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Auditor-General

Melbourne's New Bus Contracts

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The Hon. Robert Smith MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Jenny Lindell MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my report on *Melbourne's New Bus Contracts*.

Yours faithfully



D D R PEARSON
Auditor-General

24 June 2009

Foreword

Bus services form an integral component of the \$38 billion investment in public transport which the government committed under its 2008 *Victorian Transport Plan*. Its purpose is to offer a viable alternative to private car use and to provide effective transport options for those who don't have access to a car. Efficient mass public transport can reduce traffic congestion, help the environment, cut business costs and support social equity.

In 2006, prior to the *Victorian Transport Plan*, the government invested \$1.4 billion in new and upgraded bus services over ten years. It negotiated 29 new contracts with bus companies which started in July 2008. The aim was to develop more local and cross-town bus services to make public transport more accessible for people in the city's middle and outer suburbs and this was carried through to the *Victorian Transport Plan*.

In negotiating the new contracts, the Department of Transport was required to improve the quality and effectiveness of bus services, improve value for money for the government's investment, and to maintain a constructive relationship with the bus industry.

This audit examined how well the department negotiated and managed the new metro bus contracts.

I found that the department's performance was mixed. It negotiated the new contracts effectively. However, the department needed to begin planning the management of the bus service contracts earlier so that it could effectively manage them and evaluate operator performance at the outset. In this regard I am encouraged that the department has recognised that it needs to change the way it prepares for the management of future bus contracts.

In VAGO's 2007 good practice guide—*Public Sector Procurement: Turning Principles into Practice*—the importance of planning for contract management was highlighted and the guide featured several contract management guides to assist agencies to plan their contract management effectively.

The lessons from this audit—sound and timely planning, skilful negotiation and impeccable implementation—can be applied to all contract negotiations. These factors are all necessary for efficient and effective services and improved value for money for the taxpayer.



D D R PEARSON
Auditor-General

24 June 2009

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1 Audit summary

1.1 Introduction

Buses are an important part of Melbourne's public transport system. They are especially important for travel within the city's middle and outer suburbs where they connect people to the radial train services and provide for local and cross-town travel. In 2008–09, bus services carried about 20 per cent of the 480 million passenger boardings, at a cost of \$441 million to government.

Bus services started in Melbourne in 1869. The operators developed as private, self-funded organisations, setting their own schedules and fares and owning the bus depots and vehicles. By 1997 bus companies were subsidised to operate exclusive routes within a regulated fare structure using their own depots and vehicles.

The *Victorian Transport Plan* aims to improve public transport and give Melburnians a practical alternative to car-based travel. In May 2006 \$1.4 billion was committed over 10 years to develop local and cross-town bus services. The plan for improving bus services included new bus contracts to improve the value derived from the growing investment in bus services.

The Department of Transport (the department) was responsible for the negotiation and the oversight of new metropolitan bus contracts. The previous contracts expired in 2007. The department had to prepare a reform strategy for the bus industry and then agree new bus contracts with the operators.

The procurement aims were to improve the quality and effectiveness of bus services, to improve value for money and to maintain a constructive relationship with the bus industry.

In June 2008 the Minister for Public Transport announced that 29 new metropolitan bus contracts would come into effect from 1 July 2008.

1.2 Audit objective

The audit assessed the effectiveness of the new metropolitan bus contracts by examining whether the department had:

- applied appropriate processes to negotiate the new contracts
- assessed the extent to which the contract requirements had been implemented
- established processes to evaluate and improve performance.

1.3 Conclusions

The department's performance has been mixed. It negotiated the new contracts effectively. However, it had not finished the work needed to manage contracts effectively by the time they became operational. This caused some shortcomings in implementing the contracts and evaluating operator performance.

Specifically, the department:

- had negotiated new contracts adequately, but its preparation for managing them was inadequate
- implemented most, but not all, aspects of the new contracts as intended
- had not established the critical components of the performance management and evaluation framework because it had not started planning in time.

The department has recognised that it needs to change its preparation for managing new bus contracts. The deputy director bus and regional services will oversee the negotiation of new regional and school bus contracts and is responsible for service delivery and contract management. This will renew the focus on contract management during these negotiations.

1.4 Findings

1.4.1 Contract negotiation

The department succeeded in negotiating new contracts that are likely to improve value for money. Specifically the department:

- understood the strengths and weaknesses of the previous arrangements and used this knowledge to improve the contracts
- followed the required policies and guidelines for the planning, tendering and awarding of public sector contracts, including those for assessing and improving value for money
- demonstrated that the contracts provided improved value for money by clearly presenting the costs, expected benefits and trade-offs. While the new contracts have not immediately cut service costs, they have set the framework for improved value for money by, for example, including provisions to competitively tender SmartBus orbital and new local bus services.

On a less positive note, the department did not adequately prepare for the management of the new contracts. It did not prepare the required contract management plan, setting out the processes, structure and resources for managing the new contracts before they started. This is a significant omission.

The department consulted operational staff in developing the new contracts. However, for future bus procurements, it needs to engage these staff more effectively before embarking on new arrangements.

1.4.2 Contract implementation

The obligations for performance reporting were only partially applied because the necessary documentation had not been completed. The operators' reports on performance did not fully comply with the contracts because the department had not finalised the documentation to guide their reporting. The operators continued to report against the old contracts' benchmarks and some operators had not provided all the required reports.

In May 2009 the department and the bus operators agreed on the form and content of updated reports on operational performance. These reports should address the contracts' reporting requirements when applied.

The new contracts also committed to developing improved performance management, and progress had clearly been made. However, developing the service quality regime is behind schedule because the department did not start the work in time to meet the contractual deadline.

In terms of contract implementation, the essential processes for the payment of bus services and the monitoring and handling of fare revenue are happening as intended.

1.4.3 Evaluating and improving performance

The department needs to improve how it collects and uses performance information. This area is critical to demonstrate that the expected increase in value for money is being realised.

Most of the indicators were relevant because they clearly related to the objective being assessed. However, the department did not have documents describing the analysis and rationale for setting performance benchmarks and this made it difficult to determine whether they were appropriate.

In reviewing the department's performance evaluation we found that the:

- patronage incentive regime was well designed to measure performance
- passenger information indicators and benchmarks were relevant and appropriate but not reported, thereby preventing a comprehensive review
- operational performance regime needs to be strengthened to provide greater assurance about the on-time running information.

The department had not used the performance information to evaluate and improve operators' performance, partly because the information had not been updated with the new contract benchmarks.

1.5 Recommendations

For new bus contracts the department should:

- engage more effectively with operational staff to complete the contract management documentation and plan for the transition to the new arrangements before the existing contracts expire (**Recommendation 4.1**).
- review its performance against the planned time frames so it can formulate more realistic estimates (**Recommendation 4.2**).
- provide early advice to government on the strategic options and constraints for future metropolitan bus contracts (**Recommendation 4.3**).

To improve the implementation of the new contracts the department should:

- create and maintain a record of performance against the Metlink performance indicators (**Recommendation 5.1**).
- document the contract payment processes and ask operators to submit a monthly record of missed or additional services as the basis for adjusting monthly contract payments (**Recommendation 5.2**).

To improve performance evaluation the department should:

- document the basis for its current performance indicators and benchmarks and update this document when the performance management system is amended (**Recommendation 6.1**).
 - strengthen the processes around the measurement of on-time running by verifying that the operators' approaches are adequate and periodically inspecting their operational records (**Recommendation 6.2**).
 - design processes so that information about service changes is effectively and quickly passed to the relevant organisations (**Recommendation 6.3**).
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2 Audit Act 1994 section 16— submissions and comments

2.1 Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report was provided to the Department of Transport with a request for comments or submissions.

The comments and submissions provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for their accuracy, fairness and balance rests solely with the agency head.

2.2 Submissions and comments received

RESPONSE provided by the Secretary of the Department of Transport

I note your conclusions in respect of the negotiation of and the preparation for managing the contracts.

I accept your recommendations and note the department is in the process of progressively implementing them.

3 Background

3.1 Bus services in Melbourne

3.1.1 The role of buses in Melbourne

Bus services are important because they provide many Melburnians, who do not live near a train station or tram line, with an alternative to travelling by car. Trams and trains offer a similar alternative to those living in Melbourne's inner suburbs, and between stations along the rail lines that intersect the central business district.

Most bus services operate in Melbourne's middle and outer suburbs where they:

- connect people to the radial train network
- offer local and cross-town travel where there are no train or tram services.

In 2008–09 it is expected that Melbourne buses will carry 94 million passengers, or 20 per cent of the 480 million public transport boardings. Bus operators will be paid an estimated \$441 million for these services. The Department of Transport (the department) recovers about a quarter of this amount through fares.

For the 20-year period up to 2005–06, the number of people using buses remained fairly constant. Since 2005–06 it has risen by 20 per cent, which coincided with a 25 per cent expansion of publicly funded bus services that:

- increased the frequency, duration and coverage of local bus services
- introduced 'SmartBus', a premium bus service for cross-town connections along major arterial roads linking train stations, tram lines and major activity centres. SmartBus services run more often and for longer hours than most bus services, and are more reliable because they have priority over other traffic.

