

(15) 3

Independent Regulators' Group – Rail

IRG–Rail

**Position paper on current proposals on competitive tendering for
public service contracts**

14-15 April 2015

I. Executive summary

1. In its proposal to amend Regulation 1370/2007 the European Commission introduces mandatory competitive tendering for public service contracts as an integral part of the 4th railway package, to improve transparency, allow fair competition and eliminate the potential for discrimination.
2. IRG-Rail considers that competition in the provision of rail services can provide a powerful incentive, and valuable benchmark, for improvements in efficiency and quality.
3. IRG-Rail fully endorses the Commission's original proposal for the Fourth Package to introduce, as a general rule, mandatory implementation of competitive tendering for rail public service contracts.
4. Any exceptions from this general rule should be limited to clearly defined and substantiated specific circumstances.
5. IRG-Rail has serious concerns regarding the amendments made in the European Parliament's (EP) first reading of the package in this respect. The proposals risk a permanent and broad continuation of direct award, thus impeding market opening.
6. IRG-Rail acknowledges the compromise proposals put forward by the Latvian presidency in January 2015 which could be a good basis for progress. Nevertheless further detail is required in places to prevent the proposed Latvian approach on competitive tendering from being misused and allow competent authorities to bypass the tender requirements. In its recent orientation debate in March 2015, the Latvian presidency pointed out that there are still controversial opinions of Member States and further compromises may be required. No details were discussed during that debate.
7. We encourage the Commission, Member States and MEPs to engage constructively in the negotiations, and help to secure the benefits of competition for rail users and funders.
8. As any possible further compromise solution within the current negotiation process will have a direct impact on regulatory bodies' work and role the IRG-Rail considers it necessary and helpful to deliver further input to the legislative process in this regard. The position paper presents our views in relation to our individual responsibilities, without, however, necessarily reflecting all individual policy positions at national level.

II. IRG-Rail position - Mandatory competitive tendering

IRG-Rail supports mandatory competitive tendering as the basis for public service contracts.

9. In its previous position papers, IRG-Rail stated that competitive tendering should be mandatory, and exceptions should be strictly limited to clearly defined and substantiated specific exceptions, such as emergency cases, technical specification, and exceptions based on de-minimis threshold conditions.
10. The EC's impact assessment provides evidence that the introduction of compulsory competitive tendering has resulted in significant savings of up to 30% for public service contracts in some Member States, and comprehensive consultation/survey results showed that 60% of participating stakeholders support opening of domestic passenger service through compulsory competitive tendering as a main tool for progressing further market integration of the rail sector.¹ Competitive tendering for public service contracts and the pressure of competition are likely to create incentives for bidders to offer improvements in efficiency, performance and quality of rail services. Consequently it may ensure reduced costs and maximum efficiency of public spending as public authorities are offered better value for money.
11. In the rail sector there are several areas where competitive tendering already has a positive impact, such as procurement of rolling stock and infrastructure. The proposed new rules will give new operators the opportunity to compete for public service contracts in order to ensure better value for money spent on public transport services, as also illustrated in the following examples:
12. In Sweden, all public service train operations are competitively tendered. The first round resulted in public subsidies reductions of up to 20%² despite the lack of new entrants.³ The new entrants were mainly small operators and with some multinational firms such as Veolia and Arriva. In some cases, new entrants brought innovation to the railway sector, for example, BK Tag reformed the working conditions of the drivers and

¹ European Commission, impact assessment, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2013:0012:FIN:EN:PDF>

² Gunnar Alexandersson, *Rail Privatization and Competitive Tendering in Europe, 2009*.

³ The reduction of subsidies is not the same over time, it decreases.

Tagkompaniet created a new pricing scheme with a more user-friendly booking system.

13. In the United Kingdom, the first rounds of bids were won by existing transport companies⁴ and were accompanied by a reduction in subsidy. Since privatization of the railways, competitive tendering has resulted generally in a decrease of public funding. The franchise system has attracted a high number of competitors for franchises. This may be due to the absence of a dominant incumbent. It is worth noting that a preparatory phase is usually put in place by the franchising authority allowing it to discuss the specifications of the franchise with potential bidders and help them to better know the market and adapt the call for tenders.
14. In Germany, the number of bid winners other than the incumbent has grown progressively. The market share of competitors increased and competitors won 25% of new contracts in 2013.⁵ This illustrates a positive development with regard to the development of a level playing field. Respective assessments on public procurement of regional passenger railway services in Germany, when comparing competitive tendering vs direct awards have come to the conclusion that the procurement price is up to 25 percent lower on tendered lines than on those with direct awards⁶.
15. The objections and counter-arguments that have been put forward to these proposals often suggest that competitive tendering *in isolation* may not be sufficient to realise the benefits of competition. Indeed, IRG- Rail's experience shows that competitive tendering alone may not be the universal remedy as long as other barriers exist. IRG-Rail therefore acknowledges that attention to framework conditions is crucial for competition to flourish.
16. A well-designed competitive bidding process should allow the potential participation of different railway undertakings in order to increase the value for money for customers and public transport authorities. One of the key determinants of the success of competitive tendering is the expertise of public authorities. They must not only have the necessary expertise to organise the tendering procedure, but also to monitor the successful bidder while the service is running (enforcement of the contract, risk management, and possible renegotiation etc.). The success of the

