New South Wales Auditor-General's Report

Performance Audit

Franchising of Sydney Ferries Network services

Transport for NSW

audit office
OF NEW SOUTH WALES

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Our major responsibility is to conduct financial or 'attest' audits of State public sector agencies' financial statements. We also audit the Total State Sector Accounts, a consolidation of all agencies' accounts.

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In accordance with section 38E of the *Public Finance and Audit Act 1983*, I present a report titled **Franchising of Sydney Ferries Network services: Transport for NSW.**

A T Whitfield PSM
Acting Auditor-General
4 February 2016

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Executive summary

Scheduled ferry services on the Sydney Ferries Network are provided under the Ferry System Contract managed by Transport for NSW (TfNSW). Harbour City Ferries (HCF), a partnership between Transdev and Broadspectrum, has been operating ferry services under this contract since 28 July 2012.

The contract is a seven-year franchise arrangement. Sydney Ferries, a statutory authority, provided these scheduled services immediately prior to the franchise under a seven-year service contract. This was terminated after 27 months to allow the franchise to proceed.

Franchising of scheduled ferry services on the Sydney Ferry Network was a policy of the government elected in March 2011.

Under the franchise arrangement, TfNSW retains:

- fare revenue
- control over the fare structure, routes and timetables
- ownership of the original Sydney Ferries fleet of vessels and the shipyard maintenance and berthing facility while leasing them to the franchisee to maintain and operate.

This audit assessed whether:

- the decision to franchise ferry services on the Sydney Ferries Network was justified
- TfNSW's management of the franchise has been effective.

Conclusion

The decision to franchise ferry services on the Sydney Ferries Network was justified, and TfNSW's management of the franchise has been largely effective.

Franchising has resulted in cost savings, good service performance, and effective risk transfer from government to the private sector operator.

The expected benefits of franchising have been realised. The HCF contract price is around 12 per cent per annum less than the terminated Sydney Ferries contract price. The performance of HCF against key performance indicators has been generally good and comparable to that of Sydney Ferries over the 27 months of its contract which preceded franchising.

TfNSW, with the support of Treasury, undertook sufficiently robust analysis to conclude that franchising would lead to material cost savings, service improvements and effective risk transfer to the private sector. TfNSW's process to select the private sector operator was also sufficiently robust. There were some minor shortcomings in the analysis and processes used, but these were not sufficiently material to affect the decisions made.

TfNSW's design and management of the contract with HCF has been largely effective. The contract promotes effectiveness and the contract management framework has been generally effective. However, there are some minor deficiencies in contract design and contract management documentation.

The expected benefits of franchising have been realised

A comparison of the five years that remained of the contract with Sydney Ferries to the first five years of the contract with HCF (and based on the timetable and service in place at the start of the HCF contract) indicates total savings of around $100 million in 2013-14 dollars.

Taking into account transaction costs, the HCF contract price is approximately 12 per cent per annum below that of the preceding Sydney Ferries contract price.

The performance of HCF against key performance indicators (KPIs) has been generally good and comparable to that of Sydney Ferries over the 27 months of its contract which preceded the franchising. Customer complaints are down slightly, on-time running and customer satisfaction are up slightly. Collisions and groundings are up, but well below the specified acceptable level.

Franchising has also led to a transfer of risk from the government to the private sector operator.

The decision to franchise Sydney Ferries Network services was soundly based

TfNSW's analysis was sufficient to support the proposition that franchising was likely to lead to reduced costs, service improvements and cost risk transfer to the private sector. This included drawing on the outcomes of a market testing exercise on ferry services it conducted in 2008-09. The process could have been improved if TfNSW had prepared a consolidated document estimating costs, benefits and risks which factored in unavoidable transaction costs (such as payments to key Sydney Ferries staff to transfer to the private sector operator) to the estimate of net benefits. However, this did not affect the outcome.

TfNSW adopted a comprehensive process to select the private sector operator. A minor deficiency was that the estimate of ongoing Sydney Ferries costs in TfNSW's Financial Base Case was on the high side due to a conservatively low estimate of future staffing reductions. An estimate based on the existing contract price and predicted staffing would have improved its usefulness for assessing the reasonableness of total contract prices bid. This would not have affected the decision to select HCF, and the Financial Base Case was useful to test the reasonableness of other aspects of the bids.

TfNSW's contract with HCF is largely well-designed

The KPIs, targets and incentives in the contract with HCF were developed through a robust process and largely promote effectiveness, but there are improvement opportunities.

The contract with HCF does not have indicators, targets or incentives specifically for customer satisfaction, or timely travel information, which are specific government objectives in 'NSW – Making it Happen' and were in the superseded 'NSW 2021' State Plan.

The incentive regime in the contract with HCF is less stringent than that in Sydney Metropolitan Bus Service contracts. In the bus contracts, financial penalties are available where operators fail to meet service reliability KPI targets.

The financial incentive for annual patronage increases is also inconsistent with the more contemporary approach and rationale used on the subsequent Sydney Metropolitan Bus Service contracts. TfNSW argued for the bus contracts that imposing penalties was inappropriate, due to operators having little control over patronage numbers because the main drivers of patronage are outside the control of operators. A revenue protection target and KPI would be preferable.

While the cleanliness of vessels operated by HCF has been demonstrably good, and better than the other modes of public transport, cleanliness measurement is not fully effective. A vessel could be deemed clean despite parts of the ferry being quite dirty.

In the event of underperformance, TfNSW can require HCF to develop and implement a cure plan, or direct it to undertake a service improvement project. While a cure plan places accountability clearly with HCF, a service improvement project would have to be specified by TfNSW and therefore would blur accountability for addressing underperformance. TfNSW has advised that to-date it has not required a service improvement project.

TfNSW's management of the contract with HCF has been largely effective

TfNSW has implemented a comprehensive framework for managing the contract with HCF and obtains adequate assurance that the information it has on HCF's performance is valid and reliable. There are, however, some minor deficiencies in contract management documentation. Documents describing responsibilities (including delegations) for key decisions, directions and notices under the HCF contract are not completely accurate. While TfNSW is measuring service reliability KPIs in line with contract requirements, its detailed procedures do not accurately describe the process.

Recommendations

TfNSW should:

1. in any future franchising process:
   - 1.1. prepare a single document outlining expected costs and net benefits for government consideration
   - 1.2. adopt appropriate assumptions in any Financial Base Case prepared and used to test the reasonableness of bids
2. when renewing the Ferry System Contract review the incentive and penalty regime to:
   - 2.1. incorporate customer satisfaction and travel information indicators and targets to align with government priorities
   - 2.2. include specific service reliability incentives
   - 2.3. remove the financial penalty for patronage growth, and replace it with a specific revenue protection indicator and target
   - 2.4. remove service improvement projects directed by TfNSW as a contractual remedy
   - 2.5. improve the measurement methodology used to assess vessel cleanliness
3. by August 2016, for the current contract with Harbour City Ferries:
   - 3.1. rectify minor deficiencies in procedure documents
   - 3.2. develop procedures to ensure service improvement projects specified by TfNSW continue not to be used as a contractual remedy.