These improvements have come at a cost, with expenditure on buses rising by 45 per cent between 2005–06 and 2008–09. Most of this comes from the 25 per cent rise in services and a 10 per cent price rise. The remainder is due to service expansion at times when bus drivers are entitled to premium payments, for example, driving on a Sunday.

3.1.2 The bus industry in Melbourne

Development of the previous bus contracts

The operation of bus fleets in Melbourne dates back to 1869 when the Melbourne Omnibus Company began running 11 horse-drawn buses from the city to Fitzroy. From then on, bus companies grew as private, self-funded firms developing bus routes, determining their own schedules and fares, and buying the bus depots and vehicles.

In 1974 the government introduced regulated fares across the metropolitan public transport system. To achieve this, bus operators were paid a subsidy, marking the start of their contractual relationship.

Despite the introduction of subsidies, Melbourne's bus industry takes the view that the history of private investment entitles it to operate the routes it has developed exclusively. The industry disputes the government's right to competitively tender these services. The government does not accept this position but the issue has never been legally tested.

The National Bus Company (NBC) and Melbourne Bus Link (MBL) are different to the other bus operators. The government established and privatised these companies in the early 1990s, and the operators cannot claim the same historic ownership rights over the routes they operate.

By 1997 standard contracts were in place with all operators that:

- granted exclusive routes
- determined contract payments designed to cover the costs of operation and to provide a reasonable rate of return
- included a common fare structure
- recognised the operators' ownership of the strategic assets, including the bus depots and vehicles
- did not provide the government with the right to competitively tender routes except for the NBC and MBL.

Industry structure

The industry has been structured so that operators do not compete. Bus routes have evolved and been planned to meet the needs of the local populations they serve and to complement adjacent and connecting routes. The department has taken the view that it would be inefficient to let subsidised operators duplicate services and compete for passengers on the same route.

Under the new 2008 contracts there are 29 private bus operators using about 1 500 buses to deliver bus services on approximately 300 routes. The four largest companies operate 70 per cent of the buses in Melbourne. The smaller companies operate a small number of buses sometimes on a single route. After the 2008 contracts were introduced, the structure and scale of the industry did not significantly change.

Metlink, a partnership of Melbourne's public transport operators and the government, was also important to the contract negotiations. Metlink provides public transport customers with a one-stop-shop for information about services and fares and is also responsible for introducing new signage across the network. The Metlink performance indicators were included in the contracts to give it timely and accurate information on bus service changes.

3.2 Transport policy and plans

3.2.1 Policy aims

Growing Victoria Together set out a long-term vision for the state and identified the goals that have shaped priorities. One of these goals is to grow and link all of Victoria, using the transport system to support growth and to maintain Victorians' quality of life.

The aim for Melbourne's public transport is to create a high-quality, accessible service that gives people a practical alternative to car-based travel. The greater use of public transport has the benefit of reducing the economic and environmental impacts of traffic congestion.

3.2.2 Transport plans

In May 2006, *Meeting our Transport Challenges* was published, as a long-term plan to build a world class transport system for Victoria. The plan included a commitment of \$1.4 billion over 10 years, to develop a 900 km cross-town SmartBus network and to improve the frequency, coverage and duration of local bus services. These projects began in 2007–08.

The plan included a commitment to reflect the improved standards of service in the new bus contracts scheduled for completion in 2008. The department was responsible for preparing a reform strategy for the bus industry. This meant existing contracts had to be amended if the department was to successfully improve the framework for planning and implementing the additional bus services.

The \$38 billion *Victorian Transport Plan 2008* expanded on *Meeting our Transport Challenges* by including a series of additional road and rail infrastructure projects. It kept the key features of the bus investments described in the May 2006 plan.

3.3 Moving to new bus contracts

3.3.1 Procurement responsibilities

The department was responsible for the negotiation and oversight of the new metropolitan bus contracts. The Bus Association Victoria (BusVic) represented the bus operators in the negotiations. In June 2008 the Minister for Public Transport announced that 29 new metropolitan bus contracts would come into effect on 1 July 2008. The contracts for NBC and MBL would run for five years and the remaining 27 would run for seven years with an optional three-year extension.

The department's task was to develop new contracts that were acceptable to the government and the bus operators before the existing contracts expired, in February 2007 for NBC, and in December 2007 for the remainder.

3.3.2 Procurement policy, guidelines and oversight

The Victorian Government Purchasing Board (VGPB) was set up under the *Financial Management Act 1994* to guide government departments' purchasing activities. Its functions are:

- to develop, implement and review procurement policies and practices
- to provide advice and document better practice guidance
- to monitor departmental compliance with its policies.

VGPB policies set minimum standards for the procurement of goods and services and guide contract planning, bidding and award process, and the subsequent management of the contract. For example, these policies include rules about the minimum level of competition for contracts of different values. All government departments must comply with these policies.

The Department of Treasury and Finance has published guidance to help departments apply the VGPB policies.

Under the VGPB departments are required to set up an accredited purchasing unit (APU). The department's APU assesses procurement proposals of more than \$100 000, approves proposals within the department's accreditation limit, and endorses proposals to the VGPB that go beyond this limit.

3.3.3 Procurement aims, objectives and process

Aims

The department's project to agree on new bus contracts had several aims. They were to promote partnership, openness and trust with the bus industry, to improve the quality and effectiveness of bus services and to drive improved value from the government's growing investment.

Objectives

The department's procurement objectives were to:

- get greater efficiency, flexibility and innovation in service planning and delivery
- make the costs of services and asset purchase transparent
- improve value for money
- assist operators to remain financially sustainable
- make sure that bus services would not be disrupted if an operator failed
- improve performance management, and thereby outcomes.

Part 4 examines the department's success in changing the contracts in line with these objectives. Part 5 examines whether, to date, the contracts have been carried out as intended. Part 6 examines the performance management system and whether it is likely to result in:

- bus patronage growth
- bus services that are reliable and arrive and depart as scheduled
- bus services that meet or exceed customers' quality expectations, including safety and cleanliness
- improved information for bus passengers.

Process

The procurement process may be summarised as follows:

- in the second half of 2005 the department worked with the Departments of Treasury and Finance, and Premier and Cabinet to develop a reform strategy for the metropolitan bus industry
- in late 2005 the government endorsed this strategy and agreed on a set of contract principles to allow the department to consult with the bus industry
- in mid-2006 the government endorsed the basis for the department entering detailed contract negotiations with the bus industry
- in early 2007 the government approved the detailed commercial principles and financial processes proposed by the department as the basis for finalising new bus contracts
- on 1 July 2008 new contracts started for all metropolitan bus operators. The previous contracts ended on 31 December 2007 but were extended for six months. The NBC contract ended on 28 February 2007 and had a 16-month bridging extension.

The procurement design was endorsed by:

- the APU and VGPB—because the approach and processes conformed to VGPB policies
- the government—because it represented an outcome that was likely to improve value for money and manage the risks of service disruption and discontinuity.

3.4 The audit

The audit assessed the effectiveness of the new metropolitan bus contracts by examining whether the department had:

- applied appropriate processes to negotiate the new metropolitan bus contracts
- assessed how and the extent to which the new contract requirements have been implemented
- established processes to evaluate and continuously improve the performance of metropolitan bus operators.

The audit was performed in accordance with Australian Auditing Standards applicable to performance audits, and included tests and procedures to enable audit conclusions to be reached. The total cost of the audit was \$490 000.

4

Negotiating new contracts

At a glance

Background

The Department of Transport (the department) faced a challenge in achieving the procurement objectives while conforming with government procurement policies and maintaining a constructive relationship with the bus industry.

The audit assessed the department's performance by examining whether it:

- applied the lessons learnt from the previous contracts
- used an adequate framework to negotiate the new contracts
- demonstrated that the new contracts improved value for money.

Findings

The department:

- analysed the previous contracts thoroughly to understand the strengths and identify the weaknesses that required attention
- in the new contracts fully or partly addressed the lessons it had identified
- followed the required policies for the planning, tender and award of the contracts; however, there was inadequate preparation for contract management
- applied the required processes to assess value for money
- demonstrated that the contracts are likely to improve value for money once fully implemented
- should have started the renegotiation process earlier.

While the immediate efficiency gains were limited, the contract changes provide the basis to improve the project outcomes over time.

Recommendations

For new bus contracts the department should:

- engage more effectively with operational staff to complete the contract management documentation and plan for the transition to the new arrangements before existing contracts expire
- review its performance against the planned time frames so it can formulate more realistic estimates
- provide early advice to government on the strategic options and constraints for future metropolitan bus contracts.

4.1 Introduction

The procurement objectives meant the Department of Transport (the department) had to negotiate significant changes to the existing contracts while conforming with government procurement policies and maintaining a constructive relationship with the bus industry. This presented challenges and required all parties to the negotiations to compromise.

