 Background

The main way that DoI sought to obtain value-for-money from its renegotiations with the franchisees was by developing public sector benchmarks (PSBs) for the train and tram franchises. The PSBs were financial models that predicted the future revenues and costs of operating the 2 franchises.

The purposes of the PSBs were:

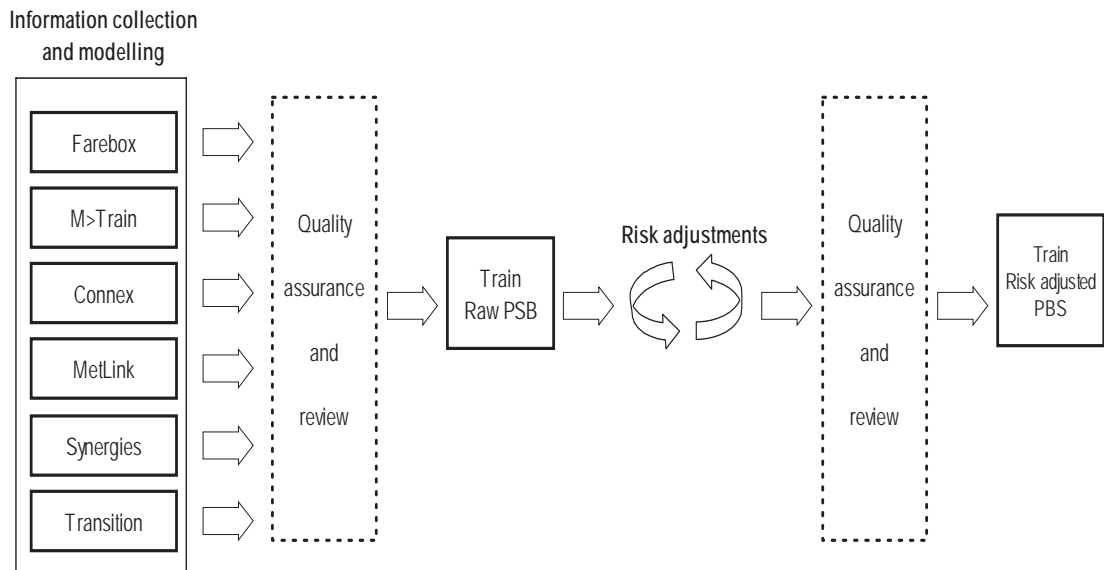
- to inform the government about what it would cost an efficient public sector organisation to operate the franchises, in the event that the negotiations were not successful, and
- to evaluate the reasonableness of the Connex and Yarra Trams offers.

Figure 5A shows DoI's approach to developing the PSB for the train franchise¹. First, DoI modelled the PSB using data from the original train franchisees, and then used further information about other costs and benefits to create a raw (or base) PSB². Second, DoI assessed the risks underlying the major revenue and cost inputs (such as fare revenue, and train driver costs), and assessed the extent to which the risks would be retained or passed onto the private sector. It then adjusted the base PSB for these risks to create a consolidated, risk-adjusted PSB for trains.

¹ DoI took the same approach to benchmarking the tram franchise.

² The original relevant train franchisees were Connex and M>Train.

FIGURE 5A: DOI'S APPROACH TO DEVELOPING THE TRAIN FRANCHISE PUBLIC SECTOR BENCHMARK



Note: Synergies are potential benefits resulting from combining the 1999 train franchises into one train franchise for the 2004 agreements. Transition costs may also be incurred by the 2004 train franchise, as a result of combining the 1999 train franchises.

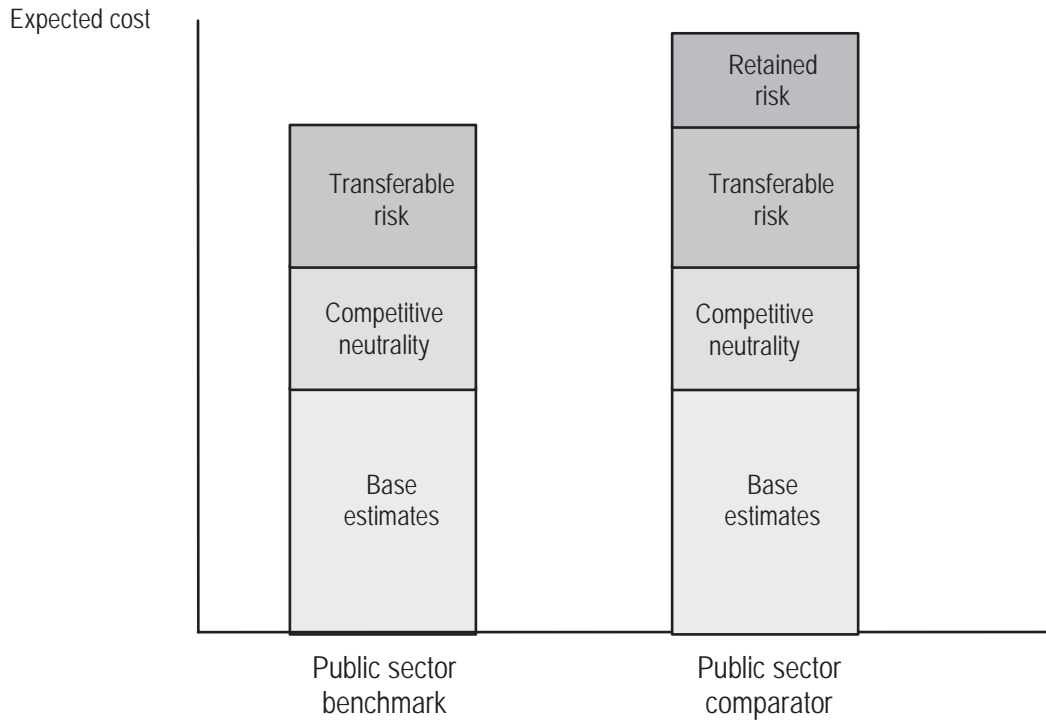
Source: Department of Infrastructure.

DoI's PSBs were similar to (but not exactly the same as) the public sector comparators that agencies develop for Partnerships Victoria projects. A conventional public sector comparator usually quantifies:

- the base estimates of the likely cost of a particular project
- adjustments to achieve "competitive neutrality" (such as payroll tax, which a public sector operator would not pay)
- the value of risks to be transferred to the private sector (transferable risks), and
- the value of risks to be retained by the state (retained risks).

Because DoI's PSBs were used to compare the cost of public sector operation of the franchises with the costs projected in the Connex and Yarra Trams offers, they did not include risks to be retained by the state, whether the renegotiations were successful or not. Figure 5B shows the difference between the two. Part 4 of this report assesses whether DoI allocated risks effectively.

FIGURE 5B: DOI'S PUBLIC SECTOR BENCHMARKS COMPARED WITH A CONVENTIONAL PUBLIC SECTOR COMPARATOR



Source: Victorian Auditor-General's Office.

DoI finalised the 2 PSBs in September 2003, and presented them to relevant ministers. DoI used the PSBs (and particularly the revenue, cost and risk inputs) to assess and negotiate the franchisees' offers. The final PSBs estimated that the cost of providing train and tram services, through government payments to the franchisees, would be \$1 548 million and \$598 million, respectively, over the franchise term (2004-2010)³.

This part of the report examines whether DoI's PSBs were effective by determining whether DoI:

- developed robust PSBs, and
- used the PSBs effectively during the offer evaluation and negotiation process.

³ Costs are in net present value terms.

5.2 Were DoI's public sector benchmarks robustly developed?

5.2.1 Criteria

To be effective tools in the evaluation of offers, the PSBs needed to be robustly conceptualised and developed. To assess whether they were, we compared them with a good practice model that we developed for this audit. We based this model on a review of Partnerships Victoria guidance, and on practices in the UK and other overseas jurisdictions.

As indicated previously, this was not a Partnerships Victoria project, but the guidance material for Partnerships Victoria projects provided valuable input to our good practice model.

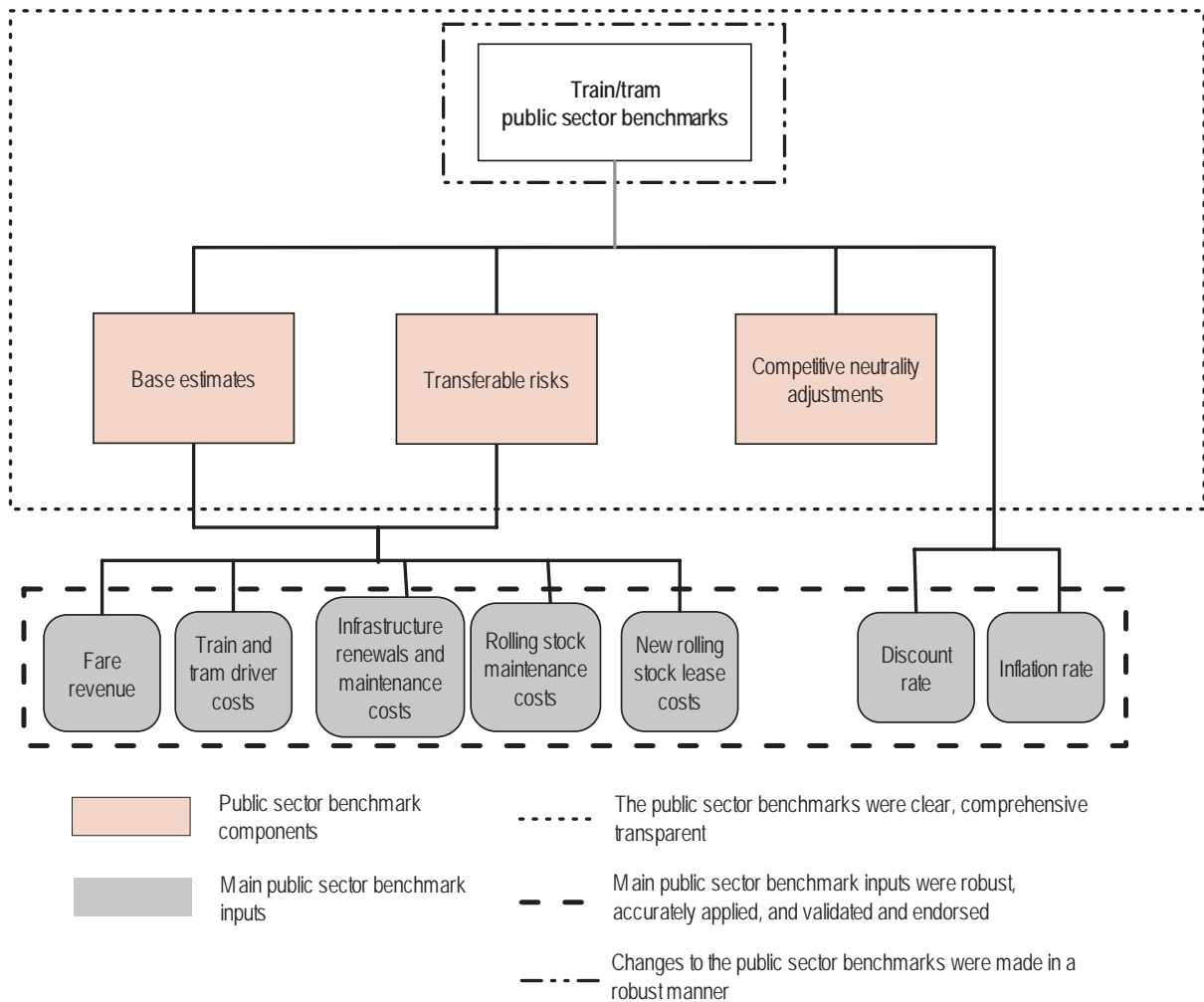
Our good practice model required that:

- the PSBs were clear, comprehensive and transparent
- the PSBs main inputs were robust, accurately applied, validated and endorsed, and
- changes made to the PSBs⁴, once the offer evaluation and negotiation process commenced, were made in a robust manner.

Figure 5C shows the good practice model, as it relates to the PSBs developed by DoI.

⁴ Partnerships Victoria guidance provides for a public sector comparator (or a public sector benchmark, in this case) to be changed under specific circumstances.

FIGURE 5C: PSB GOOD PRACTICE MODEL



Source: Victorian Auditor-General's Office.

5.2.2 Were the benchmarks clear, comprehensive and transparent?

Criteria

In assessing whether DoI's PSBs were clear, comprehensive and transparent, we examined if the PSBs:

- had clear purposes, which were met
- separately comprised base estimates, competitive neutrality adjustments and transferable risks
- were consistent with government expectations, and
- were transparent.

Were the purposes of the PSBs' clear, and were they met?

DoI clearly identified that the purposes of the PSBs were to evaluate the reasonableness of the franchisees' financial offers, and to inform the government about the likely costs for an efficient public sector organisation to operate the train and tram franchises, in the event that the renegotiations were not successful.

DoI used the PSBs:

- to evaluate the financial offers made by Connex and Yarra Trams, and
- to quantify the likely costs to the state of operating the train and tram franchises.

The purposes were clear, and they were met by the PSBs.

Were the PSBs separately comprised of base estimates, competitive neutrality adjustments and transferable risks?

Base estimates

In modelling the PSBs, DoI identified and quantified the base estimates of the most important revenue and cost inputs.

Driver costs

DoI's quantification of costs of train and tram drivers was informed by reviewing and assessing:

- historical and current data provided by the franchisees
- details of current wage agreements, and predictions about future agreements, and
- data included in the interim operating agreements.

Infrastructure renewals and maintenance costs

DoI engaged 2 consultants to develop forecasts for infrastructure-related costs. These costs were based on past expenditure and estimates from maintenance practitioners.

Rolling stock costs

DoI engaged a consultant to develop forecasts for rolling stock-related costs. These costs were based on contracted maintenance programs, with the new rolling stock lease payments based on pre-existing contracts continuing into the new franchise agreements.

Fare revenue

DoI engaged a consultant to develop annual forecasts of train and tram patronage, and to estimate fare revenue⁵.

DoI first established the base fare revenue by adjusting 2002-03 fare revenue⁶ to exclude revenue that would not be passed on to franchisees (such as tertiary card payments)⁷. DoI then forecast how this base revenue would grow over the period 2003-10, using:

- the consultant's forecasts of real fare revenue growth, and
- the past history of fare revenue growth for the metropolitan train and tram system.

Finally, DoI applied an inflation rate of 2.25 per cent each year to the most likely estimates of real revenue to estimate nominal fare revenue.

We found the cost and revenue inputs all adequately took account of the historical, current and projected future performance of public transport operators in Victoria.

Competitive neutrality adjustments

To ensure franchisee offers were comparable with the PSBs, we expected the PSBs to have been adjusted for any advantages or disadvantages (such as not paying particular taxes) accruing to a public sector operator because of their state ownership.

DoI adequately adjusted the PSBs to take account of:

- payroll tax to be paid by the franchisees
- the cost of maintaining franchisee performance bonds (valued as a percentage of the total performance bond)⁸
- the cost of maintaining a minimum level of shareholder funds, and
- service levels and resources outlined in the *Contract Design Guide*⁹.

⁵ Fare prices are established by the government.

⁶ Actual fare revenue based on audited financial statements of the franchisees.

⁷ The *Contract Design Guide* specifies that this revenue should not be paid to the franchisees. Department of Infrastructure 2003, *Passenger Rail Franchising in Victoria – Contract Design Guide*, Department of Infrastructure, Melbourne.

⁸ Each franchisee must pay a performance bond to the state, which the state can claim if the franchisee defaults on, or “walks away” from their agreement.

⁹ The *Contract Design Guide* states the principles, which the government intended to adopt in designing and drafting the franchise agreements.

Transferable risks

A conventional public sector comparator identifies and values risks that are transferred to the private sector operator, and risks that are retained by the state. Risks retained by the state were not required to be identified or valued in the PSBs. DoI identified all relevant transferable risks. DoI estimated the value of these risks using sophisticated mathematical tools such as Monte Carlo risk analysis¹⁰.