Introduction

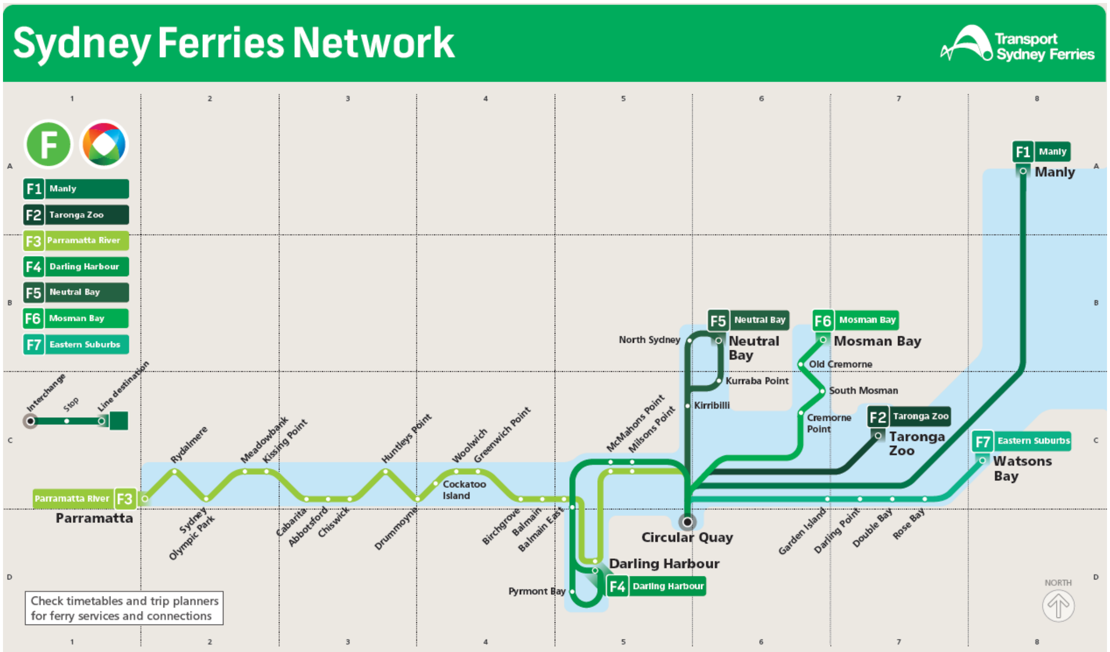
1. Background

Ferries play an important role in metropolitan Sydney's public transport mix

Sydney is a harbour city, and the city's ferry services play a vital role in helping people to access work, education, shopping, health services, as well as social, cultural and recreational activities. They also help reduce traffic congestion and its resultant pollution.

Ferry services remain popular and an important part of Sydney's overall transport strategy. Services on the Sydney Ferries Network carried around 14.8 million passengers on a 32 vessel fleet (including four chartered vessels) in the 2014-15 financial year. The network consists of seven separate routes and 36 ferry stops, ranging from Manly in the north east to Parramatta in the west of Sydney (See Exhibit 1).

Exhibit 1: Sydney Ferries Network Map



Source: TfNSW.

While relatively small in terms of passengers carried per annum when compared to Sydney's metropolitan bus contracts (257 million passenger journeys in 2014-15 financial year), the Sydney Ferries Network provides an important public transport function. This includes harbour residents, particularly those travelling from Manly, as well as servicing a large tourist component drawn to the world-renowned destination of Sydney harbour.

Scheduled ferry services in Sydney are provided under a contract managed by TfNSW

Scheduled ferry services in the Sydney Ferries Network are provided under the Ferry System Contract managed by TfNSW. Harbour City Ferries (HCF), a partnership between Transdev and Broadspectrum (formerly known as Transfield) has been operating ferry services under this Contract since 28 July 2012.

The contract is a seven-year franchise arrangement, under which HCF took over the operations of the Sydney Ferries Network from Sydney Ferries, a statutory authority. Sydney Ferries had been providing such ferry services under a seven-year contract with TfNSW since April 2010. This was terminated after 27 months to allow the franchising to proceed.

Under the franchise arrangement, TfNSW retains:

- fare revenue
- control over the fare structure, routes and timetables
- ownership of the original Sydney Ferries fleet of vessels and the Balmain Shipyard maintenance and berthing facility.

In addition to operating ferry services on the Sydney Ferries Network, HCF leases and is responsible for the care and maintenance (including operational and long-term) of both the vessels and the shipyard facility. Roads and Maritime Services is responsible for providing and maintaining the ferry passenger wharves.

The total cost for delivery of services on the Sydney Ferries Network under the Ferry System Contract amounts to $871 million over the seven-year franchise period (2012-13 to 2018-19), expressed in 2013-14 dollars. This amount includes an additional $50.0 million contract variation flowing from a 2013 network review which resulted in substantial timetable changes. This represents an average cost to government of $124 million per year (in 2013-14 dollars).

Separate to the ferry services provided under the franchise agreement for the Sydney Ferries Network, TfNSW contracts with several smaller private ferry operators to deliver public ferry passenger services across New South Wales. These operators service nine routes located in Pittwater, Clarence River, Parramatta River, Port Hacking, Hawkesbury and the Central Coast. Many of these routes service islands and isolated communities. Between them, these services account for over one million passenger trips each year. Also, in April 2015, a non-subsidised high speed ferry service between Manly and Circular Quay commenced. The operator, Manly Fast Ferry, operates services alongside HCF's franchised services.

This audit focused exclusively on ferry services conducted within the Sydney Ferries Network under the franchise agreement.

There are government priorities relevant to ferry services

TfNSW is the lead agency for delivering the following Premier's and State priorities in relation to transport as part of the 'NSW – Making it Happen' plan:

Improving government services

- Improve customer satisfaction with key government services every year within this term of government.

Ensure on-time running for public transport

- Maintain or improve reliability of public transport services over the next four years
- Updating timetables and providing clear information to get people to their destination on time.

Franchising of Sydney harbour ferry services was recommended by the 2007 Special Commission of Inquiry

Sydney Ferries Corporation was established as a State owned corporation in 2004 to provide passenger ferry services on the Sydney Ferries Network. These services were operated without a service contract being in place, and were subsidised by government.

In 2007, the government commissioned a Special Commission of Inquiry into Sydney Ferries Corporation. The inquiry report (the Walker Report) contained 17 recommendations covering various aspects of Sydney Ferries Corporation's operations and existing governance arrangements. The Walker Report found that Sydney Ferries Corporation's performance had been less than satisfactory in that it:

- had not achieved much by way of productivity gains from its workforce
- had many cultural problems
- did not have in place the management tools needed to efficiently run its operations.