In this part we assess whether the department's contract negotiation met these requirements, by examining whether it:

- understood and addressed the weaknesses and retained the strengths of the previous arrangements
- applied an adequate framework to develop and finalise the contracts
- demonstrated that the new contracts improved value for money.

4.2 Applying the lessons learnt

4.2.1 Past strengths and weaknesses

The department's analysis

The department thoroughly analysed the previous contracts to understand the strengths and identify the weaknesses that required attention.

The department:

- commissioned a review of the previous contracts and benchmarked their unit costs against other bus operations in Australia
- consulted with the contract managers, the bus industry and other stakeholders for their views on the contracts
- consulted with the government.

Strengths

The department recognised that the metropolitan bus industry had:

- run the required bus services without any major disruption
- maintained financial stability with no operators stopping trade because of financial hardship
- achieved service quality that customers rated higher than metropolitan trains and trams
- formed a constructive working relationship with the department and responded positively when the government wanted to expand bus services.

Competitive tendering

The department viewed the absence of competitive tendering as the main weakness of the previous contracts. It recognised that international best practice was to tender competitively for individual routes. Opening routes to competition between existing operators and new entrants had the potential to reduce costs and improve service.

The previous contracts, except for those with NBC and MBL, did not include the right for the government to tender routes at their conclusion. Three significant barriers to greater competition were identified:

- **asset ownership**—the bus operators owned most of the depots and buses needed to deliver services and any new entrant would have to spend time and resources assembling these assets to compete with an existing operator
- **information on costs**—the department knew very little about the operators' actual costs and this information would be critical in judging whether competitive bids were financially sustainable and represented value for money
- **risk of a legal challenge**—the bus industry did not recognise the government's right to competitively tender and was likely to test this in court. At the very least a challenge would delay the signing of new contracts and damage the relationship between the industry and government.

Other weaknesses

The department's analysis found further weaknesses of the previous arrangements:

- **patronage incentives**—none of the contracts, except for the NBC agreement, included any financial incentives to generate additional patronage
- **inflexible arrangements**—made it difficult for the department to rationalise the route network without compensating operators who lost revenue
- **passenger information**—passengers did not have reliable, seamless information across the bus and interfacing train and tram networks
- **new bus purchase**—the way operators procured new buses lacked transparency
- **performance measurement**—the contract outcomes that mattered to paying customers were not adequately measured
- **performance management**—the provisions for addressing poor performance were limited, only allowing for default and termination
- **service continuity**—the contracts did not include adequate provisions to continue services if an operator became insolvent or was terminated.

These weaknesses had to be addressed while maintaining a constructive relationship with the bus industry to avoid disrupting the contract negotiations and bus services. This made for a challenging negotiation.

4.2.2 Applying these lessons to the new contracts

The department worked to achieve full compliance with the procurement objectives and Figure 4A shows where there were changes to the new bus contracts. The gains are likely to be significant, but in some important areas only went part of the way to achieving the objectives. The department informed the government about the reasons for these compromises and went ahead with its endorsement.

Figure 4A
Improving the metropolitan bus contracts

Previous contract weaknesses	Extent		Measures applied to new contracts
Absence of competitive tendering	Partial	⊖	No right to tender existing local services
		⊖	No agreement to tender at the contract end
		✓	Preserved the right to tender NBC and MBL contracts
		✓	Right to tender orbital and new, local services
		✓	Expect 30 per cent of network to be competitively tendered after 2012
The government has very limited access to strategic assets	Partial	⊖	No rights over existing local bus services assets
		✓	Strengthened the provisions in the NBC and MBL contracts for asset transfer if competitively tendered
		✓	Tendering of SmartBus orbital and new, local services gives opportunity to set new asset control terms
		✓	Right to access assets on early termination of contract or sale of bus businesses
The department does not have access to operators' financial data	Partial	✓	Open book access to NBC and MBL contracts
		✓	Other operators provided detailed financial templates
		⊖	No open book access for most operators
Absence of patronage incentives	Full	✓	Patronage incentives from 1 July 2009
Difficult for the department to rationalise services	Full	✓	Rights to review and change services to improve network efficiency
Absence of seamless information	Full	✓	Formal obligations to provide information
Absence of bus purchase transparency for the department	Full	✓	Revised approach to bus purchase
Inadequate performance measurement	Full	✓	Additional Metlink performance indicators on timely, accurate and complete information
		✓	Introduction of patronage incentive and quality performance regimes from 1 July 2009
		✓	Future development of improved operational performance regime
		✓	Opportunities to introduce incentives and penalties across performance regimes
Inadequate performance management	Full	✓	Revised performance management allows for gradual escalation, remedy and cure
No provision for service continuity	Full	✓	Additional provisions to provide continuity should a bus operator fail

Source: Victorian Auditor-General's Office, using data supplied by the Department of Transport.

4.3 Following a sound contracting framework

4.3.1 Procurement policies and guidelines

The Victorian Government Purchasing Board (VGPB) is responsible for policies that set minimum standards for departments' purchases of goods and services. These cover planning for bidding and awarding contracts and preparation for managing the contracts.

The department also needed the approval of its internal accredited purchasing unit (APU). This unit is responsible for internally reviewing major contracts.

The Department of Treasury and Finance (DTF) publishes practical procurement guidance in the *Practitioners' Guide to Strategic Procurement, June 2006*.

We examined the processes used to plan for tendering, awarding and preparing for the management of the bus contracts to determine whether these:

- conformed with the VGPB policies and followed DTF's guidance
- secured the required approvals from VGPB and the department's APU.

4.3.2 Conforming to policies and guidance

The required policies and guidance for planning, tendering and awarding bus contracts were closely followed; however, a contract management plan was not prepared before the new contracts started.

Procurement planning

The department adequately addressed the planning policy requirements; however, a business plan format would have given a clearer comparison of the procurement options.

A strategic procurement plan that covered most of the content prescribed in the VGPB policies was prepared but did not, as recommended, include a procurement business case. The department added information in submissions to the government and these, together with the plan, formed the basis of the procurement decisions.

DTF has since issued its *Good Practice Guidelines—Developing a State Purchase Contract Business Case, January 2009*. For new major bus procurements, the department should use this guidance to develop a business case as part of the strategic procurement plan. The business case format is a clear and disciplined way to compare the costs, benefits and risks of the procurement options.

Contract tendering and award

The department complied with VGPB policy for the tendering, evaluation and award of the new bus contracts.

The most important decision was to limit the tendering to direct negotiation with the existing bus operators rather than putting the contracts out to the market. The department followed the policies by securing a certificate of exemption endorsed by its secretary and the APU chair.

The department also presented its preferred procurement route to the VGPB board and the government for their approval.

Planning for the contract management

The VGPB policies clearly state that the processes, structure and resources for managing contracts should be identified during the procurement planning. A contract management plan should be prepared and should:

- explain how compliance with contract conditions will be monitored
- identify the contract's milestones and key deliverables and outcomes
- define the roles and responsibilities of the participants
- describe the financial management arrangements
- include the approach to monitoring risks
- set out the performance monitoring requirements.

In its strategic procurement plan the department recognised that it needed a detailed contract management plan. It did not have one before the new contracts started on 1 July 2008.

Under the new contracts the department was required to have the operators' service plans, describing the services they would run by the end of July 2008. The department had to reconcile these plans with the services run under the previous contracts and any agreed service changes by September 2008. The plans included information on bus hours and bus kilometres for each route and day of the week.

Delays in receiving the information at the end of July 2008 occurred and the reconciliation was not completed by September 2008. The department has since analysed the agreed service plans that are still current, but has not fully reconciled these to the new signed contracts.

In addition, the following documents that inform some of the contract obligations had not been finalised by the start of the new contracts:

- the *Bus Tripartite Agreement*, designed to define the rights and obligations linking the department, Metlink and BusVic
- the *Metlink Operations Manual*, designed to help these parties and the bus operators comply with the tripartite agreement and the contracts' Metlink Performance Regime.

In May 2009 these documents were drafted but had not been finalised.

Probity arrangements

In 2005 VGPB approved the *Policy for the Conduct of Commercial Engagements* as its statement of probity policy. The audit:

- compared the department's arrangements to those prescribed in the policy
- reviewed the reports of the probity auditor
- inspected the department's records for evidence that it had applied the probity processes

The department's probity arrangements conformed to those set out in the VGPB policy. It documented a probity plan, appointed a probity auditor and had processes to maintain confidentiality, identify and deal with conflicts of interest, keep adequate records and manage communications with tenderers.

The department did not separate the probity advisor and probity auditor roles, so the auditor also provided probity advice. While this conforms with DTF's guidance on probity, VAGO views the combination of these two roles as confusing the allocation of responsibility and weakening the perception of independence.

The probity auditor wrote an interim and a final report. Both reports concluded the following about the department's approach to probity, 'in all material respects and based on the government's probity requirements, we are not aware of any probity issues...'. These reports were brief and did not give enough information about the adequacy of the probity arrangements. For example, while the conclusion was positive, the reports did not outline how the probity auditor reached this conclusion.