The PSBs separately comprised base estimates, competitive neutrality adjustments and transferable risk, and were quantified.

Were the PSBs consistent with government expectations?

The government's expectations of the franchising agreements were stated in the *Contract Design Guide*. Among other things, the guide required that:

- there be one train and one tram franchise for the metropolitan system
- the franchisees establish and operate a new ticketing body (MetLink), and
- the calculation of fare revenue excludes commissions payable to agents.

The PSBs complied with the requirements of the guide. DoI prepared separate PSBs for the train and tram franchises. The PSBs included a 50 per cent contribution by each franchisee to MetLink. All of the main PSB inputs were consistent with the guide's requirements.

Were the PSBs transparent?

Transparency is a matter of clearly documenting:

- the process of developing the PSBs
- the assumptions underpinning the PSBs, and their rationale
- major risks not included in the PSBs (such as the risk of a catastrophe and compliance with the *Disability Discrimination Act 1992*), and
- each of the PSBs components (base estimates, competitive neutrality and transferable risk) as separate items.

DoI clearly documented its process for developing the PSBs, the assumptions underpinning the PSBs, and their rationales. It also identified risks that it excluded from the PSBs.

¹⁰ Monte Carlo risk analysis is a statistical tool that permits the modelling of complex combinations of uncertainties and assists in making predictions. It takes into account randomness by investigating different scenarios, with the results used to inform decision-making.

DoI quoted the values of revenue and cost inputs in its calculations for the PSBs differently to how it quoted them in the offer evaluation and negotiation process. In its calculations, DoI quoted each revenue and cost input as a single value, but clearly identified the base estimate, competitive neutrality adjustments and transferable risks that made up the total value of each input. However, for the offer evaluation and negotiation process, transferable risks were quoted as a single total, and the base estimates for each revenue and cost input were quoted separately. Competitive neutrality adjustments were not quoted.

DoI provided us with evidence to show that these 2 sets of values reconciled with each other. DoI's approach would have been improved if its calculations for the PSBs and the values quoted for the evaluation and negotiation process had been in the same format.

5.2.3 Were the main inputs in the benchmarks robust, accurately applied, validated and endorsed?

Were the main inputs robust?

Criteria

In assessing whether main PSB inputs were robust, we examined if DoI took account of:

- Partnerships Victoria guidance, and
- interstate and international practices.

We also examined if DoI:

- identified and presented the main PSB inputs, and the overall PSB, as a range of values to relevant parties, and
- used internal and/or external personnel with expertise to develop the PSBs.

Did DoI adequately take account of Partnerships Victoria guidance?

Partnerships Victoria provides general guidance to agencies developing a public sector comparator¹¹. This guidance also refers to the application of discount and inflation rates¹².

¹¹ Department of Treasury and Finance 2001, *Partnerships Victoria - Public Sector Comparator Technical Note*, Department of Treasury and Finance, Melbourne.

¹² Through the application of a discount rate, future values are converted into comparable, present-day values. The inflation rate adjusts these values from real to nominal terms, and vice-versa.

Discount rate

Partnerships Victoria considers transport projects to be low risk, and that they should have a real discount rate of 6 per cent¹³ applied to them (or a nominal rate of 8.38 per cent¹⁴, assuming a 2.25 per cent inflation rate). In its calculations for the PSBs, DoI used a nominal rate of 8.25 per cent. In its reporting for the offer evaluation and negotiation process, DoI used a nominal rate of 8.65 per cent in the PSBs and in the franchisees' financial offers.

Neither of these rates was consistent with Partnerships Victoria guidance. However, the impact of this was insignificant.

Inflation rate

Partnerships Victoria guidance recommends agencies seek guidance from DTF when determining the inflation rate they should use. This rate should be based on long-term inflation forecasts. In its PSBs, DoI used an inflation rate of 2.25 per cent to index revenue and cost estimates. This rate was based on forecasts to 2008-09 provided by DTF, which was consistent with Partnerships Victoria guidance.

However, the rate of inflation used to calculate the discount rate was 2.5 per cent, rather than the recommended 2.25 per cent. DoI subsequently advised that it did not use the lower rate because the difference in inflation rates would not have had a material effect on the calculation of the discount rate, and on the calculation of the overall PSB estimate. While this is true, we found no evidence that DoI considered this at the time the decision was made.

Did DoI adequately take account of interstate and international practices?

DoI commissioned a consultant to review all Victorian rail businesses to identify possible efficiency gains in driver costs, infrastructure maintenance costs and rolling stock maintenance costs. The consultant researched overseas practices, using sources such as the US National Transport Database and the Union of International Public Transport.

DoI effectively used the consultant's findings from the review to inform its quantification of the main cost inputs.

¹³ Department of Treasury and Finance 2001, *Partnerships Victoria - Public Sector Comparator Technical Note*, Department of Treasury and Finance, Melbourne.

¹⁴ The nominal rate was calculated using the Fisher equation. Department of Treasury and Finance 2003, *Partnerships Victoria - Use of the Discount Rate in the Partnerships Victoria Process Technical Note*, Department of Treasury and Finance, Melbourne.

Did DoI identify and present the main PSB inputs, and the overall PSB, as a range of values?

As part of developing the PSBs, DoI conducted a workshop to identify a range of transferable risks associated with main revenue and cost inputs. Representatives of DoI and DTF, and subject-matter experts from 2 consulting companies, attended the workshop. Figure 5D shows key risks the workshop identified.

FIGURE 5D: KEY RISKS ASSOCIATED WITH MAIN PSB INPUTS

Main PSB input	Risks
Fare revenue	<ul style="list-style-type: none"> • That growth assumptions (such as demographic assumptions) will be incorrect. • That major disasters will disrupt services.
Train and tram drivers	<ul style="list-style-type: none"> • That drivers will strike or take other industrial action. • That absenteeism will reduce services.
Infrastructure renewals and maintenance	<ul style="list-style-type: none"> • That changes to the Disability Discrimination Act may increase compliance costs. • That latent defects will make infrastructure unusable for periods of time.
Rolling stock maintenance	<ul style="list-style-type: none"> • Ageing rolling stock. • That latent defects will make rolling stock unusable for periods of time.

Source: Information provided by Department of Infrastructure.

DoI used Monte Carlo risk analysis to predict the minimum and maximum value of each identified risk, on an annual basis, to determine the range within which the actual value would lie if the risk eventuated. For example, risks associated with train drivers were estimated to range between \$23 million and \$25 million for 2004-05.

DoI presented its initial analysis of these values to the Benchmarking and Modelling Committee¹⁵ in June and July 2003. That is, the base estimates of each PSB input were adjusted to be a range, reflecting the risk analysis conducted above. However, we found no evidence that DoI presented the final PSBs as a range of values to the Benchmarking and Modelling Committee or to any other committee before the evaluation and negotiation of offers. Neither did it provide this range of values to heads of departments or to the government.

¹⁵ The Benchmarking and Modelling Committee was an interdepartmental committee that oversaw the development of the PSBs. The committee comprised members of DoI and DTF, and it reported to the Project Oversight and Evaluation Committee.

Reporting a range of values would have clearly indicated to oversight committees, the department head and government what DoI considered to be the lowest and highest dollar values of an acceptable offer. This would have been good practice, as it would have provided a more realistic picture of the best-case and worst-case scenarios for public operation of the franchises.

However, we also accept that presenting the PSBs as a range of values may not have greatly affected the negotiated outcomes since the franchisees' offers were close to DoI's PSBs (see section 5.3 of this report for further discussion on evaluation and negotiation of offers).

Did DoI use internal and/or external personnel with expertise to develop the PSBs?

DoI engaged 3 consulting companies to provide specialist advice, as part of the development of the PSBs. The audit reviewed the credentials of each party, and considered that they had the appropriate expertise, and their consultants the appropriate qualifications, to provide advice for the PSBs.

Were the main inputs accurately applied?

Criteria

In assessing whether PSB inputs were accurately applied, we examined if DoI:

- accurately applied the data in source documents to the PSBs, and
- identified interdependencies between inputs, and the PSBs took account of these interdependencies.

Evidence

DoI engaged a consultant to ensure that the data in source documents supported the data used in the PSBs. The consultant only reviewed material that DoI had developed (such as train and tram driver costs). The consultant's review found that the data used in the PSBs was generally supported by the data found in source documents. The review also raised several deficiencies (such as documenting the source of risk parameters for train driver training). During the audit, we found that DoI satisfactorily addressed most of these issues. We consider that the issues DoI did not address would not have materially affected the final PSBs.

Patronage growth had the most significant influence on the PSBs, because it affected both revenue and cost forecasts. Growth in patronage would result in more services being needed, which would increase both revenue and driver costs. We examined DoI's PSBs, and found that they adequately took account of the additional services that would be required to service any patronage growth. The PSBs also adequately took account of the impact of labour costs (such as from staff turnover and wage rate movements) on fare revenue, infrastructure and rolling stock maintenance costs.

Were the main inputs validated and endorsed?

Criteria

In assessing whether the main PSB inputs were validated and endorsed, we examined if DoI:

- effectively tested the assumptions about PSB risks, and
- effectively used quality assurance processes.

Did DoI effectively test assumptions about PSB risks?

DoI conducted 5 risk review workshops. Two covered labour costs, one on rolling stock, one on infrastructure and one on patronage. The majority of participants in each workshop were DoI staff. We found that the expertise of these staff was sufficient to provide an informed opinion on the matters considered by the workshops.

We examined the records of these workshops. The records were minimal and were not comprehensive. For example, not all risks associated with main PSB inputs were recorded (such as the risks listed in Figure 5D). The records had limited descriptions of the mechanisms by which the risks could occur, and the value assigned to the risks. Only one of the workshop records was signed by the participants. As a result of the deficiencies in DoI's recordkeeping for the risk review workshops, we could not determine whether DoI identified, valued and reviewed all the relevant risks pertaining to the PSBs, before using them in the offer evaluation and negotiation process.

Did DoI effectively use quality assurance processes?

DoI effectively used 2 mechanisms to provide assurance about the robustness of the PSBs.

Interdepartmental committees

As discussed earlier, the Benchmarking and Modelling Committee was established to oversee DoI's development of the PSBs. Some committee members also participated in the risk review workshops.

The Benchmarking and Modelling Committee reviewed the main PSB inputs, and addressed issues raised by 2 consultants (see below) in their regular progress reports to the committee. The Project Oversight and Evaluation Committee¹⁶ endorsed the PSBs, before the offer evaluation and negotiation process began.

External reviews of the PSBs

DoI engaged 2 consultants to review and provide independent assurance about aspects of the PSBs.

One was engaged to review the consistency of the PSBs with Partnerships Victoria guidance, and to review the robustness of the risk analysis underpinning the main inputs of the PSBs. The consultant found that the PSBs were broadly consistent with Partnerships Victoria guidance, and that the approach taken to identifying and valuing risks was appropriate. The consultant's review raised several issues (such as incorporating sign-off mechanisms for each PSB input). We examined these issues and found that DoI satisfactorily addressed them.

Another consultant was engaged to review whether the data in source documents supported the data used in DoI's calculations for the PSBs. The outcomes of this review were discussed previously under the heading *Were the main inputs accurately applied?*

¹⁶ The Project Oversight and Evaluation Committee comprised: the Director of Public Transport, representatives of DoI's Public Transport Division, the Department of Treasury and Finance and the Department of Premier and Cabinet.

5.2.4 Were changes to the benchmarks made in a robust manner?

Criteria

Partnerships Victoria guidance recommends that a public sector comparator (or PSBs in this case) should only be changed if the scope of the arrangements change, or if it becomes apparent that a significant component has been mispriced or omitted (such as where a material and quantifiable risk has not been included but has later been brought to the attention of the procurement team)¹⁷. Changing the PSBs in any other circumstance would reduce confidence in the transparency and certainty of the development process.

In assessing whether changes made to the PSBs were made in a robust manner, we examined if:

- changes were made to correct any errors or to take into account new information
- all changes were adequately documented, and
- all changes were validated and endorsed by relevant parties.

Were changes made to correct errors or to take account of new information?

Appendix B of this report lists the 38 changes that DoI made to the PSBs according to the basis for making the changes. All of these changes were made to correct errors, to take account of new information, and where the scope of the arrangements changed. The changes reduced the total value of the PSBs by almost \$83 million¹⁸ (or about 2 per cent of their total value) over the 2004-2010 forecast period.

We found no evidence that inappropriate changes were made to the PSBs.

Were changes adequately documented?

DoI created and maintained a list of all changes made to the PSBs. The list showed when each change was made, a description of each change and the financial impact of each change. However, the list did not clearly identify which PSB inputs were affected by each change. Documenting the PSB inputs that were affected would have provided greater assurance to the Benchmarking and Modelling Committee that the PSBs were changed in a robust manner.

¹⁷ Department of Treasury and Finance 2001, *Partnerships Victoria - Public Sector Comparator Technical Note*, Department of Treasury and Finance, Melbourne.

¹⁸ This amount is in net present value terms.

Were changes validated and endorsed?

DoI had policies for when changes were to be made, and who was to endorse them. For example, any changes of significant impact on the PSBs were to be endorsed by the Project Oversight and Evaluation Committee and the Benchmarking and Modelling Committee.

We found no evidence that changes made to the PSBs were endorsed by the Project Oversight and Evaluation Committee, the Benchmarking and Modelling Committee or by any other party.

It is likely that the Project Oversight and Evaluation Committee reviewing the changes made to the PSBs effectively represented its endorsement of them. It would have been better had this been documented.

5.3 Were the public sector benchmarks used effectively to evaluate offers and assist in negotiations?

5.3.1 Did DoI negotiate the franchisees' offers effectively?

Criteria

In assessing whether DoI negotiated the franchisees' offers effectively, we examined if it:

- used the PSBs to effectively evaluate various aspects of the franchisees' offers, and
- used the PSBs during negotiations to achieve the best possible outcome for the state.

Did DoI use the PSBs to effectively evaluate offers and to achieve the best possible outcome for the state?

In September 2003, Connex and Yarra Trams lodged initial offers with DoI. Both offers were significantly higher than the PSBs. DoI took the position that the offers should be comparable with the PSBs' estimates for several items (mainly rolling stock maintenance, related party transactions and other miscellaneous costs) before DoI could assess them further.

By October 2003, both franchisees had reduced their offers. This was the result of a better understanding by Connex and Yarra Trams of DoI's requirements, the correction of errors in the offers and changed bidding strategies by the 2 franchisees.

After negotiations and clarifications, the franchisees' final offers were accepted in December 2003 (for trams) and February 2004 (for trains). DoI negotiated both Connex's and Yarra Trams' final offers to within about 3 per cent of the respective PSBs¹⁹.

The final offers included one-off transitional costs (including staff redundancy payments for about 230 staff), mainly resulting from all tram and train operations being brought together. They also included an expected deterioration in performance due to driver shortages. Connex forecast doubled train cancellations and an 11 per cent increase in late trains in the first 2 years of the new franchise agreements. Connex also forecast having to pay \$6 million in penalty payments in 2004-05. Penalties above this forecast would be at the franchisee's expense.

In summary, any evaluation of offers would have involved an element of uncertainty because the PSBs were, at best, an estimate (although one based on extensive research by highly-experienced and qualified personnel). Despite this inherent uncertainty, the relatively small gap between the franchisees final offers and the PSBs demonstrates that DoI used the PSBs effectively to evaluate and negotiate the franchisees' offers.

5.3.2 Did DoI review the accuracy of forecasts made by the franchisees in their offers?

Background

As indicated in Part 2 of this report, the main factors that impacted on the original franchisees between 1999 and 2002 were unrealistic forecasting of passenger and revenue growth, and, to a lesser extent, unrealistic forecasting of operating costs²⁰.

DoI advised that the original franchises were based on unrealistic forecasts due to:

- the competitive nature of the bidding process, which resulted in "deal fever"²¹ among the bidders
- favourable circumstances in the UK rail industry at the time, and
- a failure to adequately consider conditions unique to Victoria (such as high levels of car use and urban sprawl).