⁴ But those were not companies in the rail sector before the reform. For example Stagecoach was just a bus operator.

⁵ DB, Annual competition report 2014, p. 18.

⁶ R. Lalive and A. Schmutzler, *Auctions vs negotiations in public procurement : which works better ?*, 2011

competition for the market also depends on how the bidding process is organised. Therefore, IRG-Rail believes that transparency is essential. Ex-ante transparency involves publishing the requirements of the awarding authority and ex-post transparency on the contract winner's performance. The risk of collusion by sharing full detailed information cannot be ignored.

17. Some academic work in economics shows that giving competent authorities a certain level of discretionary powers when choosing the winning bidder can also be an efficiency factor when combined with good transparency of the selection process. For example this allows the public authority to reject an over-optimistic tender. The discretionary power also allows the public authority to give some margin for innovation to the bidders, by not being too prescriptive in the call for tender. Transparency is one way to address the potential adverse effects of discretionary power. Consequently, a combination of transparency and discretionary powers of competent authorities is needed.
18. Generally speaking, another key determinant for the efficiency of competitive tendering is the nature and level of investments required to enter the market as this may constitute a significant barrier to entry. Hence, in the railway sector, access to **rolling stock** is a concern. In several German regions, for instance, candidates tendering for public service contracts are required to provide their own rolling stock. Such an obligation may create a barrier to entry for small operators who may not have the capacity to finance such investments. This also raises the issue of the use of rolling stock once the contract has expired if its length is much shorter than the useful life of the purchased vehicles. This risk is more important for new entrants than for the incumbent, and is also more important for small operators than for larger ones. For instance in the UK, the winner of a tender tends to take over the assets and the staff of the previous train operator and to lease the rolling stock, thus, the level of investment required is much lower, reducing barriers to entry.
19. **Information:** Practical experience of competitive tendering in several Member States (for instance in the UK and in Germany) shows the importance of ensuring that asymmetric access to information does not act as a barrier for new competitors seeking to win a public service contract. All relevant information (such as technical specifications and asset conditions) must be made available to bidders as part of any bidding process
20. **Ticketing:** Bid-winners must have non-discriminatory access to ticket retail systems where necessary, and particularly in relevant stations. Experience shows that through-ticketing and revenue-redistribution systems can provide an effective solution to avoid discrimination.

21. Another important issue is the allotment of networks⁷, that is to say the fact of splitting one large network into smaller ones. The separation into lots, tendered out separately, could facilitate the entry of small operators. It could also allow the competent authorities to have access to data to compare operators. However, this approach would also imply a potential loss of economies of scale and scope and a potential increase of transaction costs (process, contractualisation, fare coordination etc.). Therefore, competent authorities have to take into account these different aspects to define the optimal number of lots or size of lots for a public service contract under consideration. This is a question of tradeoff between gains from competition and diseconomies of scale.¹ One must consider that large monopolies are often organized in divisions (regional for example). Thus, the problem of diseconomies of scale may not exist in reality.
22. These practical examples, however, should not be seen as a valid argument against competitive tendering *per se*. On the contrary, this is a good reason for the Commission, Parliament and Member States to examine the enabling framework conditions mentioned above.
23. To conclude, IRG-Rail believes that it will be necessary to introduce mandatory competitive tendering of public service contracts, and tackle additional barriers at the same time with appropriate instruments for Member States and competent authorities. Clear and transparent tender procedures are required. Procedures should be designed to ensure that administrative costs of tendering are proportionate.
24. The Commission's proposal to introduce a greater degree of competition in the provision of rail services has encountered opposition in other areas, most notably on the issues of 'social dumping' and redundancies in the rail sector. IRG-Rail does not seek to involve itself with the terms and conditions of employment that pertain in different member states, as the negotiations between national governments and employee representatives are conducted at the national level. The social and employment conditions are one of the aspects to be tackled by Member States in opening its domestic market for competition but these are public policy choices and should not therefore be used as an argument against competitive tendering. However, IRG-Rail would like to point out that in UK where the rail market is open for competition, considerable increases in rail usage has been observed. This market growth has been

