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*(Information)*INFORMATION FROM EUROPEAN UNION INSTITUTIONS, BODIES, OFFICES  
AND AGENCIES

## EUROPEAN COMMISSION

## COMMUNICATION FROM THE COMMISSION

**on interpretative guidelines concerning Regulation (EC) No 1370/2007 on public passenger transport services by rail and by road**

(2014/C 92/01)

## 1. INTRODUCTION

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) No 1191/69 and 1107/70 <sup>(1)</sup> was adopted on 23 October 2007. This Regulation, which entered into force on 3 December 2009, aims to create an internal market for the provision of public passenger transport services. It does so by complementing the general rules on public procurement. It also lays down the conditions under which compensation payments stipulated in contracts and concessions for public passenger transport services shall be deemed compatible with the internal market and exempt from prior State aid notification to the Commission.

Regulation (EC) No 1370/2007 is of major importance for the organisation and financing of public transport services by bus, tram, metro and rail in the Member States. A coherent and correct application of its provisions is economically and politically important. This is because the value added and employment in the public transport sector each correspond to about 1 % of GDP and of total employment, respectively, of the Union. A well performing public transport sector is a cornerstone of effective social, economic and environmental policy.

Both an external ex-post assessment of the implementation of Regulation (EC) No 1370/2007 <sup>(2)</sup> conducted by an external consultant as well as representatives of European associations and of Member States speaking at an EU-wide stakeholders' conference organised by the Commission on the implementation of that Regulation on 14 November 2011 <sup>(3)</sup> called on the Commission to provide guidance on certain provisions of that Regulation. Diverging interpretations of provisions concerning the definition of public service obligations, the scope of public service contracts, the award of such contracts and the compensation of public service obligations can hamper the creation of an internal market for public transport and lead to undesired market distortions.

Before adopting this Communication, the Commission consulted Member States and stakeholders representing parties interested in this issue, such as European associations of the public transport sector, including transport staff and passenger organisations.

<sup>(1)</sup> OJ L 315, 3.12.2007, p. 1.

<sup>(2)</sup> DLA Piper, Study on the implementation of Regulation (EC) No 1370/2007 on public passenger transport services by rail and by road, 31 October 2010, published at [http://ec.europa.eu/transport/modes/rail/studies/rail\\_en.htm](http://ec.europa.eu/transport/modes/rail/studies/rail_en.htm)

<sup>(3)</sup> Documents on the conference are published at [http://ec.europa.eu/transport/modes/rail/events/2011-11-14-workshop\\_en.htm](http://ec.europa.eu/transport/modes/rail/events/2011-11-14-workshop_en.htm)

In this Communication, the Commission sheds light on its understanding of a number of provisions of the Regulation, inspired by best practices, to help Member States reap the full benefits of the internal market. This Communication does not aspire to cover all provisions in an exhaustive manner, nor does it create any new legislative rules. It should be noted that, in any event, the interpretation of Union law is ultimately the role of the Court of Justice of the European Union.

On 30 January 2013, the Commission adopted a proposal to amend Regulation (EC) No 1370/2007 in anticipation of the opening up of the market for domestic passenger transport services by rail <sup>(1)</sup>. Some of the provisions of the Regulation that the Commission proposed to modify, such as the provisions on the award of public service contracts in rail, are interpreted in the present Communication. As regards these provisions, the guidance provided in this document should be considered valid until any amendment to Regulation (EC) No 1370/2007 enters into force.

## 2. THE COMMISSION'S UNDERSTANDING OF REGULATION (EC) No 1370/2007

### 2.1. Scope of Regulation (EC) No 1370/2007

This chapter on the scope of Regulation (EC) No 1370/2007 provides interpretative guidance on the relationship between this Regulation and the following directives: Directive 2014/24/EU of the European Parliament and the Council on public procurement and repealing Directive 2004/18/EC <sup>(2)</sup> ('Directive 2014/24/EU'); Directive 2014/25/EU on procurement by entities operating in the water, energy, transport and postal services sectors and repealing Directive 2004/17/EC <sup>(3)</sup> ('Directive 2014/25/EU'); and Directive 2014/23/EU on the award of concession contracts <sup>(4)</sup> ('Directive 2014/23/EU'). This chapter also clarifies the modalities of the Regulation's application to inland waterways and national seawaters, and clarifies its applicability to freight transport contracts until 2 December 2012.

#### 2.1.1. Article 1(3) and Article 5(1). Relationship between Regulation (EC) No 1370/2007 and the public procurement and concession directives

Regulation (EC) No 1370/2007 governs the award of public service contracts, as defined in Article 2(i) thereof, in the field of public passenger transport by road and by rail. However, these public service contracts may also fall within the scope of the public procurement directives (Directive 2014/24/EU and Directive 2014/25/EU). Since the directives referred to in Regulation (EC) No 1370/2007 (Directive 2004/17/EC and Directive 2004/18/EC) have been repealed and replaced by the above-mentioned directives, the references in Regulation (EC) No 1370/2007 should be understood as relating to the new directives.

Article 1(3) provides that Regulation (EC) No 1370/2007 shall not apply to public works concessions within the meaning of Article 1(3)(a) of Directive 2004/17/EC or Article 1(3) of Directive 2004/18/EC. After the entry into force of Directive 2014/23/EU on the award of concession contracts, the term 'works concession' is defined in Art 5(1)(a) of this Directive. Therefore, works concessions for public passenger transport services by rail and other track-based modes and by road are governed solely by Directive 2014/23/EU.

For the relationship between Regulation (EC) No 1370/2007 and the public procurement directives as well as Directive 2014/23/EU, it is important to distinguish between service contracts and service concessions.

Article 2 points (1), (2) and (5) of Directive 2014/25/EU defines 'service contracts' as contracts for pecuniary interest concluded in writing between one or more contracting entities and one or more economic operators and having as their object the provision of services. When these contracts involve 'contracting authorities' within the meaning of Article 2(1) point (1) of Directive 2014/24/EU, they are considered as 'public service contracts' in accordance with Article 2(1) points (6) and (9) of Directive 2014/24/EU.

<sup>(1)</sup> Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1370/2007 concerning the opening of the market for domestic passenger transport services by rail, COM/2013/028 final.

<sup>(2)</sup> OJ L 94, 28.3.2014, p. 65.

<sup>(3)</sup> OJ L 94, 28.3.2014, p. 243.

<sup>(4)</sup> OJ L 94, 28.3.2014, p. 1.

Article 5(1)(b) of Directive 2014/23/EU on the award of concession contracts defines a 'service concession' as 'a contract for pecuniary interest concluded in writing by means of which one or more contracting authorities or contracting entities entrust the provision and the management of services other than the execution of works referred to in point (a) to one or more economic operators, the consideration of which consists either solely in the right to exploit the services that are the subject of the contract or in that right together with payment'. Art 5(1) specifies further that 'the award of a works or services concession shall involve the transfer to the concessionaire of an operating risk in exploiting those works or services encompassing demand or supply risk or both. The concessionaire shall be deemed to assume operating risk where, under normal operating conditions, it is not guaranteed to recoup the investments made or the costs incurred in operating the works or the services which are the subject-matter of the concession. The part of the risk transferred to the concessionaire shall involve real exposure to the vagaries of the market, such that any potential estimated loss incurred by the concessionaire shall not be merely nominal or negligible'.