¹⁹ Derived from the train and tram franchisee offers.

²⁰ The franchisees forecasts of operating costs were also affected by unplanned costs such as the costs related to the ticketing system.

²¹ Department of Infrastructure 2005, *Public transport partnerships: an overview of passenger rail franchising in Victoria*.

When the offers for the 1999 franchises were submitted, the government did not seek to establish whether the revenue forecasts were realistic²². Bidders' patronage growth forecasts were used only to rank bidders according to the extent to which they could provide "substantial and sustained patronage growth"²³.

Given the significant impact of the unrealistic revenue forecasts on franchisees' viability, it was important that this problem was approached more rigorously this time around by DoI (at least) assessing the accuracy of the revenue forecasts prepared by the franchisees in their offers for the 2004 franchise agreements. DoI also needed to examine whether the franchisees' offers were financially sustainable.

Criteria

In assessing whether DoI reviewed the accuracy of forecasts made by the franchisees in their offers for the 2004 franchise agreements, we examined if it assessed whether:

- the franchisees' revenue forecasts were realistic, and
- the franchisees' offers were financially sustainable.

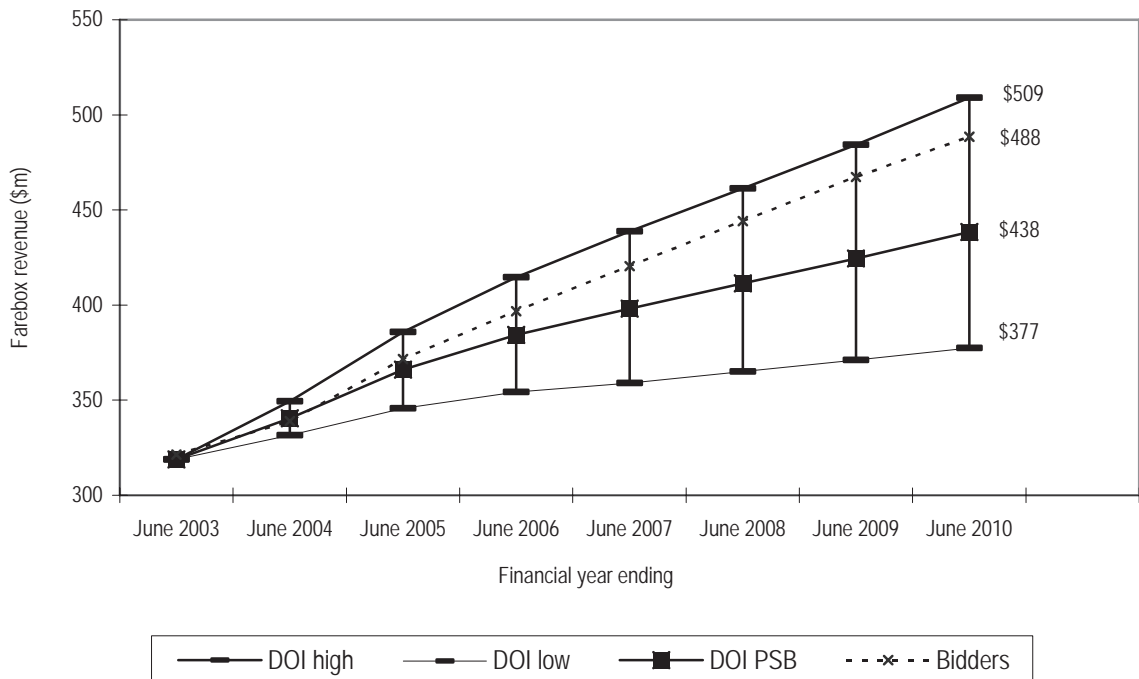
Were the franchisees revenue forecasts realistic?

DoI used analysis by a consultant, and its own historical information about fare revenue trends, to forecast a total fare revenue range for each year of the franchise period. It then made a most likely revenue estimate for each year, and applied this in the PSBs. DoI also compared its forecasts with the franchisees' forecasts of total train and tram fares. Figure 5E shows the comparison.

²² Department of Infrastructure 1999, *Comparative bid evaluation report*.

²³ *Ibid.*

FIGURE 5E: FORECAST TOTAL TRAIN AND TRAM FARES, 2003-2010 (\$MILLION PER YEAR)



Note: The range shows the lowest point (worst-case scenario) and the highest point (best-case scenario) for forecast fare revenue for each point in time. The range was based on a 5 per cent probability that the total fares would be higher than the highest forecast for each points, or lower than the lowest forecasts.

The forecasts use nominal figures.

Source: Information provided by Department of Infrastructure and franchisee offers.

Figure 5E shows that franchisees’ forecasts are close to DoI’s most likely estimates to June 2005. After June 2005, the franchisees’ forecasts move towards the upper end of the DoI range. In the final year, the franchisees’ forecast is about 11 per cent (or \$50 million) more than the PSB figure.

The franchisees projected annual real growth in revenue of 2.7 per cent for 2003-2010. This compares with annual real growth of 1.3 per cent for DoI’s PSB forecast over the same period. While the franchisees’ rate of growth is double that of DoI’s, this can be explained by the franchisees (and not DoI) accounting for:

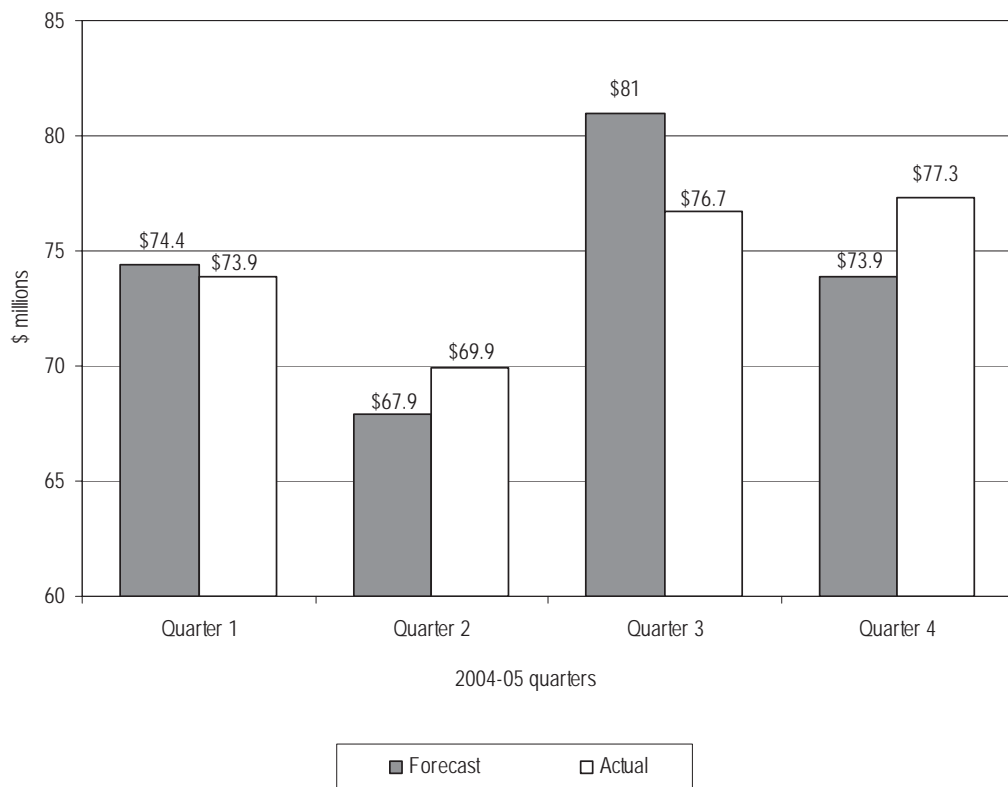
- additional MetLink promotional activities
- bus system improvements later in the franchise term, and
- reductions in fare evasion.

Such activities have in the past resulted in growth in total fare revenue. While the franchisees’ forecasts are towards the upper end of the DoI range, they are in line with the real rate of fare revenue growth over the last decade (3 per cent since 1994 and 3.8 per cent since 1999).

As a further way to test the realism of the franchisees' passenger and revenue growth projections, we looked at how their forecasts for fare revenue compared with the actual fare revenue generated, since April 2004.

Since the new franchise agreements were signed, DoI has produced 4 quarters of data, covering the first year of the current agreement. As Figure 5F shows, franchisees' revenue forecasts are close to revenue performance to date²⁴.

FIGURE 5F: TRAIN AND TRAM FRANCHISEE FORECASTS AND ACTUAL FARE REVENUE, 2004-05 (\$MILLION PER QUARTER)



Note: Amounts are in net present value terms.

Source: Information provided by Department of Infrastructure and the franchisees.

Overall, the franchisees revenue forecasts were reasonable.

Were the franchisees offers financially sustainable?

DoI conducted an analysis of the sustainability of the franchisees²⁵. It did so by using the PSBs' revenue and cost estimates and risk allocations, and assessed the probability of each franchisee making a profit or having negative cash flows. Figure 5G summarises its findings.

²⁴ The actual fare revenue is indicative and subject to audit.

²⁵ This analysis is contained in the *Passenger Rail Franchising in Victoria, Financial Advisory Team* reports completed for the train and tram offers.

FIGURE 5G: DOI ANALYSIS OF FRANCHISEE FINANCIAL SUSTAINABILITY

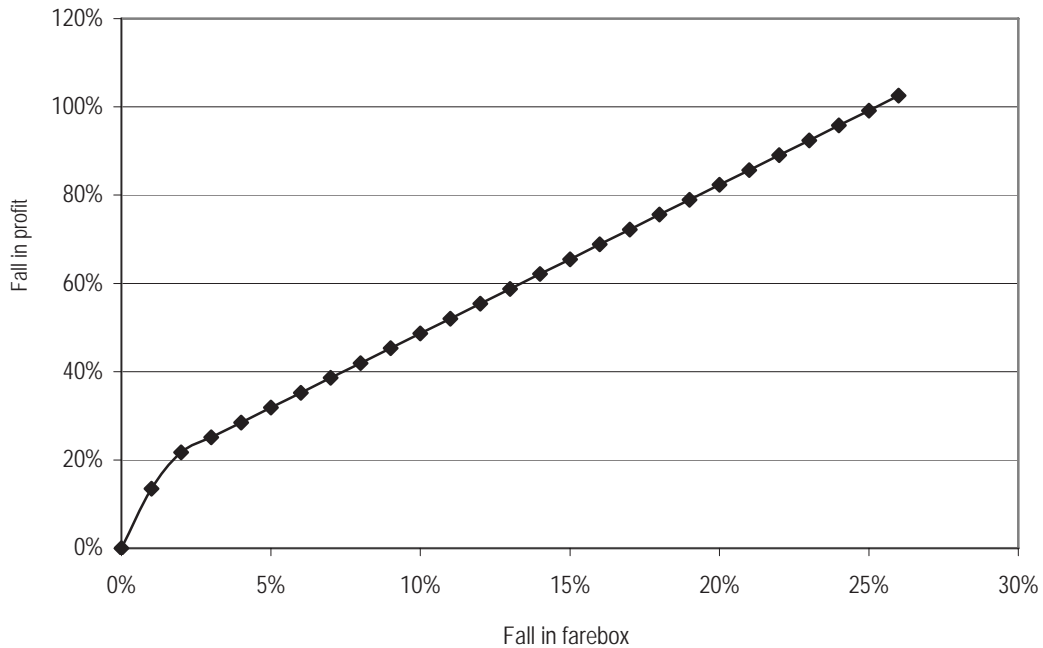
Bidder	Year	Finding
Connex	2004-05	Ninety per cent probability of a profit margin between 3.5 per cent and 9 per cent. No chance of negative cash flow.
	2009-10	Ninety per cent probability of a profit margin between 1.9 per cent and 10.6 per cent. No chance of negative cash flow.
Yarra Trams	2004-05	Ninety per cent probability of a profit margin between 3.4 per cent and 8.7 per cent. No chance of negative cash flow.
	2009-10	Ninety per cent probability of a profit margin between 1.5 per cent and 10.5 per cent. One point one per cent chance of negative cash flow.

Source: Information provided by Department of Infrastructure and franchisees offers.

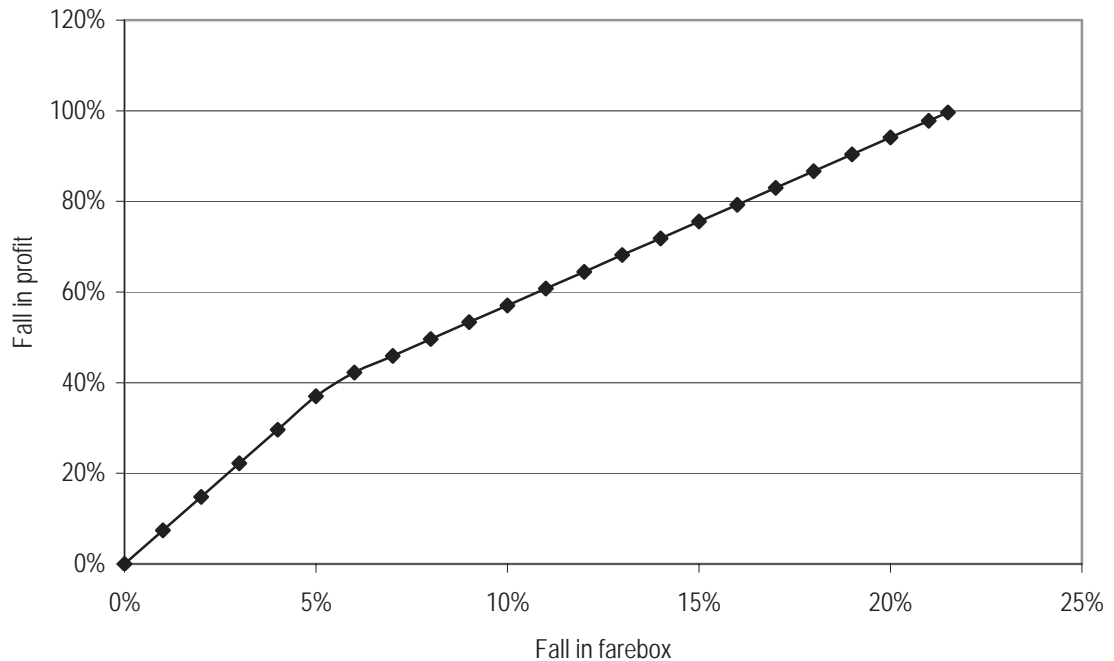
We analysed the sustainability of the franchisees’ offers by assessing whether their profits could withstand the impact of unrealistic fare forecasts.

Figures 5H and 5I show the projected impact on franchisees’ profits of a fall in fare revenue in 2004-05.

FIGURE 5H: TRAM FARE REVENUE IMPACTS ON PROFIT, 2004-05



Source: Victorian Auditor-General’s Office.

FIGURE 5I: TRAIN FARE REVENUE IMPACTS ON PROFIT, 2004-05

Source: Victorian Auditor-General's Office.

A 10 per cent fall in total fare revenue would eliminate about half of each franchisee's expected profit. A fall of this magnitude has not happened in the past decade. Rather, total fare revenues have seen an average annual real increase of 3 per cent.

We also compared forecast profits using the franchisees' fare revenue forecasts with forecast profits using DoI's worst-case scenario for total fare revenue. When DoI's forecast was used, the present value of profit for the 7 years (2003-04 to 2010-11) falls by 66 per cent for trains, and 58 per cent for trams (compared with profits based on franchisee forecasts). In other words, even if the worst-case scenario eventuated, franchisees would still be profitable.

In summary, the franchisees' revenue forecasts were reasonable and consistent with past trends in fare growth. DoI's best estimate of total fare revenue may turn out to be slightly conservative in light of the assumptions used in the PSBs, and of compound fare growth over the past decade. However, given the scale of falls in revenue needed before the franchisees' profits are threatened, we believe that there is no material risk that franchisees' profits will be eliminated under the current agreements.

