

Memorandum

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To: Steve Hull, President, Independent School Bus Operators Association

c. Karen Cameron, Executive Director, Independent School Bus Operators Association

From: Denis Chamberland

Re: Non-Negotiated Fixed Price Contracts

The student transportation industry in Ontario is in a period of transition. Part of the changing landscape saw the creation a few years ago of school board transportation consortia for the purpose of achieving better efficiencies and economies in student transportation. As an integral part of the development of a new student transportation funding model, the Ministry of Education's Efficiency and Effectiveness Reviews identified some deficiencies in contract management and procurement practices, particularly focusing on competitiveness. As result, the Contracting Practices Advisory Committee (CPAC) established template documents for use in acquiring student transportation services.

During this period of change, it appears to have been an implicit assumption that any approach to procuring that does not involve the use of requests for proposals (RFPs) is inadequate, and therefore cannot achieve the value-for-money objective sought by the school boards. This seems to have remained an unexamined assumption, as we are not aware of any analysis offered by the Government* that has assessed the strengths and weaknesses of what may broadly be termed the "non-negotiated fixed-price" approach to procuring student transportation services, which has been widely used in Ontario since the late 1990s. (*By 'Government', we mean mainly but not exclusively the Ministries of Education and Finance, whose mandate has been most directly related to the student transportation mandate in Ontario).

This memorandum argues that while the non-negotiated fixed-fee approach may be improved, it produces many of the benefits normally associated with competitive procurement because it is, in substance, competitive. In fact, if properly understood and implemented, it can produce benefits greater than those flowing from the use of traditional RFPs. A central theme of this memorandum is that RFPs should be viewed as one tool available in the toolkit of school board

consortia, and that the indiscriminate use of RFPs in all circumstances when procuring student transportation services fails to optimize the long-term value achievable by school boards. It also impairs the ability of school boards to consider the long-term implications on their respective markets of their decisions to issue RFPs – an essential public policy imperative that belongs to both the school boards and the Ministry of Education, which provides extensive direction to the former in this area. In this regard, we highlight our concern below (at page 8) that the Ministry of Education appears to be overly engaged in directing the school boards in their procurement obligations, such that school boards are, at least with respect to procurement, almost certainly discharging their mandate in breach of the requirements of the Broader Public Sector Procurement Directive (the "Directive").

We review below some aspects of how student transportation services were procured prior to the arrival of formalistic RFPs, and explain why the non-negotiated fixed-price ("Non-Negotiated Fixed-Price") approach to procuring student transportation services (widely known as the "benchmarking" approach) is optimal for the industry.

A. Non-Negotiated Fixed-Price Model: The Mechanics

As we understand it, there have been variations across Ontario in the way student transportation services have been procured by school boards outside the context of RFPs in the last decade. In general, however, the following practices have prevailed:

Often, each operator association for a particular region offers itself as the spokesperson on behalf of its member-operators. In discussions between the local consortium and the association, the parties agree on the 'base rate' - that is, the base cost to operators of operating their business - and a per-kilometer rate is added, encompassing certain other costs, such as maintenance and a portion of driver costs as well as the operators' profit margin on the services being provided to the school board. While the accounting treatment of student transportation contracts may vary from consortium to consortium, a profit margin of 5 per cent of the costs of providing the services is not uncommon. Such a return on investment - which applies equally to single and to very large bus operators, hence demonstrating how the market has already achieved significant 'efficiencies' across the board - is well below the return on investment in most other industries, particularly where the investment capital is financed by the supplier base itself, which also assumes a very high level of risk.

Some important qualifications to the above noted model are fundamental to an understanding of the value received by the school boards:

1. As a matter of industry practice, operators have consistently absorbed their own capital costs of providing the services, in effect subsidizing the school boards, which are otherwise obligated to invest their own capital where they provide the services internally. The practice adopted by the student bus operators is inconsistent with the approach taken in many industries where the public agency outsources functions previously performed in-house. It is often the case that where service providers are required to make some form of capital investment upfront so as to provide the services, such capital is not put at risk, but is recoverable in any context or circumstance where the agreement for the services is terminated.
2. Where school boards operate their own student buses, it is generally the case that the costs of funding the services internally vastly exceeds the costs of purchasing such services from arms-length service providers. As we understand it, this the case in British Columbia.
3. School boards in every part of Ontario have had province-wide access to operator pricing, with the result that the pricing for the entire industry is largely transparent. In fact, until recently a government website displayed all operator rates on an ongoing basis.
4. From year-to-year, safety improvements and other features required by the school boards have typically been funded by the operators themselves.

B. Types of Contracts

Negotiated Fixed-Price Contracts

The most frequently used type of contract in the public sector is the firm fixed-price contract. With such contracts the bargain is stated in terms of a fixed amount of compensation with no formula or mechanism to vary the price in the event of the occurrence of unforeseen contingencies.