This distinction between (public) service contracts and concessions is important because according to Article 10(3) of Directive 2014/23/EU this Directive shall not apply to concessions for public passenger transport services within the meaning of Regulation (EC) No 1370/2007. The award of service concessions for these public passenger transport services is solely governed by Regulation (EC) No 1370/2007.

Article 5(1) of Regulation (EC) No 1370/2007 specifies that the award of (public) service contracts for transport services by bus or tram is governed by Directives 2004/17/EC<sup>(1)</sup> and 2004/18/EC<sup>(2)</sup>, except where such contracts take the form of service concessions. The award of (public) service contracts for public passenger services by bus or tram is thus solely governed by Directives 2014/24/EU and 2014/25/EU.

The award of (public) service contracts for public passenger transport services by railway and metro is governed by Regulation (EC) No 1370/2007 and excluded from the scope of Directive 2014/24/EU according to its Recital 27 and Article 10(i) and from the scope of Directive 2014/25/EU according to its Recital 35 and Article 21(g).

Table

**Summary of the applicable legal basis for contract awards by type of contractual arrangement and by transport mode**

Public passenger services by	(Public) service contracts as defined in Directives 2014/24/EU and 2014/25/EU	Service concessions as defined in Directive 2014/23/EU
Bus and tram	Directives 2014/24/EU and 2014/25/EU	Regulation (EC) No 1370/2007
Railway and metro	Regulation (EC) No 1370/2007	Regulation (EC) No 1370/2007

**2.1.2. Article 1(2). Application of Regulation (EC) No 1370/2007 to inland waterways and national seaways**

Article 1(2) states that Regulation (EC) No 1370/2007 shall apply to national and international public passenger transport services by rail, by other track-based modes and by road and that Member States may apply that Regulation to public passenger transport by inland waterways. To ensure legal certainty, a Member State's decision to apply Regulation (EC) No 1370/2007 to public passenger transport by inland waterways should be adopted in a transparent manner through a legally binding act. Applying Regulation (EC) No 1370/2007 to inland waterway passenger transport services may be especially useful where those services are integrated into a wider urban, suburban or regional public passenger transport network.

<sup>(1)</sup> Repealed and replaced by Directive 2014/25/EU.

<sup>(2)</sup> Repealed and replaced by Directive 2014/24/EU.

In the absence of a decision to apply Regulation (EC) No 1370/2007 to inland waterway passenger transport services, these services will be governed directly by Article 93 of the Treaty on the Functioning of the European Union (TFEU). Certain aspects of passenger transport by inland waterways are further covered by Council Regulation (EEC) No 3921/91 of 16 December 1991 laying down the conditions under which non-resident carriers may transport goods or passengers by inland waterways within a Member State <sup>(1)</sup> and by Council Regulation (EC) No 1356/96 of 8 July 1996 on common rules applicable to the transport of goods or passengers by inland waterway between Member States with a view to establishing freedom to provide such transport services <sup>(2)</sup>.

Article 1(2) also provides that Member States may apply Regulation (EC) No 1370/2007 to national seawater transport services only if this is without prejudice to Council Regulation (EEC) No 3577/92 of 7 December 1992 applying the principle of freedom to provide services to maritime transport within Member States (maritime cabotage) <sup>(3)</sup>. Certain key provisions of that Regulation do not fully match with those of Regulation (EC) No 1370/2007 (such as the provisions on its application to freight transport, contract duration, exclusive rights and on the thresholds for directly awarding small-scale contracts). Applying Regulation (EC) No 1370/2007 to national seawaters raises a number of difficulties. In a Communication <sup>(4)</sup>, the Commission provides guidance on Regulation (EEC) No 3577/92, where these difficulties are addressed.

### 2.1.3. Article 10(1). Applicability of Regulation (EEC) No 1191/69 to freight transport contracts until 2 December 2012

In the past, some specific rail freight transport services may have been subject to public service obligations covered by Regulation (EEC) No 1191/69 of the Council of 26 June 1969 on action by Member States concerning the obligations inherent in the concept of a public service in transport by rail, road and inland waterway <sup>(5)</sup>. Regulation (EC) No 1370/2007, which repeals Regulation (EEC) No 1191/69, does not, however, apply to freight transport services. To help phase out compensation not authorised by the Commission in accordance with Articles 93, 107 and 108 TFEU, Article 10(1) of Regulation (EC) No 1370/2007 states that Regulation (EEC) No 1191/69 shall remain applicable to freight transport services for a period of three years after the entry into force of Regulation (EC) No 1370/2007 (i.e. until 2 December 2012). Freight transport services can only be qualified as services of general economic interest when the Member State concerned establishes that they have special characteristics compared to those of commercial freight services <sup>(6)</sup>. If Member States wish to keep State aid schemes in place for rail freight transport services which do not fulfil the specific conditions defined in the *Altmark* judgment <sup>(7)</sup>, they must notify those schemes to the Commission so that they can be approved in advance. Those schemes shall be assessed under Article 93 TFEU directly. If those schemes are not notified in advance, they will constitute new and unlawful aid, as they will no longer be exempted from the obligation to notify State aid.

## 2.2. Definition of public service obligations and general rules/contents of public service contracts

This chapter provides interpretative guidance on the constitutive features of public service contracts, key characteristics of general rules, and how competent authorities define the nature and extent of public service obligations and of exclusive rights in the context of Regulation (EC) No 1370/2007. Furthermore, it addresses the conditions under which extensions of the duration of public service contracts can be granted as well as the conditions for subcontracting, including in the case of internal operators.

<sup>(1)</sup> OJ L 373, 31.12.1991, p. 1.

<sup>(2)</sup> OJ L 175, 13.7.1996, p. 7.

<sup>(3)</sup> OJ L 364, 12.12.1992, p. 7.

<sup>(4)</sup> Communication from the Commission on the interpretation of Council Regulation (EEC) No 3577/92 applying the principle of freedom to provide services to maritime transport within Member States (maritime cabotage) (not yet published in the Official Journal).

<sup>(5)</sup> OJ L 156, 28.6.1969, p. 1.

<sup>(6)</sup> Case C-179/90 *Merci Convenzionali Porto di Genova SpA v Siderurgica Gabrielli SpA* [1991] ECR I-5889, paragraph 27. Case C-242/95 *GT-Link A/S v De Danske Statsbaner (DSB)* [1997] ECR I-4449, paragraph 53. Case C-266/96 *Corsica Ferries France SA v Gruppo Antichi Ormeggiatori del Porto di Genova Coop, arl and Others* [1998] ECR I-3949, paragraph 45.

