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Setting a Public Service Obligation for Macedonian Railways

- n **Our remit:**
 - n **Produce a CBA-based justification for the State PSO payments**
 - n **Identify those services which failed to pass the test**
 - n **Define – subject to efficiency savings – what the payment buys**
 - n **Devise a monitoring mechanism linked to the payments**
 - n **Ensure conformity to EU requirements**
 - n **Alternative ways of serving passengers (buses!)**

What else needed to be done?

- n **We weren't asked to, but couldn't avoid considering:**
 - n **Track access charges (40-50% of all costs); financial performance of individual services severely affected by charge structure**
 - n **Efficiency savings (similar cost sensitivity)**
 - n **Financial performance of whole rail sector (PSO affects only passenger services – in Macedonia less than 10% of turnover.**
 - n **Wider policy issues about the role of rail in the Macedonian economy**
 - n **Long term Government plans for the future of the industry such as privatisation and open access**

The context of the PSO

- n PSO is just one of a number of related, supporting, pieces of work:
 - n Corporate plans
 - n Track access arrangements
 - n Policy initiatives
 - n Market analyses
- n These other work streams are not part of the Obligation itself but the Obligation cannot exist without them: they are the inputs
- n The Obligation is the output from these other work streams

Overview of our findings and recommendations

- n **No “absolute” or “right” sum of subsidy required**
- n **Therefore the State has some choices to make about closures and levels of service**
- n **Major assumptions about cost impact of investment and access charges**
- n **This version of Obligation will change because of:**
 - n **3rd party operators**
 - n **Better information/monitoring of trends**
 - n **Privatisation**
 - n **Change from cash to accrual accounting**
 - n **Policy development (buses!)**
 - n **Organisational development**

Structure of the PSO

- n **The PSO is just that – the expression of what the State is buying from the railway**
- n **Supporting work – plans, analyses -not part of the Obligation**
- n **Obligation sets out what is to be delivered**
 - n **Service levels**
 - n **Service Quality**
 - n **(Maybe) Price to be charged to passengers**
- n **Obligation sets out the compensation the railway is to receive**
- n **Obligation may set out penalties and bonuses for non-delivery**
- n **Underlying assumptions as agreed between State and operator will be set out in other documentation**

PSO – Structural Issues

- n **How much detail in specifying deliverables?**
- n **Legal vehicle for PSO**
 - n **Contract**
 - n **Direction**
 - n **Shareholders' resolution**
- n **Legal vehicle for setting out agreed underpinning assumptions**
- n **EU proofing**

Justifying the PSO

- n **No “right” figure for railway subsidy any more than there is a “right” figure for health or education expenditure**
- n **“Pure” CBA won’t help here:**
 - n **Most CBA benefits arise from time savings**
 - n **Philosophical debate about valuing “mobile” jobs**
- n **“Modified” CBA – Multivariate analysis**
 - n **Emphasis on important but difficult-to-quantify factors – accessibility, social cohesion**
 - n **Assessed against costed options for different levels of service**

Inputs to PSO

- n **Social analyses**
 - n Deprivation/poverty
 - n Employment
 - n Access to education, jobs and services
 - n Social inclusion
- n **Transport Analyses**
 - n Usage
 - n Alternative modes – buses, car ownership, road infrastructure
- n **Financial analyses**
 - n Costs of operations and infrastructure
 - n Available resources – system capacity, trains, crew
 - n Available money – fares, state payments, investment cash
 - n Efficient use of resources

Outputs – defining the PSO

- n Ranked social performance of existing routes**
- n Service specification to maximise efficient use of resources**
- n Payment streams linked to individual services' costs and revenues**
- n Performance measures**

Cost modelling

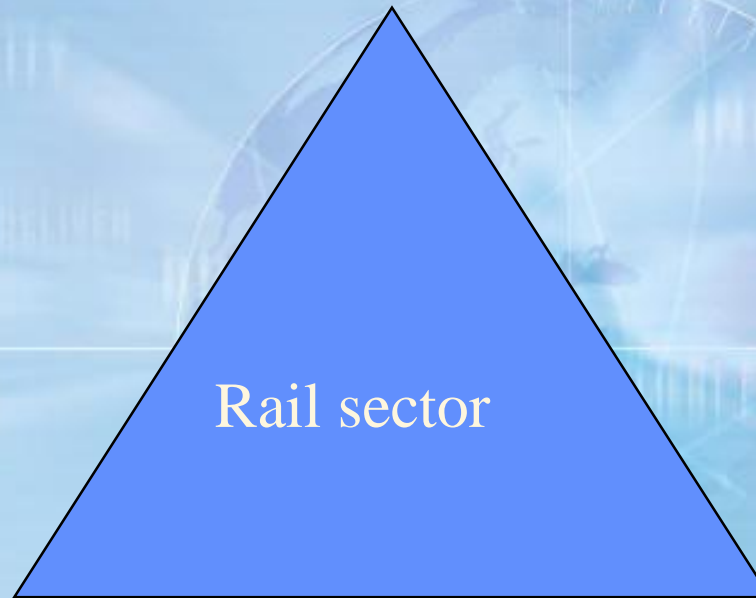
- n **We constructed a cost model to show for each line of route:**
 - n **Allocated fixed costs**
 - n **Avoidable fixed and variable costs**
 - n **Variable costs under different operating scenarios**
 - n **Splitting up joint costs**
- n **Key assumptions**
 - n **Cost allocation formulae**
 - n **Investments by route**
 - n **Service patterns**
 - n **Type of rolling stock used**

