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## **Railway Reform:**

Toolkit for Improving Rail Sector  
Performance

## **Chapter 8:**

**Buying Services from Railways**

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## 8 Buying Services from Railways

### 8.1 Introduction

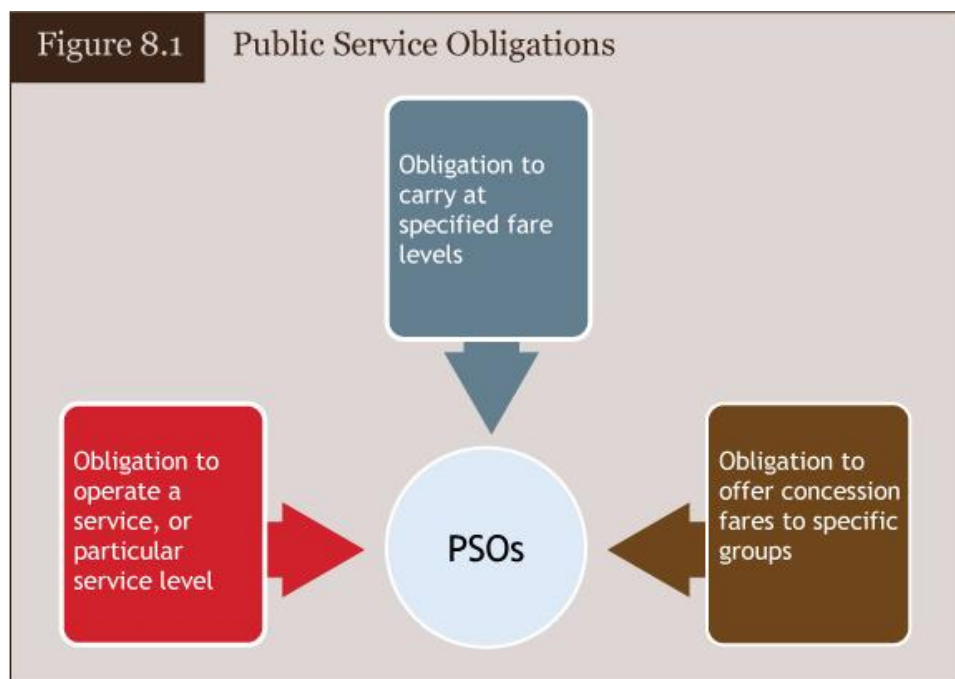
Most governments want to retain influence over railway passenger services and fares. Chapter 6 argued that the best way to do this is by using a model in which governments use a contract to purchase the services and fare concessions they want, which this chapter will discuss in detail. First, it will introduce the public service obligation (PSO) concept, underlying the two primary contracts—PSO contracts (Section 8.3) and public services contracts (PSC) (Section 8.4). Second, the chapter will explore the possibility of introducing competitive bidding for such contracts (Section 8.5) and introduce (in Section 8.6) examples, which are also described in the Annexes.

### 8.2 Public Service Obligations

A good working definition of public service obligations (PSOs) was developed by the European Commission for use in the European Union and is adapted here for more general application: “a requirement defined or determined by government, which the transport undertaking in question, if it were considering its own commercial interests, would not assume or would not assume to the same extent or under the same conditions, without reward.”

Government in this context refers to either the central or local government authority. Three main types of PSO apply to passenger railways. (Figure 8.1.)

*A Public Service Obligation is a requirement defined by government, which the railway would not assume if it were considering its own commercial interests.*

