

Agenda

Advancing economics in business

Funding public transport services: in need of standard regulation tools?

Many public transport services are provided for their wider economic benefits rather than their commercial profitability, in return for which they often receive public compensation. Recent European legislation has set out new conditions under which such compensation can be granted to transport operators. What is the basis for these compensation rules, and do they have parallels in the economic regulation of other sectors?

In situations where transport services that are in the general social or economic interest cannot be provided on a commercial basis, national governments or local authorities can create a public service obligation (PSO). The PSO can be implemented either by its inclusion in a public service contract (PSC) with a specific operator or through general rules covering all public transport operations. In the transport sector PSOs can range from vehicle quality standards, to maximum tariffs, to the provision of unprofitable routes or frequencies. While some authorities provide PSOs themselves via an internal (public) operator, others award PSCs to private operators. Where authorities do this, the contracts usually involve either the granting of exclusive rights or financial compensation in return for the provision of the PSO.

There has been significant debate about the funding of PSOs, both in terms of how to place a cost on them and in terms of the optimal funding mechanism to use. This debate has taken place in a range of contexts—eg, in the telecoms and postal sectors there has been much discussion about how to cost and fund a universal service obligation that requires a uniform price for all services. A key aspect of this debate about PSO funding has focused on how to ensure their viability when they are exposed to competition in a (at least partially) liberalised market. This aspect may become even more pressing from 2009 when a new Regulation comes into force in Europe, encouraging competitive tendering for transport public service contracts.¹

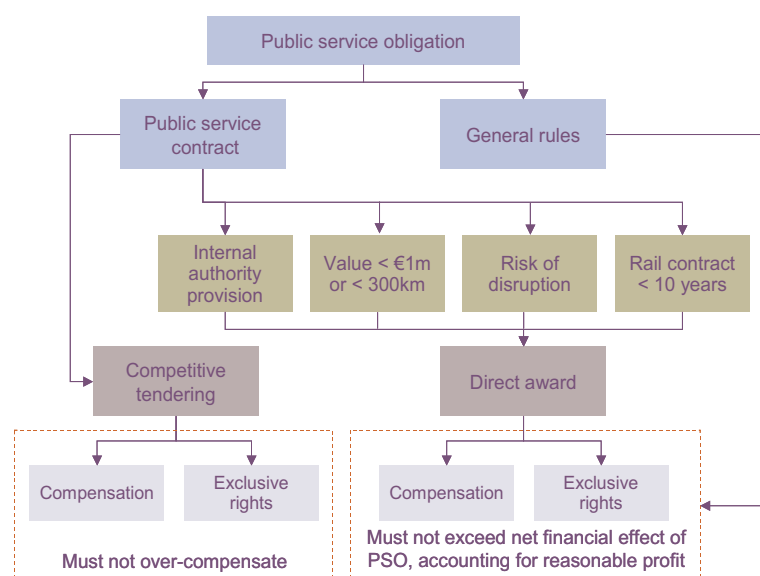
Passenger transport Regulation 1370/2007 was introduced in 2007 and deals with

several of these issues (see Figure 1). In particular, it sets out requirements for granting compensation for PSO provision, covering national and international public passenger transport services by light and heavy rail and by road. It will come into force in December 2009.

A new Regulation at EU level

One of the primary aims of Regulation 1370/2007 is to create transparent and fair competitive award procedures for PSCs. While these already exist in some Member States, there are significant disparities, which have created a degree of legal uncertainty around operators' rights and authorities' duties. The Regulation should

Figure 1 Stylised illustration of options for PSO provision as set out by Regulation 1370/2007



Note: The value or kilometre limits may be increased for operators of not more than 23 vehicles.
Source: Oxera.

harmonise procedures across the EU. As such it creates a legal framework for competition rather than promoting market opening itself.

The key development arising from the Regulation is that PSCs will now be required to be either competitively tendered or provided internally by the competent authority or an entity over which it has control. In the latter case, there is an expectation that the terms on which the public service is provided are transparently set out in a contract. There are a few other exceptions where direct award of a PSC to an external operator will be permitted, including what effectively amounts to a 'de minimis' rule.

Another significant component of the Regulation relates to the conditions to which authorities must adhere when compensating operators for the provision of a PSO. The Regulation requires that the parameters along which the compensation is based, or the exclusive rights granted, should be clearly defined. Over-compensation should be avoided, regardless of how a PSC is awarded. In situations where a contract is not competitively tendered (eg, where it is provided by an internal operator), compensation must be provided in a way that covers the net financial effect on costs and revenue after allowing for a reasonable profit. This compensation method is discussed below.