5.4 Overall conclusion and recommendation

The PSBs were an effective tool in helping the government become an informed purchaser during the renegotiation of the rail franchises. The PSBs were developed in a robust manner, according to good practice, and were effectively used to negotiate the franchisee's offers. The franchisees' forecasts were reasonable and consistent with past trends, and their overall offers were financially sustainable.

However, DoI's recordkeeping of the PSB development process was deficient in 2 ways. DoI did not adequately document the outcomes of the risk review workshops conducted, and did not document whether changes made to the PSBs during the offer evaluation and negotiation process were endorsed or not. To ensure high levels of accountability are maintained in future procurement exercises, DoI should address these deficiencies in its recordkeeping.

Recommendation

4. **That DoI, when conducting future financial benchmarking exercises, ensure that it can demonstrate that:**
 - **all relevant risks have been identified, valued and reviewed, and**
 - **changes made to the financial benchmarks have been validated and endorsed.**
-



6. Did DoI effectively
use other
negotiation
strategies?



6.1 Background

In April 2003, the government decided that, as a first step, DoI should negotiate with the interim operators (Connex and Yarra Trams) about continuing to operate Melbourne's train and tram services. This decision was explained in Part 3 of this report.

The government's decision effectively meant that DoI sought to procure train and tram services by negotiating with the operators, rather than through a competitive tender process. Competitive tendering is common practice for procurements of this value, recognising that competition among a number of bidders usually results in the best deal. This is because competitive processes draw out the latest technologies and experiences, and enable the government to identify what is possible for the least cost.

However, if full competitive tendering is not possible, if it involves significant risks, or if it is not the government's preferred option for other reasons, the government must use other mechanisms to protect the taxpayer.

The main way that DoI evaluated the franchisees' offers was using the 2 PSBs. These were examined in Part 5 of this report.

6.2 Did DoI effectively use its other negotiation strategies?

In assessing whether DoI had adequate alternative strategies, we examined the strategies (other than the PSBs) that it had developed and used to influence the environment within which negotiations were taking place, and to assess franchisees' offers. There were 8 of these strategies, as shown in Figure 6A.

FIGURE 6A: STRATEGIES DOI USED TO ASSESS FRANCHISEES' OFFERS

Strategy	Strategy used?
Competitive tension: DoI took steps to maintain competitive tension throughout the negotiation process.	A
Excessive profit sharing: DoI required franchisees to share profits above specified levels.	A
End-of-term arrangements: DoI included in the franchise agreements clear arrangements for the return of assets at the end of the contract period (or on earlier termination) in an agreed condition.	A
Franchisees forecast profits: DoI identified a reasonable profit margin for franchisees, taking into account the industry, risk allocation and sustainability, and used this to evaluate offers.	B
Forecast profits for other entities within the franchisees structure and review of parent entity performance: DoI identified reasonable profit margins for other entities within the franchisees structure, taking into account the industry, risk allocation and sustainability, and used this to evaluate offers. The performance of the franchisees parent entities was reviewed as part of evaluating offers.	B
Open book examination before receiving offers: DoI examined franchisee's records to understand actual and projected revenues and costs, and used this understanding to evaluate offers.	B
Savings: DoI identified potential savings from merging networks and reallocating costs and risks.	B
Dummy offer: DoI prepared a comprehensive offer in a private sector frame of mind, and compared the franchisees offers with it.	B

Note: A – The strategy was effective. B – The strategy was partially effective.

Source: Victorian Auditor-General's Office.

An assessment of the strategies adopted is detailed below.

6.2.1 Competitive tension

The development of the PSBs as proxy tenders for the franchises was an important component in DoI's strategy to replicate competitive tension. We consider that this made DoI a more informed purchaser.

DoI conducted the renegotiation process in a way that would have allowed for an open tender should negotiations have failed. For example, it established a data room and provided comprehensive documentation that would also facilitate an open tender arrangement, if necessary.

6.2.2 Excessive profit sharing

Government franchises often include the requirement that the franchisee share its profits above a specified level with the state. Profit-sharing arrangements are more important if a franchise has not been competitively tendered: they provide government with a safety mechanism against a franchise reaping windfall profits because of overly conservative revenue forecasts.

The 2004 franchise agreements required franchisees to share with the state any profits of more than 125 per cent of forecast-adjusted EBITDA. The profit-sharing arrangement is underpinned by contractual provisions including regular reporting, mandated accounting policies (in particular capitalisation policies) and the validation of related-party transactions supported by the right of audit or inspection.

The arrangements to share excessive profits are sound and are adequately supported by contractual provisions.

6.2.3 End-of-term arrangements

Long-term contracts need to include clear arrangements for the return of assets to the state when the contract ends, so that the state is able to consider the full range of options for the continuation of services. This applies whether contracts run their term, or are terminated.

The 2004 franchise agreements contained such arrangements. The main one being the requirement that franchisees ensure that assets, supplier/maintenance contracts, and employee terms and conditions are maintained in an agreed condition, in order to allow continuity of service. Further, within one year of the current agreements expiring, franchisees cannot alter the terms of employment of staff, dispose of any assets or alter key supply or maintenance contracts without the state's agreement.

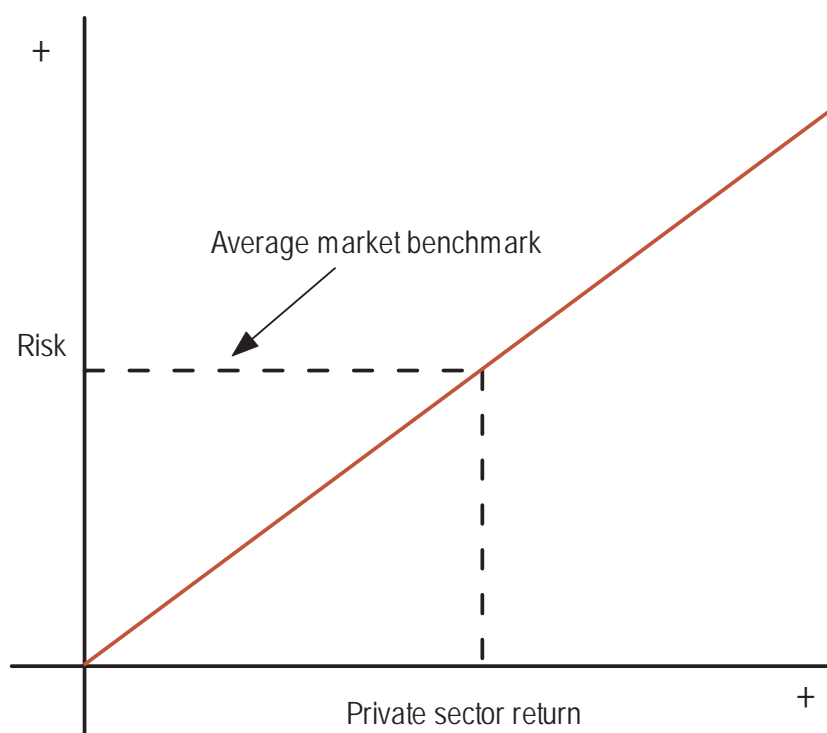
There are adequate contractual provisions to facilitate an alternative service provision model at the end of the contract period or on termination.

6.2.4 Franchisees' forecast profits

The state, as well as the franchisees, has an interest in the franchisees' returns, and their profits. Very low returns could affect a franchisee's performance and sustainability. Very high returns could call into doubt the value-for-money received by the state. Ideally, returns (as well as covering costs and returning a profit) should adequately compensate the franchisee for taking on risks, provide a buffer against future revenue and cost shocks, and reflect national and international industry returns. Returns, however, do not need to fund the upgrading and replacement of infrastructure: the state owns the infrastructure.

Figure 6B shows the relationship between risk and returns¹. The more risk the private sector assumes, the higher the expected returns to it.

¹ Department of Treasury and Finance 2003, *Partnerships Victoria Guidance Material – Use of Discount Rates in the Partnerships Victoria process*, Department of Treasury and Finance, Melbourne.

FIGURE 6B: RELATIONSHIP BETWEEN RISK AND RETURN

Source: Based on Partnerships Victoria guidance.

In October 2003, DoI sought external advice about the margins that the franchisees would be likely to want, to accept the risks outlined in the proposed 2004 franchise agreements. The advisers compared the proposed risk allocation with comparable public transport systems around the world, and compared the franchisees' target and historical profit margins. They found that the UK franchise structure was the most comparable with the Victorian franchise structure, and used the likely new UK franchise arrangements (which were also being changed and retendered) in developing their advice.

Based on the risk profiles and historical profit margin trends of UK franchises, and the risk capital invested, the advisers concluded that an acceptable profit margin range would be between 6-9 per cent of EBITDA, as a percentage of operating expenses less rolling stock lease payments². As it turned out, the projected profit margins in the franchisees offers were at the lower end of this range.

² Rolling stock lease payments flow in and out of the franchise to the new rolling stock lease companies and so have no impact on the franchisees operations. They are, therefore, excluded from total franchisee expenditure.

However, we found some significant differences between the final franchise agreements in Victoria and in the United Kingdom, which would affect franchisees' profit margins. There are differences in the timing of revenue shortfall guarantees and thresholds, the length of franchise terms, level of guarantees provided for employee entitlements, rolling stock maintenance responsibilities and insurance responsibilities. Further, the advisers' comparisons did not comment on the geographical and demographical differences between the 2 jurisdictions, which could also affect allocations of risk and franchisees' profit margins.

DoI's advisers report acknowledged such differences, and concluded that DoI should conduct a further study to determine exactly where in the 6-9 per cent range the franchisees' profit margins should ideally lie. DoI did not do so because the forecast profit margins in both franchisees' offers were at the bottom end of the range.

DoI's modelling indicated that there was no risk of negative cash flow in 2004-05 for either the consolidated train or tram franchisee; and no risk of negative cash flow in 2009-10 for the train franchisee and only a 1.1 per cent risk for the tram franchisee. This was a very high level of protection against negative cash flows. Further, the franchisees have some scope to improve profitability by increasing revenues, cutting costs and improving productivity beyond their forecasts.

DoI identified significant differences between the UK and Victorian franchise agreements, which were not evaluated by DoI. However, DoI's analysis of the franchisees' forecast profit margins was adequate.

6.2.5 Forecast profits for other entities within the franchisees structures and review of parent entity performance

Although we have referred to Connex and Yarra Trams as the 2004 franchisees throughout this report, in fact both franchisees have structures comprising a number of wholly-owned and partly-owned entities. Estimates of returns under the franchise agreements need to include returns to these entities, which also benefit from the agreements. Each of these entities requires a profit margin, which adds to the overall cost of operating the franchise.

The forecast profit margins of all entities within the franchisees structure were within the acceptable range of 6-9 per cent, as determined by DoI. However, the risks accruing to entities within Connex's franchise entity structure were not quantified and evaluated against the overall forecast margin. DoI accepted that the overall margin generated by the franchisee fell within the acceptable range.

We consider that DoI's analysis of forecast profits for entities within the franchisees structures was adequate.

6.2.6 Open book examinations before receiving offers

An "open book" examination is essentially a health check conducted by the state on the financial affairs of a private sector operator. Under the 1999 franchise agreements, the state had no power to conduct "open book" examinations. In 2002, with the agreement of the then franchisees, DoI appointed external advisers to review franchisees' business plans. The advisers examined the original 1999 offers, the franchisees' accounts and their financial forecasts for 2002, 2003 and 2004. The review was not an audit, and the information that franchisees provided to the external advisers was not independently verified. However, the review did provide insights into the key revenue items and costs of each franchisee.

In the 2004 franchise agreements, the state has the power to conduct "open book" examinations. While DoI did not conduct an "open book" examination of the franchisees' records before receiving their offers, it did, via the government-appointed receiver and manager, have detailed knowledge of the operations of M>Train, M>Tram and V/Line Passenger. DoI also asked the interim operators for specific information, such as fine detail about line items in their offers.

DoI adequately validated the franchisees' historical and forecast costs.

6.2.7 Savings

DoI estimated the potential savings that would result from merging the metropolitan train and tram networks. It concluded that such a merger would result only in minimal corporate overhead savings. DoI required Connex and Yarra Trams to identify these potential cost savings in their offers.

DoI and the franchisees identified some costs (such as insurance and funding of MetLink) that were to return to the state under the 2004 franchise agreements. Both the PSBs and the franchisees' offers were adjusted for these costs.

In the 2004 franchise agreements, some of the 1999 risks returned to the state. Franchisees' 2004 offers did not, therefore, need to account for these risks, or include the cost of accepting them. However, in light of the significant losses made by the 1999 franchisees, DoI did not comprehensively quantify all risks retained by the state, and reduce the franchisee payment accordingly (this is discussed further in Part 4 of this report). Instead, DoI examined franchisees' profit margins (including their risk profiles) to determine if their forecast profit margins were commensurate with the risks they were accepting.

DoI adequately assessed potential savings arising from a merger, and potential savings from the reallocation of risks.

6.2.8 Dummy offer

Agencies sometimes develop a dummy (or shadow) offer to understand the strategies that the private supplier will use to develop their offers, and their negotiating strategies. A dummy offer can also be used to benchmark offers received.

DoI prepared a dummy offer for the metropolitan train franchise to test the assumptions on which the PSB was based, and to better understand the franchisee's negotiating tactics. It did not use the dummy offer to directly assess the franchisee's offer, and it was not meant to be a comprehensive strategy to reduce the franchisee's offers. For example, DoI prepared the dummy offer in just 2 weeks, and based it on information from the government-appointed receiver and manager, previous consultants' work and interviews with the franchisee's staff. The dummy offer estimated the total annual expenses for a private sector train operator to be about 2 per cent higher than did the PSB.

DoI did not prepare a dummy offer for the metropolitan tram franchise.

While the dummy offer provided DoI with some useful insights into possible franchisee tactics, it was not comprehensively developed and used.

6.3 Conclusion

On the whole, DoI had adequate strategies (other than the PSBs) to influence the environment within which negotiations were taking place, and to assess franchisees offers. We found that some were effective, and some were not. Throughout the renegotiation process, DoI simulated, as best as it could, the competitive pressures of an open tender process. DoI also used the renegotiation process to establish arrangements whereby the government shares excessive profits made by the franchisees. However, there were deficiencies in the development and use of several strategies, such as the dummy offers.



Connex operates Melbourne's train services.



7. Did DoI observe probity requirements?



7.1 Background

To ensure that all public sector agencies conduct all their commercial transactions with probity, the Victorian Government Purchasing Board (VGPB) has produced 2 documents: *Probity Best Practice Advice* and *Probity Policy*. All government agencies must adhere to the policy for commercial transactions. Figure 7A shows the policy's main requirements.

FIGURE 7A: VICTORIAN GOVERNMENT PURCHASING BOARD PROBITY REQUIREMENTS

	Requirement	Description
1	Fairness and impartiality	Potential suppliers are treated equally and must have the same opportunity to access information and advice.
2	Use of a competitive process	A competitive process should be used at all times.
3	Consistent and transparent process	Tenderers are evaluated in a systematic manner against explicit predetermined evaluation criteria.
4	Security and confidentiality	The processes used to receive and manage supplier information ensure the security and confidentiality of intellectual property and proprietary information.
5	Identification and resolution of conflicts of interest	Any person involved in the tender process is to declare and address any actual or perceived conflict of interest before undertaking any quote or tender evaluation.
6	Development of a probity plan	Departments intending to let a tender worth more than \$10 million are to develop a probity plan before the tender process starts.

Source: VGPB probity policy.

7.2 Was DoI's probity plan adequate?

7.2.1 Criteria

The VGPB *Probity Policy* requires public sector agencies to have a probity plan for all transactions valued in excess of \$10 million. Figure 7B shows the VGPB's minimum requirements for a plan.