<sup>(7)</sup> Case C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht* [2003] ECR I-7747.

### 2.2.1. Article 2(i). Constitutive features of a public service contract

According to Article 2(i), a public service contract consists of 'one or more legally binding acts confirming the agreement between a competent authority and a public service operator to entrust to that public service operator the management and operation of public passenger transport services subject to public service obligations'. The contract may also consist of a decision adopted by a competent authority taking the form of an individual legislative or regulatory act or containing conditions under which the competent authority itself provides the services or entrusts the provision of such services to an internal operator. The notion of 'public service contract' as defined by Regulation (EC) No 1370/2007 also covers public service concessions.

To take account of the different legal regimes and traditions in the Member States, the definition of a public service contract provided by Regulation (EC) No 1370/2007 is very broad and includes various types of legally binding acts. It thereby ensures that no legal situation escapes the scope of that Regulation, even if the relationship between the competent authority and the operator is not formally and strictly expressed in the form of a contract within the strictest meaning of the term. For this reason, the definition also includes public service contracts consisting of a decision taking the form of an individual legislative or regulatory act. A combination of a general legal act, assigning the operation of services to an operator, with an administrative act, setting out the detailed requirements concerning the services to be provided and the method of compensation calculation to be applied, can also constitute a public service contract. The definition also covers decisions adopted by the competent authority stating the conditions under which the authority itself provides the services or entrusts the provision of services to an internal operator.

### 2.2.2. Article 2(l). Characteristics and establishment process of general rules

General rules are defined in Article 2(l) as measures that apply 'without discrimination to all public passenger transport services of the same type in a given geographical area for which a competent authority is responsible'. General rules are therefore measures for one or several types of public transport services by road or by rail that may be imposed unilaterally by public authorities on public service operators in a non-discriminatory manner or that may be included in contracts concluded between the competent authority and the public service operators. The measure is restricted to the geographical area for which a competent authority is responsible, but does not necessarily need to cover the entire geographical area. A general rule can also be a regional or national law applicable to all existing or potential transport operators in a region or a Member State. It is therefore usually not negotiated with individual public service operators. Even if the general rule is imposed by a unilateral act, it is not excluded that public service operators are consulted in a transparent and non-discriminatory manner before general rules are established.

### 2.2.3. Article 3(2) and (3). Setting up general rules inside and outside a public service contract. Scope of general rules

Recital 17 of Regulation (EC) No 1370/2007 states that 'competent authorities are free to establish social and qualitative criteria in order to maintain and raise quality standards for public service obligations, for instance with regard to minimal working conditions, passenger rights, the needs of persons with reduced mobility, environmental protection, the security of passengers and employees as well as collective agreement obligations and other rules and agreements concerning workplaces and social protection at the place where the service is provided. In order to ensure transparent and comparable terms of competition between operators and to avert the risk of social dumping, competent authorities should be free to impose specific social and service quality standards'.

Member States and/or competent authorities may organise public transport through general rules such as laws, decrees or regulatory measures. However, when these general rules involve compensation or an exclusive right, there is an additional obligation to conclude a public service contract pursuant to Article 3(1) of Regulation (EC) No 1370/2007. This obligation does not exist when general rules establish maximum tariffs for all passengers or for certain categories of passengers pursuant to Article 3(2) of that Regulation. In that case, there is no obligation to conclude a public service contract and the compensation mechanism can be defined on a non-discriminatory, generally applicable basis.



A competent authority may decide to use general rules to establish social or qualitative standards in accordance with national law. If the general rules provide for compensation or if the competent authority thinks that the implementation of the general rules requires compensation, a public service contract or public service contracts defining the obligations and the parameters of the compensation of their net financial effect will also have to be concluded, in accordance with Articles 4 and 6 as well as with the Annex to Regulation (EC) No 1370/2007.

*2.2.4. Article 3(3). Notification under Union rules on State aid of general rules on maximum tariff schemes for transport of pupils, students, apprentices and persons with reduced mobility that are outside the scope of Regulation (EC) No 1370/2007*

Article 3(3) allows the Member States to exclude from the scope of Regulation (EC) No 1370/2007 general rules on financial compensation for public service obligations which establish maximum tariffs for the transport of pupils, students, apprentices and persons with reduced mobility. If a Member State decides to do so, the national authorities must assess the compensation provisions under the Treaty rules instead, in particular those relating to State aid. If those general rules constitute State aid, the Member State must notify those rules to the Commission in accordance with Article 108 TFEU.

*2.2.5. Article 2(e) and Article 4(1). Definition by competent authorities of the nature and extent of public service obligations and of the scope of public service contracts*

Article 14 TFEU and Protocol No 26 on services of general interest annexed to the TFEU lay out the general principles of how Member States define and provide services of general economic interest. Article 14 TFEU states that 'the Union and the Member States, each within their respective powers and within the scope of application of the Treaties, shall take care that such services (of general economic interest (SGEI)) operate on the basis of principles and conditions, particularly economic and financial conditions, which enable them to fulfil their missions'. According to Protocol No 26, national, regional and local authorities play an essential role and have wide discretion in providing, commissioning and organising SGEIs tailored as closely as possible to the needs of the users. It is a shared value of the Union that SGEIs strive for a high level of quality, safety, affordability, equal treatment and the promotion of universal access and the rights of users. The possibilities for Member States to provide, commission and organise SGEIs in the field of public passenger transport by rail and by road are regulated by Regulation (EC) No 1370/2007. Article 1 of Regulation (EC) No 1370/2007 states that its purpose 'is to define how, in accordance with the rules of Union law, competent authorities may act in the field of public passenger transport to guarantee the provision of services of general interest which are among other things more numerous, safer, of a higher quality or provided at lower cost than those that market forces alone would have allowed'. As mentioned in Article 2(e) of Regulation (EC) No 1370/2007, a public service obligation is a requirement to ensure public passenger transport services in the general interest that an operator, if it were considering its own commercial interests, would not assume or would not assume to the same extent or under the same conditions without reward<sup>(1)</sup>. Thus, within the framework laid down by Regulation (EC) No 1370/2007, Member States have wide discretion to define public service obligations in line with the needs of end users.