VAGO reviewed the department's documentation to verify the application of most of the processes described in the probity plan relating to conflict of interest, confidentiality, and record keeping.

4.3.3 Departmental and Victorian Government Purchasing Board approvals

The department's APU and the VGPB endorsed the procurement approach subject to several conditions. The documentation demonstrates compliance with some, but not all of these conditions. The department needs to verify that these conditions have been met or allowed for and provide this information to VGPB.

The department's accredited purchasing unit

The APU endorsed the strategic procurement plan in December 2006, subject to:

- including in the plan, steps to benchmark the contracts' costs against the tendering outcomes for the NBC and MBL contracts and the competitively tendered SmartBus contracts for SmartBus orbital routes planned for 2012
- developing a risk management plan and an associated risk log.

An updated version of the plan amended to reflect the additional benchmarking requirements has also not been completed. The department developed a risk management plan and maintained a project risk log. However, the log did not identify and address all critical issues including delays in finalising the new bus contracts.

Victorian Government Purchasing Board

The VGPB approved, subject to nine conditions, the process set out in the strategic procurement plan in December 2006.

The department had fully addressed six of the conditions by:

- submitting a completed conduct plan for commercial engagements
- gaining ministerial approval
- executing contracts that were consistent with the strategic procurement plan
- complying with requirements for Commonwealth competition, fair trading and consumer protection laws
- including details of all the contracts on the VGPB contracts publishing system
- gaining APU approval for the documentation describing the completed contract negotiations.

The VGPB requested that the department consider a Gateway type review process at major project milestones. The department stated that a Gateway review was considered but inapplicable because the procurement was not a capital project.

The VGPB also requested an updated analysis confirming the success of the contracts about 12 months after their introduction.

Finally, the VGPB recommended that the department clarify that Members of Parliament and the minister's officers should attend at the committees governing the delivery of the new bus contracts as observers. Consequently, the ministerial advisor did not attend any further meetings of the project steering committee.

The department should acquit these conditions to the VGPB and indicate how it plans to report on the progress of the contracts after the first year of operation.

4.4 Demonstrating value for money

4.4.1 Value for money

DTF's procurement guidelines—*Practitioners' Guide to Strategic Procurement (non-SPCs)*, June 2006—defines value for money as achieving the government's service objectives at competitive market prices on a whole-of-life basis. For buses it meant:

- delivering services of the required type and quality
- introducing greater cost transparency and competition
- managing the project risks, including the potential service disruption and costs of failing to reach agreement with the bus industry.

For most purposes, value for money is best served where competing companies bid against each other to deliver well-defined services. The commissioning agency can compare prices and deliverables and demonstrate which bid offers value for money.

This works when:

- there is genuine competition, with multiple, capable bidders willing to compete with each other
- none of the incumbents control the market or key assets in a way that prevents effective competition
- the management of significant risks can be resolved during the bidding process.

However, there are situations where agencies may have to consider an alternative to competitive tendering. For metropolitan bus services the government did not own or control most of the assets needed to run bus services. This meant the department had to compare the costs, benefits and risks of competitive tendering with a negotiated settlement to inform the decision on the best procurement route.

Criteria for assessing value for money

To assess value for money the audit examined whether the department had:

- the processes to assess and deliver improved value for money as recommended in the *Practitioners' Guide to Strategic Procurement (non-SPCs)*, June 2006
- shown that the arrangements improved value for money.

The practitioners' guide notes that verifying improved value for money can only happen after the services have been delivered. This section assesses whether the final contracts are likely to deliver improved value for money. Part 5 assesses implementation and Part 6 reviews performance monitoring and examines whether performance to date has met expectations.

4.4.2 Processes for improved value for money

The department applied the processes for improved value for money recommended in the practitioners guide. Given the scale and profile of the contracts the department presented its key recommendations for government approval before proceeding.

The practitioners' guide provides the following steps for improving value for money:

- defining the procurement objectives and negotiation position early in the process
- analysing the costs of the previous and proposed arrangements and using these to drive greater efficiency
- assessing the benefits of changing the contractual arrangements
- forming a risk management strategy to identify and mitigate the material risks
- planning for continuous improvement throughout medium- to long-term contracts.

Objectives and commercial principles

The department clearly defined the procurement objectives and the principles to guide its approach to the negotiations with the bus industry.

Understanding the costs and driving greater efficiency

The department thoroughly analysed bus operators' costs and was only able to make limited efficiency gains during negotiations. The costs of the new contracts, after allowing for inflation, were similar on a like-for-like basis to the costs of the previous contracts.

The department:

- benchmarked the costs of the previous contracts against those of bus operators in other Australian states
- determined the range of profit margins that represented a reasonable return
- accessed detailed information for the first time on the bid costs and margins through the financial templates submitted by the bus operators
- compared the operators' unit costs and profit margins, to identify the more expensive outliers and negotiated changes with some of these operators.

Benchmarking costs and modelling reasonable margins

The department's analysis suggested that Melbourne's bus operators were compensated slightly more than their interstate counterparts on a total kilometre basis. However, the location and number of depots in Melbourne means buses are nearer to the routes they service and, on average, do not travel as far between these routes and the depots. As a consequence Melbourne's bus services are slightly cheaper than their interstate counterparts on a service kilometre basis.

The planned tendering of the SmartBus orbital routes and new local bus services will shed light on the potential cost gains from exposing bus services to competitive tendering.

Comparing costs and margins across all operators

The bus operators agreed to provide the department with a detailed breakdown of their costs by populating a financial template. This material was assembled by a consultant to the bus industry and verified by an accountancy firm working to the department.

The unit costs and margins varied significantly from the average values. Figure 4B shows the ranges around the average for each type of cost and profit margin. The ranges arise because of different operating circumstances and bus operator efficiency.

Figure 4B
Range of costs and margins around the averages for all operators

	Variation from average (%)	
	Lowest	Highest
Costs related to bus hours (e.g. wages)	-15	+13
Costs related to bus kilometre (e.g. fuel)	-18	+27
Costs related to the number of buses (e.g. overhead costs for depots)	-26	+65
Profit margin	-44	+61

Source: Victorian Auditor-General's Office summary of Department of Transport's analysis.

As part of the invitation to negotiate, bus operators agreed to be benchmarked and to justify or amend costs and margins where these exceeded the industry average by the agreed upper limits. These upper limits were:

- 10 per cent for bus hour costs
- 10 per cent for bus service kilometre costs
- 20 per cent for bus overhead costs
- 2 percentage points for profit margin.

The department examined 18 operators who were above the industry upper limits and negotiated cost reductions for 11 of them. The higher figures for seven operators were accepted on the basis of the particular operating conditions, such as extraordinary traffic congestion or additional service requirements.

The department made modest cost reductions through the benchmarking process, reducing the contract costs by about \$1.3 million, or 0.3 per cent of the typical annual costs of \$400 million. In total, and on a like-for-like basis, the costs of the new and previous contracts were very close.

In a separate exercise it reviewed the financial sustainability of all the bids. It concluded that for one operator the previous contract payments would not sustain the business. This was based on an open book review. The department agreed to increase the contract payments by 15 per cent or \$7.7 million above the former owner's bid. This gave the operator the smallest margin in the industry and a five-year contract that will be competitively tendered when it expires.

The department's latitude to drive greater efficiencies was limited because it needed to persuade the bus operators to voluntarily provide detailed information on their actual costs that had not been part of previous negotiations. As a result, the terms of the invitation to negotiate only allowed for limited change, which explains why the department agreed to the generous benchmark limits.

The costs of contract administration and incentives

The new contracts will incur additional monitoring and administration costs. The department estimated that these costs would require an additional \$7 million per annum. The scale of these costs was unlikely to change the key procurement decisions.

The new contracts allowed for the future payment of financial incentives to operators for increased patronage and improved operational and service quality. The money set aside for these incentives has been set at 2 per cent of the contract value. The patronage incentive scheme is scheduled to start from 1 July 2009. The department is still consulting with BusVic on the details of the other incentive schemes and when these are likely to start.

The department stated that the size of the incentive pool was agreed on by negotiation with the industry as sufficient to provide an incentive but also commensurate with the operators' control of risks. The department did not have documents recording these decisions and their basis.

Understanding the benefits

The department described how the new contracts would address the contract objectives and clearly explained where and why these would not fully achieve these objectives.

Understanding and managing the risks

The strategic procurement plan described the key project risks and the department's mitigation plans. While it managed most risks well, there were lessons for the contract management and project timeline risks.

Approach to risk management

The procurement plan described the key risks, assessed their importance and briefly described how the department would manage them. The review of the procurement submissions and records showed that most of these risks had been well handled and the proposed management actions had been reflected in the new contracts.

The department's APU requested additional information on risk management. However, it was not evident the department acted on this request. The department prepared and maintained a detailed risk log but this did not deal with the risks of failing to meet the procurement time lines.