The central recommendation was that the government enter a service contract with a private enterprise to provide ferry services on the Sydney Ferries Network, subject to this being no more expensive than delivery by Sydney Ferries Corporation under a similar arrangement.

The government had TfNSW conduct a market review in late 2008, calling for bids from the private sector, as well as Sydney Ferries (which became a statutory authority in January 2009), to operate ferry services on the Network. Following the market review, the government made a policy decision that Sydney Ferries would continue to operate Sydney Ferries Network services under a negotiated service contract, commencing April 2010.

Following a change in government in March 2011, the incoming government announced that Sydney Ferries Network services would be franchised to the private sector. This commitment was originally made in 2008, while in opposition, and restated as part of its election platform. Sydney Ferries' service contract was terminated effective July 2012. HCF then commenced ferry services under a seven-year Ferry System Contract following a comprehensive tender process, which started in May 2011.

Audit scope and focus

This audit assessed whether:

- the decision to franchise ferry services on the Sydney Ferries Network was justified
- TfNSW's management of the franchise has been effective.

This audit follows on from a recent similar performance audit on TfNSW's design and management of Sydney Metropolitan Bus Service Contracts. We focused on the period 2009 onwards, as the performance of Sydney Ferries pre and post its 2010 service contract with TfNSW was relevant to the audit. We did not examine service contracting arrangements TfNSW has with other operators outside the Sydney Ferries Network.

Key findings

2. The expected benefits of franchising have been realised

A comparison of the five years that remained of the contract with Sydney Ferries to the first five years of the contract with Harbour City Ferries (HCF) (and based on the timetable and service in place at the start of the HCF contract) indicates total savings of around $100 million in 2013-14 dollars.

Taking into account transaction costs, the HCF contract price is approximately 12 per cent per annum below that of the preceding Sydney Ferries contract price.

The performance of HCF against key performance indicators has been generally good and comparable to that of Sydney Ferries over the 27 months of its contract which preceded the franchising. Customer complaints are down slightly, on-time running and customer satisfaction are up slightly. Collisions and groundings are up, but well below the specified acceptable level.

Franchising has also led to a transfer of risk from the government to the private sector operator.

Savings from franchising have been substantial

Delivery of ferry services on the Sydney Ferries Network under the franchise with HCF has been cheaper than it would have been under the terminated contract with Sydney Ferries.

A comparison of the five years that remained of the contract with Sydney Ferries to the first five years of the contract with HCF (and based on the timetable in place at the start of the HCF contract) indicates total savings of around $100 million in 2013-14 dollars.

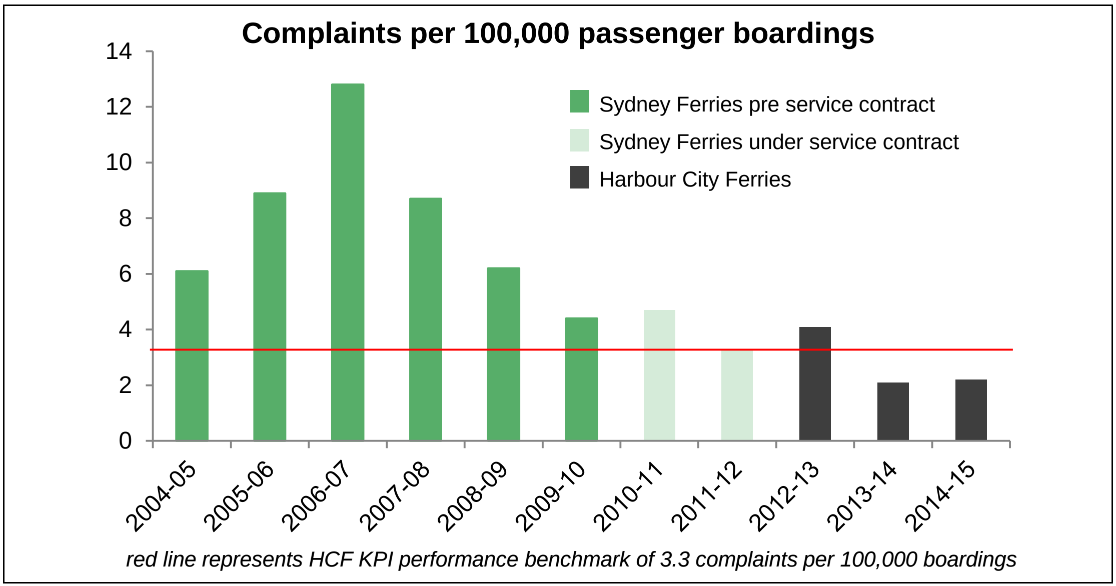
Taking into account one-off staff transfer payments of over $18.0 million by TfNSW to facilitate an effective transition to HCF, a conservative estimate is that savings of around 12 per cent over this five-year period will be realised.

HCF has generally been effective in providing ferry services under the Ferry System Contract

From July 2012 to June 2015, HCF mostly met all ten contracted key performance indicator (KPI) targets. The only KPIs not met were the ‘cancelled service’ KPI target on four occasions, the ‘complaints per 100,000 boardings’ KPI target on two occasions, and the ‘vessel cleanliness’ KPI target on one occasion.

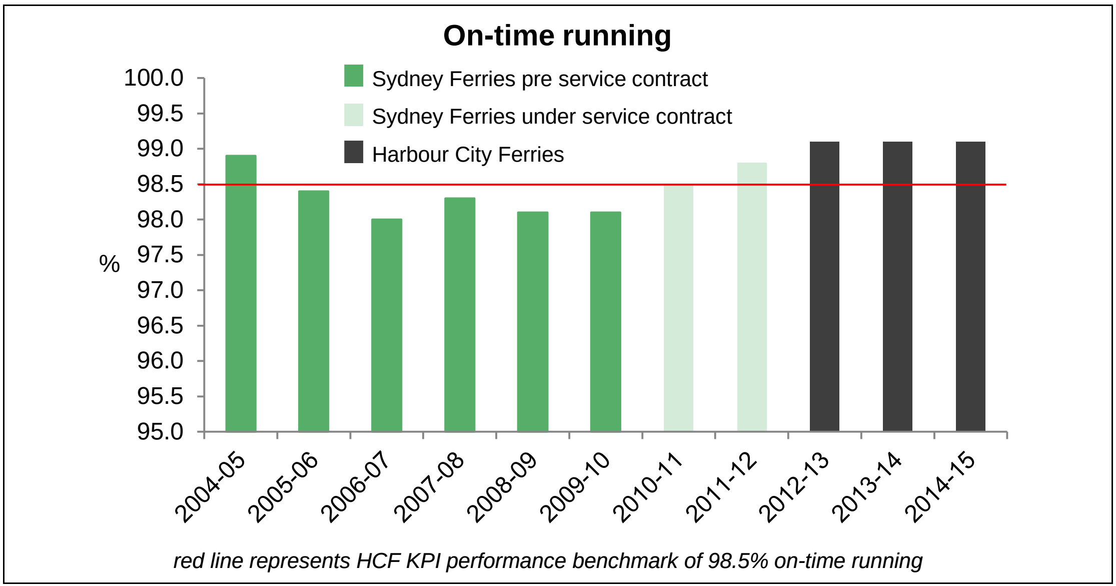
The following charts show HCF’s and Sydney Ferries’ performance relating to customer complaints, on-time-running, and customer satisfaction.

