Concession agreement for railway services: Assessment in respect of the Fair Competition Act

14 December, 2001

1. Introduction

As agreed upon at a meeting of the Fair Trading Commission (FTC), the Chairman of the Jamaica Railway Corporation (JRC), the Ministry of Transport and Works (MTW), the National Investment Bank of Jamaica (NIBJ) and the Attorney-General's office on November 13th, 2001, the FTC would conduct a detailed examination of the implications of the privatization of Jamaica's railway services based on the proposed concession agreement with Railtech (the concessionaire), to determine the extent to which the relevant licence can be accommodated under Section 17 of the Fair Competition Act (FCA).

Section 17(1) of the Act applies to—

> "agreements which contain provisions that have as their purpose the substantial lessening of competition, or have or are likely to have the effect of substantially lessening competition in a market."

According to subsection 17(3)—

> "subject to subsection (4), no person shall give effect to any provision of an agreement which has the purpose or effect referred to in subsection (1); and no such provision is enforceable."

According to subsection 17(4), subsection (3) does not apply to any agreement which the Commission is satisfied—

"(a) contributes to—

(i) the improvement of production or distribution of goods and services; or

(ii) the promotion of technical or economic progress,

while allowing consumers a fair share of the resulting benefit;

(b) imposes on the enterprises concerned only such restrictions as are indispensable to the attainment of the objectives mentioned on paragraph (a); or

(c) does not afford such enterprises the possibility of eliminating competition in respect of a substantial part of the goods or services concerned."

In order to carry out the assessment, the staff of the FTC requested answers to a number of questions as set out below.

To understand the background on the privatization itself, the following questions were asked:

1. *What is the background to the current negotiations to award the contract to Railtech?*

2. *What are the key elements of the proposed contract?*

3. *What, in detail, are the investments and financial obligations that will be undertaken by the following parties (include breakdowns as well as totals):*

   – *Railtech*
   – *The government*
   – *Other parties, if any (please identify)?*

4. *How will the annual subsidies from the Government of Jamaica (GOJ) to Railtech be determined?*

To ascertain the justification for the proposed exclusive licence, the following question was asked:

5. *Why is an exclusive licence necessary to facilitate the investment?*

To assess the contributions which the proposed agreement wold make to "the improvement of production or distribution of goods and services; or the promotion of technical or economic progress, while allowing consumers a fair share of the resulting benefit" (as per Section 17(4)(a) of the FCA), the following questions were asked:

6. *What criteria were used, and what process was undertaken, in choosing Railtech as the recipient of the contract?*

7. *Were there other bidders for the contract? If so, what factors led to Railtech being chosen?*

8. *How does the technology that will be employed, for example, the type of tracks that will be laid, the trains that will be used, the signalling and control systems, etc, compare with the leading technologies in the world?*

9. *How will the fares, for both commuter and freight services, be set and how will future changes in these fares be determined?*

10. *Will any performance standards be set? If so, what are they and who will enforce them?*

11. *What penalties, if any, will be imposed if Railtech does not meet the required standards? Who will enforce this?*

12. *What factors or events could result in rising costs and delays in the start of the operations of the new system? Who would bear the risk of these unanticipated increases in costs and delays?*

Questions (6) and (7) relate to the point that, if competition in the market is not available, the benefits to consumers are best ensured if there were competition for the market, i.e., a fair and transparent process to select the best operator. Question (8) assesses the benefits of the proposal and question (9) considers the possibilities of abuse of dominance and excessive pricing to the detriment of consumers. Questions (10), (11) and (12) assess the checks and balances in place to ensure that consumers are allowed a fair share of the benefits.

Section 17(4)(b) states that the restraints imposed should be "indispensable to the attainment of the objectives mentioned on paragraph (a)". In the case of the privatization of the rail service, this implies that the terms of the licence should be no more restrictive than is necessary to allow the enterprise to contribute in the manner set out. To assess this criterion, the following questions were asked:

13. *What is Railtech's projected level of profits (or losses) over the contractual period? What factors are taken into account in reaching these forecasts?*

14. *What justification is there for a 25-year contract, as compared to a shorter contract?*

Finally, to assess the possibility of introducing competition, if feasible, after the licence expires, the following questions were asked:

15. *Who will have ownership of the infrastructure and any necessary databases, during and after the contractual period? Please consider all infrastructure, hardware and software, in your response.*

16. *What elements in the contract, if any, will enable the introduction of competition, where feasible, after the end of the 25-year period?*

2. Assessment

The above 16 questions were asked of the NIBJ and the MTW in order to facilitate the assessment. In response, MTW provided the MTW's 1997 cabinet submission (55/97) on the JRC. This was to provide the basis for our assessment.