⁷ See Baumstark, Ménard, Puccio, Roy, Yvrande-Billon, *Rapport PREDIT : Risques et avantages de l'allotissement dans les transports publics urbains de voyageurs*, 2007. French.

accompanied by an increase in the number of staff employed in the rail sector, and improvement in the salaries that they command.⁸

III. IRG-Rail major concerns about additional exceptions to competitive tendering

A. Direct award when efficiency criteria demonstrated – European Parliament proposal

Concern about exceptions perpetuating state of play, hindering improvements.

25. EP's first reading in 2014 includes far-reaching exceptions which would allow Member States to directly award public service contracts. Specifically, there is a proposal to allow exceptions from competitive tendering if competent authorities are able to demonstrate that a number of efficiency criteria, which have been set out in their public transportation plans, are satisfied through direct award. In this case, public authorities would have to justify such a decision to the regulatory body. If the regulatory body considers that the requirements are not met, it would be able to oblige the competent authority to award the next contract through competitive tendering.
26. IRG-Rail believes that direct award of public service contracts should only be permitted in a limited and clearly-defined number of cases. Reasons for invoking such exceptions should be fully substantiated by competent authorities and open to appeals by courts or other independent authorities.
27. IRG-Rail has several concerns with these proposals as these requirements leave extensive room for manoeuvre for competent authorities who may prefer to keep direct award as a general instrument, thus perpetuating the status quo. As a result, the respective part of the market would remain only partially or even non-liberalised, and the Single European Railway Area will remain incomplete.

Concerns about design and arrangement of the proposal

Efficiency criteria vague and not appropriate:

⁸ Realising the Potential of GB Rail: Final report of the rail value for money study: Sir Roy McNulty, 2011, p193-195; http://orr.gov.uk/_data/assets/pdf_file/0017/1709/rail-vfm-detailed-report-may11.pdf

28. According to the EP proposal, Member States would be required to set out in their public transport plans the following “efficiency criteria” for passenger rail services covering *punctuality, cost-efficiency, frequency of services, customer satisfaction and the quality of rolling stock*. Member States would be allowed to directly award public service contracts if they can demonstrate that these efficiency criteria can be satisfied through direct award. IRG-Rail fears that in practice it would be impossible to evaluate and conclude the appropriateness and success of a public service contract on the basis of those criteria. Each criterion leaves too much room for interpretation. Their application is not clear and it is not clear to which impact and goal the “criteria” should be related in order to ensure efficiency. Furthermore, while one would need “input criteria” in order to ensure an assessment of efficiency, the proposed criteria seem to be “output criteria”, and are therefore insufficient to provide a measure of efficiency.
29. Another key issue is that it will be very difficult to assess *a priori* if a railway undertaking can fulfill these criteria (in particular for punctuality or customer satisfaction), unless performances levels are set too low, for instance because they are determined with regard the past performances of the incumbent. It would be necessary to compensate by imposing strong financial incentives (bonus/malus system) linked to those criteria within the contract, but this direct award with efficiency criteria may not be more efficient than a traditional direct award with the same type of financial incentives.
30. Secondly, assuming that only the relevant criteria⁹ are kept, the competent authority would need to define challenging but achievable targets and obtain data for the purpose of comparison. Additional safeguards would be crucial in this exercise. One approach, which IRG-Rail would consider in this context, could be the use of yardstick competition¹⁰.

⁹ It is difficult to define which are relevant. The best choice may be to keep only the cost-efficiency criteria while controlling at the same time quality (rolling stock, punctuality, etc.).