Exhibit 2: Sydney Ferries and HCF service quality comparison: Complaints per 100,000 passenger boardings



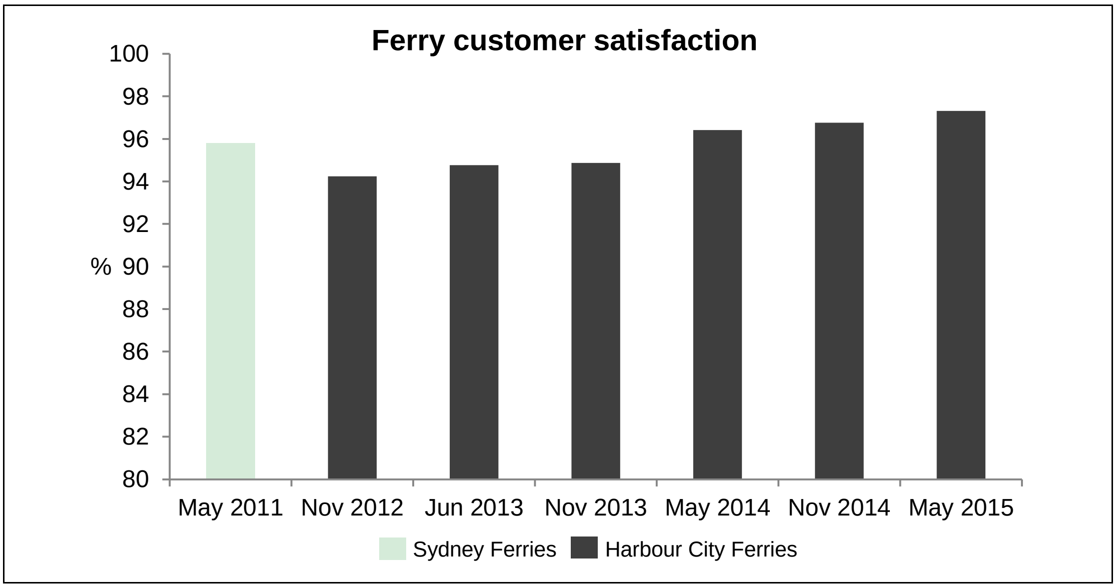
Source: Sydney Ferries annual reports, TfNSW.

Exhibit 3: Sydney Ferries and HCF service quality comparison: On-time running



Source: Sydney Ferries annual reports, TfNSW.

Exhibit 4: Sydney Ferries and HCF service quality comparison: Customer satisfaction



Source: TfNSW.

The following table indicates the performance of Sydney Ferries and HCF on other service indicators.

Exhibit 5: Sydney Ferries and HCF service quality comparison: Other indicators

Key result area	Indicators	KPI target	Sydney Ferries		Harbour City Ferries		
			2010-11	2011-12	2012-13	2013-14	2014-15
Safety	Significant incidents	--	1	--	1	--	--
	Collisions and groundings	15	3	--	5	4	5
	Passenger injuries	16	17	4	2	10	6
Reliability	Percentage of services that run	99.5%	99.9%	99.9%	99.9%	99.8%	99.7%
Customer Satisfaction	Complaints response	Within 5 business days	99%	96%	100%	100%	100%
		Within 15 business days	100%	100%	100%	100%	100%
Cleanliness	Vessel cleanliness*	95%	N/A	N/A	N/A	100%	98%
Reporting	Percentage of reports submitted on time	100%	N/A	N/A	100%	100%	100%

* KPI applied from October 2013.

N/A Not applicable.

Source: TfNSW 2015.

The results for HCF are comparable to those achieved by Sydney Ferries over the 27 months prior to its contract being terminated.

Franchising has led to a transfer of some risks from the government to the private sector operator

While difficult to value, franchising increases the certainty that contracted services will be delivered at the agreed price, with the private sector operator absorbing any cost increases, when compared to ongoing government ownership of the service provider.

The franchise model has also transferred some service risk to the private sector operator through the contract KPIs and performance incentives. There is a practical limit to such risk transfer, however, as government ultimately remains accountable for the delivery of public transport services.

3. The decision to franchise ferry services on the Sydney Ferries Network was soundly based

TfNSW's analysis was sufficient to support the proposition that franchising was likely to lead to reduced costs, service improvements and cost risk transfer to the private sector. This included drawing on the outcomes of a market testing exercise on ferry services it conducted in 2008-09. The process could have been improved if TfNSW had prepared a consolidated document estimating costs, benefits and risks which factored in unavoidable transaction costs (such as payments to key Sydney Ferries staff to transfer to the private sector operator) to the estimate of net benefits. However, this did not affect the outcome.

TfNSW adopted a comprehensive process to select the private sector operator. A minor deficiency was that the estimate of ongoing Sydney Ferries costs in TfNSW's Financial Base Case was on the high side due to a conservatively low estimate of future staffing reductions. An estimate based on the existing contract price and predicted staffing would have improved its usefulness for assessing the reasonableness of total contract prices bid. This would not have affected the decision to select HCF, and the Financial Base Case was useful to test the reasonableness of other aspects of the bids received.

Recommendation:

In any future franchising process, TfNSW should:

- prepare a single document robustly outlining expected costs and net benefits for government consideration
- adopt appropriate assumptions in any Financial Base Case prepared and used to test the reasonableness of bids.

TfNSW implemented the government's policy to franchise ferry services on the Sydney Ferries Network

TfNSW advised it was responding to the government's direction in 2011 to franchise ferry services on the Sydney Ferries Network.

When elected in 2011, the Coalition government had a policy (an election commitment first made in 2008) to franchise Sydney ferry services. This involved government:

- retaining ownership of Sydney Ferries, including its vessels and Balmain shipyard
- determining routes, fares and service levels
- contracting with a private sector operator for the lease, maintenance and operation of the ferry fleet and Balmain shipyard.

This policy commitment was based on findings and recommendations made by the Special Commission of Inquiry into Sydney Ferries Corporation in 2007 (Walker Report).

Franchising and public sector provision were the feasible delivery options given other government transport policy settings

Potential reform options were limited due to the government's position on government controlling fares and service levels for public transport, not only for ferries but for trains, buses and light rail.

The Walker Report considered various delivery and funding models for Sydney ferry services. It recommended either franchising or continuing with Sydney Ferries providing services if the market was not able to compare favourably with Sydney Ferries' quality and cost performance.