Financial modelling

- n We built a model of the whole of the Macedonian rail sector to include:
 - n MZ – Infrastructure and a “shadow” freight company
- n This is vital because:
 - n Passenger costs are dramatically affected by costs allocated to freight
 - n Some important policy choices will affect structure of cost allocation:
 - n Which business levers to pull?
 - n Are some businesses profitable?
 - n What will happen to funding requirements when open access is introduced?

State Intervention: The Financial Choices

**Income:
Fares/State
payments**



Investment

**Quality and
performance**

Track Access – Strategic Choices

- n **Three “families” of access pricing structure:**
 - n **Payment for use of individual assets (such as sidings) – leaves volume risk with infrastructure**
 - n **Payment by section of route (eg Veles to Bitola) – makes least used sections bear disproportionate fixed costs leading to rapid system shrinkage**
 - n **Payment for use of system as a whole – operators may not want to use whole system**
- n **Some compromise between 2nd and 3rd methods is possible to reflect actual use and cost causation**

Track Access – specific assumptions

- n **Charges to be divided into:**
 - n **Fixed (central costs – financing charges, HQ costs, and so on) – distributed by route kilometre**
 - n **Variable (maintenance costs that vary with volume of train service) – distributed by vehicle kilometre**
- n **Hierarchy of users:**
 - n **Prime user pays fixed charge for route kilometres and takes priority “on the graph” + own variable costs**
 - n **Secondary user pays only own variable costs of wear and tear**
- n **Assume that freight is prime user wherever it runs (and passenger secondary wherever it shares with freight)**
- n **Passenger prime on those passenger-only routes**

Track access – financial issues

- n Need to avoid “gold-plating” by monopoly infrastructure provider**
- n System capacity statement setting out what operators get for their payments**
- n Underpinning assumptions about investment/renewal of assets**
- n Periodic review of assumptions (every 5 years?)**
- n Operators might pay extra for specific infrastructure they alone require**
- n Arrival of 3rd parties will automatically lead to a redivision of fixed charges**

Investment

- n **New investment has cash consequences for PSO compensation but precise effect depends on method of finance:**
 - n **Borrowing**
 - n **Cash flow**
 - n **Equity**
 - n **... and assumed interest rates**
- n **Disinvestment:**
 - n **Hits P&L in the year of implementation**
 - n **Has cash consequences**
- n **Need for agreed investment /disinvestment programme to underpin PSO cash requirements**

Funding: some key lessons

- n EU legislation calls for use of marginal costing, but ...
- n ... no clear definition of what is “marginal”
- n Wide variety of practice amongst EU member states
- n EU policy assumption that freight is marginal to passenger is inappropriate outside western European commuter networks (In Macedonia, freight is over 95% of rail income – typical for eastern Europe generally)
- n Choose costing structure that fits policy and financial objectives, therefore

Buses

- n **Compared with rail:**
 - n **Usually faster**
 - n **Usually more expensive**
 - n **More frequent**
- n **But – don't run as advertised**
- n **Licensing concerned only with starting up new routes – no control on service actually offered**
- n **No continuity of supply**
- n **No possibility of subsidy**
- n **Not an instrument of public transport policy therefore**
- n **Situation may be different in JSP operating area**

Fares

- n **Fares levels:**
 - n Less than bus travel
 - n Wide range of discounts (not available on buses)
 - n Low cost recovery
 - n Strong case for real increases
 - n Unknown price elasticities
- n **Discounts:**
 - n Must compensate for non-commercial discounts
 - n Probably no commercial case for any concessions at all
- n **Fares structures:**
 - n Future will be with travelcards and new distribution channels – weak case for change now (also lack of information) – prepare for privatisation

Transfer to private sector/Arrival of the open access operators

- n **Cash versus accruals**
- n **New costs**
- n **Pricing of risk**
- n **Interbusiness trading**
- n **Incentivisation changes**
- n **Step in handover rights**
- n **Changes to access charges**

Renvoi – Future work

- n Asset register**
- n Assessment of liabilities**
- n Full GAAP/IAS accounts**
- n Draw up corporate plans/investment programmes**
- n Monitor volume and price trends to develop forecasting tools**
- n Further analyses of efficiency savings**
- n Develop statistical platform for monitoring performance**
- n Develop policy for bus sector**
- n Draw up master transport plan for Greater Skopje**
- n Develop working relationships between State and industry**

Some general lessons

- n Lack of policy context – future of sector
- n Policy comes first, then detailed studies, then – perhaps – a review (sense check) of policy
- n Understand the sequence and interrelationship between detailed studies
- n EU requirements extremely flexible – choose those that meet each country's needs.
- n Be pragmatic – theoretical solutions won't help and may be expensive