The following lays out the information obtained in respect of the questions asked. As can be seen, the staff of the FTC was able to obtain most information required from the cabinet submissions. Where information was not made available, it is indicated below.

1. ***What is the background to the current negotiations to award the contract to Railtech?***

Formal negotiations took place between Jamaica Rail Ltd. (JRL) and the Negotiating Team for the privatisation of the JRC from December 1995 to April 1997. JRL comprised a group of local and overseas investors co- promoted by Fidelity Finance Merchant Bank and Transport Management Group, and including Alcan Jamaica, Trafalgar Development Bank, United General Insurance and Canadian Railways. On April 30, 1997 the Board of Directors of NIBJ accepted the recommendation of the Chairman of the Negotiating Team that negotiations with JRL be terminated. The recommendation was based on the fact that despite being given ample opportunity the group was unable to demonstrate financial capability. Key members of JRL, namely, TMG International and Alcan of Jamaica Ltd. had also left the group.

After negotiations with JRL fell through the NIBJ met with former members of the local private sector consortium Railway Management Services (RMS). This was based on an agreement with RMS that if negotiations fell through with JRL, RMS would be invited in for negotiations. This was also endorsed by the Honourable Prime Minister.

The Board of NIBJ had also been asked to consider the urgent requirement of the JRC for financial assistance. The JRC stated that since January 1997 it had been unable to earn any income from leasing locomotives or servicing Alcan locomotives as required by the Track User Agreement. This is because the track between Kingston and Spanish Town on which the locomotives travel to get to Alcan was below the basic safety standard and had to be officially closed.

The JRC stated that it therefore had two options remaining open. Under Option 1 funding of $54.6M would be needed to rehabilitate the track from Kingston to Spanish Town and resume the maintenance programme for Alcan. This would allow the JRC to remain open for more than six months. Under Option 2 funding of $12.9M would allow the continuation of routine duties only for three to six months.

Both options would require that Government make arrangements with Alcan so that the JRC's debts to Alcan would not be subtracted from either the Track User fee or any other payments to be made to the JRC for services performed. Alcan usually retains 70% of any payments to be made to the JRC and puts this amount toward reducing the JRC's debt to Alcan. This debt resulted from capital improvements undertaken by Alcan on behalf of the JRC. At 1997 March 31 the JRC owed Alcan J$62.9M (US$1.8M).

A third option was to close down existing operations and put extensive security arrangements in place. The JRC was of the view that only the Jamaica Defence Force would have the necessary manpower and equipment to protect its asset and that prompt arrangements would be required to deter widespread vandalism, scrapping and capturing of property, particularly railway tracks, outstations, rolling stock and machinery.

The Board of the NIBJ was of the opinion that the funding which was being requested by the JRC to maintain its operations would be more effectively used to fund the revitalisation of the railway service. The JRC's routine activities included contractual obligations to Alcan under the Track User Agreement, the administration of 700 tenants and pension payments to 200 persons, providing security for the property (2,800 acres) and routine financial and administrative activities. The obligations to Alcan required the provision of personnel, materials, equipment and maintenance.

The Board of the NIBJ therefore recommended to the Office of the Prime Minister (OPM) that the GOJ should revitalise the railway operations on a phased basis in conjunction with Alcan of Jamaica Ltd., which had indicated its commitment to the revitalisation of the railway. It was also proposed that, alternatively, an operator be identified so that the railway be divested as a going concern.

Rail India Technical and Economic Services Ltd. (RITES) was approached by the NIBJ because it has maintained an interest in the revitalisation of the railway since October 1994. RITES is a Government of India Enterprise and was established in 1974 under the aegis of Indian Railways. It has wide international experience and annual gross revenues of US$6,400 million.

RITES was authorised by the NIBJ to submit proposals for:

(i) the revitalisation of the Railway passenger and freight services between Kingston and Linstead corridors in the shortest possible time and at the least possible cost commensurate with reliability and safety;

(ii) a techno-economic feasibility study for the revival of freight services and a viability study for freight and passenger services for the entire system.

RITES prepared both proposals and presented them to the Negotiating Team, which recommended that the NIBJ contract RITES to undertake the techno-economic feasibility study for the revival of freight services and viability study for freight and passenger services.

RITES requested tax duty exemptions for the company and its expatriate staff who would be working on the studies in Jamaica. The Ministry of Finance granted the following exemptions:

1. Customs duty/GCT payable in respect of equipment, material and supplies (excluding motor vehicles) imported for the purposes of carrying out the services provided by RITES, on condition that these items are subsequently re-exported or handed over to the NIBJ. (Motor vehicles were allowed to be imported duty free on a temporary basis, subject to the posting of the required bond).
2. Payment of corporate income tax by RITES.
3. Payment of personal income tax by the expatriate personnel.