FIGURE 7B: MINIMUM REQUIREMENTS FOR A PROBITY PLAN

Requirement	Description of requirement
1 Description of the project	The project is described.
2 Probity principles	The probity principles are identified and described.
3 Decision-making process	The decision-making process is mapped.
4 Probity tasks and steps	There is a step-by-step overview of tasks to be completed.
5 Conflict of interest	A process for managing conflict of interest is described.
6 Confidentiality	A process for managing confidentiality is described.
7 Security of information	A process for securing information is described.
8 Data room (optional)	The use of a data room is described (optional).
9 Proprietary information	A process for managing proprietary information is described (optional).
10 Communication with franchisees	A process for communicating with franchisees is described.
11 Staff guidelines	There are guidelines for managing relationship with tenderers.
12 Record keeping	The development of a database for recording core documents is described.

Source: VGPB probity plan template.

To assess whether DoI's probity plan was adequate, we examined if the plan:

- met the VGPB's requirements, and
- was reviewed by the probity auditor appointed by DoI. (The VGPB's *Probity Best Practice Advice* indicates that a key task of a probity auditor is to review the probity plan for soundness.)

7.2.2 Did DoI's probity plan meet VGPB requirements?

By May 2003, DoI had developed a probity plan. The plan's objectives were consistent with those of the VGPB's *Probity Policy*. The plan specified how negotiations with the interim operators (previously the franchisees) would be conducted with probity. It also aimed to ensure that the renegotiation process would not adversely affect any subsequent retendering, if negotiations with the interim operators failed.

In all, DoI prepared a probity plan and 8 other probity documents (as a package) over 5 months, to guide the probity process. The other probity documents were the *Tender Procedures and Practices Manual*¹, a communications plan, a data room guide, an evaluation framework, 2 requests for proposals (for train and tram franchises) and 2 PSBs (for train and tram service). We used this package of documents to assess whether DoI met the VGPB's minimum requirements for a probity plan.

¹ The probity plan noted that the *Tender Procedures and Practices Manual* should be read in conjunction with the plan.

The probity plan was substantially aligned with the VGPB's minimum requirements: it met 10 of the 12 requirements. The 2 areas where it did not meet the VGPB's requirements were:

- it did not include all the information required by the template about conflicts of interest, although the probity plan described a process for managing conflicts of interest, and
- it did not include a step-by-step overview of tasks to be completed. However, it required DoI to maintain records to enable independent review and audit, and to document departures from the tasks and steps.

7.2.3 Was DoI's probity plan reviewed by the probity auditor?

In accordance with the VGPB's requirements, we expected that the probity auditor appointed by DoI would have reviewed the 9 probity documents that DoI and the interim operators used during negotiations.

The probity auditor reviewed and formally approved (by signing-off) the probity plan and the evaluation plan, but did not formally approve (by signing-off) the other 7 probity documents. During the audit, the probity auditor stated that he found the other 7 documents suitable for probity purposes. It would have been prudent, nonetheless, for the probity auditor to have formally approved all probity documents during the renegotiation process.

7.3 Did DoI effectively implement its probity plan?

7.3.1 Criteria

In assessing whether DoI effectively implemented its probity plan, we examined if:

- DoI appointed a probity auditor
- the probity auditor provided assurance that the franchise renegotiations had been conducted with probity, and
- DoI satisfactorily implemented its probity plan.

7.3.2 Did DoI appoint a probity auditor?

DoI appointed an independent probity advisor to the Franchise Review Task Force in May 2002, contracting him for an initial period of 6 months, and then extending the contract twice, until April 2004.

Upon appointment, the probity auditor's role was to provide DoI with an "initial assessment of likely probity requirements of the franchise review

process". During the contract period, the probity auditor's role changed from one of adviser, to a probity auditor providing DoI with "independent assurance about the conduct of the refranchising process"². When the role changed, DoI did not record its assessment of the suitability of the current probity auditor to act in the renegotiation process. DoI did not reflect this change in the probity auditor's statement of duties. The only statement of duties DoI provided to the probity auditor was in the original request for proposal issued by the task force to the probity auditor, although DoI did provide some general guidance about the duties in the probity plan.

Advising on the probity requirements for the franchise review process is significantly different from providing independent assurance about the probity of the process. As a consequence, DoI should have assured itself that the probity auditor could meet the new requirements. DoI should also have developed a detailed statement of duties for the new role, and noted the duties in a variation to the contract.

7.3.3 Did the probity auditor provide assurance that the franchise renegotiations were conducted with probity?

Attendance at meetings

As noted above, the probity auditor was required to provide DoI with "independent assurance about the conduct of the refranchising process". To provide this assurance, DoI's probity plan required the probity auditor to attend:

- all meetings of the Project Oversight and Evaluation Committee (POEC)
- all meetings of the transaction teams where the evaluation of offers was discussed, and
- other transaction team meetings as necessary.

Between May 2003 and February 2004, 33 POEC meetings were held. Of these, the probity auditor attended 4, all of which were between November 2003 and February 2004. DoI told us that, as the negotiations progressed, it decided the probity auditor would only attend meetings that were relevant to probity, as an explanation for why the probity auditor did not attend all meetings. DoI also told us that it used meeting agendas to determine which meetings were relevant for the probity auditor to attend.

Of the 33 POEC meetings:

- probity was on the agenda for discussion at 6 meetings between May 2003 and July 2003

² Department of Infrastructure 2003, *Probity Plan*.

- the data room was on the agenda for discussion at 6 meetings between August 2003 and October 2003
- the 9 probity documents were on the agenda for discussion at 3 meetings between July 2003 and August 2003, and
- the evaluation of offers from Connex and Yarra Trams were discussed at meetings in November 2003 and December 2003, respectively.

According to DoI's own criteria, it should have asked the probity auditor to attend a much larger number of the 33 meetings of the POEC. The fact that the probity auditor attended only 4 POEC meetings and no transaction team meetings leaves open the question of whether he was in a position to provide adequate assurance that the renegotiation process was conducted with probity.

Final audit report

The probity plan required the probity auditor to provide DoI, at the end of the franchise renegotiations, with a formal audit report indicating whether (and the extent to which) the requirements of the probity plan and DoI's probity objectives had been met during the whole franchise renegotiations.

The probity auditor did not provide such a formal audit report. DoI told us that it accepted an evaluation report prepared by the probity auditor, and provided as an appendix to the offer evaluation report, as the sign-off of the whole renegotiation process. The evaluation report did not address whether, or the extent to which, DoI had met the requirements and objectives of the probity plan. During the audit, the probity auditor advised that he considered the evaluation report addressed the requirements and objectives of the probity plan. However, we do not consider the evaluation report an adequate sign-off of the process.

7.3.4 Did DoI satisfactorily implement the probity plan?

Using DoI's 9 probity documents, we identified the core processes that DoI needed to implement to ensure that it maintained appropriate standards of probity. These processes can be broadly described as those for the tender procedures and practices, maintaining confidentiality, communications and the security of, and access to, franchisees' documents. These are discussed below. Managing conflicts of interest, which is also a core probity requirement, is discussed separately at section 7.4 of this report.

Tender Procedures and Practices Manual

The *Tender Procedures and Practices Manual* was referred to at length in DoI's probity plan. It was intended to set out detailed rules and guidelines about (among other things) handling documents and confidential information, managing conflicts of interest and the conduct of meetings with franchisees.

The manual was not completed. DoI told us that it had been subsumed into the other probity documents. We examined the other 8 probity documents to see if they contained the detailed rules and guidelines that were meant to be in the manual. Of all 9 documents, only the communications plan included detailed guidance to staff. This guidance covered communicating with franchisees, and communications between the incumbent franchisees and the franchisees in receivership. None of the other probity documents provided guidance about issues in the probity plan, including maintaining confidentiality and managing conflicts of interest. During the audit, the probity auditor advised that it was not necessary for the other probity documents to include detailed rules and guidance. It would have been good practice to ensure that the necessary detailed rules and guidelines were in place. The decision as to where these should have been placed was DoI's. Our concern is that they were not developed.

Confidentiality agreements

To maintain the confidentiality of the renegotiation process, DoI required all parties to the process to sign confidentiality agreements. This included all of DoI's renegotiation staff (regardless of their role and access to documents) and staff of the franchisees.

Of an estimated 215 DoI renegotiation staff, 184 signed confidentiality agreements, as did representatives of both Connex and Yarra Trams. However, the 31 that did not sign confidentiality agreements included 12 staff authorised to communicate with the franchisees, and 19 other staff. DoI told us that these staff did not sign agreements because they did not need to access offer documents. It would have been prudent, at the minimum, for these staff authorised to communicate with the franchisees to sign the agreements.

Communication plan requirements

The probity and communication plans required that DoI:

- establish a group of people authorised to communicate with franchisees
- write to all renegotiation staff telling them of the importance of communication protocols, with a copy of the communication plan, and
- verbally brief all renegotiation staff about the communication plan.

DoI established a group of authorised people, and advised all relevant staff about any changes to the group (authorised people included DoI staff and advisers).

DoI sent copies of the communication plan to the franchisees, Revenue Clearing House, MetLink and the Melbourne Passenger Growth Initiative (companies involved in distributing revenue and promoting public transport). We found no evidence that DoI wrote to the renegotiation process staff about the importance of the communication plan. A memo to staff from the Director of Public Transport in June 2003 identified communication as an issue, but not in a way that satisfied the requirements of the communication plan. As required by the plan, the Director of Public Transport made a presentation to renegotiation staff on probity, which included a discussion of the communications plan.

Security of franchisees' documents

Data rooms help to ensure a major procurement process is fair and impartial by providing restricted but fair access to the franchisees' documents, which are held in a secure environment.

DoI established 3 data rooms to securely store franchisees' documents. DoI produced a *Data Room Guide*, which detailed the rules and guidelines for accessing the data rooms and documents. A consultant managed 2 of the data rooms, and DoI managed the third.

To ensure fairness and impartiality, we expected that the probity auditor would have assured himself that all parties adhered to the rules and guidelines in the data room guide.

The probity auditor checked the 2 data rooms managed by the consultant. He did not physically check the data room managed by DoI, relying instead on verbal reports by the data room manager, and by the Deputy Director of Public Transport, about access to the room.

Conclusion

Responsibility for implementing the probity plan lay with DoI. While DoI started to implement the probity plan, it did not satisfactorily complete the process. This means that DoI could not provide complete assurance that it maintained appropriate standards of probity during the renegotiation process.



The X'Trapolis train operated by Connex.

7.4 Did DoI adequately manage potential conflicts of interest?

Managing potential conflicts of interest is a core aspect of probity. In many instances conflicts are unavoidable and, therefore, public sector agencies must have processes to manage conflicts in a transparent and accountable manner.

7.4.1 Criteria

In assessing whether DoI's conflicts of interest processes were adequate, we examined if DoI:

- identified the conflicts of interest risks (including at-risk functions and positions) relevant to the franchise renegotiations
- defined and explained conflicts of interest to staff
- established and used procedures to identify and resolve conflicts of interest, and
- maintained a conflicts of interest register³.

³ These criteria are derived from New South Wales Independent Commission Against Corruption and Queensland Crime and Misconduct Commission 2004, *Managing Conflicts of Interest in the Public Sector*, Sydney. The VGPB's *Probity Best Practice Advice* does not cover conflicts of interest processes.

7.4.2 Did DoI identify conflicts of interest risks?

DoI did not conduct a risk analysis of the possible conflicts of interest that renegotiation process staff might experience, or that the process might generate, including the identification of at-risk functions and positions.

7.4.3 Did DoI define and explain conflicts of interest to staff?

To accurately identify a potential conflict of interest, a person must clearly understand what the term means. The probity plan broadly defined conflict of interest, and required staff to report perceived or real conflicts. However, it did not explain or scope the concept or the different types of conflict (such as actual, apparent, perceived and potential).

The conflict of interest declaration provided staff with some guidance about conflicts (with 4 circumstances that might constitute a conflict). We found no evidence that DoI gave staff a more in-depth explanation of conflict of interest.

7.4.4 Did DoI establish and use procedures to identify and resolve conflicts of interest?

As a way of identifying conflicts of interest, DoI required all renegotiation process staff to complete conflicts of interest declarations, and to update their declarations every 6 months. Of an estimated 215 renegotiation staff, 188 signed conflicts of interest declarations; 27 did not. These 27 included 13 staff authorised to communicate with franchisees, and 14 other staff. No staff updated their declarations.

In the event of an identified conflict of interest, the probity plan required the probity auditor to advise the Director of Public Transport, with the director then required to resolve the conflict. We found 2 occasions where a possible conflict of interest existed, but found no evidence that these were brought to the attention of the director.

We also found no evidence of any processes DoI had to:

- assess declarations to determine whether conflicts were actual, apparent, perceived or potential
- establish the impact any declarations may have had on the renegotiation process, and
- resolve a conflict of interest, had the probity auditor advised the Director of Public Transport.

7.4.5 Did DoI maintain a conflicts of interest register?

It is good practice in public sector agencies to maintain a register to record conflicts of interest, and to store all declarations. DoI did not maintain a conflicts of interest register. It kept a register of all declarations completed, but did not separate forms that declared a conflict from those that did not.

7.4.6 Conclusion

DoI did not adequately implement processes to deal with conflicts of interest. Not all staff completed conflict of interest declarations, the Director of Public Transport was not informed of the 2 identified conflicts, and there were no processes to resolve conflicts. The lack of detailed guidance in the VGPB probity policy best practice advice should not prevent agencies from following good practice.

7.5 Overall conclusion and recommendation

We found no evidence that probity had been breached during the franchise renegotiations. However, DoI did not fully and effectively implement its probity plan, particularly concerning conflicts of interest. This increased the risk of probity breaches. We acknowledge the probity auditor's advice about aspects of the probity process. However, DoI must improve its probity processes so that it minimises probity risks in future commercial transactions.

Recommendation

5. That DoI reviews its probity practices so that issues raised in this report are addressed for future significant transactions.

These issues include:

- ensuring probity plans fully meet all of the Victorian Government Purchasing Board's minimum requirements
 - ensuring that probity auditors formally approve all probity documents
 - documenting and communicating all changes to core documents, including probity plans and contracts
 - setting out the specific duties of probity auditors in contracts, and documenting any changes
 - managing contracts better to ensure that processes for appointment of probity auditors are robust, and that probity auditors fulfill the requirements
 - ensuring that formal probity sign-off of processes and documents meets agreed criteria and standards
 - managing conflicts of interest better by developing a conflicts of interest policy, and
 - improving existing processes to ensure that all documents relating to conflicts of interest and confidentiality are accounted for.
-



8. Did DoI build in
adequate
performance
monitoring
arrangements?



8.1 Background

The 2004 franchise agreements between DoI and the 2 franchisees have provisions that enable DoI to monitor the franchisees' performance. For the purposes of this audit, we split these into "performance monitoring arrangements for payments", and "performance monitoring arrangements for key contract items".

Performance monitoring arrangements for payments

"Performance monitoring arrangements for payments" identifies the monitoring that DoI should undertake before it makes a base payment, adjustment, incentive or sharing payments to franchisees. Figure 8A shows the type and frequency of payments in each category.

FIGURE 8A: PAYMENTS BY CATEGORY, TYPE AND FREQUENCY

Payment category	Payment type (frequency of payment)
Base payment	Fixed monthly franchise sum (monthly) Concession top-up (quarterly)
Adjustment	Rolling stock adjustment (monthly) Special event balancing (annual) Employee entitlements (annual) New ticketing revenue guarantee (quarterly) Access charge (on approval) Fare change (quarterly) Excess redundancy (on approval – tram only) Employee transfer (on approval – train only) Games payments (on approval)
Incentive	Operational performance regime (monthly) Service quality Incentive (annual) Service growth incentive (annual)
Sharing	Profit sharing (annual) Revenue risk sharing (annual) Travel time improvement (annual - tram only)

Source: Information provided by Department of Infrastructure.

