19th Florence Rail Forum.
European Green Deal: What Implications for State Aid in the Rail Sector?

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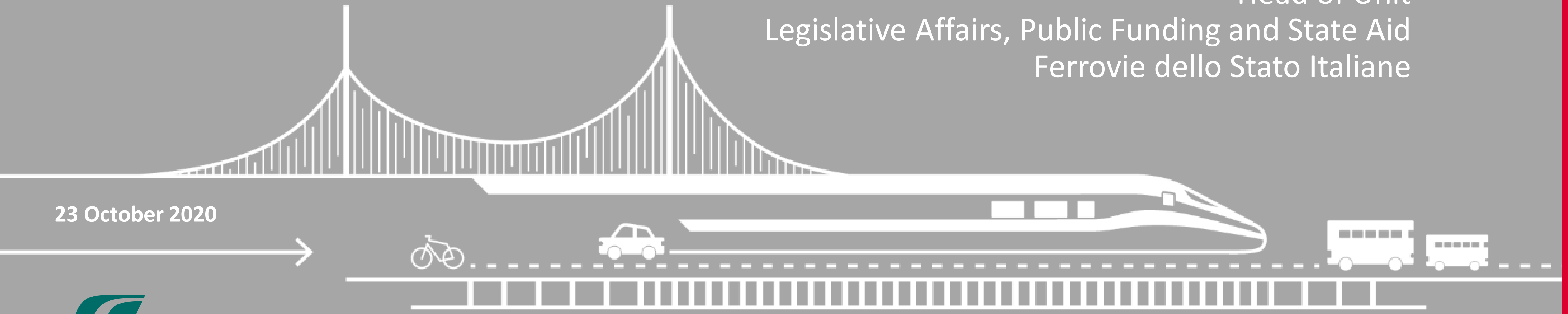

23 October 2020

Calculation of PSO compensation

EU legal framework

- **Regulation (EC) No 1370/2007, as amended by Regulation (EU) 2016/2338,** lays down the conditions under which competent authorities, when imposing or contracting for public service obligations, compensate public service operators and/or grant exclusive rights in return for the discharge of public service obligations. Specifications and compensation must achieve the objectives of public transport policy cost-effectively and be consistent with the policy objectives stated by the Member States.
- Irrespective of how the contract was awarded, **all compensation connected with a general rule or a public service contract** shall comply with Article 4, which states that they shall establish in advance, in an objective and transparent manner:
  - **the parameters on the basis of which the compensation payment, if any, is to be calculated**;
  - **the nature and extent of any exclusive rights granted, in a way that prevents overcompensation**.
- With regard to **public service contracts directly awarded**, the abovementioned parameters shall be determined in such a way that **no compensation payment may exceed the amount required to cover the net financial effect on costs incurred and revenues generated in discharging the public service obligations. Furthermore, competent authorities shall take account of revenue relating thereto kept by the public service operator and a reasonable profit**. In particular, the compensation must be calculated in accordance with the rules laid down in the Annex.

Calculation of PSO compensation

EU legal framework

Regulation (EC) No 1370/2007 - Annex

1. The compensation connected with public service contracts awarded directly in accordance with Article 5(2), (4), (5) or (6) or with a general rule must be calculated in accordance with the rules laid down in this Annex.
2. **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. In order to calculate the net financial effect, the competent authority shall be guided by the following scheme**:
   - costs incurred in relation to a public service obligation or a bundle of public service obligations imposed by the competent authority/authorities, contained in a public service contract and/or in a general rule,
   - minus any positive financial effects generated within the network operated under the public service obligation(s) in question,
   - minus receipts from tariff or any other revenue generated while fulfilling the public service obligation(s) in question,
   - plus a reasonable profit,
   - equals net financial effect.
3. Compliance with the public service obligation may have an impact on possible transport activities of an operator beyond the public service obligation(s) in question. In order to avoid overcompensation or lack of compensation, quantifiable financial effects on the operator’s networks concerned shall therefore be taken into account when calculating the net financial effect.
4. Costs and revenue must be calculated in accordance with the accounting and tax rules in force.
5. In order to increase transparency and avoid cross-subsidies, where a public service operator not only operates compensated services subject to public transport service obligations, but also engages in other activities, the accounts of the said public services must be separated so as to meet at least the following conditions:
   - the operating accounts corresponding to each of these activities must be separate and the proportion of the corresponding assets and the fixed costs must be allocated in accordance with the accounting and tax rules in force,
   - all variable costs, an appropriate contribution to the fixed costs and a reasonable profit connected with any other activity of the public service operator may under no circumstances be charged to the public service in question,
   - the costs of the public service must be balanced by operating revenue and payments from public authorities, without any possibility of transfer of revenue to another sector of the public service operator’s activity.
6. **‘Reasonable profit’ must be taken to mean a rate of return on capital that is normal for the sector in a given Member State and that takes account of the risk, or absence of risk, incurred by the public service operator by virtue of public authority intervention.**
7. The method of compensation must promote the maintenance or development of:
   - effective management by the public service operator, which can be the subject of an objective assessment, and
   - the provision of passenger transport services of a sufficiently high standard.