Approval was given for the waiver of GCT payable in respect of the services provided by RITES under the contract.

As a result of the study, RITES recommended a two-phased programme to revive and operate the railway services. It was recommended to Cabinet that RITES be contracted to rehabilitate and operate the service as they proposed. It was also recommended that Cabinet approve the exemptions from taxes, duties, fees, levies and other impositions under the laws and regulations in effect in Jamaica, as requested by RITES.

RITES has since come into partnership with CPCS Transcom Ltd. (a Canadian company) to form Railtech, with whom the GOJ is now in negotiations. The prospective concessionaireis now Railtech.

What are the key elements of the proposed contract?

The Railtech proposal for the revitalisation of the railway service from Kingston to Williamsfield has two phases:

- *Phase I*—would entail the rehabilitation of the Kingston–Spanish Town–Linstead line over 3 ½ months, at a cost of J$87.12M. It would begin 2 weeks after the contract is signed and financial arrangements confirmed and would cover all operational facilities. The passenger service would start 4 months after the signing of the contract and would consist of 8 trains per day on the Kingston to Spanish Town sections and 4 trains per day on the Kingston to Linstead sections. Each train would have 3 coaches. This service would be in operation for 3 months before operations in Phase II would begin.

- *Phase II*—in this phase the rehabilitation of the Spanish Town to Williams field line would begin when the passenger service in Phase I begins and would be completed in 3 months at a cost of J$199.69M. It would result in additional trains being introduced thereby reducing transit time and enhancing trailing loads. Trains on the Spanish Town to Williamsfield section would carry 6 coaches and the other trains would have additional coaches. The Kingston to Spanish Town section would, by then, have ten trains per day; the Spanish Town to Williamsfield section 2 trains per day. The proposal includes operation of the Kingston to Spanish Town to Williamsfield line for 1 year.

2. ***What, in detail, are the investments and financial obligations that will be undertaken by the following parties (include breakdowns as well as totals):***

   – ***Railtech***
   – ***The government***
   – ***Other parties, if any (please identify)?***

The table below summarises the costs presented by Railtech for the refurbishing of the railway and operations on the Kingston – Spanish Town – Linstead line for 3 months followed by operations on the Kingston to Williamsfield line for 12 months.

Table 1: Estimated costs for refurbishment and operation of railway services[1]

Phases	Capital Costs		Operating Costs		Total All Costs	
	US$M	J$M equivalent	US$M	J$M equivalent	US$M	J$M equivalent
Phase I	1.627	58.575	0.793	28.548	2.42	87.12
Phase II	0.889	32.004	4.658	167.688	5.547	199.692
Total	$2.516	$90.576	$5.451	$196.236	$7.967	$286.812

[1] The conversion is made based on an exchange rate of US$1.00 = J$36.00; This information in this table was obtained from MTW's 1997 cabinet submission (55/97).

Railtech costs estimated above do not include estimates for the collection of revenues, the cost of electricity, fuel or lubricants, duties and taxes. JRC has estimated that the Railtech proposal will require fuel, lubricants and electricity of J$6.3M per annum and that annual revenue from fares at $1.70 per passenger mile would amount to $26.72M. There is also the possibility of some revenue from unscheduled freight services. Table 2 shows the total costs of the operations.

Table 2: Total costs of Railtech's proposal[1]

Cost Elements	$M	$M
Capital Costs (US$2.516)	90.58	
Operating Costs (US$5.45)	196.24	
		286.82
Estimates for fuel, lubricants and electricity		7.86
		$294.68
Less projected revenues from fares @ $1.70 per passenger mile		-33.40
REQUIRED FINANCING		**$261.28**

[1] This information in this table was obtained from MTW's 1997 cabinet submission (55/97).

Railtech will:

- Be responsible for fare collection, all operating expenses, including normal security functions related to equipment and facilities and to rehabilitate at least five passenger stations, three existing locomotives and 21 existing passenger coaches for commuter use. It will set its own passenger fares and freight tariffs with the approval of OUR.
- Have exclusive use of JRC's buildings and facilities during the concession period and be able to modify and enhance the buildings and facilities at its discretion. The National Heritage Trust is to be consulted where appropriate.