Performance monitoring arrangements for key contract items

“Performance monitoring arrangements for key contract items” identifies the monitoring that DoI should undertake to ensure that franchisees are performing adequately, in areas that caused difficulties in the original franchises, or are otherwise of high public interest. The arrangements that we examine in this part of the report are:

- **Revenue protection:** In their 1999 offers, the franchisees forecast reductions in the levels of fare evasion. These reductions did not occur. This was partly the result of the poor performance of the ticketing system, as many passengers could not buy tickets because ticketing machines were often out-of-service. All franchisees had separate revenue protection systems and strategies, resulting in ineffective deployment of revenue protection staff, variations in the rates at which they checked tickets and little coordination of revenue protection activities. These factors all contributed to there being more fare evasion than forecast.
- **Financial viability:** The 1999 agreements did not enable DoI to adequately monitor the franchisees’ financial health, and
- **Rolling stock management and maintenance, and infrastructure management and maintenance:** These are of high public interest, because of their expense and importance to safety.

To assess whether the 2004 agreements have adequate performance monitoring arrangements, we investigated in detail 8 payments (shown in Figure 8B) and 4 contract items (shown in Figure 8C).

8.2 Is DoI’s performance monitoring adequate?

8.2.1 Performance related to payments

Criteria

In assessing whether DoI’s performance monitoring (framework and practices) for payments is adequate, we examined if it:

- will assure DoI that the franchisees have fulfilled their obligations in relation to a specific payment, and
- includes audit controls that will assure DoI that they are making payments on the basis of reliable and accurate performance information.

Evidence

Figure 8B records our opinion about whether DoI's actual performance monitoring arrangement met the arrangement that we would have expected for each type of payment. We found that DoI met our criteria for each payment. DoI's performance monitoring arrangements for payments are detailed further in Appendix C, Figure C1 of this report.

FIGURE 8B: PERFORMANCE MONITORING FOR PAYMENTS

Payments	Expected performance monitoring arrangement	Meets audit criteria
Rolling stock adjustment	Evidence that DoI's Public Transport Division (PTD) has received acceptance certificates for new rolling stock entering service.	Yes
	Evidence that PTD has received safety sign-offs for new rolling stock.	Yes
	Evidence that franchisees have used reasonable efforts to meet specified delivery dates for new rolling stock.	Yes
	Evidence that new rolling stock is in regular service.	Yes
Special event balancing	A process to monitor franchisees' compliance with its obligations to prepare: indicative and detailed plans for servicing special events; and debrief reports.	Yes
	A process to review franchisees' debrief reports and use insights gained for future planning purposes.	Yes
	A process to verify claims made by franchisees for any special event balancing payments.	Yes
	A checklist showing that special event provisions have been addressed (tram only).	Yes
Fixed monthly franchise sums	A process to ensure that franchisees' master and daily timetables are consistent with passenger service requirement (PSR) specifications.	Yes
	A process to monitor franchisees' compliance with contracted load standards and seating capacity.	Yes
	A process to monitor franchisees' implementation of the forward capacity plan.	Yes
	A process to monitor franchisees' compliance with the master timetable.	Yes
	A process to ensure that franchisees record, report and explain deviations from the master timetable.	Yes
	A process to monitor franchisees' compliance with publishing requirements at stations.	Yes
	A process to monitor franchisees' compliance with the requirement to notify MetLink and passengers of master timetable changes.	Yes
	A process to monitor coordination between passenger services and shuttle services.	Yes
Concession top-up	A process to monitor franchisees' compliance with the requirement to provide concession fares.	Yes
Operational performance regime (OPR)	A process to monitor whether franchisees meet OPR targets.	Yes
	A process that enables PTD to alert franchisees to poor performance and to initiate corrective actions.	Yes
Service quality incentive	A basis for service quality incentive payments that is transparent, specified in advance and understood by franchisees.	Not applicable
Profit sharing	A process to verify franchisees' profit sharing payment statements.	Yes
Revenue risk sharing	A process to verify franchisee's revenue statements, including any claims for payment.	Yes

Source: Victorian Auditor-General's Office.

8.2.2 Performance related to key contract items

Criteria

In assessing whether DoI's performance monitoring (framework and practices) for key contract items are adequate, we examined if it:

- will assure DoI that the franchisees have fulfilled their obligations in relation to a key contract item (including whether DoI has specified them as outputs), and
- includes audit controls that will assure DoI that they are making payments relating to key contract items on the basis of reliable and accurate performance information.

Evidence

Figure 8C records our opinion about whether DoI's actual performance monitoring arrangement met the arrangement that we would have expected for each type of key contract item. We found that DoI met our criteria for most of the key contract items. DoI's performance monitoring arrangements for contract items are detailed further in Appendix C, Figure C2 of this report.

FIGURE 8C: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS

Items	Expected performance monitoring arrangement	Meets audit criteria
Rolling stock management and maintenance	A process to verify that franchisees have undertaken required maintenance of rolling stock.	Yes
	A process to verify that franchisees have renewed rolling stock items when required or as scheduled.	
	A basis for ensuring that a random sample is used so that the same rolling stock is not always used for Target Condition Index scoring.	Yes
	A process to verify that acceptance testing has been completed, and is testing the correct criteria.	Yes
Infrastructure management and maintenance	A process to verify that franchisees have undertaken the required infrastructure maintenance.	Yes
	A process to verify that franchisees have renewed infrastructure when required, or as scheduled.	
	A process to verify that franchisees have completed repairs in accordance with infrastructure standards.	Yes
	A process to verify that franchisees have completed infrastructure works before PTD pays funds held in its escrow account.	Yes
	A process to verify that key performance indicators (KPIs) are set and monitored, and reported against quarterly.	Yes
	A process to ensure that franchisees' information technology capabilities are current and up-to-date, and in accordance with guidelines.	Yes

FIGURE 8C: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS - continued

Items	Expected performance monitoring arrangement	Meets audit criteria
Revenue protection	A process to verify that franchisees are maintaining the number of authorised officers specified in the franchise agreements.	Yes
	A process to monitor franchisees' compliance with uniform, communication and supervisory requirements for authorised officers.	No
	A process to monitor whether training for authorised officers is consistent with the standards set out in the franchise agreements.	Yes
	A process to monitor the performance of authorised officers and their completion of duties set out in the revenue protection plan.	Yes
	A process to verify that minimum deployment levels for authorised officers between 3-7 p.m. and after 9 p.m. are being met (train only).	Yes
	A process to ensure that franchisees take into account timely and accurate information about customer safety issues when determining the deployment of authorised officers across the system.	Yes
	A process to ensure that franchisees' revenue protection plans address the requirements of the franchise agreements.	Yes
	A process to verify that franchisees' revenue protection plans have been submitted to MetLink and have been considered in the development of MetLink's network revenue protection plan.	Yes
	A process to monitor the effectiveness of franchisees' revenue protection activities.	Yes
Financial viability	A process to identify signs that franchisees are in financial difficulty.	Yes
	Standard(s) for determining whether franchisees are experiencing financial difficulty that have been clearly identified and communicated to the franchisees and to PTD staff.	Yes
	A process to enable the causes of financial difficulty (if detected) to be thoroughly investigated.	Yes
	A process to monitor the franchisees' implementation of mutually agreed mitigation actions.	Yes
	Open-book arrangements that give the government the authority to access the franchisees' books and records.	Yes

Source: Victorian Auditor-General's Office.

8.2.3 Audit controls

DoI has established that the franchisees' external reporting practices comply with Australian accounting standards, and the requirements of the franchise agreements.

At the end of 2003-04, DoI checked that the franchisees' audited published financial reports indicated that they complied with Australian accounting standards. It intends to conduct such checks in all future years.

Schedule 13 and clause 13.3 of the franchise agreements specify how franchisees should report their financial information on a monthly and quarterly basis. DoI monitored the franchisees' monthly and quarterly reports to check that these requirements were met. In June 2004, DoI also engaged independent accountants to audit an annual statement prepared by franchisees reconciling their monthly and quarterly reports with their published audited annual financial reports¹.

In future, DoI intends to brief franchisees' auditors about the franchise agreement requirements, so that they can sign-off that these requirements have been met.

At any time, DoI can also audit the information provided to it, including from other entities within the franchisee's structure.

In summary, DoI has audit controls in place to assure itself that payments are made according to reliable and accurate performance information.

8.2.4 Partnerships Victoria guidance

Criteria

In assessing whether Partnership Victoria's performance management guidance was met, we considered whether:

- the franchise agreements specified outputs to be produced, and
- public reporting on the performance of franchisees was adequate.

Do the franchise agreements specify outputs?

Partnerships Victoria guidance recommends that contractual requirements should be specified as outputs, rather than inputs. If contractual items are specified only as inputs, contractors are rewarded for committing the required resources rather than delivering required outputs.

As explained in Part 4 of this report, DoI specified infrastructure and rolling stock maintenance and renewal requirements, and revenue enforcement requirements (such as protection, staffing and security) as inputs. Given the technical difficulties inherent in measuring outputs for these requirements (particularly revenue enforcement), we consider DoI's performance monitoring arrangements for these requirements to be appropriate.

¹ DoI engaged 2 separate consultants to audit Connex's and Yarra Trams' statements.

Is public reporting on franchisee performance adequate?

Partnerships Victoria guidance emphasises the need for transparency and disclosure of project outcomes. For the franchise agreements, this ensures that the public are well-informed about the government's and the franchisees' obligations, and about the franchisees' performance.

DoI produces *Track Record*, a monthly and quarterly bulletin about the performance of Victoria's public transport services. The bulletins are available on DoI's website <www.doi.vic.gov.au>. *Track Record* includes comprehensive data on punctuality (on-time performance), cancellations, reliability, passenger compensation, operational performance incentives and penalties, and customer satisfaction surveys. We consider the public reporting on franchisee performance to be adequate.

8.3 Did DoI allocate performance monitoring responsibilities to ensure effective monitoring?

8.3.1 Criteria

In assessing whether DoI allocated performance monitoring responsibilities to franchisees and to government so as to ensure effective monitoring, we examined if responsibilities had been allocated among the parties shown in Figure 8D².

² These responsibilities were derived by our Office using the Victorian Government Purchasing Board, *Victorian Government Purchasing Board - Contract Management Guidelines*, Victorian Government Purchasing Board, viewed 2 March 2004, <http://www.vgpb.vic.gov.au/CA256C450016850B/0/ED2B03E305ABEC86CA256C770014DD8E?OpenDocument>.

FIGURE 8D: AUDIT CRITERIA FOR ALLOCATION OF RESPONSIBILITIES FOR PERFORMANCE MONITORING

Franchisee should be responsible for	Government should be responsible for
Achieving clearly specified performance standards.	Clearly specifying the performance standards required of franchisees, and the circumstances that constitute a breach of those standards.
Providing timely and accurate information to government on its performance in meeting those standards.	Clearly specifying the consequences/penalties and processes relating to breaches of performance standards.
Implementing any corrective actions required to address any adverse performance or breaches of performance standards.	<p>Regularly analysing franchisee performance information to determine their adherence to performance standards.</p> <p>Ensuring that processes underpinning the collection/analysis of franchisee performance information provide reasonable assurance of its accuracy.</p> <p>Investigating the causes of breaches of performance standards and implementing established processes related to dealing with those breaches.</p> <p>Identifying any corrective actions required to address any breaches of performance standards, and for communicating these to franchisees.</p> <p>Monitoring whether identified corrective actions for resolving breaches of performance have been effectively implemented.</p>

Source: Victorian Auditor-General's Office.

8.3.2 Evidence

Using the criteria outlined above, we investigated in detail the allocation of performance monitoring responsibilities between the government and the franchisees for 8 payments and 4 contract items. We found that, in all instances, the responsibilities were appropriately allocated.

8.4 Will DoI's performance monitoring framework enable it to remedy adverse performance?

8.4.1 Criteria

In assessing whether DoI's performance monitoring framework enables it to remedy adverse performance, we examined if the franchise agreements provide the government with the necessary powers to do this³.

³ This list of powers was derived by our Office, using the key default and remedy provisions specified in Department of Treasury and Finance 2001, *Partnerships Victoria Guidance Material; Risk Allocation & Contractual Issues*, Department of Treasury and Finance, Melbourne.

8.4.2 Evidence

The following matters are covered adequately in the agreement:

- the range and severity of default events that constitute adverse performance
- provisions that permit franchisees to identify and implement corrective actions so as to remedy curable defaults
- government authority to delay/withhold payments for services until defaults have been remedied by franchisees
- government authority to seek compensation from franchisees for incurable or unsatisfactorily cured defaults
- government authority to “step-in” (or to appoint an alternative “step-in” party) in the case of significant material incurable defaults, which the franchisees either cannot or will not remedy
- government authority to terminate the franchise agreements in the event of serious and incurable defaults that threaten to seriously disrupt the provision of services, and
- how and when remedial powers available to the government can be exercised in the event of specific franchisee defaults.



The State of Victoria owns the train infrastructure and leases it to Connex.

8.5 Overall conclusion

The 2004 franchise agreements contained a comprehensive framework for DoI's monitoring of the franchisees' performance. The framework is designed to ensure that difficulties in the 1999 franchise agreements are not repeated.

The current franchise agreements have allocated responsibilities so as to enable effective performance monitoring. They provide the government with the information and the powers it needs to rectify adverse performance by the franchisees.



Appendix A.
Difficulties with 1999
franchise agreements



FIGURE A1: MAIN PROBLEMS WITH THE ORIGINAL FRANCHISE AGREEMENTS, AND HOW THEY WERE ADDRESSED IN NEW AGREEMENTS

Problem with 1999 franchise agreement	How the Department of Infrastructure (DoI) addressed the problem in the new franchise agreements
<p>Passenger and revenue forecasting</p> <p>Inaccurate forecasting of passenger and revenue growth was the biggest single factor eroding the financial viability of the franchisees. Although growth in passenger numbers between 1991 - 1999 was just one per cent, the franchisees forecast annual growth of 3.6 per cent. The franchisees did not achieve these forecasts, and so received less fare income than they expected. As well, government payments steadily reduced, because it had been agreed that these would be needed less as passenger numbers grew. As a result of all these factors, the franchisees incurred growing financial losses.</p>	<p>DoI assessed the accuracy of franchisees' forecasts by comparing them with the forecasts DoI developed for the public sector benchmarks.</p>
<p>Risk allocation</p> <p>The original franchise agreements provided for the franchisees to assume all risks associated with generating revenue. Consequently, the franchisees had to bear the full burden when these risks eventuated, which resulted in growing losses.</p>	<p>DoI determined the party best able to manage each risk. Risks have either been wholly allocated to the state or the franchisees, or are shared (such as revenue risk).</p>
<p>Fare evasion</p> <p>In the original bids, the franchisees forecast reductions in the levels of fare evasion. These reductions did not occur. The poor performance of the ticketing system had a negative impact on reducing fare evasion, with many passengers unable to buy tickets because ticketing machines were often out of service. All franchisees had separate revenue protection systems and strategies, resulting in ineffective deployment of revenue protection resources, variation in the rates of checking tickets and flawed coordination of revenue protection activities. These factors all contributed to unrealised fare evasion reductions.</p>	<p>Franchisees must prepare and submit annual revenue protection plans to Metlink, which develops a network-wide revenue protection plan. Franchisees must also employ a minimum number of authorised officers¹.</p>
<p>Revenue allocation</p> <p>Under the original agreements, the Revenue Clearing House allocated revenue to the franchisees according to the results of usage surveys. Although the franchisees and DoI expected these surveys to be highly accurate, the survey method turned out to be flawed. Surveys used a small sample size and were subjectively reported. This led to survey results (and, therefore, the percentage of revenue paid to each franchisee) being volatile. This system of revenue allocation also led to protracted disputes between the franchisees over revenue shares.</p>	<p>DoI fixed the share of revenue to each franchisee, which ended the volatility. Connex and Yarra Trams each receive 40 per cent of total fare revenue, with the remaining 20 per cent for buses.</p>

¹ Authorised officers are mainly responsible for revenue protection, passenger information, and safety and security. Connex must employ a minimum of 290 full-time authorised officers, and Yarra Trams a minimum of 215 full-time authorised officers.