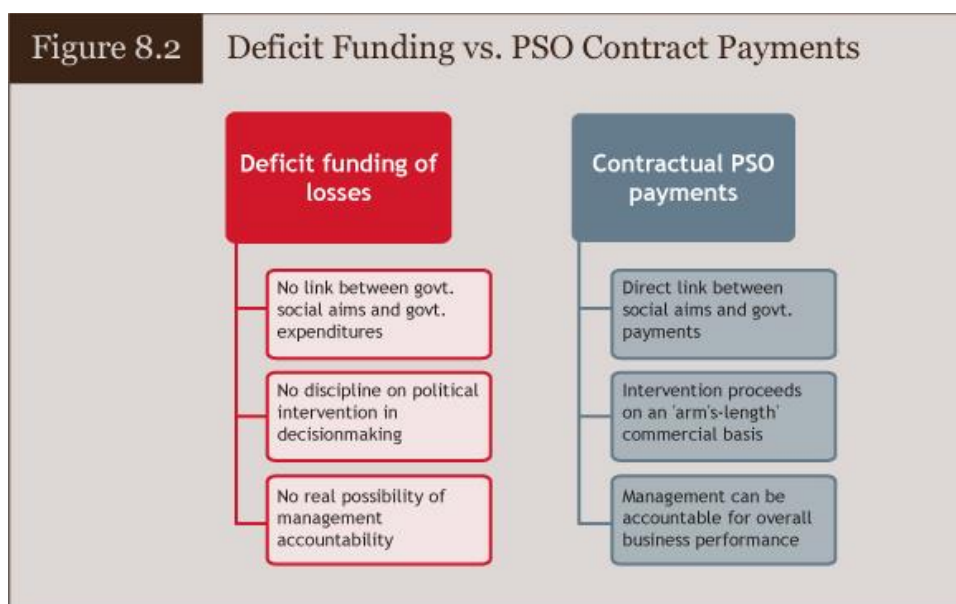


Public service obligations could include: (i) a specified service or group of services such as those on low-density branch lines, commuter services, or off-peak services at night or on Sundays, regardless of demand levels; (ii) a regulated non-commercial fare structure or restriction of fare increases below those recommended by railway management or at a lower rate than cost increases; (iii) offering concession

fares to specified groups such as students, pensioners, military personnel, civil servants, the disabled, and so on.

Around the world, many passenger railways face explicit service obligations established by government or imposed through regulatory intervention, but rarely reimbursed directly. In other cases, railway managers face similar *unstated* obligations that, if ignored, might prove career-limiting for them. Whether explicit or implicit, unfunded service obligations undermine railway management's pursuit of commercial performance and their own commercial accountability. Typically, managers continue to fulfill the obligations and then try to recoup the costs at the end of the year from government by bundling service obligation costs with railways' total annual losses, which are then covered by government. Unfunded obligations undermine government spending efficiency and effectiveness because there are no links between government objectives, actions, outcomes, and budget impacts. Instead, the costs of unfunded obligations are buried somewhere in the bottom line of deficit funding for the whole service package.

By contrast, contracting for PSOs establishes a funding framework that reveals the costs of government-imposed obligations and allows the railway to treat both commercial activities and PSOs, on a commercial basis. A comparison of deficit funding of losses and PSO contractual arrangements is shown in Figure 8.2



### 8.3 Public Service Obligations Contracts

Preparing a PSO contract requires identifying the public services obligations and then determining the principles of compensation.

The PSOs that arise from explicit government direction should be the easiest to define. However, if obligations are not explicit, the railway must analyze its activities in detail to select the services and fares it would offer under circumstances of commercial freedom. Then it can present to government a list of services and fare differentials between actual and commercial cases. This gives government the opportunity to balance social aims and affordability by selecting which obligations the railway will be asked to continue. These obligations become the PSOs.

Ideally, compensation for PSOs should be the full commercial net cost of provision. For a service PSO, cost estimates should equal the efficient cost of supply, including return on capital, less revenue from services.<sup>81</sup> For a pricing PSO, cost estimates should equal net revenue lost through adopting the pricing obligation, allowing also for the increase in cost from providing capacity to meet any increase in demand. These levels of compensation should form the basis of the PSO contract with governments. However, if governments are reticent about funding the non cash costs of depreciation and return on capital (that it may anyway have funded as a grant) the minimum level of compensation should leave the railway no worse off on a cash basis from meeting the PSOs. But in this case, capital renewal for PSO activities would have to be compensated through a future grant from government to the railway.

Under a PSO contract system, the reporting lines of the government purchaser and the reporting lines of railway provider must be clearly separated, as described in Section 6.4, to ensure that the purchaser can be objective in assessing railway performance in meeting its obligations.