Calculation of PSO compensation

EU legal framework - The reasonable profit margin

- In the case of **tendering procedures**, there is **no need to apply the detailed rules on compensation** set out in the Annex.
- In the case of **directly awarded public service contracts**, public service operators must be guaranteed **a reasonable profit**, defined by Annex as *"a rate of return on capital that is normal for the sector in a given Member State and that takes account of the risk, or absence of risk, incurred by the public service operator by virtue of public authority intervention"*.
- **Commission interpretative guidelines concerning Regulation (EC) No 1370/2007** and **Commission Communication on services of general economic interest** (SGEI Communication) provide further guidance on the determination of the reasonable profit margin.
- In particular, the SGEI Communication defines the reasonable profit as *"the rate of return on capital that would be required by a typical company considering whether or not to provide the service of general economic interest for the whole duration of the period of entrustment, taking into account the level of risk. The level of risk depends on the sector concerned, the type of service and the characteristics of the compensation mechanism".*
- Where **a generally accepted market remuneration exists** for a given service, **the level of reasonable profit should be in line with normal market conditions** and should not exceed what is necessary to reflect the level of risk of the service provided.
- Where such **market benchmarks do not exist**, **the level of reasonable profit should be determined by comparing the profit margin required by a typical well run undertaking active in the same sector** to provide the service in question.

Calculation of PSO compensation

National regulatory framework

- At national level, the Italian Transport Regulation Authority **hugely redefined the regulatory framework on local public passenger transport services by rail and by road** (LPT services) in order **to enhance transparency and to improve the efficiency and cost-effectiveness of the services**.
- **Decision No 120/2018** defined the methodologies, criteria and procedures to ensure the **efficient management of regional rail transport services**. The regulatory measures only applied to regional rail passenger transport services that are subject to PSOs, are operated by RUs on the national or interconnected railway network, and are covered by PSCs in accordance with any methods provided for by the law.
- **Decision No 154/2019** went further into depth defining the regulatory measures for the award of local public passenger transport services by rail and by road, in accordance with the different procedures allowed by the law. These measures apply both to contracts awarded by tendering procedure and to contracts awarded on a concession basis. Furthermore, it set forth rules and criteria governing the award procedures and the **calculation of PSO compensation**.

Calculation of PSO compensation
National regulatory framework

- **Annex 5 of the Decision No 154/2019** establishes that the Awarding Entity shall draw up **a simulated Economic-Financial Plan (EFP)**, broken down for all the years of the contract period, in line with Regulation (EC) No 1370/2007. It applies both to contracts awarded by public procurement and to contracts awarded on a concession basis.
- The simulated EFP is aimed at determining **the tender price or the PSC compensation** to be awarded, **testing the economic and financial equilibrium of the PSC** throughout the contract period and allowing **for comparison of the tenders submitted by each tender participant in the case of public procurement.** In the performance of the PSC, the simulated Economic-Financial Plan provides the Awarding Entity with a tool to monitor the management of the award.
- The Annex 5 consists of four schemes (see further details in Appendix 1):
  - **Scheme 1 (Regulatory Income Statement)** to calculate the share of **costs of ordinary operations** that are incurred to comply with PSO, **which are not covered by the revenues arising from the fulfilment of PSO** (including positive network effects)
  - **Scheme 2 (Regulatory Balance Sheet)** to determine the **regulatory net invested capital** (NIC) **for the application of the WACC** provided by the Authority and to calculate the reasonable profit
  - **Scheme 3 (Simulated Regulatory Financial Plan)** to determine the **net financial effect** arising from expenses and income that are attributable to cost and revenue items
  - **Scheme 4 (Cash flow statement),** to be filled in by the tender participant, is intended to assess the **development of the financial position during the PSC period**, in particular in the case of planned investments