Sydney Ferries, the government service provider, was excluded from bidding as a consequence of the government's policy of private sector provision of ferry services on the Sydney Ferries Network.

TfNSW's analysis was sufficient to support franchising

Franchising and the consequent exclusion of Sydney Ferries from bidding was government policy. Having said this, TfNSW should have advised the government if its policy was likely to have an unsound outcome.

TfNSW undertook sufficient analysis to justify franchising and the exclusion of Sydney Ferries from bidding.

TfNSW undertook a market testing process in 2008-09 for Sydney ferry services. It received bids from Sydney Ferries and private operators. Ultimately, it negotiated a seven-year contract with Sydney Ferries in April 2010 for delivery of ferry services on the Sydney Ferries Network. The negotiated contract required Sydney Ferries to undergo some realistically achievable reforms to reduce its costs and provide the service levels required.

This process contributed to TfNSW (supported by Treasury) concluding that:

- there would be clear benefits from franchising in terms of sustainable cost savings and service improvements, and in transferring the risk of cost overruns to a private sector operator
- Sydney Ferries should not be allowed to tender, as it was highly unlikely to be able to further reduce its costs to the level of a private sector operator while maintaining adequate levels of service.

This process was Cabinet-in-Confidence, so the supporting information we can provide is limited, but it is clear from our examination of the Cabinet documents that these were reasonable conclusions.

Further, while being aware of service level improvements by Sydney Ferries since the start of its contract in April 2010, TfNSW and Treasury were also aware that Sydney Ferries had management practices and generous industrial instruments that contributed to its relatively high costs and that prospects for early and sustained reform were low.

TfNSW was therefore justified in using the recently negotiated Sydney Ferries contract price as assurance that the government would not be likely to pay more if using a private operator.

The process could have been improved if TfNSW had prepared a consolidated document estimating costs and net benefits, with the calculation of expected net benefits factoring in unavoidable transaction costs such as payments to key Sydney Ferries staff to transfer to the private sector operator. TfNSW made the unavoidable transaction costs clear to government, but did not prepare a cost benefit analysis factoring them in.

To facilitate the franchising, the government approved providing financial incentives to encourage essential Sydney Ferries staff identified by the private sector bidders to transfer to the franchisee. For the contract with HCF, these came to $18.0 million. As earlier outlined, however, savings in the order of $100 million in 2013-14 dollars would be realised when comparing contract payments to be made to HCF against payments which would have been made to Sydney Ferries over the five-year period their contracts overlapped. As a result, the staff transfer costs did not materially affect the TfNSW analysis providing assurance that government would not be paying more for services under a private operator.

If franchising is pursued in future, it is unlikely that analysis will have the benefits of a prior market testing process. In such circumstances, it may be beneficial to prepare a stand-alone document to inform the government which estimates robustly:

- the likely ongoing cost of government service provision, taking into account achievable saving opportunities and transaction costs, such as transfer payments, and the likely cost of private sector operation
- the likely service performance (effectiveness) under government and private sector service providers, and the key levers to be used to manage service performance
- the risk position under both government and private sector service provision.

TfNSW's process for ensuring the best private sector bid was accepted was largely robust

TfNSW conducted a comprehensive two stage process of eliciting interest from the market for provision of ferry services under a franchise agreement, and then selecting a shortlist of demonstrably capable service providers to tender. From these, TfNSW selected the best value bid for the service levels defined in the tender documents.

TfNSW prepared a Financial Base Case to test the reasonableness of tenders submitted. This is good procurement practice, similar to a pre-tender estimate. An important element of any major tendering exercise is to prepare a realistic estimate of a market price before going to tender. This gives some assurance as to affordability, reasonableness and completeness of bids received both in terms of price and comprehensiveness.

The Financial Base Case provided useful assurance that the tenders under consideration by TfNSW were based on realistic assumptions and an adequate understanding of the nature and scope of the proposed franchise operations.

It provided a lower level of assurance that the overall prices tendered were reasonable. The Financial Base Case's total cost estimate erred on the high side which detracted from its capability to indicate whether total bid prices were competitive. Despite this, the bids received were all significantly below the Financial Base Case and TfNSW also received assurance about bid price reasonableness from the 2008-09 market testing exercise. We concluded that the high estimate in the Financial Base Case had no impact on the validity of the decision.

The basis for the Financial Base Case total cost was an extrapolation of Sydney Ferries' staffing costs in the 2010-11 financial year for the following seven years. This is despite the negotiated service contract with Sydney Ferries foreshadowing staff reductions of approximately 7.5 per cent over this period, and other TfNSW analysis which noted the relatively high cost structure of Sydney Ferries, including generous industrial instruments and inefficient management and operational practices.

4. TfNSW's contract with HCF is largely well designed

The key performance indicators (KPIs), targets and incentives in the contract with HCF were developed through a robust process and largely promote effectiveness, but there are improvement opportunities.

The contract with HCF does not have indicators, targets or incentives specifically for customer satisfaction and timely travel information, which are specific government objectives in 'NSW – Making it Happen'.

The incentive regime in the contract with HCF is less stringent than that in Sydney Metropolitan Bus Service contracts. In the bus contracts, financial penalties are available where operators fail to meet service reliability KPI targets.

The financial incentive for annual patronage increases is also inconsistent with the more contemporary approach and rationale used on the subsequent Sydney Metropolitan Bus Service contracts. TfNSW argued for bus contracts that imposing penalties was inappropriate, due to operators having little control over patronage numbers because the main drivers of patronage are outside the control of operators. A revenue protection target and KPI would be preferable.

While the cleanliness of vessels operated by HCF has been demonstrably good, and better than the other modes of public transport, cleanliness measurement is not fully effective. A vessel could be deemed clean, despite parts of the ferry being quite dirty.

In the event of underperformance, TfNSW can require HCF to develop and implement a cure plan, or direct it to undertake a service improvement project. While a cure plan places accountability clearly with HCF, a service improvement project would have to be specified by TfNSW and therefore would blur accountability for addressing underperformance. TfNSW has advised that to-date it has not required a service improvement project.

Recommendation:

TfNSW should:

- when renewing the Ferry System Contract, review the incentive and penalty regime to:
    - incorporate customer satisfaction and travel information indicators and targets to align with government priorities
    - include specific service reliability incentives
    - remove the financial penalty for patronage growth, and replace it with a specific revenue protection indicator and target
    - remove service improvement projects directed by TfNSW as a contractual remedy
    - improve the measurement methodology used to assess vessel cleanliness
- by August 2016 for the current contract with Harbour City Ferries, develop procedures to ensure service improvement projects specified by TfNSW continue not to be used as a contractual remedy.

The indicators and targets in the Ferry System Contract generally promote effectiveness

The Ferry System Contract with HCF includes performance indicators in the Key Result Areas of safety, reliability and customer satisfaction.