FIGURE A1: MAIN PROBLEMS WITH THE ORIGINAL FRANCHISE AGREEMENTS, AND HOW THEY WERE ADDRESSED IN NEW AGREEMENTS - continued

Problem with 1999 franchise agreement	How the Department of Infrastructure (DoI) addressed the problem in the new franchise agreements
<p>Cost reduction forecasting</p> <p>In their original bids, the franchisees forecast reductions in operating costs (mainly for labour, but also in the costs of power and corporate overheads). In the event, franchisees did not reduce costs as planned, which increased their financial difficulties. Their situation was worsened by unplanned costs.</p>	<p>DoI assessed the accuracy of the franchisees cost forecasts by comparing them with the forecasts used for the public sector benchmarks.</p>
<p>Financial shocks</p> <p>Franchisees incurred costs that were either not planned for, or exceeded original expectations. These included the costs related to the ticketing system.</p>	<p>DoI included safeguards in the new franchise agreements for events where the financial impacts are uncertain. Events include the 2006 Commonwealth Games and the new ticketing system.</p>
<p>Performance monitoring</p> <p>Flaws in the performance monitoring aspects of the franchise agreements affected the government's ability to foresee problems.</p>	<p>Franchisees must provide DoI with business plans, and monthly and quarterly performance reports. DoI can also instigate a viability review at any time to assess the franchisees' financial health.</p>
<p>Coordination of public transport activities</p> <p>Franchisees did not work together effectively to coordinate activities. There was a "cultural and institutional" separateness between the 3 companies² established to market public transport and increase patronage.</p>	<p>The government created MetLink to replace the 3 companies, to substantially increase patronage and fare revenue.</p>
<p>Contract length</p> <p>The 12-15 year length of the original franchise agreements made it harder for franchisees to forecast costs, revenues and risks, and gave them greater exposure to longer-term macroeconomic factors.</p>	<p>The new franchise agreements are for 5 years, with an option to extend for a further 18 months.</p>
<p>Contract flaws</p> <p>There were ongoing disputes between the franchisees, and between the franchisees and the government. Disputes included the allocation of revenue, the functioning of the interim operating agreements and claims for losses and costs associated with perceived flaws in the agreements. The disputes consumed considerable management resources, although they did not have a significant financial impact on the franchisees.</p>	<p>Many of the disputes were resolved in the steps above. The "one train, one tram" policy has also ensured that many interoperator disputes have not recurred as of the time of the audit.</p>

Source: Information provided by Department of Infrastructure.

² The Revenue Clearing House, VicTrip and Melbourne Passenger Growth Incentive.



Appendix B. Changes made to the public sector benchmarks



FIGURE B1: CHANGES MADE TO THE PUBLIC SECTOR BENCHMARKS ACCORDING TO DOI'S BASIS FOR MAKING CHANGES

Basis for making changes	Description of change made to train public sector benchmark	Description of change made to tram public sector benchmark	Overall \$ increase/ (decrease) in public sector benchmarks
Situations where insufficient information was acquired	<ul style="list-style-type: none"> ● Revised X'Trapolis (type of train) maintenance cost basis from units to trains ● Revised Connex X'Trapolis lease payments ● Correction to revised Connex X'Trapolis lease payments adjustment above ● Increase utilisation of Nexas (type of train) from \$100 000 to \$125 000 per year, as per consultant's advice ● Reduce utilisation of X'Trapolis from \$100 000 to \$85 000 per year, as per consultant's advice ● Bayside infrastructure costs updated to consultant's advice ● Connex infrastructure costs updated to consultant's advice ● Reverse Bayside infrastructure costs updated to consultant's advice ● Reverse Connex infrastructure costs updated to consultant's advice ● Australian Posters and Buspak reduced income stream 	<ul style="list-style-type: none"> ● Revised integration benefits. Previously all allocated to operations ● Revised integration benefits - from 28 to 25 full-time employees. In addition, removed one government business enterprise structure for train and for tram ● Revised asset maintenance and renewals cost as per consultant's advice 	(\$63.6 million)
Policy, offer or contract changes resulted in changed requirements	<ul style="list-style-type: none"> ● Budget saving: Remove system upkeep ● Budget saving: Remove Passenger Service Requirement to meet load standards ● Switch Craigieburn extension - off (cost-side impact only) ● Budget saving - reverse Passenger Service Requirement (that is, reintroduce load breach for Service Growth Incentive) 	<ul style="list-style-type: none"> ● Budget saving: Remove Passenger Service Requirement to meet load standards ● Budget saving - Tram Priority (cost-side only) ● Budget saving - Tram Priority (fare impact) ● Switch South Vermont - off (cost-side impact only) 	

FIGURE B1: CHANGES MADE TO THE PUBLIC SECTOR BENCHMARKS ACCORDING TO DOI'S BASIS FOR MAKING CHANGES - continued

Basis for making changes	Description of change made to train public sector benchmark	Description of change made to tram public sector benchmark	Overall \$ increase/ (decrease) in public sector benchmarks
Policy, offer or contract changes resulted in changed requirements - continued	<ul style="list-style-type: none"> Remove Early Termination Value on lease basis Inclusion of Broadmeadows to Donnybrook as part of Infrastructure Lease - maintenance costs only (includes overhead, margin and risk) 	<ul style="list-style-type: none"> Reinstate - South Vermont extension (cost-side impact only) Reverse Budget saving - Tram Priority - fare impact Reverse Budget saving - Tram Priority (cost-side impact only) Budget saving - reverse Passenger Service Requirement (that is, reintroduce load breach for Service Growth Incentive) 	(\$104.2 million)
Omissions and errors that came to light during discussions with franchisees and evaluation of offers	<ul style="list-style-type: none"> Revised train service - increased services for financial year 2002-03 Connex Labour Overtime Model Correction Inclusion of core and non-core VicTrack property lease costs Reallocate property costs relating to system upkeep to separate line M> Train and Connex (no net change) Reallocate vegetation costs from infrastructure maintenance to system upkeep as per consultant report Treat Disability Discrimination Act costs as operational expense for consistency with Connex offer Move Disability Discrimination Act cost from operational to capital expense 	<ul style="list-style-type: none"> Revised tram service - increased services for financial year 2002-03 Accidentally omitted 3 full-time employees: re operational performance analysis - M> Tram Inclusion of core and non-core VicTrack property lease costs Revised Citadas (type of tram) maintenance cost step up 	\$85 million
Total			(\$82.8 million)

Source: Information provided by Department of Infrastructure.



Appendix C.
Results of audit of
Dol's performance
monitoring and
payment
arrangements



The results of our audit of the DoI's performance monitoring and payment arrangements are detailed below. A summary of the results are found in Part 8 of this report.

FIGURE C1: PERFORMANCE MONITORING FOR PAYMENTS

Payments	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Rolling Stock Adjustment	<p>Evidence that Public Transport Division (PTD) has received Acceptance Certificates for new rolling stock entering service.</p> <p>Evidence that PTD has received safety sign-offs for new rolling stock.</p> <p>Evidence that franchisees have used reasonable efforts to meet specified delivery dates for new rolling stock.</p> <p>Evidence that new rolling stock is in regular service.</p>	<p>Connex provided PTD with acceptance certificates before any rolling stock was placed in service.</p> <p>There is a 3-stage process to establish the acceptance certificate. As part of the first stage, Connex provided PTD with safety sign-offs for new rolling stock.</p> <p>All rolling stock was received ahead of schedule. Delivery dates were only prescribed for the first and last item, not each and every item of rolling stock.</p> <p>The Operating Performance Regime reports demonstrate that accepted rolling stock is already in regular service.</p>	<p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>
Special Event Balancing	<p>Process to monitor franchisees compliance with its obligations to prepare:</p> <ul style="list-style-type: none"> • indicative and detailed plans for servicing Special Events • debrief reports. <p>Process for reviewing franchisees' debrief reports and using insights gained for future planning purposes.</p> <p>Process to verify claims made by franchisees for any Special Event Balancing Payments.</p> <p>Checklist outlining that Special Event provisions have been addressed (tram only).</p>	<p>Franchisees produce detailed action plans, to illustrate how they are preparing for, and servicing, Special Events.</p> <p>PTD franchise managers analyse the debrief reports to identify issues (e.g. layout of Grand Prix stops) to inform PTD's planning exercises.</p> <p>PTD's Manager of Franchise Services conducts informal site visits on an ad-hoc basis (e.g. The manager may check services operating before and after rugby matches or Grand Prix event). PTD is currently reviewing this process to formalise the sampling of services.</p> <p>The provision of track shunts, crossovers and (where appropriate) temporary safety zones are considered during the preparation of event-specific transport plans. These plans are developed in planning sessions involving the franchisee, the event organiser, other stakeholders and PTD.</p>	<p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>

FIGURE C1: PERFORMANCE MONITORING FOR PAYMENTS - continued

Payments	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Fixed Monthly Franchise Sums	<p>Process to ensure consistency of the franchisees' master and daily timetables with Passenger Service Requirement (PSR) specifications.</p> <p>Process to monitor franchisees' compliance with contracted load standards and seating capacity.</p> <p>Process to monitor franchisees' implementation of Forward Capacity Plan.</p> <p>Process to monitor franchisees' compliance with Master Timetable.</p>	<p>Tram: PTD uses the PASS PSR system to analyze the compliance of proposed master and daily timetables with the PSR.</p> <p>Train: PTD manually crosschecks the master and daily timetables with the PSR to ensure consistency. The DoI Practice Note 'Timetable and Service Changes – Train', describes the process in detail. PTD has commenced implementation of the PASS PSR system for train timetables.</p> <p>The Director, PTD can request 2 passenger counts per year. The methodology used for the counts is outlined in Franchise Agreement (FA) – Schedule 5.</p> <p>PTD franchise managers cross-check implementation of Forward Capacity Plan, using manual and computer-based systems.</p> <p>PTD's Information & Analysis Group uses the PASS OPR system to measure the extent to which operators run services in conformance with both the master and daily timetable. The OPR system calculates the amount of passenger inconvenience in "Passenger Weighted Minutes (PWWMs)" for any diversion from both the master and daily timetable.</p> <p>Franchisees record descriptions of the deviations between the master and daily timetables. These are reported to DoI through its PASS OPR system.</p> <p>PTD franchise managers conduct physical checks of stations and stops to check that the publications at stations are current.</p> <p>Franchisees notify MetLink through the electronic daily timetables.</p>	<p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>
	<p>Process to ensure that franchisees record, report and explain deviations from Master Timetable.</p> <p>Process to monitor franchisees' compliance with publishing requirements at stations.</p> <p>Process to monitor franchisees' compliance with requirement to notify MetLink and passengers of Master Timetable changes.</p> <p>Process to monitor coordination between passenger services and shuttle services.</p>	<p>Franchisees notify MetLink through the electronic daily timetables.</p> <p>PTD franchise managers conduct physical checks of stations and stops to check if the Shuttle services are coordinating with Passenger Services.</p> <p>PTD IS group completes checks using the PASS OPR system.</p>	<p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>

FIGURE C1: PERFORMANCE MONITORING FOR PAYMENTS - continued

Payments	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Concession Top-up	Process to monitor franchisees' compliance with requirement to provide concession fares.	<p>PTD has no formal check that franchisees offer concession fares. However:</p> <ul style="list-style-type: none"> a fares and ticketing manual (available on request) identifies who is eligible for concessions; posters and other information publicising concession entitlements are widely displayed; PTD relies on public complaints to alert it if concession fares are not offered most fares are purchased in a manner where the franchisee has no say in the ticket purchased (e.g. by selecting the "concession" option button on a ticket machine). 	Yes
Operational Performance Regime (OPR)	Process to monitor whether franchisee has met OPR targets.	<p>PTD's Information and Analysis Group uses its PASS OPR system to monitor performance against the OPR targets in Schedule 7.</p> <p>Tram: Yarra Trams uses the electronic Automated Vehicle Monitoring (AVM) system to report to PTD on its services. This system uses "scripted data protocols" to ensure that PTD receives accurate, valid and reliable data.</p> <p>Train: Connex forwards electronic files of manually compiled performance data to PTD on a daily basis. PTD checks the accuracy of this data by performing quarterly independent audits of a sample of services. PTD adjusts the OPR payments in accordance with these audit findings. In the longer-term, Connex and PTD are planning to implement an automated system.</p> <p>Director, PTD has direct access to the franchisees' computer systems containing source data. If a service is not recorded, PTD treats it as an unplanned cancellation.</p>	Yes
Service Quality Incentive	Process that enables PTD to alert franchisees to poor performance and to initiate corrective actions.	<p>Using its PASS OPR system, PTD's Information and Analysis Group analyses the franchisees' data and flags any areas of poor performance. Franchise managers discuss these with franchisees at their next quarterly meeting.</p> <p>At this stage, PTD has not established any Service Quality Incentive initiatives. In the event of such an initiative, PTD intends to develop a set of key performance indicators (KPIs) to measure delivery of the initiative prior to payment.</p>	Yes
	Basis for Service Quality Incentive payments that is transparent, specified in advance and understood by franchisees.		n.a.

FIGURE C1: PERFORMANCE MONITORING FOR PAYMENTS - continued

Payments	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Profit Sharing	Process to verify franchisees' Profit Sharing Payment Statement.	<p>PTD's Analytical Services Manager uses financial data provided by franchisees (see Financial Viability section in Figure C2) to calculate the franchisees' EBITDA, and adjusts this for the following PTD payments to calculate the "adjusted EBITDA":</p> <ul style="list-style-type: none"> • Franchise Payment • Insurance Premium Payment • Insurance Deductible Payment • Employee Entitlement Payment • Special Event Balancing Payment • Service Growth Incentive Payment • Concession Fare Payment • Games Revenue Guarantee Payment • New Ticketing Revenue Guarantee Payment • Revenue Risk Sharing Payments. <p>Once completed, the Analytical Services Manager checks the calculations for errors, and reconciles them to the franchisees' statement, before making the payment.</p>	Yes
Revenue Risk Sharing	Process to verify franchisee's revenue statements, including any claims for payment.	<p>PTD has not yet needed to make any revenue risk sharing payments.</p> <p>When it does need to make this payment, PTD will use financial data provided by franchisees (see Financial Viability section in Figure C2), particularly the MetLink statement certifying fare revenue, to verify the franchisee's claim.</p>	Yes

Source: Information provided by Department of Infrastructure.