- Provide debt and equity capital to train employees, acquire and install modern operating systems, rehabilitate locomotives and coaches and complete refurbishing and repairs to commuter facilities and equipment.
- Manage the implementation of rehabilitation of the tracks and the construction of new spurs and facilities funded by GOJ.
- Fund the maintenance of JRC's track network, buildings, facilities and movable assets thereby reducing or eliminating need for future infrastructure investment by the GOJ.
- Be responsible for the acquisition of replacement and additional movable assets, except for passenger train rolling stock and equipment.
- Assume the existing WINDELCO track lease and assume JRC responsibilities under the lease.

The GOJ will in turn:

- Retain ownership of the track and other fixed assets of JRC and convey the use of assets to Railtech.
- Fund the rehabilitation or extension of the track to permit the operation of the commuter trains.
- Be responsibility for future purchases of passenger rolling stock for commuter operations to augment or replace existing passenger equipment fleet.
- Retain responsibility for the outstanding obligations of the JRC, including severance payments for redundant staff, removal of encroachment on JRC's right of way, and the clean-up of existing environmental contamination on JRC property.
- Be responsible for the protection of passengers against violence and other criminal activity.

3. *How will the annual subsidies from the GOJ to Railtech be determined?*

The subsidies are provided based on the expectation that the passenger services are not profitable. The subsidies are capped at USD750,000 per year for commuter services losses. No information was made available as to how the exact level of subsidy will be determined, assuming that the subsidy will not always be at the highest permitted level under the contract.

The GOJ hopes that the freight lines will be in operation soon so that the returns from the provision of those services will cover the losses made from the passenger services, thus reducing the need for subsidies from the GOJ.

4. *Why is an exclusive licence necessary to facilitate the investment?*

No information was made available on this point. Exclusive licences are, however, common for railway infrastructure due to the natural monopoly characteristics and safety considerations. This is no exception.

5. ***What criteria were used, and what process was undertaken, in choosing Railtech as the recipient of the contract?***

There was no open bidding process in selecting Railtech. The GOJ approached individual potential investors based on the interest that they had indicated to the GOJ and on the GOJ's knowledge of their reputations.

6. ***Were there other bidders for the contract? If so, what factors led to Railtech being chosen?***

There were no bidders for the contracts. Potential concessionaires were approached, one at a time, by the GOJ.

7. ***How does the technology that will be employed, for example, the type of tracks that will be laid, the trains that will be used, the signalling and control systems, etc, compare with the leading technologies in the world?***

No information was made available on this point. However, as the proposal is mainly to refurbish existing lines, engines and compartments, it is unlikely that top-end technology will be introduced.

8. ***How will the fares, for both commuter and freight services, be set and how will future changes in these fares be determined?***

Save and except that Railtech will be bound by the terms and conditions of the Alcan Track Release in providing the Alcan Rail Freight Service, it will fix its own passenger fares and freight tariffs. The Office of Utilities Regulation (OUR) will be responsible for <u>monitoring</u> (not regulating) its activities in relation to the fixing of fares and tariffs.

9. ***Will any performance standards be set? If so, what are they and who will enforce them?***

There are no specific performance standards, beyond the requirement to operate a minimum number of trains on each line.

10. ***What penalties, if any, will be imposed if Railtech does not meet the required standards? Who will enforce this?***

Railtech shall conduct satisfaction surveys of passengers and customers no less than once a year. If any survey conducted indicates that the level of satisfaction in respect of any particular aspect of the system has deteriorated below the level indicated by any previous survey conducted to any material extent, it shall, if so requested by the JRC, submit to the JRC proposals to remedy the situation. If the JRC does not consider that such proposals are reasonable steps to remedy the deterioration, the parties shall in good faith use reasonable endeavours to agree review proposals.

11. ***What factors or events could result in rising costs and delays in the start of the operations of the new system? Who would bear the risk of these unanticipated increases in costs and delays?***

Any rise in costs could feed into higher commuter fares.

12. ***What is Railtech's projected level of profits (or losses) over the contractual period? What factors are taken into account in reaching these forecasts?***

No information was made available on this point.

13. ***What justification is there for a 25-year contract, as compared to a shorter contract?***

No information was made available on this point. The appropriate duration of any exclusive contract depends on the level of investment and the projected level of profits. The exclusive period should be just long enough to allow the investor to recover his cost of capital on his investment. Therefore, the lower the investment and/or the higher the expected annual profits, the shorter the appropriate duration of the contract should be from a competition perspective.

Without information on Railtech's projected level of profits, it is not possible to fully assess the justification for the 25-year contract. Nonetheless, a 25-year contractual period is normal (not excessive) for railway contracts. To the extent that the investment required and expected profits are not significantly different from international norms, the 25-year duration is justified.