TfNSW undertook a comprehensive and robust assessment to determine the KPI regime, including KPIs, KPI targets, incentives and sanctions for the Ferry System Contract. This included reviewing the KPI regimes for other modes of public transport in Sydney and interstate, and also its experience with the Sydney Ferries service contract.

Of the ten performance indicators in the Ferry System Contract, six are the same as the KPIs in the preceding service contract with Sydney Ferries. These are:

- significant incidents
- collisions and groundings
- proportion of scheduled services that run
- on-time running
- timeliness of responses to customer complaints.

The other contract KPIs cover:

- total cost per service
- complaints per 100,000 boardings
- vessel cleanliness
- timeliness of report submissions to TfNSW.

Seven KPIs are equivalent to those currently in the Sydney Metropolitan Bus Service contracts, which were the subject of a recent performance audit. These are:

- proportion of scheduled services that run
- on-time running
- timeliness of responses to customer complaints
- timeliness of report submissions to TfNSW
- complaints per 100,000 boardings
- vessel cleanliness
- significant incidents
- collisions and groundings.

The targets set for the Ferry System Contract KPIs are significantly more stringent than for the bus contracts in most of the equivalent indicators. For example, the targets for:

- services which run on time is 98.5 per cent for ferries and 95 per cent for buses
- customer complaints per 100,000 boardings is 3.3 for ferries and 22 for buses.

The measurement methodology for vessel cleanliness is not fully effective

The cleanliness of the vessels operated by HCF has been demonstrably good, and superior to the other modes of public transport.

A vessel can be deemed to be ‘clean’ when measured against the KPI target however, despite some parts of the vessel being very dirty.

This is because vessel cleanliness is determined through the weighted average of a four-level rating scale. As a result, a pristine rating in some parts of the vessel can compensate for an extremely dirty rating in another part of the vessel.

The vessel cleanliness measurement methodology is very comprehensive, and is fully described in project documentation. The rating system was developed using independent expert advice with extensive customer consultation to determine levels of cleanliness which were considered acceptable or unacceptable.

Exhibit 6: Vessel cleanliness rating system

Rating level	Contaminants in deck and cabin areas	Litter	Graffiti	Toilets
3 Spotless, clean	Completely clean, would need to examine closely to notice contaminants	0 items	0 tags	Clean toilet bowls, basins, floors and toilet seat No litter or graffiti Soap and toilet paper available
2 Acceptable, daily wear and tear	Visible quantity of contaminant (e.g. layer of dust on window sill)	1-3 items on single deck ferry 1-5 items on double deck ferry	1 tag	Basin is dirty; or floor is dirty; or less than 4 items of litter; or less than 4 graffiti tags are present
1 Unacceptable, dirty	Contaminant is wet, sticky, greasy, sharp or dangerous	4-7 items on single deck ferry 6-11 items on double deck ferry	2-3 tags	Toilet bowl is dirty; or toilet seat is dirty; or 4 or more items of litter; or 4 or more graffiti tags are present
0 Unacceptable, offensive	Contaminant has an offensive odour, or customer would have clothes/shoes soiled by contaminant, or could be harmed if they behaved as usual (e.g. spill on floor which can't be easily walked around, large pile of dirt on seat, chewing gum on doorknob etc.)	8 or more items on single deck ferry 12 or more items on double deck ferry	4 or more tags	Toilet is unusable due to being dirty; or soap or toilet paper are not available; or any 2 or more of the following: dirty basin, dirty floor, dirty toilet bowl, dirty toilet seat, 4 or more items of litter, 4 or more graffiti tags are present

Source: TfNSW.

The issue of concern is not the rating system, but the use of a weighted average rating level of 2 to determine that a vessel is clean. This could be resolved if the definition was changed so that a vessel could not be deemed clean if it exceeded a defined number of unacceptably clean areas. For example, this could be that a vessel is deemed not clean if it gets any level 0 ratings or a small number of level 1 ratings.

The Ferry System Contract does not have indicators or targets for customer satisfaction and real time travel information

While the Ferry System Contract has ten KPIs, the Sydney Metropolitan Bus Service contracts have 30 KPIs and sub KPIs. A notable omission from the Ferry System Contract is customer satisfaction survey results.

This is particularly important as the government is seeking improved customer satisfaction across transport modes and government services in general.

A customer satisfaction survey KPI with suitable targets and possibly sanctions would seem to be appropriate for all public transport services. The reason for its omission in the Ferry System Contract is not clear.

Only two of the KPIs and incentives in the Ferry System Contract are consistent with, and promote, the government's objectives for public transport, as outlined in the NSW 2021 State Plan, which was in force at the time the contract was initiated. The two KPIs and incentives are increased patronage and on-time running. KPIs to measure improved customer satisfaction and increased real-time travel information measures are not present. We also found no direct link between the increased patronage incentive and the targets established for public transport generally in the NSW 2021 State Plan for patronage increases. The State Plan patronage increases were around peak travel times, while the Ferry System Contract incentive was based on annual patronage increases. In the recently released State Priorities in 'NSW – Making it Happen', which replaces the NSW 2021 State Plan, improved customer satisfaction, travel information and on-time running remain as specific government objectives.

The Ferry System Contract has incentives to promote effectiveness, but is less stringent than that in Sydney Metropolitan Bus Service contracts

A significant financial incentive in the Ferry System Contract is a rebate payable to TfNSW by the operator if the operator fails to achieve a one per cent increase in patronage year on year above a baseline determined at the start of the contract. Failure to do so results in a rebate equivalent to 25 per cent of the annual contract margin.

Aside from the patronage growth penalty, the effectiveness incentive regime in the Ferry System Contract is weaker than what we found in our audit of Sydney Metropolitan Bus Service contracts for private sector operators.

In the bus contracts, financial penalties are available where operators fail to meet certain critical KPI targets. These include revenue protection, customer satisfaction, on-time at trip commencement, cancelled services, customer complaints per boarding and report submissions to TfNSW. Conversely, the only direct financial penalty in the Ferry System Contract for failure to meet KPI targets is for patronage growth.

However, as for the bus contracts, under the Ferry System Contract, TfNSW can direct the operator to correct a performance deficiency through the operator preparing and implementing a cure plan at the operator's expense.

In addition, the Ferry System Contract incorporates a funding pool of $500,000 which can be used to address unsatisfactory performance in effectiveness KPIs. The pool is established and topped up by retaining a portion of contract progress payments due to the operator. If TfNSW considers performance by the operator to be unsatisfactory in any effectiveness KPI, it may direct the operator to carry out a service improvement project, funded out of the pool. In doing so, TfNSW must specify the project to be carried out, which blurs accountability for addressing underperformance.

We note that the incentive regime for the Ferry System Contract involving the funding pool was a carry-over from the earlier contract with Sydney Ferries, where the risk of failure stayed with government due to the operator being a government entity. Now that the ferry operator is from the private sector, the effectiveness of this incentive is questionable, and the cure plan approach is a better option as performance risk will remain with the operator.