Contract management

The department identified that 'the risk of a breakdown in the contract management function is high and that the consequences due to poor contract management will have a high impact on project objectives and delivery'. The proposed risk controls included the preparation of a detailed contract management plan to help the contract managers with their tasks.

The department did not develop a contract management plan before the new contracts became operational on 1 July 2008. The main work to formulate a contract management plan happened after the contracts commenced. A contract management manual was completed in October 2008 and the department was still developing contract management processes in May 2009.

For future procurements the department should always complete a contract management plan and start to implement it before new contracts begin. This means identifying the staff who will manage the contracts and engaging them at an early stage.

The department has recognised the need to change the way it prepares for the management of new bus contracts. The negotiation of the new regional and school bus contracts will be overseen by the deputy director bus and regional services, who is responsible for service delivery and contract management. This will provide a renewed focus on contract management during these negotiations.

Project time lines

The NBC contract expired in February 2007 and the other contracts expired in December 2007. The strategic procurement plan identified the risk of failing to meet the project time lines before the existing ones. The controls to manage this risk included:

- agreeing to extend the existing NBC and MBL arrangements if new contracts had not been agreed by the expiry date
- reinforcing the requirement to finalise contracts with the other operators by the expiry date in December 2007 through a deed committing all parties to achieve the deadline.

The department used the extension and finalised the NBC contract 16 months after the expiry deadline of February 2007.

The commitment deed did not result in contract completion by December 2007 for the remaining contracts and the new arrangements started six months late, on July 2008. However, by extending the previous arrangements, there were no disruptions to bus services.

The department explained that some of the extra contract requirements had prolonged information gathering and negotiation. In particular the assembly, submission and review of detailed data on the operators' actual costs had taken longer than expected.

The department should apply this experience when estimating the time needed for future bus procurements, especially when they introduce similar amendments.

The timing of advice and its impact

In contrast to most metropolitan bus contracts, the government had the right to competitively tender the NBC and MBL contracts but did not have reasonable access to the operators' assets. One of the reasons the department advised against a competitive tender for NBC and MBL was that other companies could not assemble the assets required in time to bid for the contract.

If these companies were not willing to provide access to these assets at a reasonable price it would take between two and three years to procure new buses and might take up to six years to create new depots. Competitive tendering was contingent on these companies providing access to their assets. After an initial consultation the department concluded that a negotiated, open book tender process was the best way forward. However, the new contracts include provisions that should make competitive tendering viable after these contracts expire in five years.

The other metropolitan contracts include no commitment to competitive tendering or access to assets for most bus services. Given the lead times involved in securing alternative assets, the department should provide early advice to government on the strategic options and constraints for future metropolitan bus contracts.

Continuous improvement within the contracts

The contracts include provisions that should improve service over the contract term. In particular operators must improve the measurement and management of services that are important to bus passengers. If done as intended these provisions should enhance performance and improve value for money.

These mechanisms to improve performance are not accompanied by the means to drive further efficiency gains for the services that will not be subject to competitive tendering during the life of these contracts.

The contract negotiation gave the department an improved understanding of the operators' costs through the submission of financial templates. While not totally open book, where the department can inspect operators' financial records, the templates gave enough detail to offer a valuable insight into industry costs.

However, this window closed after the negotiations ended. The operators have no obligation to update these templates over the contract term. The contracts allow for inflation but do not include ways for the department to track changes in efficiency and to share the gains or losses that result from them. The department accepted this in return for accessing, for the first time, detailed information on the bus operators' costs.

4.4.3 The impact on value for money

The contracts, for the most part, did not produce immediate gains but set the preconditions for delivering improved value for money during the implementation.

While the gains were insignificant in terms of reducing the cost of service provision, the department fully achieved the following contract objectives:

- gaining agreement to expand and improve performance measurement and the provisions for managing performance
- including the department's right to review and amend bus services to improve the effectiveness and efficiency of the bus network
- providing for service continuity, if bus operators experienced financial failure
- agreeing on set rates for varying existing services, in contrast to the old contracts where each variation involved a stand alone negotiation
- improving the way new buses are procured to make this more transparent.

For other contract objectives the department made significant but partial gains by:

- securing agreement to competitively tender new local services and the SmartBus services forming orbital routes around Melbourne, with the expectation that 30 per cent of services would be tendered during the term of these contracts

- gaining access for the first time to detailed information on the bus operators' costs during the negotiation phase
- achieving limited improvement in its rights to access the assets needed to operate bus services if contracts were terminated early.

The decision not to pursue full competitive tendering was based on a thorough analysis of the potential efficiency gains, the risks and the consequent costs. For all but one of the previous contracts, the government had no rights to access the assets needed to run buses and the contracts did not include a right to competitively tender services. The department fully informed and involved government in the key decisions about the procurement of these services.

The previous NBC and MBL contracts were different. The government had the right to competitively tender these services but did not have free access to the assets, except for NBC's depots. It would have required a minimum lead time to assemble these assets to allow a competitive tender.

Again the department fully informed and engaged with the government in the key procurement decisions. However, part of the department's rationale for a negotiated tender was the lack of time for competitors to assemble the necessary assets. Therefore, the department should provide early advice to government on the strategic options and constraints for future metropolitan bus contracts.

Recommendations

For new bus contracts the Department of Transport should:

- 4.1 engage more effectively with operational staff to complete the contract management documentation and plan for the transition to the new arrangements before the existing contracts expire.
 - 4.2 review its performance against the planned time frames so it can formulate more realistic estimates.
 - 4.3 provide early advice to government on the strategic options and constraints for future metropolitan bus contracts.
-

5 Implementing the new bus contracts

At a glance

Background

This part examines the implementation of the obligations that are critical to the achievement of the contract objectives.

Findings

- The current performance reporting obligations had only been partially met because the application guidelines were incomplete.
- The Department of Transport (the department):
 - started developing the improved performance regimes outlined in the contracts. However, it is unlikely to deliver the quality performance regime on-time because the work didn't start early enough
 - correctly paid operators for the bus services they had delivered, but the payment processes need to be strengthened to address the continuity risks and improve their efficiency
 - followed contract provisions in its authorisation and payment for replacement buses.
- Arrangements for monitoring and handling fare revenue had been carried out as intended and were adequate.

Recommendations

The department should:

- create and maintain a record of performance against the Metlink performance indicators
- document the contract payment processes and ask operators to submit a monthly record of missed or additional services as the basis for adjusting monthly contract payments.

5.1 Introduction

A good contract translates into effective services when obligations are met and the required outcomes are achieved. This part examines whether:

- the Department of Transport (the department) has applied processes to measure bus operator compliance with the contracts
- this information shows that the contracts have been used as intended.

Some of the contractual obligations:

- involve clauses that had not been activated, for example the provisions for dealing with a situation where a bus operator failed financially
- provide a legal safeguard but do not obligate the department to actively monitor aspects of the contract, for example the operator commitment that all warranties are up-to-date.

This part focuses on the active contractual obligations that are critical to the achievement of the contract objectives. The obligations covered below relate to:

- performance management
- payment for bus services
- purchase of new buses
- collection and handling of fare revenue.

5.2 Performance management

5.2.1 Performance measurement and reporting

The types of performance measures

New contracts offer guidance on the management of:

- **operational performance**—measures whether operators have run the required number of bus services according to the published timetable
- **patronage growth performance**—measures and rewards patronage growth
- **qualitative performance**—measures aspects of service quality that are important to bus passengers
- **service information performance (Metlink performance regime)**—measures whether operators have complied with their obligations to provide timely and accurate information on bus services and any adjustments to Metlink, the body responsible for collating and publishing this information.

The approach to developing improved performance management

The previous contracts measured and managed operational performance and relied on operator reports about service delivery and on-time performance. The new contracts were designed to improve and expand the scope of performance management.

The department adopted a two-stage approach to improving performance management. This included the immediate implementation of a limited performance regime and the commitment to expand and improve on this initial approach over the course of the contracts. The department adopted this two-stage approach because it needed more time to:

- develop technology that can improve operational performance measurement
- reach an agreement with operators about qualitative performance measures
- negotiate the measures, benchmarks, penalties and incentives that will apply to the operational, qualitative and service information performance regimes.

While the development and implementation of a bus tracking system will take several years, the contract includes a provision for the quality performance regime to start one year into the new contracts. Had the department started the preparatory work for the quality performance regime earlier, it would have been ready to implement when the contracts started.

Immediate obligations and longer-term commitments

The performance obligations under the new contracts included:

- carrying over the previous contracts' operational performance indicators, while clarifying and expanding the operator's reporting requirements
- introducing requirements for the timely provision of accurate and complete information on bus service changes to Metlink. The contract does not specify when these provisions become active, which means they are applicable from the contract start date.

The new contracts obligated the department and the operators to:

- develop bus tracking technology to improve the measurement of operational performance
- agree on a new performance regime and implement it once the technology was proven
- implement the patronage growth performance regime described in the contracts from 1 July 2009
- develop a qualitative performance regime for implementation from 1 July 2009.