¹⁰ In Japan, for instance, yardstick competition in railways is applied. The Ministry of Land, Infrastructure and Transport uses a yardstick competition approach to increase efficiency among existing railway companies. Yardstick competition is seen as competition among rail operators operating in different markets. Under this approach, the Ministry sets up several performance measures such as operating cost and evaluates rail operators' performance. For example, if a rail operator performs worse than other operators, then, as a penalty, the Ministry does not approve the fare level desired by the operator. For the less efficient rail operator, the costs taken into account for the fare level are the standard costs and not the actual costs which are higher. On the other hand, if an operator's performance is better than that of others, then the fare level for the more efficient rail operator, whose actual costs are lower than the standard costs, are set at the average of the actual costs and the standard costs. Thus any monopolistic behaviour can be counterbalanced to some degree by this approach. Mizutani's (1997) results, based upon

31. Yardstick competition can be seen as a means to introduce some “virtual” competition into industries where market competition is either not viable or not desired. Indeed, if there are several comparable firms operating in markets characterized by a natural monopolistic structure, the regulator¹¹ could devise an approach that specify the revenues of each firms as a function of the firm’s relative performance with respect to its peers. The regulator who uses such a regulatory approach could be able to reduce its disadvantageous position with regard to asymmetry of information when formulating the regulatory policy and, at the same time, create incentives for firms to be efficient.
32. Against this background, it might be useful to assess if yardstick competition could be an appropriate safeguard for the European rail market, taking into account the specificities of Member States. In Member States where the national passenger market is not open to competition, data collection may only represent the (potentially inefficient) incumbent. However, if such a country has a decentralized system of rail transport management in different regions/ counties where different competitors are active, the use of yardstick competition could still allow the most efficient one to be identified. There can be differences between them, for example in terms of local management. Yardstick competition would allow to identify the one with best practices and could be seen as a tool to collect performance data. This first assessment already shows the complexity of potential safeguards which IRG-Rail would consider a must if the EP proposal would be applied.
33. Therefore, IRG-Rail has serious concerns with the EP proposal, and concludes that these criteria cannot serve as an appropriate instrument
- to ensure an assessment of efficiency
 - to ensure an appropriate level of objectivity and
 - to avoid “easy-to-fulfill” options.

Role of the regulatory body (RB), procedure and scope of examination unclear and inappropriate:

34. According to the EP proposal, the regulatory body is required to evaluate the reasons provided by the competent authority for the direct award (either on the basis of complaints or acting on its own initiative) and must take a decision with regard to the contract in question. No later than two

Japanese railways’ data set, have shown that yardstick competition among large private railways has a significant statistical effect on costs reduction.

¹¹ Regulator in the broad sense as it includes organizing authorities

years before the end of the directly awarded contract, the regulatory body is required to assess whether the requirements have been complied with and, if it concludes that this is not the case, it can oblige the competent authority to tender a new public service contract. In this regard, IRG-Rail questions whether the regulatory body can oblige the competent authority to tender a new public service contract immediately or for the next contract period.

35. IRG-Rail considers the added value of these requirements as limited. According to the EP proposal, the regulator will be involved at a very late, *ex post* stage of the procedure. The regulatory body will be in charge of assessing tender relevant criteria while in most Member States the regulatory bodies do not yet have the necessary experience. If such a competence is retained the regulatory bodies would need to build the necessary expertise and collect data in this area,¹² Notably with regard to the supervision of performance and efficiency criteria mentioned in the EP proposal, a high level of expertise and additional resources would likely to be required to ensure a robust level of regulatory assessment and supervision.
36. Concerning the supervision by regulatory bodies of reasons for direct award, the amendment proposed by the EP is not clear. If the regulatory body finds against the direct award, it is not clear whether the contract is then void and whether and how rail services can still be provided. The position of would-be competitors is also unclear as they may be obliged to wait until the end of the directly-awarded contract. In combination with the general nature of the “criteria” themselves, supervisory instruments and competences seem insufficient. In light of these uncertainties, and in combination with the general nature of the “criteria” themselves, supervisory instruments and competences seem insufficient.
37. In any case, if further exceptions to competitive tendering are to be advocated by Member States, IRG-Rail believes that there is a role for courts or national regulatory bodies to ensure that competent authorities do not use these exceptions to unreasonably block competition for public service contracts.

¹² A number of Member States have authorities responsible for verifying public tendering rules. The EP proposal does not indicate how powers concerning the tendering procedure in question should be distributed.