The Regulation contains various other measures relating to PSOs. One of these is a limit on contract duration in order to mitigate the risk of market foreclosure over time. These contract limits are ten years for road-based modes of transport and 15 years for track-based modes,² although there is scope for a 50% extension if the operator provides sufficient assets that may undergo significant depreciation. At a more practical level the Regulation contains requirements for the information to be provided in each PSC. Where PSO contracts are awarded directly and the PSO operator also undertakes other activities, there is a requirement for accounting separation. This separation requirement is designed to increase transparency and prevent cross-subsidisation between PSO and non-PSO services.

Compensating operators

By definition, providing a PSO leads to the operator earning an insufficient rate of return, unless it receives some benefit, often in the form of financial compensation or exclusive rights. One of the requirements of the Regulation is that all PSCs and general rules set out these benefits in advance in a way that aims to prevent over-compensation. Additional conditions are applied to cases where competitive tendering does not occur. The manner in which this is to be determined is set out in the Annex to the Regulation:

The compensation may not exceed an amount corresponding to the net financial effect equivalent to the total of the effects, positive or negative, of compliance with the public service obligation on the costs and revenue of the public service operator. The effects shall be assessed by comparing the situation where the public service obligation is met with the situation which would have existed if the obligation had not been met.³

Thus the compensation for directly awarded and general rule PSOs can essentially be described by the following formula:

$$\text{Compensation} = \text{costs} - \text{receipts} - \text{other financial effects} + \text{reasonable profit}$$

One interesting element here is the 'reasonable profit'. This is taken by the European Commission to mean a rate of return on capital that is typical for that sector (ie, not the social time preference rate that is applied by governments for discounting future cash flows from government activity), taking into account the level of risk associated with potential public authority intervention.⁴ The Commission's guidance also indicates that the reasonable rate of return must not normally exceed the amount that was the average in that sector for the preceding years.⁵ The last part of this definition—the reference to potential public authority intervention—appears to be an explicit recognition of the existence of regulatory risk.

In contract valuation the required rate of return on capital is the relevant discount factor to apply to forecast cash flows. Given the importance of this rate to the final contract value, its derivation is likely to be one of the most controversial aspects of any compensation award. The implication of the requirement for 'reasonable profit' is that competent authorities may have to calculate the weighted average cost of capital (WACC) of the transport operator they are contracting with. Other requirements in the Regulation include the allocation of costs associated with the provision of services between, for example, maintenance and capital expenditure, and the quantifiable financial effects of the PSO on the operator's wider networks. The calculations that authorities will have to undertake could therefore require the gathering of detailed information.

A further implication of the reasonable profit approach arises when it is applied to a PSO that includes a maximum tariff requirement. In these cases authorities may have to set the maximum tariff in a manner similar to the price caps sometimes applied by economic regulators of network utilities. The maximum tariff will need to be chosen to ensure that the operator obtains a reasonable rate of return, while questions of the

appropriate asset base to apply the rate of return to, efficient levels of operating and capital expenditure, and covering tax liabilities, will all need to be considered, as with a price control review. Arguably, even in cases where a maximum tariff is not set, and there is a requirement to demonstrate that over-compensation has not taken place, these calculations will all be necessary.

State aid

It is worth considering the requirements in Regulation 1370/2007 for the PSO compensation process in the context of wider state aid law.

Article 87(1) of the EC Treaty prohibits state funding for service provision if that funding is deemed to constitute unfair state aid, as defined by the following cumulative conditions:

- there has been intervention by the state or its resources;
- the intervention is likely to affect trade between Member States;
- the aid is selective (in favour of a company, sector or region);
- competition has been, or may be, distorted.

There is an exception to these rules that can be invoked in situations where the application of state aid rules would hamper the operation of services in the general economic interest.⁶ However, in these situations where a Member State wishes to grant aid using such an exemption, it must notify and seek approval from the Commission.

The European Court of Justice's *Altmark* judgment set out the exemptions that might apply to transport PSOs.⁷ The judgment ruled that state compensation for PSO provision is not to be considered an advantage (ie, state aid), provided that four cumulative conditions are met:

- the recipient of the compensation must be providing a PSO;
- the parameters for compensation must be established *ex ante*;
- the compensation cannot exceed the costs of the services, accounting for revenues and a reasonable profit;
- where PSOs are awarded directly, there must be no over-compensation based on analysis of the costs incurred by a hypothetical well-managed provider of the services.

Regulation 1370/2007 appears to be based on this judgment, and the four conditions are transposed within the Regulation. Therefore, if the conditions set out in the new Regulation are met, the relevant authorities would

not need to notify the Commission before granting compensation for PSO provision, once the Regulation is implemented.