There is a strong financial incentive to grow patronage, but patronage is primarily affected by factors outside the control of the operator

The one indicator subject to a significant direct financial penalty is failure to sufficiently increase patronage. There is no financial penalty for failure to increase patronage in the Sydney Metropolitan Bus Service contracts. TfNSW advised during our audit on bus contracts that it would be unreasonable to penalise operators for not increasing patronage because most of the factors which impact on patronage are not influenced by operator performance. This explanation has merit because fares, routes and timetables, which are set by the government, and external factors such as weather, state of the economy and tourism numbers, can all influence patronage on ferries.

In deciding to include the patronage incentive, TfNSW noted that it would:

- reflect government policy objectives to expand and revitalise services
- promote a customer focus and help to protect fare-box revenue.

At the same time, TfNSW noted:

- that other jurisdictions were moving away from direct patronage incentives
- the large degree of expected changes to ferry services driven by government, such as the network review, introduction of the Opal card and wharf upgrades which would impact on patronage.

We have noted that TfNSW considers the sanction associated with failure to meet the patronage target provides incentive to the operator for fare-box revenue protection.

TfNSW advised that the ferries approach predated the more contemporary approach adopted in the bus contracts. .

5. TfNSW's management of the contract with HCF has been largely effective

TfNSW has implemented a comprehensive framework for managing the contract with Harbour City Ferries (HCF) and obtains adequate assurance that the information it has on HCF's performance is valid and reliable.

There are, however, some minor deficiencies in contract management documentation. Documents describing responsibilities (including delegations) for key decisions, directions and notices under the HCF contract are not completely accurate.

While TfNSW is measuring service reliability KPIs in line with contract requirements, its detailed procedures do not accurately describe the process.

Recommendation:

TfNSW should, by August 2016 for the current contract with Harbour City Ferries rectify minor deficiencies in procedure documents.

TfNSW has implemented a comprehensive framework for managing the contract with HCF, but there are minor deficiencies

TfNSW has implemented a comprehensive contract management plan outlining how it will manage the contract with HCF from award to completion. It lists the key obligations of both the operator and TfNSW and, in particular, the monitoring and reporting responsibilities. To support the contract management plan, TfNSW also developed detailed procedures for managing each of the ten effectiveness KPIs. Additionally, TfNSW incorporated a robust governance framework in the contract which involves monthly reporting by the operator and regular (monthly and quarterly) meetings between senior and executive management of the contracting parties.

However, we have noted that the detailed procedures for the KPIs dealing with service reliability (cancelled services and on time services) are inconsistent with what is stated in the contract. While the contract states these are assessed and measured monthly, the detailed procedures have the performance being measured on an annual basis. TfNSW has demonstrated, however, that it does manage service reliability KPIs in accordance with the contract.

TfNSW has recently developed a contract-specific responsibility matrix (including delegations) for the key decisions, directions and notices which are required to be made by TfNSW in managing the contract with HCF. This can include decisions such as approving service amendments, and whether to waive sanctions for breaches of KPIs. We noted the document was incomplete, for example, it provided no delegation to request and approve cure plans or direct service improvement projects funded from the funding pool in the event of a non-compliance event. There is also no specific provision and delegation for approving force majeure claims. Force majeure is a common contract provision that frees either party of a liability or obligation in the event of an extraordinary event or circumstance beyond the party’s control. In the case of the Ferry System Contract, it could include inclement weather such as fog or high seas which would prevent ferry operations due to safety considerations. These omissions indicate more work needs to be done on this document to make it fully effective.

An example of the consequences of the failure to comprehensively document procedures and delegations at key decision points can be seen from the following case study on management of force majeure claims by TfNSW.

Case Study

Under the Ferry System Contract, the operator is entitled to have late or cancelled ferry services removed from measurement of KPI performance in cases of force majeure. The conditions entitling a force majeure claim are outlined in the contract. The contract, however also gives discretion to TfNSW to reduce contract payments due to the operator for any scheduled service hours not operated due to force majeure. The contract does not provide details on the circumstances when the discretion is to be exercised. The contract specific responsibility matrix is also silent on this matter.

In assessing and approving claims made by the operator for cancellations caused by force majeure, TfNSW has not to date exercised this discretion. Up to mid-July 2015, there were 862 cancelled services approved due to force majeure events, which if the discretion were exercised in all cases, would result in a significant sum being payable to TfNSW.

We would expect that to manage this aspect of the contract, TfNSW would have a procedure which outlines under what circumstances it would or would not exercise this discretion, including any appropriate delegation to do so.

TfNSW was not able to produce such a procedure. TfNSW advised that following the submission of the first force majeure claim by the operator, shortly after contract commencement, an executive decision was made not to exercise the discretion on all such claims if approved. This was to ensure that:

- the safety of HCF staff and passengers was foremost in the decision process by HCF management (and not monetary) in seeking force majeure approval
- HCF fully co-operated with TfNSW in the provision of support 'bus' services due to cancellations (for example, when the Manly service is cancelled due to extreme weather, bus replacement services are put into service for customers at HCF's expense). TfNSW views this replacement bus strategy as a critical customer service outcome in such circumstances.

While possibly reasonable, the reasons given were after the event. Presumably the authors of the contract had a reason for incorporating discretion in such a provision. This should have been reflected in some guidance to the contract administrators, rather than having to be decided at the first instance of a claim, and the decision to not exercise the discretion locked in for all subsequent approved force majeure claims.

TfNSW advised the responsibility matrix is 'part of the continual improvement process in bus and ferry contracts'. TfNSW needs to expeditiously address such key deficiencies in this important document.

TfNSW has obtained adequate assurance that the information on operator performance is reasonably valid and reliable

TfNSW has implemented a range of strategies to give reasonable assurance that data and information provided by the operator on contract performance are accurate. These include:

- an internal independent review on fare-box and patronage reporting by HCF in May 2014
- an external review on the management systems of HCF in December 2014
- an internal independent ferry complaint analysis in December 2013
- an external safety audit (not yet completed) in August 2015
- an internal independent asset assurance assessment on the vessel fleet and Balmain shipyard in July 2015.

The completed reviews generally concluded that systems and controls used by HCF were sound and were producing reliable performance information to TfNSW.

While the completed reviews commented favourably on HCF's systems and controls, TfNSW also tests information provided by the operator. For example, TfNSW reviews HCF's monthly revenue collection claims for variances on a month to month basis for annual trends against forecasts, as well as questioning monthly variances greater than five per cent. Revenue protection strategies include providing HCF with hand held Opal card readers to check passengers when on board, on board checks by transport officers, and the TfNSW ferry contracts branch membership of a TfNSW public transport network revenue protection committee.