5.2.2 Immediate performance obligations

Operational performance

Reporting on operational performance did not fully comply with the contractual requirements because the department had not finalised the practice note that would inform the content of the operators' monthly reports. In the absence of this guidance operators have continued to use the reporting template from the previous contracts. The department and the industry have now agreed on a new form of reporting that should resolve this issue when implemented.

Requirements

The new contracts require operators to prepare a monthly operational report. This is a detailed report and analysis of their operational performance, including:

- an analysis of all cancellations and missed services and the on-time running performance of a 5 per cent sample of the local bus services
- special event service kilometres and hours
- details of complaints received.

In addition, every July operators must inform the department about the private charter and advertising revenues earned in the previous year.

The information in the reports should be set out as prescribed in the department's practice note so performance can be measured against the following benchmarks:

- no local service must leave a specified timing point on its route earlier than 59 seconds before the departure time in the timetable
- no more than 5 per cent of local services should arrive at their scheduled destination more than five minutes and 59 seconds after the scheduled arrival time
- no operator can cancel more than 0.5 per cent of local services on any day
- the department will adjust an operator's payments for any missed services.

Compliance with these requirements

The 29 bus operators had prepared all but three of the 261 monthly reports for the period from July 2008 to March 2009, but the information supplied did not fully comply with the new reporting requirements.

The template used for these reports was carried over from the previous contracts because the department had not, as at May 2009, agreed on a final version of the practice note for the updated reporting requirements.

The old-style reports provide information about the number of weekly scheduled bus trips and cancellations, patronage and, for a 5 per cent random sample, on-time running. These reports did not comply with the new contractual requirements because they:

- use different performance benchmarks for early and late running
- do not include enough information to determine whether an operator has cancelled more than 0.5 per cent of services on any day
- do not include information on special event services and customer complaints.

In May 2009 the department and the bus operators agreed on the form and content of updated reports on operational performance. These reports should address the contracts' reporting requirements when applied.

Information provided to Metlink on bus service changes

The contractual obligations were not completely clear because their meaning partly depended on documentation that had not been finalised as at May 2009. Additionally, the contracts did not ask operators to report on their performance and there is no consolidated, written record of achievement against these benchmarks.

Requirements

Under the contracts operators must:

- provide Metlink with '*complete, current and accurate*' transport information on new or amended bus services within time frames specified in the contracts
- inform Metlink about any damage to bus stops and transport signage and must do this within the time frames specified in the contracts
- comply with Metlink's guidelines about the information available on buses.

The advanced notice required for service changes does not apply where the department requests a new or amended service so that the operators cannot comply with the notice requirements. Although the contracts did not include incentive and penalty payments for these requirements, the possibility of negotiating these over the contracts' terms remains.

The contracts refer to the *Metlink Operations Manual* for definitions of *completeness, currency* and *accuracy* related to the transport information operators must provide to Metlink. Manual preparation was in an advanced stage as at May 2009, but had not been finalised.

Compliance with these requirements

There were no reports detailing the operators' compliance with these requirements. Metlink told VAGO that for some service adjustments there was a much shorter notice period than the one required under the contract.

The department gave examples of when it had asked for new or adjusted bus services at short notice and operators were unable to meet the contractual notice requirements. In another case, an operator had not immediately notified Metlink of a service adjustment.

The department should:

- confirm that operators are clear about their Metlink performance obligations
- create and maintain a written record of operators' performance in meeting their Metlink obligations.

5.2.3 Longer-term performance developments

Operational performance

The department has a plan to deliver a working bus tracking system and a trial regime by the end of 2012, with the full application of the upgraded operational performance regime expected by the end of 2013. Based on these time lines the upgraded operational performance regime should start about five and a half years after the new contracts began in July 2008. These contracts are meant to run for seven years, with the option of a further three-year term at the end of seven years.

For the project to be a success the department needs to:

- carefully manage the associated risks in a project involving technology applications
- take a balanced approach to combining the technological and operational requirements and constraints with the contractual negotiations.

The department secured funding, on the basis of an approved business case to develop and use technology to monitor the operations of all metropolitan buses by the end of 2012. The business case required the department to fit similar equipment to that used to track the buses on SmartBus routes. It rejected basing the tracking system on the new smartcard ticketing system because of the interface and information exchange risks. This new tracking system, together with the definition of performance indicators, benchmarks and reporting requirements will allow a year-long trial to start by 2013.

There was evidence that the department had started to implement the preferred bus tracking technology. Although progress has been slower than expected, the department demonstrated that it still had enough time to deliver the working technology in all metropolitan buses by the end of 2012.

The chair of the project's governance group for the project is the person who manages the contracts and unites those responsible for the technology, operations and contract negotiations. This should help the department make project decisions based on the full range of relevant requirements.

Patronage growth

The department and the bus operators have agreed on the patronage growth indicators, benchmarks and incentives. The department has access to validation data that gives an adequate estimate of annual patronage to measure and reward performance.

There is nothing preventing the regime from starting as at 1 July 2009, but there was some uncertainty about what this entails. The confusion arose because it was unclear whether the patronage data collected in 2009–10 should be:

- compared with 2008–09 patronage, with the first payments calculated at the end of June 2010, or
- compared with 2010–11 patronage, with the first payments calculated at the end of June 2011.

The department has reached a resolution on this issue and the patronage incentive and payments will start from 1 July 2009.

Service quality

To achieve the July 2009 deadline the department would have needed to start intensive work soon after the contracts came into operation in July 2008. The work on this project started in early 2009 and it will not meet its contractual deadline. The quality performance regime is now scheduled for implementation by October 2009, some four months after the 1 July date in the contracts.

The department has started designing qualitative performance measures and benchmarks and agreeing on these with the bus industry. It has yet to start negotiations with the bus industry on the incentives and penalties that will apply to the performance outcomes.

To date the negotiations between the department, the bus industry, and other parties have taken longer than expected. Given this track record, the development of the quality performance regime will need to be carefully managed to meet the October 2009 target.

5.3 Payment for bus services

The data on total payments to date and the analysis of a sample of operator payments shows the department has correctly paid operators for the bus services they delivered under the new contracts, based on the information provided to the payments team. This result relied on the experience and attention to detail of the small team responsible for calculating these payments, rather than the comprehensiveness of the controls around the payment system.

Changes to the way payments are calculated have made the process more labour intensive and complex, increasing the department's reliance on the capacity of the payments team. The department needs to improve its payment processes to guard against the loss of key staff, and to make the processes more efficient.

5.3.1 Payment processes

Under the new contracts the way operator payments were calculated has changed.

Under the previous contract system the payments team entered information into a custom software application that calculated and then processed the payments. Changes under the new contracts meant that the application could not calculate payments without modification.

The department rejected the option of paying to modify the existing bus payments software because of the likely costs and time lines for completing the upgrade. In addition, the department's long-term response to develop a contract management package to handle the payments for the new bus, tram and train contracts, meant that the upgraded system would have to be replaced. The department concluded that the most cost-effective solution was to develop a spreadsheet to calculate service payments as a short-term fix. The department is currently developing a business case for this project; however, a new system is unlikely to be available for several years.

The payments team calculates monthly service payments based on:

- knowing what amount each operator should receive for a full schedule
- gathering information about on missed or extra services from the department's bus regional managers
- applying this information to calculate each operator's monthly payment
- manually entering this information into the custom application used under the previous contracts to generate a payment.

The payments team produces a monthly report on the amounts given to each operator and reconciles this against the level of expected payments.

5.3.2 Examining the payment processes

A selection of payments was examined and found to be accurate. However, the result relied on the payments team's ability to apply processes and check their accuracy. These processes had become more manual and labour intensive and sometimes informal.

One area of uncertainty concerned the deduction of operator payments for missed services. The payments team relied on operators submitting statements about cancelled or curtailed services and their impact on planned service hours and kilometres. Only two operators had provided these statements. The operational reports provided by operators did not contain this information under the old format used up to May 2009.

The operational reports for a small number of operators reported that there had been cancellations. However, not all these cancellations had resulted in statements of missed services being supplied to the payments team. The new-style operational reports agreed on with the industry will report this information for all operators once implemented.

The department should review the information on cancellations since the start of the contract and check that operator payments have been amended to reflect these missed services.

5.3.3 Areas for improvement

The department should improve its payment processes through:

- documenting these processes to mitigate risks of key staff becoming unavailable
- validating the data submitted as the basis for payments through better documentation of monthly service outputs that requires operators to produce a record of all missed and additional services.

5.4 Purchasing replacement buses

The department has followed the improved contract provisions to authorise and pay for replacement buses under the new contracts.

5.4.1 Bus replacement processes

The department has an agreed replacement program for metropolitan buses, which was in place under the previous contracts.

Bus operators, under the old and new contracts, buy buses in line with the replacement program guidelines and receive an amount to cover the finance charges on a loan over a 14-year period, based on the expected useful life of a bus. The department calculates the payments based on a variable, market-based interest rate.

The new contracts make the operator payment process for purchasing replacement buses more transparent. Operators must now provide evidence that they have purchased a bus before the department provides any payment. This allows the department to check and authorise the bus specification before handing over any money.