Fixed-price contracts are often negotiated and are most suitable when acquiring supplies or services where there are reasonably definitive functional or detailed specifications for the supplies or services to be provided. While the risks of fixed-price contracts are generally thought to be assumed by the contractors, the public agency can run the risk of overpaying, if it overestimates the requirements.

From the public side, such contracts are optimal particularly when any of the following circumstances are present:

- a) There is adequate price tension/competition in the market;
- b) There is an established price comparator, supported by valid costs or pricing data;
- c) The cost or pricing that is available allows for a realistic estimate of the likely actual cost of performance; or
- d) The performance uncertainties can be reasonably ascertained upfront such that the contractor is confident of being able to manage them successfully.

In light of the Non-Negotiated Fixed-Fee approach to procuring student transportation services, described in A, above, it stands to reason why school boards have made use of the fixed-price approach to contracting. The school board's liability is limited to the contract price and, with the exception of the fuel escalation provision, if the costs of providing the services increase during the term of the contract, the operator absorbs such costs, even if doing so means choosing between performing the terms of the contract at a loss and breaching the contract.

In addition, under the Non-Negotiated Fixed-Fee model, described in A, it is the operators that finance the costs of providing the services, in two ways: first, the operators only get paid in arrears, after the services have been adequately provided; and second, the capital costs of acquiring the equipment to provide the services is borne entirely by the operators. The capital investment risks and the risks of increases in performance costs are assumed entirely by the operators.

Cost-Plus Contracts

At the other end of the contracting spectrum are cost-plus contracts, and their many variations. The plain cost-plus contract provides for the public agency to pay the contractor its allowable costs incurred in performing, plus a pre-defined profit margin (the 'plus'). Such contracts are generally considered to be 'high-risk' for public agencies because here the contractor has little incentive to keep its performance costs in check, given that the buyer will ultimately pay these costs.

A variation is the cost-plus-fixed-fee contract, where the contractor is reimbursed for its allowable costs and receives a fixed fee for its efforts, calculated in any number of ways. A

unique feature of cost-plus contracts, with or without a form of price cap, is that the public agency has complete visibility into the contractor's cost structure. The agency is generally entitled to access the contractor's books to ensure that the costs being represented are real (unlike the straight fixed-price contract where the public agency negotiates the price and hopes to have obtained accurate information from the market to know it's not overpaying). Where there is no fixed price, there is usually some type of oversight or surveillance of the contractor's performance during the term of the contract.

It can be seen that the Non-Negotiated Fixed-Fee approach puts the operators in the most vulnerable of positions. Because the operators' cost structure is public, the school boards are able to unilaterally set the operators' profit margin. And because contract prices are fixed, the operational risks are absorbed by the operators.

C. Non-Negotiated Fixed-Price Contracts: Why they Offer More Value

In a memorandum dated May 4, 2009, the Director, School Business Support Branch (Cheri Hayward), notes that "In this period of economic uncertainty, open, objective, and transparent competitive process in transportation will be especially important to ensure best value for public money spent."

The Non-Negotiated Fixed-Price model of contracting described in part A, above, does not by itself offend any of the above-noted principles. In some important respects it improves on the highly formalistic RFP approach prescribed by the Ministry of Education, as RFPs are most effective in a non-transparent market for the very services/goods sought to be acquired.

By their nature traditional RFPs are designed to capture a snapshot of the market, at a particular time. This means that the value captured may be the best on offer in the circumstances, but may not (and usually does not) represent the best value on offer across the entire market. Such things as the timing of the public release of an RFP, the length of the open period, the conditions and requirements of the RFP -- these and other factors play a significant role in determining which companies will bid and the value each bidder will propose. In that sense an RFP creates and operates within the confines of a highly imperfect market, and cannot purport to offer the best value available across the market.

Because an RFP taps a narrow segment of the market at a particular time, the fixed pricing received by the public agency is transparent within that narrow market, but is not nearly as transparent as the approach described in A, above (The "Non-Negotiated Fixed-Fee" Model: The Mechanics). More transparency means lower costs, and better value.

Moreover, it is in the nature of an RFP to operate with a short-term horizon. It is from this perspective that as far back as 1991, the then Auditor General of Ontario expressed his concerns about avoiding monopoly situations in student transportation services. Such concerns were also articulated most recently by the Chair of the Transportation Task Force, the Honourable Coulter Osborne, in his report submitted to the Minister of Education, January 25, 2012. The Chair comments:

"As I see it, the principal downstream risk is the potential gravitation to monopoly service providers. One does not have to be an economist or possessed of particular procurement expertise to recognize that if any procurement model works to limit, or eliminate competition, the result is not in the public interest, for the obvious reason that in a monopoly seller environment, costs will almost inevitably rise, at least in the longer term."