In principle, PSO contracts can provide greater transparency and accountability in public governance and organizational performance, which can lead to improvements in both. However, in practice, in the passenger railway sector, PSO contracts are not straightforward for reasons that are conceptual, budgetary, technical, and political.

### *Conceptual*

A PSO contract system is suited to an industry with a core set of potentially profitable activities, and at the margins, another set of obligations that can be disaggregated, separately costed, and charged to government. However, financial modelling has indicated that passenger train services cannot operate without long-term budgetary support, even at efficient input-cost levels, except under very limited circumstances, such as dense inter-city rail corridors.<sup>82</sup> Most railway passenger services fall far short of recovering their full 'efficient' costs of operations and infrastructure. The challenges of attaining full commercial viability are even greater for heavily 'peaked' suburban services or less heavily utilized regional services. In many countries, hardly a single passenger railway route would or could be profitable in a full commercial sense. In these circumstances, a list of individually priced PSOs would fill the whole timetable, representing an unwieldy and impractical decision tool.

### *Budgetary*

In principle, PSO contracts are equally applicable to profitable and unprofitable railways. But when national railways are profitable<sup>83</sup>, government budget planners

<sup>81</sup> The railway obligation is not only to meet the PSO but also to provide it efficiently, and the government obligation is to fund the PSO to a level that an efficient provider would charge.

<sup>82</sup> Amos and Bullock, *The Financial Performance of Non-Urban passenger rail services*, (World Bank, 2007). [http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2008/03/24/000333038\\_20080324074100/Rendered/PDF/430250NWP0PAss10Box327344B01PUBLIC1.pdf](http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2008/03/24/000333038_20080324074100/Rendered/PDF/430250NWP0PAss10Box327344B01PUBLIC1.pdf)

<sup>83</sup> Profitable usually due to the recovery of infrastructure costs from heavy freight flows.

tend to resist the PSO contract model. Instead they usually prefer the railway to meet the obligations by internal cross subsidy. This argument is not convincing in terms of economic efficiency as it implicitly supports the idea of an internal tax on some customers to support others. But it is nevertheless persuasive to cash-strapped governments making hard budget choices; they may observe from a practical viewpoint many other network industries such as postal services, telephone networks, broadband networks, broadcasting, electricity supply, water supply and others often contain significant elements of internal cross-subsidy between customer groups.

### *Technical*

Applying PSO contracts to railways poses the challenge of making credible net cost assessments for specified services, which is a complex process. Railway operations include joint and common costs, so some costs will be assigned on the basis of professional judgment. Therefore, strong professional capacity in railway management accounting methodologies is essential to derive estimates that can satisfy skeptical finance ministries, which must verify charges.

### *Political*

Finally, the economic rationality of the PSO contract model is not well matched to political rationality. The presumption is that governments will be willing to intervene in the transport services or fares of one portion of the community, or set of electors, while leaving those of all others to the commercial disciplines of the market. Experience suggests that the political interests of most governments are not so readily divisible.

For all of these reasons, PSO contracts are not easy to implement. Moreover, even after they are agreed, there are examples in Latin America and Africa of governments eventually defaulting under pressure from hard-pressed finance ministries.

It takes a healthy dose of pragmatism to craft PSOs suitable for each country and railway. A PSO contract works best when the railway industry's internal structure nearly mirrors its commercial and non-commercial roles, providing a more transparent and separable financial structure. For example, separating suburban networks or regional services will facilitate targeted PSO payments to those units. This argument for horizontal separability was discussed in Chapter 5.

Restructuring tariffs should always be considered *before* committing to long-term PSO contracts. If the railway operates in an environment of regulated tariffs, PSO losses are partly linked to tariff policy so tariff rationalization may address part of the revenue shortfall. In many cases, a revised tariff policy is a simpler instrument to accommodate the social issue of subsidizing special categories of customers than using a PSO and service subsidies; it also performs better in terms of efficiency and equity.