Previously the department might provide payment according to its replacement plan before the operators purchased vehicles. The paperwork would follow some time after the transaction and then the department would make balancing adjustments for any over or under payment.

The arrangements are an improvement on those used under the previous contracts and are more transparent.

5.4.2 Evidence on implementation

The payment calculations in the examples we examined were correct. Our examination revealed that there is increased transparency in payment for buses and potential cost savings for the department. The new contracts' interest payments are made to operators for the 14 years over which a bus will depreciate, while under the previous contracts the interest payments continued for as long as the bus was being used.

5.5 Collection and handling of fare revenue

The arrangements for monitoring the collection and handling of fare revenue are now satisfactory because of the Transport Ticketing Authority's (TTA) work to strengthen them. This followed the discovery of discrepancies between reported ticket sales and the revenue received by TTA.

5.5.1 Obligations and responsibilities

The operators are responsible for all the fare revenue they collect and for any shortfall between recorded ticket sales and revenue. The specific obligations include:

- making sure all passengers are in possession of a valid ticket
- protecting and depositing fare revenue into a nominated bank account within 72 hours of each day of operation
- informing the department of any matter relating to fare evasion that the operator is aware of.

The department has the right to audit the operators to determine their performance against these obligations.

TTA is responsible for:

- managing the fare revenue when it is deposited in the nominated bank account
- checking that the fare revenue is consistent with recorded ticket sales
- providing the department with its 20 per cent share of fare revenue.

5.5.2 Processes

Each month TTA prepares a cash shortfall report for the department, which:

- compares reported cash against cash banked, with explanations for any variances
- reports on compliance, with the obligation to bank cash within 72 hours.

TTA also audits bus operators to examine cash controls, ticket sales and cash-to-sales reconciliations and information security. These audits are reported to the department and if an area of non-compliance is found the department follows this up with the operator.

TTA also conducts covert inspections on bus routes to observe bus driver activities to provide assurance that fare revenue is properly collected and handled.

A Revenue Audit Steering Committee, with an overall monitoring role for public transport revenue, meets quarterly. A departmental officer chairs the committee, which includes representatives from the public transport operators.

5.5.3 Evidence on implementation

In the past two years TTA has overhauled its approach to the collection, handling and verification of fare revenue. It detected anomalies when reconciling the fare revenue banked with ticket sales information. The discrepancies were connected to the activities of one firm that provided a service to transfer money from two bus operators to the bank. The police are pursuing criminal charges against this company.

TTA concluded that the controls around these processes were inadequate and developed ways of addressing the weaknesses that allowed this fraud to go undetected for some time.

We reviewed the analysis of the control weaknesses and verified that these had been addressed by:

- interviewing departmental and TTA personnel
- reviewing material that identified the control weaknesses and citing evidence that action had been taken to address these weaknesses
- reviewing the current processes to verify and report on fare revenue.

We reviewed a sample of TTA's reports on differences between recorded ticket sales and the money banked and found that variances between reported sales and cash deposited had been reconciled and satisfactorily explained. In addition, the reporting sample identified operators that failed to comply with 72-hour banking requirements.

We also reviewed a sample of TTA audit reports on operator fare and ticketing records and found that non-compliance issues had been identified and operators had been asked to provide a response outlining how these issues would be addressed.

Recommendations

The Department of Transport should:

- 5.1 create and maintain a record of performance against the Metlink performance indicators
 - 5.2 document the contract payment processes and ask operators to submit a monthly record of missed or additional services as the basis for adjusting monthly contract payments.
-

6 Evaluating the performance of the new bus contracts

At a glance

Background

An evaluation framework should include indicators that are relevant to the stated objectives, benchmarks that are appropriate for assessing performance and information that fairly represents performance.

Key findings

- Documentation justifying the appropriateness of the performance benchmarks included in the new bus contracts was not available.
- For the current performance frameworks:
 - operational performance had relevant indicators; however, performance benchmarks and approaches to performance measurement are unexplained
 - the patronage incentive system has a relevant indicator, unexplained performance benchmarks and a reliable approach to measuring performance
 - the Metlink indicators and benchmarks are reasonable but performance has not been systematically measured and reported.
- The information produced in the first 11 months of the contracts did not address the operational performance reporting requirements. The application of the revised reports agreed on in May 2009 should address this issue.
- It is not clear that the Department of Transport (the department) used the available information to evaluate and improve operators' performance.

Key recommendations

The department should:

- document the basis for its current performance indicators and benchmarks and update this document when the performance management system is amended
- strengthen the processes around the measurement of on-time running by verifying that the operators' approaches are adequate and periodically inspecting their operational records
- design processes so that information about service changes is effectively and quickly passed to the relevant organisations.

6.1 Introduction

The Department of Transport (the department) should collect information to verify performance against contract objectives. The audit examined whether indicators were relevant to the stated objectives, benchmarks were appropriate for assessing performance and information fairly represented performance.

The objectives for the contracts included:

- scheduled services with minimal cancellations arriving and departing according to the published timetables
- promoting patronage growth
- high-quality services
- improving the timeliness, comprehensiveness and accuracy of bus information.

Part 5 details the contractual provisions for the measurement of performance relating to patronage, bus operations, the quality of bus services and the provision of bus information.

The contracts included the obligation to monitor bus operations and to provide bus information from the start of the contracts and a commitment to improve operational performance. The contracts also committed to increasing patronage and service quality starting one year into the contract term.

In this part we:

- examine the adequacy of the performance indicators defined in the contract
- determine whether the contracts have generated the information the department needs to understand the operators' performance
- review how the department has used this information to refine the bus contracts.

6.2 Assessing the performance frameworks

Most of the indicators were relevant because they clearly related to the objective being assessed. The department, however, did not have documentation describing the analysis and rationale for setting performance benchmarks and this made it difficult to determine whether the benchmarks were appropriate. The department should comprehensively document an evidence based rationale for the performance benchmarks included in the new bus contracts.

6.2.1 Current and planned performance regimes

Figure 6A illustrates the current and planned performance indicators and benchmarks.

Figure 6A
Current and planned performance indicators

Key performance indicator	Benchmark(s)	Incentives/penalties*
Patronage incentive regime—from 1 July 2009		
Change in annual bus ticket validations on each bus route	Payment for patronage growth above 2 per cent per annum corrected for any growth in service kilometres	Incentive of 50¢ additional validation
Interim operational performance regime—from 1 July 2008		
Early departure from designated timing points along bus routes	No service will leave a timing point more than 59 seconds before the scheduled departure time	No incentives or penalties
Arrival time at destination	No more than 5 per cent of all services should arrive at their scheduled destination more than 5 minutes and 59 seconds after the scheduled arrival time	No incentives or penalties
The percentage of services cancelled on any day	Daily cancellations should not exceed 0.5 per cent of services	Payments adjusted for cancelled services
Trial operational performance regime—from implementation of bus tracking system for at least a year		
As for interim regime	As for interim regime	No incentives or penalties
Full operational performance regime—from end of trial regime		
Indicators to be agreed on by the department and the bus operators	Benchmarks to be agreed on by the department and the bus operators	Incentives and penalties to be agreed on by the department and the bus operators
Qualitative performance regime—from 1 July 2009		
Indicators to be agreed on by the department and the bus operators	Benchmarks to be agreed on by the department and the bus operators	Incentives and penalties to be agreed on by the department and the bus operators
Metlink performance regime—from 1 July 2008		
Provision of complete, current and accurate information to Metlink on:		
<ul style="list-style-type: none"> changes to bus services 	Minimum notice periods for providing Metlink with information on adjusted and new bus services	No incentives or penalties
<ul style="list-style-type: none"> damage to bus stops and signage 	Minimum notice period for informing Metlink once damage detected	No incentives or penalties
Maintenance of on-board information	Requirement to maintain information defined in the Metlink operations manual	No incentives or penalties

Note: * The contract includes the provision for remedial action to address poor performance and the escalation of action up to termination if these issues are not addressed.

Source: Information summarised by Victorian Auditor-General's Office from the Metropolitan Bus Service Contracts 2008.

6.2.2 Patronage incentive regime

The audit found that the performance indicator is relevant to the contract objective for this regime. The performance benchmark is appropriate and the information collected should fairly represent actual performance.

Overview

The aim of the contracts was to increase the number of people using buses. Operators are rewarded with a payment of 50¢ per additional passenger if the annual growth in route patronage exceeds 2 per cent. There are no penalties if patronage falls. Patronage growth is measured using the number of ticket validations on each route.

Assessment

The performance indicator of the change in annual route patronage is relevant because it is consistent with the department's objective of promoting patronage growth. It is also partly within the operators' control because they can offer reliable and high-quality services that encourage people to travel on buses.

It is not clear how the department determined the 2 per cent minimum growth and financial incentive amounts that will be applied in the contract. The inclusion of a minimum threshold means that minor variations in growth will not be rewarded; however, there is no documented justification of these settings.