Relationship with the English Local Transport Bill

The EU Regulation contains some specific wording indicating that little is likely to change in deregulated markets, such as the GB bus market (excluding London). The Regulation states that:

Passenger transport markets which are deregulated and in which there are no exclusive rights should be allowed to maintain their characteristics and way of functioning.⁸

However, the Local Transport Bill (currently being passed through Parliament⁹) has raised the possibility of the introduction of Quality Contracts (QCs) and Quality Partnership Schemes (QPSs) in England. These are both steps away from the deregulated market.

QCs are contracts for the exclusive rights to operate in a given area that are awarded through compulsory competitive tendering. To comply with Regulation 1370/2007, QCs may therefore need to be specified in a manner that ensures that their exclusive rights do not allow the operator to be over-compensated. Equally, the EU Regulation's duration limit is another aspect that would apply to QCs should they be implemented.

QPSs are statutory schemes between operators and local transport authorities (LTAs). LTAs provide quality bus facilities that can be accessed only by operators meeting specific standards, which can include maximum fare tariffs. The QPS process does emphasise (but does not guarantee) LTAs forming QPSs that reflect the commercial needs of operators. Thus the Local Transport Bill could be compatible with Regulation 1370/2007 in terms of offering a reasonable rate of return.

However, where QPSs envisaged in the Local Transport Bill involve maximum fares established by the LTA, the LTA may need to act like an economic regulator in order to satisfy the Article 3 provisions in the EU Regulation relating to general rules for maximum tariffs. While a QPS is open to all operators that will provide the required quality standard (the maximum fare in this case), it does create exclusive rights for those operators that provide these standards. Thus the parallel is with a network monopoly where a regulated price cap is imposed that allows a reasonable rate of return. It may be that, in some cases (and in all cases, the Regulation suggests that this will have to be tested), the maximum fare set by an LTA does not provide a sufficient return for

operators in the QPS, and in these cases the EU Regulation requires that they receive financial compensation as well.

In either case, detailed financial analysis by the competent authority will be required to ensure the correct level of compensation. This may well be a costly and onerous process. In addition, from the operators' perspective, separate accounting for the PSO will be required, which could involve considerable cost.

The reasonable rate of return does provide some protection from other potential issues with a QPS. In particular, it may help to protect against excessive quality thresholds, cherry-picking, and changes in external circumstances, by requiring sufficient compensation for an operator in each of these cases.

Outlook

Regulation 1370/2007 is likely to have several impacts on the way that PSCs are implemented throughout the EU. These impacts may affect both the competitive and regulatory environments in which PSC transport providers operate. The most significant changes that are expected include the following.

- More competition in European public transport provision. The increased competition will come from more PSCs being competitively tendered. Such

increased competition may therefore be between operators bidding to win contracts, rather than increased actual on-road/track competition.

- More transparency in the way in which PSCs are awarded in surface transport. Authorities and operators will have to set PSOs explicitly, and demonstrate clearly how much compensation is being provided in relation to each PSC that has been awarded. This increased transparency should both support any competitive tendering processes and allow any compensation to be assessed more easily for state aid.
- A third potential outcome could be that authorities begin to engage in a process akin to economic regulation. This could include determinants of reasonable profit levels, allocation of costs and impact on operators' wider networks and, hence, compensation that operators should receive. This may affect investors' perceptions of the risks associated with public transport operators subject to these new rules.

The implications for existing rules, such as those governing QCs and QPSs in the UK, as well as the wider impact on transport operators and the competition in other EU markets, is yet to be evaluated.

¹ 'Regulation (EC) no 1370/2007 of the European Parliament and of the Council on public passenger transport services by rail and by road and repealing Council Regulations (EEC) nos 1191/69 and 1107/70', adopted on October 23rd 2007.

² Except in the case of direct award of rail contracts, where a ten-year duration is required.

³ Regulation (EC) no 1370/2007, Annex, para 2.

⁴ Regulation (EC) no 1370/2007, Annex, para 6

⁵ European Commission (2007), 'Frequently asked questions in relation with Commission Decision of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, and of the Community Framework for State aid in the form of public service compensation', SEC(2007) 1516, para 6.7.

⁶ EU Treaty Article 86 (2).

⁷ Case C-280 /00, *Altmark Trans GMBH and Reierungsprasadium Magdeburg* (2003) ECR I-7747.

⁸ Regulation 1370/2007, Recital (8).

⁹ See <http://services.parliament.uk/bills/2007-08/localtransporthl.html>.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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