Typically but not exclusively, public service obligations can refer to specific requirements placed on the public service operator as regards, for instance, the frequency of services, service quality, service provision in particular at smaller intermediate stations which may not be commercially attractive, and the provision of early morning and late evening trains. As an illustrative example, the Commission considers that the services to be classified as public services must be addressed to citizens or be in the interest of society as a whole. Competent authorities define the nature and scope of public service obligations while respecting general principles of the Treaty. To achieve the objectives of the Regulation, which means to guarantee safe, cost-effective and high-quality passenger transport services, competent authorities have to strive for an economically and financially sustainable provision of these services. In the context of contractualisation as

<sup>(1)</sup> This approach is consistent with the Commission's general approach to Services of General Economic Interest in other sectors. See, in particular, point 48 of the Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest (OJ C 8, 11.1.2012, p. 4).

defined by Article 3(1) of Regulation (EC) No 1370/2007, both parties to the contract can expect their rights to be respected and must fulfil their contractual obligations. These rights and obligations include financial ones. The geographical scope of public service contracts should enable competent authorities to optimise the economics of public transport services operated under their responsibility including, where appropriate, local, regional and sub-national network effects. Reaping network effects allows for a cost-effective provision of public transport services due to the cross-financing between more than cost-covering services and not cost-covering services. This should in turn enable the authorities to achieve established transport policy objectives whilst guaranteeing, where applicable, the conditions for effective and fair competition on the network, for instance, potentially for some high-speed rail services.

#### *2.2.6. Article 2(f) and Article 3(1). Definition of the nature and extent of exclusive rights to ensure compliance with Union law*

Under Article 3(1), a public service contract must be concluded if a competent authority decides to grant an operator an exclusive right and/or compensation in return for the discharge of public service obligations. An exclusive right is defined in Article 2(f) as 'a right entitling a public service operator to operate certain public passenger transport services on a particular route or network or in a particular area, to the exclusion of any other such operator'. This right may be established in a legislative, regulatory or administrative instrument. Very often, the public service contract specifies the conditions for exercising the exclusive right, in particular the geographical scope and the duration of the exclusive right. Exclusivity protects the undertaking from competition by other operators in a specific market in so far as no other undertaking may provide the same service. However, Member States may grant certain rights that appear non-exclusive but de facto prevent other undertakings from participating in the market through legal rules or administrative practices. For example, administrative arrangements granting authorisation to operate public transport services subject to criteria, such as relating to a desirable volume and quality of such services, could have the practical effect of limiting the number of operators on the market. The Commission considers that the notion of exclusivity used in Regulation (EC) No 1370/2007 also covers the latter situation.

To ensure the smooth functioning of the internal market for public transport services, the competent authorities should give a precise definition of exclusive rights as rights that do not exceed what is necessary to provide the required economic protection for the services in question, while leaving room, where possible, for other types of services. In this context, recital 8 of Regulation (EC) No 1370/2007 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 in so far as these are compatible with Treaty requirements'. The Commission would like to point out, however, that even under a deregulated system, introducing contractual arrangements to promote the accessibility of bus services to certain segments of the population constitutes a public service obligation. This obligation falls under Regulation (EC) No 1370/2007 <sup>(1)</sup>.

If all conditions for the application of Regulation (EC) No 1370/2007 apply, including the condition that a public transport operator benefits from an exclusive right, the public service contract that has to be concluded may be directly awarded, for instance in the case of a small value contract and in the case of a small and medium sized operating company, if the conditions of Article 5(4) are met.

#### *2.2.7. Article 4(4). Conditions under which a 50 % extension of the duration of the public service contract can be granted*

Article 4(3) states that the maximum duration of a public service contract shall be '10 years for coach and bus services and 15 years for passenger transport services by rail or other track-based modes'. Article 4(4) allows for an extension of the duration of a public service contract by 50 %, if necessary, having regard to the conditions of asset depreciation. Such an extension can be granted if the public service operator

<sup>(1)</sup> See Commission Decision N 588/2002 — United Kingdom, BSO — Grant for long-distance bus services.

provides assets that are significant in relation to the overall assets needed to carry out the passenger transport services covered by the public service contract and are predominantly linked to the passenger transport services covered by the contract.

The interpretation of these two conditions depends on the particular circumstances of each case. As recital 15 of Regulation (EC) No 1370/2007 underlines, 'contracts of long duration can lead to market foreclosure for a longer period than is necessary, thus diminishing the benefits of competitive pressure. In order to minimise distortions of competition, while protecting the quality of services, public service contracts should be of limited duration'. Additionally, in the case of very long contract durations it becomes difficult to correctly attribute risks between the operator and the authority due to increasing uncertainties. On the other hand, recital 15 explains that 'it is necessary to make provision for extending public service contracts by a maximum of half their initial duration where the public service operator must invest in assets for which the depreciation period is exceptional and, because of their special characteristics and constraints, in the case of the outermost regions as specified in Article 349 TFEU'.

Any decision about extending the duration of a public service contract by 50 % should be subject to the following considerations: the public service contract must oblige the operator to invest in assets such as rolling stock, maintenance facilities or infrastructure for which the depreciation period is exceptionally long.

Normally, the competent authority will decide to extend the contract's duration before the award of a new contract. If an extension of the duration needs to be decided while the contract is running, because intended investments in new rolling stock are made not at the beginning of the contract period but, for instance, due to technical reasons at a later stage, this possibility shall be clearly indicated in the tender documents and this option shall be adequately reflected in terms of compensation. In any event, the total contract extension must not exceed 50 % of the duration stipulated in Article 4(4).

#### *2.2.8. Article 4(5). Available options to competent authorities, if they consider desirable to take measures of staff protection in case of a change of operator*

Article 4(5) provides that 'without prejudice to national and Community law, including collective agreements between social partners, competent authorities may require the selected public service operator to grant staff previously taken on to provide services the rights to which they would have been entitled if there had been a transfer within the meaning of Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses<sup>(1)</sup>. Where competent authorities require public service operators to comply with certain social standards, tender documents and public service contracts shall list the staff concerned and give transparent details of their contractual rights and the conditions under which employees are deemed to be linked to the services'.

In compliance with the principle of subsidiarity and as set out in recitals 16 and 17, competent authorities basically have the following options in the case of a change of operator as regards staff protection:

- (i) Not to take any specific action. In this case, employees' rights such as a transfer of staff only have to be granted where the conditions for the application of Directive 2001/23/EC are fulfilled, for instance, where there is transfer of significant tangible assets such as rolling stock<sup>(2)</sup>.

<sup>(1)</sup> OJ L 82, 22.3.2001, p. 16.

<sup>(2)</sup> In accordance with the case-law of the Court of Justice of the European Union, Directive 2001/23/EC is applicable to a transfer of undertaking which takes place following a tendering procedure for the award of a public service contract. In sectors of activity based on tangible assets, such as bus or rail transport, the Directive applies if significant tangible assets are transferred. The existence of a transfer within the meaning of Directive 2001/23/EC is not precluded by the fact that ownership of the tangible assets previously used by a transferor and taken over by a transferee is not transferred, for example in case the tangible assets taken over by the new contractor did not belong to its predecessor but were provided by the contracting authority; see in this regard Commission Memorandum on rights of workers in cases of transfers of undertakings at: <http://ec.europa.eu/social/main.jsp?catId=707&langId=en&intPageId=208>



- (ii) To require a transfer of staff previously taken on to provide services with the rights to which the staff would have been entitled, whether or not Directive 2001/23/EC applies, if there has been a transfer within the meaning of Directive 2001/23/EC. Recital 16 of Regulation (EC) No 1370/2007 explains that ‘this Directive does not preclude Member States from safeguarding transfer conditions of employees’ rights other than those covered by Directive 2001/23/EC and thereby, if appropriate, taking into account social standards established by national laws, regulations or administrative provisions or collective agreements or agreements concluded between social partners’.
- (iii) To require the public transport operator to respect certain social standards for all staff involved in the provision of public transport services ‘in order to ensure transparent and comparable terms of competition between operators and to avert the risk of social dumping’ as set out in recital 17 of Regulation (EC) No 1370/2007. For instance, these standards could possibly relate to a collective agreement at company level or a collective agreement concluded for the relevant market segment.
- (iv) To apply a combination of options (ii) and (iii).