The information collected is likely to be representative of actual performance. The validation data is a reliable indicator of bus boardings, except on the very few occasions when validation machines breaks down. The contract allows the department to substitute trend information if machine failure compromises the measurements.

6.2.3 Current operational performance regime

The performance indicators for current operational performance are relevant to the contract objectives but the department could not produce documentation explaining why the performance benchmarks it used are appropriate. While the data on cancellations is likely to represent actual performance, there is less certainty about the reliability of the on-time running information.

If the bus tracking system is successful it will provide reliable information. In the meantime the department should document the rationale for the current benchmarks and strengthen the oversight and review of performance information.

Overview

The department recognised the need to improve the measurement of operational performance. The contract commits the department and bus operators to improve the performance regime, including the installation of an automated bus tracking system to measure performance more reliably.

In the interim, the contracts include the benchmarks described in Figure 6A for:

- early running—no service should leave a timing point on its route more than 59 seconds before the scheduled departure time
- late running—no more than 5 per cent of an operator's services on any day should arrive at their destination more than 5 minutes and 59 seconds after the scheduled arrival time
- cancellations—no more than 0.5 per cent of an operator's daily services should be cancelled.

Bus operators are required to keep a record of all cancelled services and also measure on-time running for a 5 per cent minimum random sample of their local services.

Assessment

The performance indicators that measure the number of cancellations, late arrivals at the route end, and early departure from timing points are relevant to the contract objectives. They are also consistent with the department's aim of providing reliable bus services. Bus operators are responsible for bus cancellations and early departures, but they do not have control over some factors that lead to late running services.

The benchmarks for late running provide an incentive to avoid delays while tolerating some slippage due to factors beyond the operators' control. The definition of late running is the same as for metropolitan trains but it is not clear why the department decided this was appropriate for metropolitan buses.

Setting cancellation and early running benchmarks very low is appropriate because the bus operators have control of these factors.

Furthermore, the department agreed to less exacting benchmarks than for the previous contracts, but the rationale for this is unclear. The previous benchmarks were that no more than 5 per cent of daily services or 10 per cent of daily services on a single route should run more than five minutes later than scheduled. The current contracts dropped the 10 per cent figure and raised the five-minute threshold to five minutes and 59 seconds.

The department explained that it made the decision to keep the on-time running benchmark consistent with the one used for metro rail services. The department advised VAGO that the change to five minutes and 59 seconds clarified the benchmark because 'five minutes' could mean 'up to five minutes and 59 seconds'.

However, this approach was not documented and does not explain why the previous contracts included an early departure benchmark of 'more than two minutes' compared with the new benchmark of 'more than 59 seconds'.

The data collected on bus cancellations is more likely to represent actual performance. Several operator employees and all the passengers waiting along a route will know when a service has been cancelled. This shared knowledge and the high probability of a formal customer complaint makes it less likely that the event will not be recorded.

The department cannot have the same level of assurance about the reliability of the data on late arrivals and early departures. These are measured using a random sample of at least 5 per cent of bus services. However, the department had not:

- required operators to adopt a consistent approach to measurement
- understood how operators measure these benchmarks
- verified that the current methods of measuring and recording produced reliable and consistent results.

In summary, the department cannot be sure that the sample size of the on-time performance data and the methodology used provide a fair representation.

Addressing these issues

An upgraded performance regime based on technology to track bus movements should produce reliable data. The new regime is planned to start in about 2014, five and a half years after the start of the 2008 bus contracts begin.

In the meantime the department will rely on the interim regime. Accordingly it should improve the assurance of the performance data by:

- requiring bus operators to report the services cancelled on a monthly basis. The new reporting format agreed in May 2009 should achieve this
- understanding how operators measure on-time running to verify that it is adequate
- checking the operators' records to make sure they are up-to-date and correlate with the data reported to the department.

6.2.4 Service quality performance indicators

There is currently no assessment of the service quality of individual bus operators but the contracts require them to develop a quality performance regime for the first anniversary of the contracts.

The department could not negotiate a qualitative performance regime by the deadline for signing the bus contracts. Had it started the work earlier the system could have begun with the new contracts.

This regime will have indicators of customer satisfaction, including performance benchmarks, and may include incentives and penalties attached to the outcomes.

In Part 5 we reported that the work started some six months after the new contracts began and the regime would not be ready to start as planned on 1 July 2009.

6.2.5 Metlink service information performance indicators

For this performance regime, the indicators are relevant to the contract objective and the performance benchmarks are appropriate. However, there is currently no documented reporting of performance against these benchmarks. In addition, the documentation that defines the indicators had not yet been finalised.

Overview

The aim of the Metlink performance regime is to improve the timeliness and accuracy of information for bus users. The performance indicators require operators to:

- provide complete, current and accurate information on new and adjusted services
- inform Metlink of any damage to bus stops or transport signs
- maintain the information and branding prescribed by Metlink on all buses.

The contracts also set benchmarks for the number of days notice the operator should give Metlink for new and adjusted services, and the time allowed for notifying Metlink about damage to bus stops or transport signage.

Assessment

The performance indicators are relevant to the provision of timely and accurate information to bus passengers.

The benchmarks for the minimum notice for notifying Metlink of service changes are appropriate for preparing and distributing timetable information to potential passengers.

The absence of structured reporting mechanisms is a gap that the department needs to address. The department will know when it notified operators of a service change. Metlink records when the operators provide notification of a service change.

The department should:

- determine how to bring this information together in a report documenting operator performance against the Metlink key performance indicators (KPIs)
- review the processes used to adjust services so that the information flow between the department, the operators and Metlink is effective.

6.3 Evaluating performance

As at June 2009 three of the four performance regimes were operating. These were the patronage incentive, interim operational performance and the Metlink service information regimes. However, the information provided by the department did not allow a full assessment of performance against these regimes.

6.3.1 Patronage growth

This regime will not start until 1 July 2009; therefore, there is no performance information available.

6.3.2 Operational performance

The monthly operational reports for the period July 2008 to March 2009 were reviewed. The observations on performance are based on:

- the analysis of the operational reports for the quarter ending December 2008
- the department's aggregate figures on overall cancellations and on-time running published in the quarterly *Track Record*.

We concluded that the department has not used the operational reports to manage performance against contractual requirements.

Observations on the operational reports

The review of monthly operational reports showed that the department has not updated these reports with the indicators and benchmarks in the new contracts.

In addition, the following omissions or anomalies were noted:

- the department has not provided all reports for two of the bus operators
- one operator had not completed the section about on-time performance
- there are examples where the cancellation percentages reported by operators are incorrect.

Cancellations

Track Record shows that cancellations stayed constant at 0.1 percent under the old contracts between July 2007 and June 2008, and under the new contracts between July and December 2008. The operational reports were consistent with the *Track Record* data for the quarter ending December 2008. On average, one bus service in every thousand was cancelled.

However, this does not provide enough information to gauge performance against the cancellation benchmark, which requires no more than 0.5 per cent cancellation of services on any day.

On-time running

Track Record reports on the percentage of metropolitan bus services that arrived at their scheduled destinations late. In the previous contracts 'late' was defined as more than five minutes after the scheduled time. Under the new contracts the limit is five minutes and 59 seconds.

The benchmark is for each operator to have no more than 5 per cent of its services late on any day.

The *Track Record* figures show that under the new contracts, but using the old definition of on-time running, overall performance did not meet the 5 per cent benchmark:

- between July and September 2008, 5.7 per cent of services were late
- between October and December 2008, 5.3 per cent of services were late.

For the December 2008 quarter the monthly observations of on-time performance ranged from zero to 30 per cent for individual operators. The information in these reports does not allow the department to assess performance against the daily benchmark for on-time running.

6.3.3 Service quality

The department expects to start this regime by the end of 2009.

6.3.4 Metlink obligations

On some occasions notification of service changes had not met the benchmarks defined in the contract.

The reasons included:

- the department requesting new or adjusted services within the benchmark notification times
- operators not immediately notifying Metlink when the department requested new or adjusted services.

The absence of records means that we were unable to a comprehensively review performance to date.

6.4 Continuous improvement

6.4.1 Contractual provisions

The new contracts provide ways to raise, escalate and resolve performance issues that improve on those in previous contracts.

6.4.2 Assessing the department's response to performance issues

The contracts provide improved mechanisms for the gradual escalation and resolution of performance issues. The department uses its regional bus managers to raise performance issues with the bus operators. However, the absence of adequate performance reporting means that the department cannot provide assurance that it has reliably and consistently identified and addressed performance issues.

The new operational performance report should provide information that is consistent with the contracts' operational requirements. The department has also committed to increasing the resources needed to checking and using this performance information. This should lead to improved performance management.

Recommendations

The Department of Transport should:

- 6.1 document the basis for its current performance indicators and benchmarks and update this document when the performance management system is amended
 - 6.2 strengthen the processes around the measurement of on-time running by verifying that the operators' approaches are adequate and periodically inspecting their operational records
 - 6.3 design processes so that information about service changes is effectively and quickly passed to the relevant organisations.
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