It is disappointing that the Government chose to introduce formalistic RFPs a few years ago, without providing any public analysis of the potential for monopolistic tendencies in a market as unique as the student transportation sector. It is similarly disappointing - and alarming - that the Government has chosen to push on with its approach to RFPs in total disregard of, and a mere two months following, the above-noted comments from the Honourable Coulter Osborne. In his memorandum dated March 29, 2012, the Assistant Deputy Minister (ADM), Business and Finance Division, Ministry of Education (Gabriel Sékaly), urges the school boards to press ahead with RFPs, but provides no analysis or explanation of the grave concerns expressed by the Chair of the Transportation Task Force.

D. How Non-Negotiated Fixed-Price Contracts Comply with the Directive

Competitiveness

In his remarks, the Chair of the Transportation Task Force notes that student transportation services must be procured in accordance with the BPS Procurement Directive. Similarly, in the above-noted memorandum by the ADM, Business and Finance Division, dated March 29, 2012, the ADM states how it "is imperative that all procurement initiatives are compliant with the BPS Procurement Directive...". It is noteworthy that the ADM does not provide any guidance as to what constitutes "competitive procurement", and neither does the Ministry of Finance, which developed the Directive.

The introduction of the Directive is unquestionably a major step forward for public procurement in Ontario, because it sets a direction and because it is a legally-binding document, in the sense

that compliance with its requirements is not optional. It is, however, sorely lacking in any practical guidance. It provides no explanation or illustration of competitive and non-competitive procurement mechanisms, although the terms "competitive" and "non-competitive" are used freely in the Directive. For instance, the Directive requires BPS organizations to conduct an open competitive procurement process where the estimated value of a procurement reaches \$100,000 (Mandatory Requirement # 3); calls for open competitive procurements must be made through an electronic tendering system (Mandatory Requirement # 6); evaluation criteria must be developed, reviewed and approved by an appropriate authority prior to commencement of the competitive procurement process (Mandatory Requirement # 9); and, competitive procurement processes require an evaluation team responsible for reviewing and rating the compliant bids (Mandatory Requirement # 11). Similarly, the Directive recognizes that special circumstances may require BPS organizations to use non-competitive procurement (Mandatory Requirement # 21); and school boards may rely on a non-competitive procurement process for the procurement of student home-to-school transportation services for the period July 1, 2011 to December 31, 2011 (Mandatory Requirement # 21).

It is worth noting that the choice of a procurement document is a distinctive issue from the broader question of competitive versus non-competitive procurement mechanisms. In his memorandum of March 29, 2012, the ADM maintains that school boards and consortia may adopt some best practices when developing their procurement strategies, including determining "the appropriate procurement option (RFP, RFSQ, RSQ, RFT, etc.)". Such procurement options are merely references to formats that fit into a broader competitive strategy, and do not offer any insight on the ways to achieve similar objectives through other means.

Beyond the formats are the five key principles that, according to paragraph 3 of the Directive, allow BPS organizations "to achieve value for money while following a procurement process that is fair and transparent to all stakeholders." These are:

Accountability - Organizations must be accountable for the results of their procurement decisions and the appropriateness of the processes.

Transparency - Organizations must be transparent to all stakeholders. Wherever possible, stakeholders must have equal access to information on procurement opportunities, processes and results.

Value for Money - Organizations must maximize the value they receive from the use of public funds. A value-for-money approach aims to deliver goods and services at the optimum total lifecycle cost.

Quality Service Delivery - Front-line services provided by Organizations, such as teaching and patient care, must receive the right product, at the right time, in the right place.

Process Standardization - Standardized processes remove inefficiencies and create a level playing field.

Where a school board or consortium makes an informed decision to adopt a procurement approach consistent with the Non-Negotiated Fixed-Price model, there is no legal reason why, in principle, this would not comply with the Directive. Not only does the Directive not legally prescribe the use of RFPs under any, much less in all, circumstances, but the mechanical use of RFPs in all circumstances by a school board will ensure non-compliance with the Directive at least some of the time. Under the Directive, it is the legal obligation of each BPS organization to apply sound judgment in its supply chain activities to ensure it achieves optimal value-for-money in the specific circumstances. It is difficult to see how, when acting on the direct instructions of, or at the behest of, the Ministry of Education, school boards may be said to be discharging their statutorily assigned mandate pursuant to the Directive. It is also difficult to see how a dogmatic use of RFPs can consistently best serve the public interest.