In order to ensure transparency of employment conditions, competent authorities have the obligation, if they require a transfer of staff or impose certain social standards, to clearly specify these obligations in detail in the tender documents and the public service contracts.

#### 2.2.9. Article 5(2)(e). Conditions of subcontracting in the case of public service contracts awarded by internal operators

Public service contracts directly awarded to an internal operator may be subcontracted under strict conditions. In such a case, pursuant to Article 5(2)(e), the internal operator must provide ‘the major part’ of the public passenger transport services itself. With this provision, the legislator intended to avoid that the concept of an ‘internal operator’ under the control of the competent authority would be devoid of meaning, since the internal operator would otherwise be allowed to subcontract all or a very important share of the transport services to another entity. Article 5(2)(e) therefore aims to avoid the establishment of false internal operators. The provision of public passenger transport services by an internal operator is an exception to the principle set out in Article 5(3), according to which public service contracts shall be awarded ‘on the basis of a competitive tendering procedure’. According to recital 7 of Regulation (EC) No 1370/2007, ‘the introduction of regulated competition between operators leads to more attractive and innovative services at lower cost’. Without prejudice to a case-by-case analysis, it would seem reasonable to consider that subcontracting more than one third of the public transport services would require a strong justification, in particular in view of the objectives of Article 5(2)(e) as explained. Typically, these transport services are expressed in value terms. In any case, subcontracting by internal operators must be carried out respecting relevant public procurement legislation.

Finally, Regulation (EC) No 1370/2007 does not prevent the public service contract from stipulating a minimum percentage of transport services in value terms to be subcontracted by the operator under a public service contract. The contract can stipulate this, provided the provisions of that Regulation are respected, especially those on the maximum share of a public service contract that may be subcontracted.

### 2.3. Award of public service contracts

This chapter provides interpretative guidance on a number of provisions related to the award of public services contracts. The guidance covers the conditions under which public service contracts can be directly awarded as well as the procedural requirements for the competitive tendering of contracts.

#### 2.3.1. Article 5(2)(b). Conditions under which a public service contract may be directly awarded to an internal operator

Regulation (EC) No 1370/2007 allows local competent authorities to provide public passenger transport services by rail and by road themselves or to award a public service contract directly to an internal operator. However, if they choose the second option, they must respect a number of strict rules and conditions set out in Article 5(2). The Commission notes the following:

- (i) Article 5(2) provides that a public service contract may be awarded directly to internal operators by a competent local authority or a group of such authorities providing integrated public passenger transport services. This means that the public passenger transport services under a contract directly awarded by a group of competent local authorities must be integrated from a geographical, transport or tariff point of view across the territory for which such a group of authorities is responsible. The Commission also considers that the geographical scope of such services provided under the responsibility of a competent local authority or a group of such authorities should be defined in a manner that, typically, these local services would serve the needs of an urban agglomeration and/or a rural district.
- (ii) The rules on control of the internal operator by the competent authority defined in Article 2(j) and specified in Article 5(2) must in any event be respected. An internal operator must be 'a legally distinct entity over which a competent local authority [...] exercises control similar to that exercised over its own departments'. Article 5(2)(a) lays down a set of criteria that shall be taken into consideration in assessing whether a competent authority effectively controls its internal operator. These criteria are 'the degree of representation on administrative, management or supervisory bodies, specifications relating to this representation in the articles of association, ownership, effective influence and control over strategic decisions and individual management decisions'. The assessment of control must be based on all the criteria, if relevant.

With regard to the ownership criterion, Regulation (EC) No 1370/2007 does not require the competent authorities to hold 100 % of the internal operator's capital. This could be relevant, for example, in cases of public-private partnerships. In this respect, Regulation (EC) No 1370/2007 interprets 'in-house' operator more broadly than the Court of Justice of the European Union in its case-law<sup>(1)</sup>. However, effective control by the competent authority has to be proven by other criteria as mentioned in Article 5(2)(a).

- (iii) To reduce distortions of competition, Article 5(2)(b) requires that the transport activities of internal operators and any body or bodies under their control should be geographically confined within the competent authority's territory or jointly controlled by a local competent authority. Thus, these operators or bodies may not participate in competitive tender procedures related to the provision of public passenger transport services organised outside the territory of the competent authority. Article 5(2)(b) is deliberately drafted in broad terms to prevent the creation of corporate structures that aim to circumvent this geographical confinement. Without prejudice to the provisions on outgoing lines, as mentioned in point (v), the Commission will be particularly strict in the application of this provision on geographical confinement, in particular when the internal operator and another body providing transport services are both controlled by a local competent authority.
- (iv) By analogy with the case-law on public procurement and concessions which provides that the in-house operator's activities should not be 'market-oriented'<sup>(2)</sup>, the condition of Article 5(2)(b) that 'the internal operator [...] perform their public passenger transport activity within the territory of the competent local authority, [...] and do not take part in competitive tenders concerning the provision of public passenger transport services organised outside the territory of the competent local authority' should be interpreted as follows: the internal operator or the entity influenced by the internal operator must not operate public passenger transport services, including as a subcontractor, or participate in tender procedures outside the competent authority's territory within the Union or, due to a possible indirect effect on the internal market, elsewhere in the world.
- (v) Article 5(2)(b) allows internal operators to operate 'outgoing lines or other ancillary elements of that activity which enter the territory of neighbouring competent local authorities'. This provision provides some flexibility by catering for transport between neighbouring regions. Internal operators may therefore operate services beyond the territory of their competent local authority to a certain extent. To assess whether the services under public service contract are compliant with this provision, the

<sup>(1)</sup> Case C-324/07 *Coditel Brabant SA v Commune d'Uccle and Région de Bruxelles-Capitale* [2008] ECR I-8457, paragraph 30.

<sup>(2)</sup> The case-law related to 'in-house' undertakings does not refer to a condition prohibiting those undertakings from taking part in competitive tenders outside the territory of the competent authority. However, the case-law has clearly indicated that an undertaking that becomes market-oriented renders the municipality's control tenuous (see, Case C-458/03 *Parking Brixen GmbH v Gemeinde Brixen and Stadtwerke Brixen AG* [2005] ECR I-08585).

following criteria should be applied: whether those services connect the territory of the competent authority in question to a neighbouring territory and whether they are ancillary rather than the main purpose of the public transport activities under public service contract. The Commission will assess whether the public transport activities are of a secondary nature by comparing their volume in vehicle or train km with the total volume of the public transport activities covered by the internal operator's contract(s).