Calculation of PSO compensation

National regulatory framework - The reasonable profit margin

- With Decision No 154/2019 and Decision No 65/2020, the **Transport Regulation Authority clarified the procedures concerning the calculation of the reasonable profit margin for both directly awarded public service contracts and contracts awarded by tendering procedure**.
  - According to Decision No 154/2019, the reasonable profit margin that the Awarding Entity should provide to the public service operator is **equal to the rate of return on net invested capital (NIC)**. The NIC rate of return is determined and regularly updated by the Transport Regulation Authority by applying the **Weighted Average Cost of Capital method (WACC)**.
  - Decision No 65/2020 explains the methodology used for the calculation of the rates of return on net invested capital determining the values of WACC parameters. Their rates are different for road and rail services.

Calculation of PSO compensation

Room for improvement and levelling the playing field (1/2)

- The risk of **greatly different national regulatory frameworks** should be avoided.
- In Italy, the Transport Regulation Authority defined a **very detailed framework**. Did Italy go towards an **over-regulated system or is it the right way that should be followed at the EU level** (for instance including similar schemes in new Guidelines or in new Regulation)?

Calculation of PSO compensation

Room for improvement and levelling the playing field (2/2)

- A reporting scheme should be defined at EU level in order to **further define the criteria provided for by Annex** of Regulation (EC) No 1370/2007. These criteria should apply **to contracts awarded both directly or via a tender procedure**. This could resemble the methodology already developed by the Italian Transport Regulation Authority.
- An **equal and uniform legal and regulatory framework concerning the calculation of the return on capital should be defined at the EU level**. This would eliminate the differences existing among the Member States and thereby ensure a level playing field.
- Since it is difficult to **quantify the network effects**, **a well-defined and objective method** should be introduced for their calculation.
- In the course of the contract, the Transport Regulation Authority requires the public service operator to perform a gradual improvement in the effectiveness and efficiency of the services. However, especially with regard to railway transport, there are some costs that cannot be reduced and unforeseeable circumstances that cannot be easily addressed. Therefore, **additional mechanisms could be established in order to guarantee the economic and financial equilibrium of PSC over the years**.

Funding system for rolling stock

EU and national regulatory framework

- According to **Regulation (EC) 1370/2007, as amended by Regulation (EU) 2016/2338,** in order to ensure effective and non-discriminatory access to suitable rolling stock, competent authorities may alternatively:
  - acquire the rolling stock with a view to making it available to the selected public service operator at market price or as part of the public service contract;
  - provide a guarantee for the financing of the rolling stock at market price or as part of the public service contract;
  - commit to take over the rolling stock at predefined financial conditions at the end of the contract at market price;
  - cooperate with other competent authorities in order to create a larger pool of rolling stock.

- The Italian regulatory framework is line with the EU provisions on this matter and does not provide further details in terms of funding and owning of rolling stock.

Rolling stock ownership models

The added value of railway undertakings' ownership of rolling stock

- **One solution does not fit all**. It is recommended to let Awarding Entities free to adopt the ownership model that they consider suitable for the relevant PSC.
- In Italy, in most cases, the rolling stock is owned by the railway undertaking operating the public services obligation. This model has the following advantages:
  - railway undertakings have the know-how required to buy the rolling stock used to run the service, which is typically characterised by specific technical features;
  - railway undertakings can overcome the limitations caused by annual budget constraints that usually characterised public transport authorities;
  - it ensures a better planning/scheduling of services and investments;
  - it guarantees greater transparency in contractual relations between railway undertakings and Awarding Entities;
  - railway undertakings can make more efficient use of the assets in terms of maintenance, refurbishment and renewal.

Funding system for rolling stock

The Italian case

- In Italy, in the latest few years, important investments in renewals and refurbishments have taken place. This process has been boosted through both private investments and public funding.
- As part of its broad commitment to sustainability, FS decided to create a **Green Bond Framework** (GBF) under which it can issue Green Bonds to **finance projects with a positive impact in terms of environmental and social sustainability**. **Investments in public passenger transport rolling stock renewal** are among the FS Eligible Green Bond projects.
- Against this background, the **European Investment Bank (EIB) recently supported the FS Group's investment plan for the purchase of new trains for the Trenitalia regional fleet** with a loan of EUR 450 million. Thanks to the loan, Trenitalia will buy 135 less polluting and more efficient hybrid trains.