FIGURE C2: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS

Items	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Rolling stock management and maintenance	<p>Process to verify that franchisees have undertaken required maintenance on rolling stock.</p> <p>Process to verify that franchisees have renewed rolling stock items when required or as scheduled.</p>	<p>Franchisees prepare an annual Rolling Stock Management Plan. Franchisees report against the Rolling Stock Management Plan's KPIs on a quarterly basis. They also prepare an annual Rolling Stock Management Report for each financial year.</p> <p>Franchisees prepare an annual Rolling Stock Maintenance Plan, which sets out the number of annual planned preventative maintenance exams and overhauls. These are derived from the franchisees' Technical Maintenance Plan.</p> <p>PTD independently assesses rolling stock condition through a target condition survey. Through this survey, PTD assesses whether franchisees have maintained the rolling stock to the target condition index (completed every 3 years).</p> <p>PTD's safety auditors audit maintenance and renewal of rolling stock on an adhoc basis throughout the year. The rolling stock has multiple ownership parties – PTD, franchisees and other private entities. Due to this multiple ownership, the maintenance and renewal regime is output-based and has a fixed payment.</p> <p>Director, PTD can commission an independent survey of rolling stock, or audit the maintenance undertaken at any time. PTD also has the right to inspect a franchisee's contracted suppliers.</p> <p>PTD is currently developing an overhaul and maintenance audit regime.</p> <p>The random sample is approximately 30 per cent of fleet. Statistical formulae are used to determine how the sample is drawn. PTD's engineers continue testing rolling stock until 90 per cent confidence level is reached.</p> <p>Acceptance certificates have been addressed above.</p> <p>The criteria are pre-determined as part of the Australian safety standards for rail.</p>	Yes
	<p>Basis for ensuring that a random sample is taken so the same rolling stock is not always used for Target Condition Index scoring.</p> <p>Process to verify that acceptance testing has been completed, and is testing the correct criteria.</p>		Yes

FIGURE C2: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS - continued

Items	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
<p>Infrastructure management and maintenance</p>	<p>Process to verify that franchisees have undertaken required maintenance on infrastructure.</p> <p>Process to verify that franchisees have renewed infrastructure when required or as scheduled.</p>	<p>Franchisees provide the monthly and quarterly reports on maintenance and renewals listed below:</p> <ul style="list-style-type: none"> • Monthly reporting: <p>Franchisees' monthly reports include:</p> <ul style="list-style-type: none"> • costs of planned and unplanned works • variances between actual and planned costs for the month with explanations of the variances. <p>Invoices for maintenance and renewal works are provided with the monthly reports. Invoices are crosschecked with Schedule 11 by Financial Compliance Manager to ensure that they are legitimate claims. There are approx 18 000 items invoiced per month so the Manager focuses on items that seem irregular.</p> <p>The Financial Compliance Manager also crosschecks the hard with the soft copy of the invoices.</p> <ul style="list-style-type: none"> • Quarterly reporting: <p>Franchisees' quarterly reports include:</p> <ul style="list-style-type: none"> • outlines of works that have not complied with the plans • a summary of costs broken down to labour, material, plant and subcontracting components • KPI reports • a status update for any projects franchisees are undertaking • any improvements that have occurred including details and the intellectual property involved. <p>The reports are reviewed by PTD's Compliance Managers with any issues then raised at the next meeting.</p>	<p>Yes</p>

FIGURE C2: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS - continued

Items	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
<p>Infrastructure management and maintenance - continued</p>	<p>Process to verify that franchisee has completed repairs in accordance with infrastructure standards.</p> <p>Process to verify that franchisee has completed infrastructure works, before PTD pays funds held in its escrow account.</p>	<ul style="list-style-type: none"> • Auditing maintenance and renewal works <p>Maintenance: Works are adhoc/unplanned emergency works (e.g. broken tram track), so are actioned immediately. PTD engineers physically view this work on an adhoc basis.</p> <p>Renewal: Works are works specified in the annual works plan and are physically audited by PTD's engineers. They audit a random sample that equates to 30-40 per cent of total monthly amount of invoice.</p> <p>Any issues found by Compliance Managers are raised at the maintenance and renewal review meetings with the franchisees.</p> <p>At the same meetings, the Financial Compliance Manager raises any variances between invoices and the results of the audits. The Financial Compliance Manager monitors under-spends as they may equate to lack of work being performed; these are reported at the monthly meetings. He is now also tracking the "over-spends" to ensure works been completed to schedule.</p> <p>As discussed above, the Financial Compliance Manager selects random items/works for auditing. Auditors undertake site visits and conduct detailed audits of these items, with photographic evidence kept. They audit to Australian safety standards.</p> <p>PTD keeps 5 per cent of all payments in an escrow account. Once PTD's Compliance Managers have completed the verification process, described above, the escrow amounts are released to the franchisees.</p> <p>All payments have been released to Connex and Yarra Trams.</p>	<p>Yes</p> <p>Yes</p> <p>Yes</p>

FIGURE C2: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS - continued

Items	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Infrastructure management and maintenance - continued	<p>Process to verify that KPIs are set and monitored, with a review of the tabled quarterly report.</p> <p>Process to ensure that franchisees' IT capabilities are current and up-to-date, and in accordance with guidelines.</p>	<p>As discussed above, the franchisees' quarterly reports include KPI reports. The PTD Compliance Manager reviews the quarterly reports to ensure that KPIs are being met. PTD Compliance Manager discusses any variances with franchisees at quarterly meetings.</p> <p>The franchisee IT infrastructure upgrade project is reviewed by PTD's GM Information Systems and Analysis.</p> <p>PTD's Information Systems and Analysis Group undertake monthly site visits to monitor progress on the upgrade project. This group focuses on ensuring the quality milestones have been achieved, and place less emphasis on timeliness.</p>	<p>Yes</p> <p>Yes</p>
Revenue protection, staffing and security	<p>Process to verify that franchisees are maintaining number of Authorised Officers specified in the FA.</p> <p>Process to monitor franchisee compliance with uniform, communication and supervisory requirements for Authorised Officers.</p> <p>Process to monitor whether training for Authorised Officers is consistent with the standards set out in the FA.</p> <p>Process to monitor the performance of Authorised Officers and completion of duties outlined in the revenue protection plan.</p> <p>Process to verify that minimum deployment levels for Authorised Officers between the hours of 3-7p.m. and after 9p.m. are being met (TRAIN ONLY).</p>	<p>Franchisees' monthly reports state whether the franchisee has maintained the required number of full-time authorised officers. DoI also conduct random checks of a database containing details of all active authorised officers operating on the public transport network.</p> <p>Not monitored by PTD (except informal monitoring of uniform requirements).</p> <p>Duties of authorised officers are documented in the revenue protection plans as a "Deployment of duties statement". The statement includes specifications for training.</p> <p>The franchisees deliver bi-annual presentations to PTD at which they outline training provided.</p> <p>Authorised officers must issue "Reports of Non-Compliance" where ticketing irregularities are found, and those reports are received by PTD's Franchise Managers so they can be scrutinised for correctness and completeness.</p> <p>At weekly discussions with the franchisees, the franchise manager verbally confirms that the minimum deployment levels for authorised officers between the hours of 3-7p.m. and after 9p.m. are being met (TRAIN ONLY). DoI also audit Connex's rosters for the deployment of authorised officers.</p>	<p>Yes</p> <p>No</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>

FIGURE C2: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS - continued

Items	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Revenue protection, staffing and security - continued	<p>Process to ensure that franchisees take into account timely and accurate information about customer safety issues when determining the deployment of authorised officers across the network.</p>	<p>PTD manages a ministerial committee called the Safe Travel Taskforce, which involves senior representatives from Victoria Police (Transit Safety Division), Connex, Yarra Trams, V/Line Passenger, Transport Operators, Rail Tram and Bus Union, Victorian Taxi Directorate and Bus Association Victoria. The committee meets on a quarterly basis to:</p> <ul style="list-style-type: none"> ● assess statistics on crime and other incidents concerning customer and staff safety and security ● review customer satisfaction and staff surveys addressing public safety issues ● exchange of information between the parties including Victoria Police and the public transport operators on trends, security programs, resources, and coordination of safety and security initiatives, and ● process for public transport users and the wider community to report on criminal and other anti-social activities on the public transport system. 	Yes
	<p>Process to ensure that franchisees' revenue protection plans address all elements required under the FA.</p>	<p>The MetLink Relationship Manager reviews all draft plans and circulates them to the PTD franchise managers, GM Info Systems and Analysis, Deputy Director Public Transport – Business Support and the Head of Transport Compliance for their review.</p>	Yes
	<p>Process to verify that franchisee revenue protection plans have been submitted to MetLink and have been considered in the development of MetLink's Network revenue protection plan.</p>	<p>The Revenue Protection Working Committee includes representatives from Connex, Yarra Trams, V/Line and Bus Association Victoria. The committee meets monthly to review the plan, monitor progress of initiatives and review franchisee compliance with obligations.</p>	Yes
	<p>Process to monitor the effectiveness of franchisees' revenue protection activities.</p>	<p>MetLink conducts fare evasion surveys. This process is currently underway and is conducted every 6 months. PTD and MetLink jointly scrutinise the data on levels of fare evasion and invalid concession use to gauge the effectiveness of franchisees' revenue protection activities.</p>	Yes

FIGURE C2: PERFORMANCE MONITORING FOR KEY CONTRACT ITEMS - continued

Items	Expected performance monitoring arrangement	Actual performance monitoring arrangement in place	Meets audit criteria
Financial viability	<p>Process for identifying signs of financial difficulty of franchisees.</p> <p>Standard(s) for determining whether franchisees are experiencing financial difficulty that have been clearly identified and communicated to both franchisees and PTD staff.</p> <p>Process to enable the causes of financial difficulty (if detected) to be thoroughly investigated, and mutually acceptable actions for mitigating the situation are identified and promptly implemented.</p> <p>Process to monitor the franchisees' implementation of mutually-agreed mitigation actions.</p> <p>Open book arrangements that give the government the authority to access the books and records of the franchisee. This provision is useful in providing the government with a greater understanding of the franchisees' cost drivers and the impact on its profitability of the franchisee or any changes made to the contract or during a re-negotiation exercise. In essence, its a "health check" and is an integral part of contract management.</p>	<p>The franchisees submit monthly and quarterly reports to the Director, PTD.</p> <p>The project managers of the Analytical Services Group receive the quarterly financial statements and then determine the cash flow / liquidity status and overall profitability of the franchisees.</p> <p>PTD's practice note on the reporting requirements assists the Analytical Services department in understanding the reporting requirements.</p> <p>The project managers of the PTD's Analytical Services Group have defined how financial statements should be provided and communicated these requirements to franchisees.</p> <p>The project managers of the PTD's Analytical Services Group also briefed the franchisees' auditors regarding PTD standards and requirements.</p> <p>Franchisees' have put performance bonds in place 2 years in advance (and these are indexed). i.e. Connex – approximately \$65 million. The quarterly balance sheets that are delivered in accordance with the FA illustrate the liquidity of the franchisees.</p> <p>PTD's Analytical Services Group review any financial difficulty as mentioned above and provide franchisees with regular feedback and, if required, any actions, which may be implemented at monthly and quarterly PTD/franchisee meetings.</p> <p>PTD monitors the implementation of actions agreed at the monthly and quarterly meetings, on an ongoing basis.</p> <p>DoI can review a franchisee's viability, on its own initiative or at the franchisee's request. If the review is at the franchisee's request, the state can terminate the franchise.</p>	<p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>

Source: Information provided by Department of Infrastructure.



Appendix D. Glossary



Benchmarking and Modelling Committee

The interdepartmental committee established as part of the renegotiation process. The committee comprised representatives of DoI and Department of Treasury and Finance, and was responsible for overseeing the development of the train and tram public sector benchmarks.

Contract Design Guide

The document that stated the principles that the government intended to adopt in designing and drafting the franchise agreements.

Department of Infrastructure (DoI)

The government agency responsible for providing and managing the metropolitan train and tram system.

Franchise

The legal authority granted by the government to conduct such activities as are required to operate the metropolitan tram and train system, including to operate services and to maintain the system's infrastructure.

Franchise agreement

The contracts (and documents named in them) that provide the franchisees with the authority to operate the franchises. The 2 separate (train and tram) agreements specify the state's relationship with each franchisee, and how each franchisee and entities within each franchisee's structure will operate the tram or train system.

Franchise Review Task Force

The committee established by the government in late 2001 to ensure the continued operation of metropolitan train and tram services, and to establish a clear, stable and lasting basis for the future provision of services. The task force comprised representatives of DoI, Department of Treasury and Finance, Department of Premier and Cabinet, and the 3 original (1999) franchisees (Connex, National Express Australia Group and Yarra Trams).

Franchisee

The private sector companies responsible for operating the franchises. They are Connex Melbourne Pty Ltd (for the train franchise) and MetroLink Victoria Pty Ltd (for the tram franchise). In practice, each franchisee is a structure of entities, which are explained in Part 6 of this report.

Infrastructure

The rails, stations, signalling and traction power equipment used to operate the metropolitan tram and train system. Rolling stock is not considered to be infrastructure.

Interim operating agreement

The short-term agreements between the government and the 1999 franchisees that were signed in December 2002. They were occasioned by the imminent financial collapse of several franchisees, and replaced the 1999 franchises. The agreements were intended to maintain train and tram services while the government considered its options for the metropolitan tram and train system. Interim operating agreements were signed with Connex and Yarra Trams but not with National Express Australia Group, whose UK parent company withdrew support from its Australian subsidiary.

MetLink

The entity created to market public transport and increase patronage. It does so by conducting advertising campaigns, by providing improved network-wide customer information about services, tickets and fares, and through other activities. It is owned by Connex and Yarra Trams.

Monte Carlo risk analysis

A statistical tool that permits the modelling of complex combinations of uncertainties and assists in making predictions. It takes into account randomness by investigating different scenarios, with the results used to inform decision-making.

Offers

The initial and subsequently negotiated bids from Connex and Yarra Trams for government payments to operate the metropolitan train or tram system, based on each company's estimates of costs and revenue over the franchise term.

Partnerships Victoria

A government policy administered by the Department of Treasury and Finance that provides a framework for integrating private sector investment in public infrastructure. It provides guidance to government departments and agencies about choosing the most effective and efficient form of delivering public infrastructure.

Passenger Service Requirement (PSR)

The statement of the minimum level of train and tram services that each franchisee is required to operate under the terms of their agreement.

Performance bond

A financial surety that each franchisee was required to lodge in support of their undertaking to meet their obligations under the franchise agreement. In the event of the state incurring costs as a result of a default (e.g. franchisee becomes financially insolvent) by the franchisee, the government is entitled to use all or part of the performance bond to cover its costs.

Probity

A requirement of the VGPB of all commercial transactions. It requires fairness and impartiality, use of a competitive process, a consistent and transparent process, security and confidentiality, identification and resolution of conflicts of interest, and the development of a probity plan.

Project Oversight and Evaluation Committee

The committee responsible for ensuring that negotiations with Connex and Yarra Trams were completed in line with the processes established for the negotiations. The committee was also responsible for considering the evaluation reports of both offers, and for advising the government about its responses to the offers. The committee comprised representatives of DoI, Department of Treasury and Finance, and Department of Premier and Cabinet.

Public sector benchmark (PSB)

The financial models prepared by DoI that predicted the future revenues of, and costs to, an efficient public sector organisation operating each franchise over the franchise term. One PSB was prepared for the train franchise, and one for the tram franchise. Each PSB was similar to a public sector comparator, but did not include risks retained by the state.

Public sector comparator (PSC)

A financial model required by Partnerships Victoria policy to test the value-for-money of a private sector bid, compared with the most efficient form of public delivery. Public sector benchmarks, not comparators, were used to inform negotiations for the franchises.

Public Transport Division (PTD)

The division of DoI that is responsible for overseeing the delivery of metropolitan train and tram services by managing the franchise agreements with the franchisees.

Retained risks

The risks that have been wholly or partly allocated to the state under the franchise agreements.

Transferable risks

The risks that have been wholly or partly allocated to the franchisees under the franchise agreements.

Victorian Government Purchasing Board (VGPB)

A statutory board that meets bi-monthly to develop and approve procurement-related policies, to approve proposals for major purchases from government departments, and to discuss matters of procurement policy and practice. The board comprises external appointees and representatives of government departments. The day-to-day functions of the board are carried out by the Department of Treasury and Finance's Procurement Group.

Auditor-General's Reports

2004-05

Report title	Date issued
Results of special reviews and other studies	August 2004
Measuring the success of the Our Forests, Our Future policy	October 2004
Report of the Auditor-General on the Finances of the State of Victoria, 2003-04	November 2004
Results of 30 June 2004 financial statement and other audits	December 2004
Meeting our future Victorian Public Service workforce needs	December 2004
Managing school attendance	December 2004
Regulating operational rail safety (2005:1)	February 2005
Managing patient safety in public hospitals (2005:2)	March 2005
Management of occupational health and safety in local government (2005:3)	April 2005
Results of special reviews and other investigations (2005:4)	May 2005
Results of financial statement audits for agencies with other than 30 June 2004 balance dates, and other audits (2005:5)	May 2005
Our children are our future: Improving outcomes for children and young people in Out of Home Care (2005:6)	June 2005
In good hands: Smart recruiting for a capable public sector (2005:7)	June 2005
Managing stormwater flooding risks in Melbourne (2005:8)	July 2005
Managing intellectual property in government agencies (2005:9)	July 2005
East Gippsland Shire Council: Proposed sale of Lakes Entrance property (2005:10)	July 2005

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