### 2.3.2. Article 5(3). Procedural requirements for the competitive tendering of public service contracts

Article 5(3) stipulates that, if a competent authority uses a third party other than an internal operator to provide public passenger transport services, it shall award public service contracts through a fair, open, transparent and non-discriminatory competitive tendering procedure.

Article 5(3) provides few other details on the conditions under which a competitive tendering procedure should be organised. As laid out under point 2.4.1, contract award procedures must be designed so as to create conditions for effective competition. The application of the general principles of the Treaty, such as the principles of transparency and non-discrimination, implies, for instance, that the assessment criteria for the selection of offers must be published with the tender documents. The more detailed procedural rules of Union public procurement legislation, such as Directives 2014/24/EU and 2014/25/EU, or Directive 2014/23/EU on concessions, although not required, may be applied if Member States so wish.

However, according to Article 5(3) of Regulation (EC) No 1370/2007, the competent authority may also choose to negotiate with the pre-selected parties, after a pre-selection of tenders, in the case of specific or complex requirements. An example of this is when bidding operators must come up with technologically innovative transport solutions to meet the requirements published in the tender documents. Even when using pre-selection and negotiation, the selection and award procedure must nevertheless comply with all the conditions set out in Article 5(3).

In order to provide potential tenderers with fair and equal opportunities, the period between the launching of the competitive tendering procedure and the submission of the offers, as well as the period between the launching of the competitive tendering procedure and the moment from which the operation of the transport services has to start, shall be of appropriate and reasonable length.

To make the competitive tendering procedure more transparent, competent authorities should provide all the relevant technical and financial data, including information about the allocation of costs and revenues if available, to potential bidders to assist in the preparation of their offers. However, this shared information cannot undermine the legitimate protection of the commercial interests of third parties. Railway undertakings, rail infrastructure managers and all other relevant parties should make available appropriate accurate data to the competent authorities to enable them to comply with their information obligation.

### 2.3.3. Article 5(4). Conditions under which a competent authority may directly award a public service contract in case of a small contract volume or a SME

In the case of a direct award of a public service contract of small value or to a small or medium-sized operator (Article 5(4)), the competent authority may directly award the contract without a competitive tendering procedure. A public service contract is considered to be of small value if its average annual value is less than EUR 1 million or if it involves the annual provision of less than 300 000 kilometres of public passenger transport services. A small or medium-sized operator is an enterprise operating not more than 23 vehicles. In this case, the thresholds may be increased to an average annual value estimated at less than EUR 2 million or the annual provision of less than 600 000 kilometres of public transport services.

The SME threshold defined in terms of 'vehicles' indicates that this provision is geared to the transport by bus, but not to transport by tram, metro or train. The threshold of 23 vehicles has to be interpreted in a restrictive manner to avoid abuse of the exceptional character of Article 5(4). Therefore, the terms 'vehicles being operated' must be interpreted as referring to the total number of vehicles being operated by the public transport operator and not the number of vehicles operated for services covered by a particular public service contract.

However, the national legislator may decide to oblige its competent authority to apply to such cases the rule that public service contracts should be awarded in a fair, open, transparent and non-discriminatory competitive tendering process.

*2.3.4. Article 5(4). Possibility of Member States to set lower thresholds allowing for a direct award in the case of contracts of small value or small and medium-sized operators*

To the same extent that Article 5(4) allows the Member States (i) to oblige their competent authorities to apply the rule that public service contracts should be awarded in a fair, open, transparent and non-discriminatory competitive tendering procedure in the case of contracts of small value or small and medium-sized operators, the Member States may also decide (ii) to lower the thresholds set out in that provision for direct awards of such contracts or (iii) to use the thresholds provided for in Article 5(4) of Regulation (EC) No 1370/2007.

*2.3.5. Article 5(6). Rail services that qualify for the direct award procedure*

Article 5(6) allows competent authorities to award public service contracts directly for rail transport, 'with the exception of other track-based modes such as metro and tramways'.

The award by an authority of contracts for the provision of services of general interest to a third party has to respect general Treaty principles, such as transparency and equal treatment<sup>(1)</sup>. Contracts directly awarded under Article 5(6) are not exonerated from compliance with these Treaty principles. This is the reason why Regulation (EC) No 1370/2007 requires notably, in Article 7(2) and (3), that competent authorities publish certain information about directly awarded public service contracts in rail at least one year before and one year after the award.

The exception to the general rule of a competitive award procedure must also be applied restrictively. Rail substitute services, for instance, by bus and coach that may be contractually required from the public service operator in cases of disruption of the rail network cannot be considered as rail transport services and thus do not fall under Article 5(6). Subcontracting such rail substitute services by bus and coach according to relevant public procurement legislation is thus required.

Whether certain types of urban or suburban rail transport systems, such as the S-Bahn (in Austria, Germany and Denmark) and the RER (in France), or modes of transport that are similar to 'other track based modes' (for instance, metro or tram services), such as tram-train services and certain automatic train services operated under optical guidance systems, are included in the rail exemption of Article 5(6) must be assessed on a case-by-case basis, applying suitable criteria. In particular, this will depend on factors such as whether the systems in question are normally interoperable and/or share infrastructure with the traditional heavy rail network. Although tram-train services do use heavy rail infrastructure, their special characteristics mean they should nonetheless be regarded as an 'other track based mode'.

*2.3.6. Modifications of public service contracts*

Where a running public service contract needs to be amended, for instance where the transport service volume and corresponding compensation amount need to be adapted due to an extension of a metro line, the question arises whether the competent authority should start a new award procedure or whether the contract can be amended without a new award.

The Court of Justice has held that in the case of minor, non-substantial modifications a new award may not be necessary to ensure that general Treaty principles such as transparency and non-discrimination are

<sup>(1)</sup> See for instance recital 20 of Regulation (EC) No 1370/2007: 'Where a public authority chooses to entrust a general interest service to a third party, it must select the public service operator in accordance with Community law on public contracts and concessions, as established by Articles 43 to 49 of the Treaty, and the principles of transparency and equal treatment'.

complied with and a simple amendment of the contract may be sufficient <sup>(1)</sup>. According to the Court, in order to ensure transparency of procedures and equal treatment of tenderers, substantial amendments to essential provisions of a service concession contract or to contracts subject to the public procurement directives require the award of a new contract in certain cases. This is the case, in particular, if the new provisions are materially different in character from the original contract and are therefore such as to demonstrate the intention of the parties to renegotiate the essential terms of that contract

According to the Court, an amendment to a contract during its term may be regarded as substantial if it introduces conditions which, if they had been part of the original award procedure, would have allowed for the admission of tenderers other than those originally admitted or would have allowed for the acceptance of an offer other than that originally accepted.