From the school board's perspective, the merits of the Non-Negotiated Fixed-Price approach to procuring lie in the fact that the school board essentially controls the relevant market conditions. As noted earlier, in the absence of complete market transparency, RFPs serve to create a discrete market for certain goods and/or services at a fixed place and time. Where the market is already largely transparent, however, the buyers exercise significant leverage vis-à-vis the sellers, which is reflected in a consistently downward pricing pressure. A transparent market, then, creates a highly competitive market, one that is controlled by the buyers.

An important feature of the Non-Negotiated Fixed-Price approach described in A, above, is that the pricing and other contractual conditions agreed to between the school boards and the operators have often been non-negotiated (hence the label for this approach). This is not unusual in a transparent market where the buyer enjoys complete visibility into the operator's cost structure. Just as RFPs substitute competition for negotiation, in a transparent environment, the negotiations become a discussion over the modalities of the arrangement, and not about the fundamentals of the arrangement.

There is of course the possibility that the Non-Negotiated Fixed-Price approach has not and does not consistently produce the best results in every corner of the Province. This is not to say, however, that the Non-Negotiated Fixed-Price approach is unworkable or that it should be dismissed in favour of the RFP approach. Given its many advantages it means that it should be fine-tuned to take full advantage of its many benefits.

As the Chair of the Task Force Report notes in respect of what needs to be done, "The relevant question, in my view, is not whether there is another way, but rather whether there is a better way, taking into account all relevant circumstances including legal and quasi-legal requirements and the nature of the student transportation market." The better way, in our opinion, is to recognize the unique features of this market and to address directly how it can be improved to serve the public interest and the interest of the many independent businesses that have provided exceptional value-for-money over many decades.

Openness

There remains the question of "openness" within the context of the Directive's requirement that BPS organizations must conduct an "open competitive procurement" process (Mandatory Requirement # 3). Although the Directive offers no definition or explanation of the term "open", the term is sometimes defined to mean allowing as many suppliers as possible the opportunity to bid. In a largely transparent market where the buyers have full visibility into the cost structure and service offerings of the operators, it is a valid question to ask 'what additional benefits could be forthcoming from an open procurement process?' It is not obvious that an RFP will generate any new value every time, but the RFP will certainly raise the moral hazard of having the larger participants lower prices artificially for the purpose of undercutting competitors in the shorter term -- and witnessing their exit from the market -- and later raising prices, leveraging their dominant market position.

Accepting that openness is a fact, particularly in light of the trade agreement commitments to allowing reciprocal business opportunities to the members of the trading partners, a fundamental question is as follows: 'How can there be openness but without unfairly destroying independent businesses and leaving them stranded with their sometimes significant capital investments assumed for the benefits of their school board customers?' As was noted earlier, as a matter of industry practice, operators have consistently absorbed their own capital costs of providing the services, in effect subsidizing the school boards. Without doubt, there are ways to structure the competitive process to avoid creating, in the words of the Chair of the Task Force, "procurement casualties".

The outline of one such way could be to combine the Non-Negotiated Fixed-Price approach with a staggered approach to openness, such that the opportunity available to potential new participants would coincide in its timing with some measure of the lifecycle of a bus. The goal would be to shape the expectations of the market regarding the timing of investments by operators and the possibility of being pressured out of the market for reasons related to performance, such as a clear failure to perform the services adequately or a simple inability to

keep up with changing market conditions in the sector. For example, an operator could be warned well in advance that its performance is in question and that to remain on the roster of established service providers, it will need to strengthen its performance in identifiable areas, or it will need to compete with potential newcomers to keep the business. The operator could decide to make the appropriate changes and remain competitive, or exit the market. Either way, the school board would control its share of the market - and the value achieved within it - and it would oversee market exits in an orderly fashion, designed to avoid "procurement casualties".

A Non-Negotiated Fixed-Price approach combined with a staggered but predictable refresh opportunity would help to answer the economically unrealistic expectation currently prevailing in the sector that operators should absorb the full capital investment related to providing student transportation services while at the same time risking it all in an RFP process. The unique features of this market make this economic model unsustainable in the longer term. Because most operators have a single school-board customer, it is unreasonable to expect that operators should fund the costs of providing the services, but without any insurance that they will, at a minimum, recoup their capital investment in the event that their services are no longer required. The current approach, if sustained through the use of RFPs, also seems certain to gradually turn over the bulk of the student transportation business to the few, ensuring a large number of "procurement casualties" along the way, with the predictable consequences.

E. Ending Remarks

It appears that a much-needed fundamental analysis of some of the crucial business assumptions underlying the use of RFPs and their implications on the business model of operators and the market is called for. As noted earlier, we are not aware that any such analysis has been conducted by the Government. We firmly believe that such an analysis is much needed, and therefore fully endorse the recommendation of the Chair of the Task Force, the Honourable Coulter Osborne, that "an independent third party expert" should be appointed to review the issues raised in the Task Force Report. As the Chair emphasizes: "It is important that this review be independent and comprehensive."