## 8.4 Public Services Contracts

Public services contracts (PSCs) are also based on the concept of public service obligations (PSOs) but PSCs overcome some conceptual and practical difficulties of deriving and agreeing on a schedule of individually priced obligations. Rather than

try to divide a specific service network into commercial and non-commercial services, a PSC can specify minimum service and fare obligations for the whole service or large parts of it, and compensate the provider at an agreed amount or to an agreed formula, for the contract period.

This toolkit presents the PSC as a generic tool for managing public funding of railway passenger obligations. But it is also useful to consider the specific application of PSCs in the EU where the concept has been subject to considerable legal and regulatory development in the context of urban bus, tram and railway services, and has supplanted PSO contracts as the accepted method of meeting public interest objectives in these areas.

The EU regulations promulgated by the European Commission<sup>84</sup> recognize that many passenger transport systems serving general economic interests cannot operate on a commercial basis; therefore, EU Member States must act to ensure provision of ‘safe, efficient, attractive and high-quality’ passenger transport services. Under EU legislation, Member States can award exclusive rights to public service operators, grant them financial compensation, and impose general public transport rules on all operators.

The regulations acknowledging that financial compensation may be necessary to apply to national and international public passenger transport services—track-based modes such as trains and trams, and road-based modes such as bus services—and to both public and private service operators. Whilst contracts for road and light rail services must follow public tendering procedures, exemptions may be made for heavy rail for which member states may decide on how to award contracts.

Under the EU regulations, the central or local government authority must conclude a PSC with any passenger transport operator granted an exclusive right of operation, or compensation for public service obligations, or both. Obligations that aim to establish maximum tariffs require compensation for the net positive or negative financial impact occasioned by compliance with the pricing obligations.

The European Union PSCs, and their general rules, define, inter alia: operator obligations; parameters for calculating compensation; the nature and scope of all exclusive rights granted; cost distribution linked to service supply (staff costs, energy, infrastructure, maintenance, etc.); and transport ticket revenue distribution between public service operator and public authority.

This transparent contract agreement is critical to avoiding an open-ended deficit-funding commitment. If the PSC is not tendered, as many EU railway services are not, compensation should not exceed the net financial effect of contractual obligations on the costs and revenue of the public service operator. These effects are assessed by comparing the costs of the contractor meeting the public service obligation, with the situation which would have existed if the obligation had not been met.

The regulations offer guidance on calculating the net financial effect, which is summarized below.

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<sup>84</sup> Regulation (EC) No 1370/2007.

- **costs** incurred in relation to a PSO or a bundle of PSOs;
- **minus** any positive financial effects generated within the network operated under the PSO(s) in question;
- **minus** receipts from tariff or other revenue generated under the PSO(s);
- **plus** a reasonable profit.

Public services accounts must be ring-fenced to increase transparency and avoid cross subsidies being paid to any public service operator that is engaging in other activities while supplying compensated services under public transport service obligations.

Public service contract periods are limited. In the EU, they must not exceed ten years for bus and coach services, and fifteen years for rail or other track-based modes. This period may be extended by up to 50 percent under certain conditions, particularly to allow amortization of investments. The longest periods apply to railway contracts, acknowledging the long-term nature of rail system capital investments.

However, if PSC contract agreements with an incumbent public railway are awarded without competition, the operator will have no incentive to optimize performance. First, unless the PSC price is based on input cost or targets, such as improved rolling stock utilization or labor productivity targets, it lacks incentives for efficiency improvements. Second, if the PSC covers the difference between revenue and cost, even for efficiency-enhanced cost targets, the contract lacks incentives to optimize fare structures or collect all the fares charged. This would obligate the contracting authority to set marketing and revenue collection parameters, which would add complexity to contracts and their administration. Instead, if PSCs are contestable through tendering, these difficulties are avoided because bidders have clear incentives to plan their bid on the basis of efficient costs and fare collection systems, and if successful in their bid, to implement them. A Guide for preparing a Passenger Service Contract is in Annex 5.