In the absence of specific provisions in Regulation (EC) No 1370/2007, the principles of the above case-law are fully applicable to modifications of public service contracts covered by that Regulation. In order to determine what constitutes non-substantial modifications, a case-by-case assessment based on objective criteria is required <sup>(2)</sup>.

#### 2.4. Public service compensation

The rules on compensation laid down in Regulation (EC) No 1370/2007 ensure the absence of overcompensation and compliance with the Treaty rules. They also address the concepts of reasonable profit and efficiency incentive, the issues of cross-subsidisation of commercial activities with compensation paid for public service obligations and of under-compensation, and the Commission's ex ante and ex post investigation procedures regarding public service compensation.

##### 2.4.1. Article 4(1) and Article 5(3). Absence of overcompensation in the case of a public service contract awarded on the basis of an open and competitive public tendering procedure

Unlike other economic sectors, Article 106(2) TFEU does not apply in cases where compensation is paid for public service obligations in land transport. Rather, such compensation is covered by Article 93 TFEU. Accordingly, the Union rules regarding compensation for services of general economic interest <sup>(3)</sup> which are based on Article 106(2) TFEU, do not apply to inland transport <sup>(4)</sup>.

In the case of public passenger transport services by rail and by road, provided that compensation for those services is paid in accordance with Regulation (EC) No 1370/2007, such compensation shall be deemed compatible with the internal market and shall be exempt from the prior notification requirement laid down in Article 108(3) TFEU, in accordance with Article 9(1) of that Regulation.

This presumption of compatibility and exemption from the notification requirement does not address the question of the possible State aid character of the compensation paid for the provision of public transport services. In order not to constitute State aid, such compensation would have to respect the four conditions laid down by the European Court of Justice in the *Altmark* judgement <sup>(5)</sup>.

<sup>(1)</sup> Case C-337/98 *Commission v France* [2000] ECR I-8377, paragraphs 44 and 46, Case C-454/06 *pressetext Nachrichtenagentur* [2008] ECR I-4401, paragraph 34) and Case C-91/08 *Wall AG* [2010] ECR I-02815, paragraph 37 and 38.

<sup>(2)</sup> The Court of Justice pointed out in the *Wall AG* case that a change of subcontractor, even if the possibility of a change is provided for in the contract, may in exceptional cases constitute a substantial amendment to one of the essential provisions of a concession contract where the use of one subcontractor rather than another was, in view of the particular characteristics of the services concerned, a decisive factor in concluding the contract, which is in any event for the referring court to ascertain.

<sup>(3)</sup> Notably Commission Decision on the application of Article 106(2) TFEU to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (OJ L 7, 11.1.2012, p. 3) and EU framework for State aid in the form of public service compensation (OJ C 8, 11.1.2012, p. 15).

<sup>(4)</sup> However, Commission Regulation (EU) No 360/2012 on the application of Articles 107 and 108 to de minimis aid granted to undertakings providing services of general economic (OJ L 114, 26.4.2012, p. 8) does apply to land transport.

<sup>(5)</sup> Case C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* [2003] ECR I-7747. See, in particular, section 3 of the Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest (OJ C 8, 11.1.2012, p. 4).



An open, transparent and non-discriminatory competitive tendering procedure within the meaning of Article 5(3) will minimise the public compensation that the competent authorities will need to pay to the service provider to obtain the level of public service imposed in the tender, thus preventing over-compensation. In such a case, there is no need to apply the detailed rules on compensation set out in the annex.

In order to comply with Article 5(3), public procurement procedures must be designed in such a way that they create conditions for effective competition. The exact characteristics of the tender can vary in accordance with Article 5(3) which allows, for example, for a certain margin of negotiation between the competent authority and companies having submitted bids in the tender procedure. However, such negotiations must be fair and respect the principles of transparency and non-discrimination. For example, a purely negotiated procedure without prior publication of a contract notice is against the principles of transparency and non-discrimination of Article 5(3). Therefore, such a procedure does not comply with Article 5(3). Similarly, a tender procedure which is designed in such a way as to unduly restrict the number of potential bidders does not comply with Article 5(3). In this context, competent authorities should be particularly vigilant when they have clear indications of non-effective competition, in particular, for instance, when only one bid is submitted. In such cases, the Commission is also more likely to enquire about the specific circumstances of the tender procedure.

The selection criteria, including for example quality related, environmental or social criteria, should be closely related to the subject-matter of the service provided. The awarding authority is not prevented from setting qualitative standards to be met by all economic operators or from taking qualitative aspects related to the different proposals into account in its award decision.

Finally, there can be circumstances where a procurement procedure in accordance with Article 5(3) does not give rise to a sufficiently open and genuine competition. This could be the case, for example, due to the complexity or extent of the services to be provided or to the necessary infrastructure or assets owned by a particular service provider or to be provided for the execution of the contract.

#### 2.4.2. Article 6. Absence of overcompensation in the case of directly awarded public service contracts

The direct award of a public service contract in accordance with Article 5(2), (4), (5) or (6), or the imposition of general rules within the meaning of Article 3(2), do not guarantee that the level of compensation is reduced to the minimum. This is because that direct award will not result from the interaction of competitive market forces, but rather from a direct negotiation between the competent authority and the service provider.

Article 6(1) provides that in the case of directly awarded public service contracts or general rules compensation must comply with the provisions of Regulation (EC) No 1370/2007 as well as with its Annex to ensure the absence of overcompensation. The Annex to that Regulation establishes an *ex post* check to ensure that the compensatory payments are not higher than the actual net cost for the provision of the public service over the lifetime of the contract. Additionally, the Commission considers that regular checks are in principle needed during the lifetime of the contract in order to detect and avoid at an early stage clear overcompensation situations from developing. This is the case, in particular, for long-term contracts.

Compensation must be limited to the net financial effect of the public service obligation. This is calculated as costs minus revenues generated by the public service operations, minus potential revenues induced by network effects, plus a reasonable profit.

On the cost side, all costs directly linked to the provision of the public service can be taken into account (such as train drivers' salaries, traction current, rolling stock maintenance, overhead costs (such as cost of management and administration) and contract-related costs of affiliated undertakings). Where the undertaking also carries out activities that fall outside the scope of the public service, an appropriate part of the costs that are shared between public service and other activities (such as office rental costs, the salaries of accountants or administrative personnel) may also be taken into account on top of the direct costs necessary to discharge the public service. Where the undertaking holds several public service contracts, the common costs must not only be allocated between the public service contracts and other activities, but

also between the different public service contracts. To determine the appropriate proportion of common costs to be taken into account in the public service costs, market prices for using the resources, if available, may be taken as a benchmark. If such prices are not available, other methodologies may be used where appropriate.