To continue improving its approach to ongoing assurance, TfNSW had independent consultants prepare a Ferry Systems Contract assurance plan in December 2014. While noting that the ongoing roll out of the Opal system and elimination of various forms of paper ticketing reduces risks in HCF collecting and reporting on fare-box revenue, TfNSW advised it proposes to conduct a follow up revenue and operational audit as part of its annual audit and assurance program for ferries.

Appendices

Appendix 1: Response from Agency

NSW GOVERNMENT | Transport for NSW

Mr Tony Whitfield
Acting Auditor General
Audit Office of NSW
Level 15, 1 Margaret St
SYDNEY NSW 2000

Dear Mr Whitfield

Performance Audit: Franchising of Sydney Ferries Network services

Thank you for the opportunity to respond to *Franchising of Sydney Ferries Network services* report dated 22 December 2015.

It is pleasing to note that the performance audit finds that the decision to franchise ferry services on the Sydney Ferries Network was justified, and TfNSW's management of the franchise has been largely effective. In addition I am pleased that it was found that franchising has resulted in cost savings, good service performance and effective transfer of risk from the Government to the private sector.

TfNSW will continue to work towards the implementation of the majority of the recommendations contained in the audit report. TfNSW understands the intent of the Audit Office's recommendations regarding vessel cleanliness (recommendation 2.5) and contractual remedies (recommendation 3.2) however these will require further consideration by TfNSW.

Yours Sincerely

Tim Reardon
Secretary, Transport for NSW

29 JAN 2016

Transport for NSW
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Appendix 2: About the audit

Audit objective

The audit assessed whether:

- the decision to franchise ferry services on the Sydney Ferries Network was justified
- TfNSW management of the franchise has been effective.

Scope

In addressing the audit objective, we looked at the process TfNSW used to decide to franchise, including determining the expected benefits of franchising, and then the process it used to select the franchise operator. In addition we looked at whether the expected benefits were achieved.

We also looked at contract design and contract management by TfNSW of the Ferry Systems Contract. Under this contract, the operator, Harbour City Ferries, provides ferry services to timetables, locations and service levels as determined by TfNSW. Under the franchise arrangement TfNSW retains fare revenue and ownership of the original Sydney Ferries' fleet of vessels and shipyard and berthing facilities while leasing them to the operator to maintain and operate.

In July 2012, the franchise operator took over ferry services which had been operated by Sydney Ferries, a statutory authority, under a service contract with TfNSW since April 2010.

Audit exclusions

We did not:

- examine the specific minimum service levels established by TfNSW
- question the merits of government policy objectives.

Audit approach

We collected evidence through:

- interviews with key TfNSW staff
- interviews with key stakeholders, including Treasury and Sydney Harbour Ferries
- examining TfNSW-provided documents including contracts, submissions, research, procedures, reports and performance data used for contract management purposes.

We also examined:

- documentation from other sources obtained throughout the audit such as Cabinet documents, research papers and studies, statistical data and analysis
- information from other jurisdictions for comparison.

Audit selection

We used a strategic approach to selecting performance audits which balances our performance audit program to reflect issues of interest to parliament and the community. Details of our approach to selecting topics and our forward program are available on our website.

Audit methodology

Our performance audit methodology is designed to satisfy Australian Audit Standards ASAE 3500 on performance auditing. The Standard requires the audit team to comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance and draw a conclusion on the audit objective. Our processes have also been designed to comply with the auditing requirements specified in the *Public Finance and Audit Act 1983*.

Acknowledgements

We gratefully acknowledge the co-operation and assistance provided by Transport for NSW and its staff who participated in interviews and provided material relevant to the audit.

Audit team

Ed Shestovsky and Andrew Gill conducted the performance audit. Kathrina Lo and Rod Longford provided direction and quality assurance.

Audit cost

Including staff costs, and overheads, the estimated cost of the audit is $180,000.

Performance auditing

What are performance audits?

Performance audits determine whether an agency is carrying out its activities effectively, and doing so economically and efficiently and in compliance with all relevant laws.

The activities examined by a performance audit may include a government program, all or part of a government agency or consider particular issues which affect the whole public sector. They cannot question the merits of government policy objectives.

The Auditor-General's mandate to undertake performance audits is set out in the *Public Finance and Audit Act 1983*.

Why do we conduct performance audits?

Performance audits provide independent assurance to parliament and the public.

Through their recommendations, performance audits seek to improve the efficiency and effectiveness of government agencies so that the community receives value for money from government services.

Performance audits also focus on assisting accountability processes by holding managers to account for agency performance.

Performance audits are selected at the discretion of the Auditor-General who seeks input from parliamentarians, the public, agencies and Audit Office research.

What happens during the phases of a performance audit?

Performance audits have three key phases: planning, fieldwork and report writing. They can take up to nine months to complete, depending on the audit's scope.

During the planning phase the audit team develops an understanding of agency activities and defines the objective and scope of the audit.

The planning phase also identifies the audit criteria. These are standards of performance against which the agency or program activities are assessed. Criteria may be based on best practice, government targets, benchmarks or published guidelines.

At the completion of fieldwork the audit team meets with agency management to discuss all significant matters arising out of the audit. Following this, a draft performance audit report is prepared.

The audit team then meets with agency management to check that facts presented in the draft report are accurate and that recommendations are practical and appropriate.

A final report is then provided to the CEO for comment. The relevant minister and the Treasurer are also provided with a copy of the final report. The report tabled in parliament includes a response from the CEO on the report's conclusion and recommendations. In multiple agency performance audits there may be responses from more than one agency or from a nominated coordinating agency.

Do we check to see if recommendations have been implemented?

Following the tabling of the report in parliament, agencies are requested to advise the Audit Office on action taken, or proposed, against each of the report's recommendations. It is usual for agency audit committees to monitor progress with the implementation of recommendations.

In addition, it is the practice of Parliament's Public Accounts Committee (PAC) to conduct reviews or hold inquiries into matters raised in performance audit reports. The reviews and inquiries are usually held 12 months after the report is tabled. These reports are available on the parliamentary website.

Who audits the auditors?

Our performance audits are subject to internal and external quality reviews against relevant Australian and international standards.

Internal quality control review of each audit ensures compliance with Australian assurance standards. Periodic review by other Audit Offices tests our activities against best practice.

The PAC is also responsible for overseeing the performance of the Audit Office and conducts a review of our operations every four years. The review's report is tabled in parliament and available on its website.

Who pays for performance audits?

No fee is charged for performance audits. Our performance audit services are funded by the NSW Parliament.

Further information and copies of reports

For further information, including copies of performance audit reports and a list of audits currently in-progress, please see our website www.audit.nsw.gov.au or contact us on 9275 7100.

Our vision

Making a difference through audit excellence.

Our mission

To help parliament hold government accountable for its use of public resources.

Our values

Purpose – we have an impact, are accountable, and work as a team.

People – we trust and respect others and have a balanced approach to work.

Professionalism – we are recognised for our independence and integrity and the value we deliver.

Professional people with purpose

Making a difference through audit excellence.

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