Appendix 1

Annex 5 of the Decision No 154 - Scheme 1 (Regulatory Income Statement)

Scheme 1 —	Regulatory income statement	Year 1	Year 2	Year ...	Year N
1.a	Revenue from passenger services				
1.b	Other service-related revenue				
1	Total revenues arising from the fulfilment of PSO				
2	Positive induced network effects*				
3.a	Cost of raw materials, consumables and goods				
3.b	Cost for third-party services				
3.c	Cost for use of third-party assets				
3.d	Cost of personnel				
3.d.i	*operating personnel ***				
3.e	Changes in inventories of raw materials, consumables and goods				
3.f	Other operating expenses				
3	Total operating costs ***				
4 = 1 + 2-3	Gross operating result (EBITDA)				
5	Total depreciation				
6 = 4-5	Net operating income (EBIT)				
7	Use of provisions for risks and charges related to PSOs ****				

Appendix 1

Annex 5 of the Decision No 154 - Scheme 2 (Regulatory Balance Sheet)

Scheme 2 — Regulatory Balance Sheet		Year 1	Year 2	Year...	Year N
1.a	Intangible fixed assets				
1.b	Tangible fixed assets with separate indication of those granted under a financial lease				
1.b.i	*land and buildings (e.g. warehouses, workshops)*				
1.b.ii	*plant and machinery*				
1.b.ii. 1	*self-financed rolling stock **				
1.b.iii	*industrial and commercial equipment*				
1.b.iv	*other*				
1	**Total fixed assets**				
2.a	Inventories				
2.b	Receivables				
2.b.i	*trade ** *				
2.b.ii	*other receivables*				
2	**Total current assets**				
3.a	Payables				
3.a.i	*payables to suppliers*				
3	**Total payables**				
4 = 1 + 2-3	**Regulatory Net Invested Capital (NIC)**				

Appendix 1

Annex 5 of the Decision No 154 - Scheme 3 (Simulated Regulatory Financial Plan)

Scheme 3 — Simulated Regulatory Financial Plan		Year 1	Year 2	Year...	Year N	Cross-reference
A	Income from revenues generated by the fulfilment of PSO					*Scheme 1*
B	Positive induced network effects *					*Scheme 1*
C = A + B	INCOME + NETWORK EXTERNALITIES					
D	Expenses related to the costs incurred for the fulfilment of PSO					*Scheme 1:3 + 5*
E	Regulatory Net Invested Capital (NIC)					*Scheme 2:4*
F	Fair rate of return of NIC (%)					*ART value*
G = F*E	Return on invested capital (reasonable profit)					
H = D + G	EXPENSES + REASONABLE PROFIT					
I = H-C	NET FINANCIAL EFFECT (VARIABLE COMPENSATION)					
L = C + I	INCOME + POSITIVE NETWORK EXTERNALITIES + VARIABLE COMPENSATION					
M	NPV L		*= NPV (F;L:Year 1 — Year N)*			
N	NPV H		*= NPV (F;H:Year 1 — Year N)*			
O	NPV I		*= NPV (F;I:Year 1 — Year N)*			
P	CONSTANT COMPENSATION		*= INSTALMENT (F;N;O) where N is the number of years of the PEF*			
Q = I-P	NOTIONAL ITEMS					
CONDITION OF EQUILIBRIUM						
G	M = N		*= SE(M = N;YES;'NO')*			
H	NPV Q = 0		*= SE(NPV (F); Q:Year 1 — Year N) = 0;YES;'NO')*			
I	WACC = IRR					

Appendix 1

Annex 5 of the Decision No 154 - Scheme 4 (Cash flow statement)

Scheme 4 —	Cash flow statement	Year 1	Year 2	Year...	Year N
1.a	Receipts from fares				
1.b	Receipts from compensations				
1.c	Other receipts				
1.d	Payments to suppliers for raw materials and consumables				
1.e	Payments to service providers				
1.f	Payments to personnel				
1.g	Other payments				
1.h.	Taxes paid on income				
1	**Cash flow of operating activity**				
2.a	Investments in intangible assets				
2.b	Disinvestments in intangible assets				
2.c	Investments in tangible assets				
2.d	Disinvestments in tangible assets				
2	**Cash flow of investment activity**				
3.a	Increase in third-party assets				
3.b	Decrease in third party assets				
3.c	Increase in equity				
3.d	Decrease in equity				
3	**Cash flow of financial activity**				
4 = 1 + 2 + 3	**Change in cash and cash equivalents**				

FERROVIE DELLO STATO ITALIANE