14. ***Who will have ownership of the infrastructure, during and after the contractual period? Please consider all infrastructure, hardware and software, in your response.***

The JRC will retain ownership of the railway infrastructure. During the concession period, it will lease the infrastructure to Railtech, which shall pay a yet undetermined (or undisclosed) nominal charge in addition to an undetermined (or undisclosed) access fee for the rights to use and benefit from the infrastructure.

15. ***What elements in the contract, if any, will enable the introduction of competition, where feasible, after the end of the 25-year period?***

As the JRC will retain ownership of all railway infrastructure, it is able to re-lease it in any way it considers desirable and appropriate after the concession period.

3. Conclusion

To summarize, the proposed concession agreement is assessed in relation to the criteria set out under section 17(4) of the FCA. Specifically, the exclusive agreement would not be in contravention of the FCA if it is an agreement which the Commission is satisfied—

(a) contributes to—

(i) the improvement of production or distribution of goods and services; or

(ii) the promotion of technical or economic progress,

while allowing consumers a fair share of the resulting benefit;

(b) imposes on the enterprises concerned only such restrictions as are indispensable to the attainment of the objectives mentioned on paragraph (a); or

(c) does not afford such enterprises the possibility of eliminating competition in respect of a substantial part of the goods or services concerned."

An exclusive licence is common for the operations of railway services. This is due to the economies of scale and significant sunk costs required. For these reasons, 25-year licences for the provision of rail services are common. The concession agreement, however, places few obligations on Railtech insofar as capital expenditure is concerned. The obligations are primarily on management, maintenance and operating expenditure. It is therefore unclear if, under these circumstances, a 25-year licence is necessary.

Nonetheless, the re-introduction of a service that has not been made available for a long period of time would improve the transportation options available to consumers. Even if the extent of the improvement is unclear, there will be, nonetheless, an improvement. Further, the improvement of the transportation services may lead to economic progress.

Consumers would be allowed a fair share of the benefits if:

- the selection of the operator/contractor was done in a fair and competitive manner to ensure that the most competent operator was awarded the contract;
- there are strong and clear performance standards with the requisite penalties if the standards are not met;
- there was some form of price regulation; or
- there is sufficient competition in the market to ensure that consumers benefit.

The assessment reveals that the selection of the operator was not done in a fair and competitive manner. The agreement also says little on performance standards and penalties for poor quality from the consumer's point of view. Railtech's only obligation is to conduct consumer surveys. Only if there is a significant drop in service as compared to the past period, will there be negotiations on remedial measures. This is a weak obligation for two reasons. First, it refers to <u>comparative</u>, as opposed to <u>absolute levels</u> of customer satisfaction. In other words, as long as customer satisfaction stays at the same level, there will be no penalties, even if satisfaction stays consistently low. Second, the penalty is weak. Negotiations to decide upon remedial measure are open to long drawn out discussions with no concrete steps being taken.

In terms of fares, Railtech is generally responsible for setting the passenger and freight charges. The agreement states that the OUR will have the responsibility of <u>monitoring</u> the fares. It is unclear, however, if the OUR will have regulatory powers over the fares. Finally, it does not appear that the selection of the potential investor was done in an open, transparent and competitive manner to ensure that the best operator is selected. In other words, from the consumers' point of view, there is little in the agreement that guarantees the consumer a good deal.

However, competition in the market will not be lessened, as the market would be defined to include road transportation. As long as the existing options are available, the consumers can always choose not to use the railway services and will be no worse off. Of course, if demand for services is low, citizens may lose out due to the GOJ's expected investments in funding the infrastructure acquisition and the subsidies that will be paid out to Railtech. Nonetheless, the commuter will not be made worse off.

The conclusions can be summarized as follows:

- The concession agreement will contribute to the improvement of production or distribution of goods and services. As competition in the market will not be reduced, consumers will be ensured a fair share of the benefits. The criterion in Subsection 17(4)(a) is therefore met;

- It is unclear that a 25-year contract is necessary given that Railtech does not have responsibility towards the funding of the infrastructure (capital expenditure). In other words, it does not appear that the railway service concession agreement imposes on Railtech only such restrictions as are indispensable to the attainment of the objectives. Therefore, the criterion in Subsection 17(4)(b) is not met.

- As the agreement seeks to introduce a "new" service alongside existing transportation alternatives, however, the agreement does not afford Railtech the possibility of eliminating competition in respect of a substantial part of the services concerned. In other words, the criterion in Subsection 17(4)(c) is met. Consumers are not expected to be worse off.

In conclusion, the proposed exclusive 25-year licence seems to meet the criterion set out under section 17(4)(a) and 17(4)(c) of the FCA. This is sufficient to allow the agreement to be accommodated under this section.