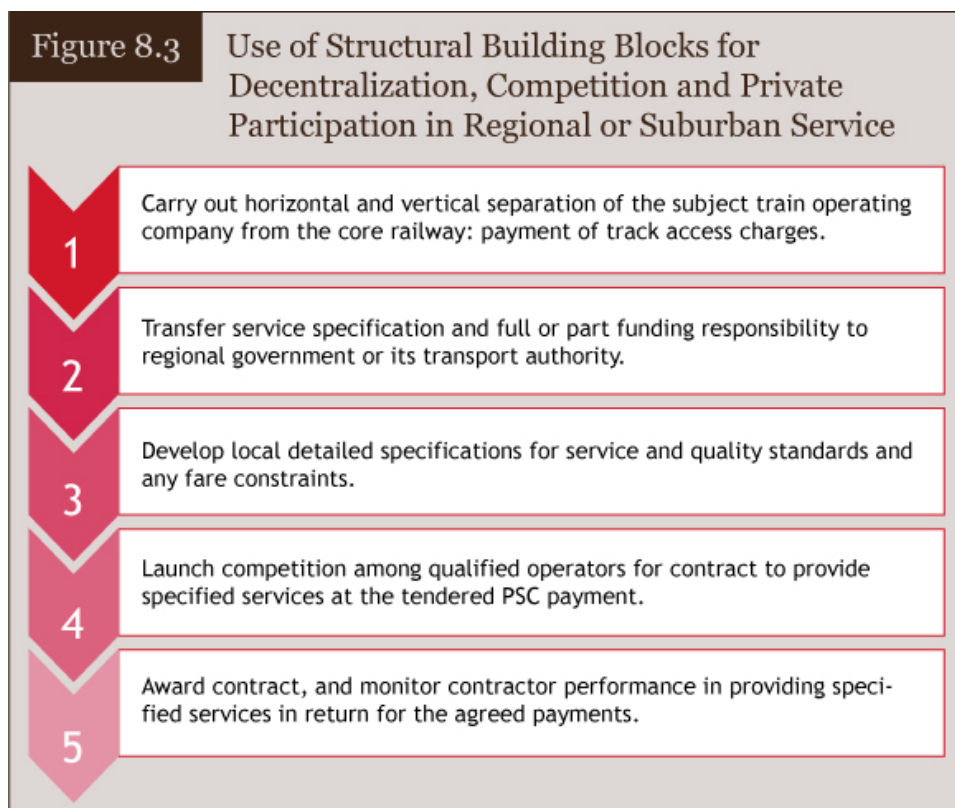
## 8.5 Competing for PSC Contracts

Under some structural options presented in Chapter 5, PSC contracts can be made contestable. First, groups of services, such as a suburban rail network, or a set of regional train operating services can be separated into new companies; then the required PSC, including performance standards such as punctuality and reliability, and rewards and penalties, can be drawn up; company operation can be concessioned through a bidding process; and finally, a special oversight unit of national or local government can monitor performance and make payments.

Figure 8.3 summarizes an example of how this could be staged for a separable regional or suburban train operation. Transferring responsibility for service specification and partial funding to lower-level government, as shown in Figure 8.3, is an attractive add-on where it has capacity and resources to perform this role but not



essential for this approach. Competitive tendering of PSO contracts has been successful in many applications in Europe, though not without important hurdles to be overcome<sup>85</sup>.



## 8.6 Case Studies

The use of contractual forms to fund passenger public service obligations is illustrated in some of the case studies presented in Annexes including examples from both private and public frameworks. Such contracts exist to ensure continuation of passenger services on many privately run freight concessions in Latin America and Africa; they also form the basis of the long-distance passenger services operated by the state-owned Via Rail on the Canadian National and Canadian Pacific private networks. In the public framework, competitively tendered PSCs are used to procure specific rail passenger services in regional markets in Germany, Finland and Sweden. The corporate case study of Virgin Rail shows how one private company has responded to being awarded what is essentially a PSC (in UK).

<sup>85</sup> Louis S. Thompson, *Competitive Tendering in Railways: What is Experience Telling Us?* Paris, (ECMT, November 2006). <http://www.internationaltransportforum.org/Pub/pdf/07TenderingRail.pdf>