B. Other exceptions - direct award of public service contracts – Latvian Presidency proposal put forward in January 2015

38. The Latvian Presidency proposal of January 2015 recognises that the market for competitive tendering may not be sufficiently mature and developed in some Member States for full-blown tendering procedures. It therefore allows competent authorities to adopt a less burdensome and lengthy procedure, with parties invited to express an interest rather than having to participate in fully-fledged open tenders.
39. IRG-Rail strongly supports the need for a high level of transparency to ensure that all market actors are well-informed and able to get the best outcome for users and funders. Therefore, IRG-Rail welcomes the obligation for competent authorities to publish an information notice containing a detailed description of the public service contract to be awarded. Legislation should however clarify when, where this information notice should be published, including publication in the EU Official Journal. Where appropriate, legal consequences of such publication should be clarified. The core elements to be included in the information notice may also be specified. This principle of transparency should also apply to the transport plan which should be easily accessible.
40. In these circumstances, when no more than one operator has expressed such an interest, the proposal acknowledges that direct award of a public service contract can be an effective option, provided that, as mentioned in the Presidency text, the absence of competition is not the result of an artificial narrowing-down of the procurement parameters, and that there are no reasonable alternatives.
41. It is to be noted that the proposal oversimplifies the negotiation procedures laid down in the Concessions Directive (2014/24 Directive). These procedures are limitative, subject to a number of conditions and criteria (delays, information publication). Any compromise proposal should be consistent with the conditions laid down in the Concessions Directive to prevent any procedure from favouring any specific railway undertaking.
42. Firstly, with regard to the Latvian proposal that the information notice must contain a “*detailed description of the services that will be the subject of the contract to be awarded as well as the type and the duration of the contract*”, it should be noted that the different means to call for competition in the Concessions Directive are strictly limited in time and the type of information provided is listed in the directive. In addition, without having any previous experience with competitive tendering it will be difficult for the competent authorities to initiate a proper competitive call.
43. Secondly, with regard to delays, the proposal introduces a ceiling of *60 days following the publication of the information notice for the operators*

may express their interest. It should be considered whether such a delay is long enough, especially for the large contracts where it is more difficult for a railway undertaking to prepare the call.

44. Thirdly, the proposal introduces three cumulative conditions in order not to launch the tender:
- *only one operator has expressed its interest to participate in the procedure to award the public service contract ;*
 - *the absence of competition is not the result of an artificial narrowing down of the parameters of the procurement;*
 - *when no reasonable alternative or substitute exists.*
45. IRG-Rail notes that the last criteria should be more explicit. We wonder how to substantiate the artificial narrowing down of the parameters of the procurement. For instance, the specifications could be either too narrow (e.g. a specific rolling stock) or too vague so that only one railway undertaking responds to the call. The third criteria related to the reasonable alternative or substitute seems to be close to the first one. Indeed, there is no other alternative where there is potentially only one railway undertaking who has manifested its interest.
46. In any case, IRG-Rail strongly recommends that the competent authority should publish its decision to directly award the contract and its justification according to the three criteria.
47. Any party that has been affected should be able to lodge a complaint and IRG-Rail would suggest including a complaint mechanism. This would ensure that potential competitors are able to challenge the competent authority's decision to go down this award route, if they feel that there has been an "artificial narrowing down of the parameters of the procurement" or alternatives have not been assessed appropriately. In this case, the complainant should be able to appeal to courts or an independent body, e.g. the regulatory body. The regulatory body or any other independent body should be a competent to assess whether the conditions were satisfied and fully substantiated.
48. IRG-Rail acknowledges that there may be a need for the compromise proposal permitting direct award of public service contracts in the case of special technical specifications for isolated rail systems, but consider that the scope of such rail systems should be clearly defined and substantiated. Clarification is also needed on criteria applicable to "differ significantly".
49. Similarly, IRG-Rail supports the possibility of direct award in an emergency (eg: financial failure of an operator or a withdrawal of a safety certificate or a license) but the definition of emergency measures as

expressed in the proposal should be clear, transparent and substantiated. There is a potential that this could be invoked very easily, potentially hampering competition and the opening of the market, and at least causing uncertainty for investor and consumer.

50. As a general rule a competent authority, in case of invoking an exception to competitive tendering, always must state reasons and justify the use of the exception, and that all these decision should be open to appeal (e.g. court or any other independent institution).

V. Conclusions

51. In summary, IRG-Rail does not endorse the EP proposal, with its additional exceptions for direct award. Competitive tendering should be recognized as the default process, with exceptions only allowed in limited number of clearly defined and substantiated cases. Any exceptions or facilitation measures for tender procedures should be accompanied by a high level of transparency, clear, precise and appropriate conditions and supervisory tasks and competences, and additional safeguards to avoid the potential for abuse. There should also be sufficient supervision, with powers of enforcement given to the relevant bodies.
52. IRG-Rail would strongly encourage the members of the Transport Council to engage timely and constructively in the negotiations, with a special focus of the requirements also identified in this document in order to pave the way for the adoption of the Fourth Railway Package as a whole. The revision of Regulation 1370/2007 proposing competitive tendering of public service contracts complements not only market opening but also the harmonization of technical and safety measures foreseen under the technical pillar of the package which should not be undermined.