Revenues directly or indirectly related to the provision of the public service, such as revenues from the sale of tickets or from the sale of food and drinks, must be deducted from the costs for which compensation is claimed.

The operation of public passenger transport services under a public service contract by a transport undertaking also involved in other commercial operations may bring about positive induced network effects. For example, by serving a certain network under a public service contract which links to other routes operated under commercial terms, an operator may be able to increase its client base. The Commission welcomes induced network effects such as those brought about by through-ticketing and integrated timetabling, provided they are designed to benefit passengers. The Commission is also aware of the practical difficulties in quantifying these potential network effects. Nevertheless, in accordance with the Annex to Regulation (EC) No 1370/2007, any such quantifiable financial benefits shall be deducted from the costs for which compensation is claimed.

#### 2.4.3. Article 4(1) and the Annex. The notion of 'reasonable profit'

Article 4(1)(c) provides that the costs to be taken into account in a public service contract may include 'a suitable return on capital'. The Annex specifies that compensation for a public service obligation may not exceed the net financial effect of the obligation, defined as costs minus revenues generated by public service operations, minus potential induced network revenues, plus a 'reasonable profit'.

The Annex states that '“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'. However, no further guidance is offered on the correct level of 'return on capital' or 'reasonable profit'.

While the Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest <sup>(1)</sup> (SGEI Communication) is based on a different legal basis than Regulation (EC) No 1370/2007 and thus not applicable in cases where compensation is paid for public service obligations in land transport, it provides some guidance on the determination of the level of reasonable profit that may serve as an indicator for competent authorities when awarding public service contracts under Regulation (EC) No 1370/2007 <sup>(2)</sup>. The SGEI Communication explains that 'where generally accepted market remuneration exists for a given service, that market remuneration provides the best benchmark for the compensation in the absence of a tender' <sup>(3)</sup>. Such benchmarks would ideally be found in contracts in the same sector of activity, with similar characteristics and in the same Member State. The reasonable profit must therefore be in line with normal market conditions and should not exceed what is necessary to reflect the level of risk of the service provided.

However, such market benchmarks do not always exist. In that case, the level of reasonable profit could 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 <sup>(4)</sup>.

A standard way in which to measure the return on capital of a public service contract is to consider the internal rate of return (IRR) that the company makes on its invested capital over the lifetime of the project, that is to say the IRR on the cash flows of the contract. However, accounting measures, such as the return on equity (ROE), the return on capital employed (ROCE) or other generally accepted economic indicators for the return on capital may also be used.

<sup>(1)</sup> OJ C 8, 11.1.2012, p. 4.

<sup>(2)</sup> See in particular point 61 of the SGEI Communication.

<sup>(3)</sup> Point 69 of the SGEI Communication.

<sup>(4)</sup> Further guidance is given in the SGEI Communication on what is to be considered a 'typical well-run undertaking'. See in particular points 70-76.

It should be noted that indicators may be influenced by the accounting methods used by the company and reflect the company situation only in a given year. Where this is the case, it should be ensured that the accounting practices of the company reflect the long-term economic reality of the public service contract. In that context, whenever feasible, the level of reasonable profit should be assessed over the lifetime of the public service contract. The differences in the economic models of railways, tramways, metro and bus transport should also be taken into account. For example, while railway transport is generally very capital-intensive, bus transport tends to be more dependent on personnel costs.

In any event, depending on the particular circumstances of each public service contract, a case-by-case assessment by the competent authority is needed to determine the adequate level of reasonable profit. Among other things, it must take into account the specific characteristics of the undertaking in question, the normal market remuneration for similar services and the level of risk involved in each public service contract. For example, a public service contract that includes specific provisions protecting the level of compensation in the case of unforeseen costs is less risky than a public service contract that does not contain such guarantees. All other things being equal, the reasonable profit in the former contract should therefore be lower than in the latter contract.

The use of efficiency incentives in the compensation mechanism is generally to be encouraged <sup>(1)</sup>. It should be underlined that compensation schemes which simply cover actual costs as they occur provide few incentives for the transport company to contain costs or to become more efficient over time. Their use is therefore better confined to instances where uncertainty about costs is large and the transport provider needs a high degree of protection against uncertainty.

#### *2.4.4. Article 4(1) and (2) and the Annex. Preventing compensation received for a public service obligation from being used to cross-subsidise commercial activities*

When a public service provider also carries out commercial activities, it is necessary to ensure that the public compensation it receives is not used to strengthen its competitive position in its commercial activities. In this context, the Annex lays down rules to avoid the cross-subsidisation of commercial activities with revenues from public service operations. These rules essentially consist of accounting separation between the two types of activities (public service and commercial) and a sound cost allocation method reflecting the real costs of providing the public service.

Article 4(1) and (2), together with the rules laid down in the Annex, require costs and revenues pertaining to the provision of services under each public service contract awarded to a transport undertaking and to commercial activities to be correctly allocated between the two types of activities. This is to effectively monitor public compensation and possible cross-subsidisation between the two activities. The adequacy of the cost-sharing and ring-fencing measures between the public service obligation and the commercial activities are crucial in this respect. For example, when means of transport (such as rail rolling stock or buses) or other assets or services needed to discharge the public service obligation (such as offices, personnel or stations) are shared between public service and commercial activities, the costs of each must be allocated to the two different types of activities in proportion to their relative weight in the overall transport services provided by the transport undertaking.

If, for example, the public service and the commercial activities of the same transport undertaking made use of services in stations, but the full costs of those services were allocated only to the public service activities, this would constitute a cross-subsidisation incompatible with Regulation (EC) No 1370/2007. Directive 2012/34/EC of the European Parliament and of the Council of 21 November 2012 establishing a single European railway area <sup>(2)</sup> also lays down specific obligations for the separation of accounts of railway undertakings.

<sup>(1)</sup> See in particular point 7 of the Annex to the Regulation.

<sup>(2)</sup> OJ L 343, 14.12.2012, p. 32. See Article 6 on the separation of accounts of railway undertakings and railway infrastructure managers.

Each public service contract should contain specific rules on compensation and should give rise to specific accounting entries. In other words, if the same undertaking has entered into several public service contracts, the accounts of the transport undertakings should specify which public compensation corresponds to which public service contract. At the written request of the Commission, these accounts must be made available in accordance with Article 6(2) of Regulation (EC) No 1370/2007.

#### 2.4.5. Article 4(1). Design of compensation schemes to promote efficiency

Recital 27 of Regulation (EC) No 1370/2007 states that in the case of a direct award or general rules, the parameters for compensation should be set in such a way that compensation is appropriate and reflects a 'desire for efficiency and quality of service'. This means that the competent authorities should, through the compensation mechanism, encourage the service providers to become more efficient, by providing the required level and quality of service with the fewest resources possible.

The rules on compensation in Regulation (EC) No 1370/2007 leave some leeway for the competent authorities to design incentive schemes for the public service provider. In any event, competent authorities are obliged to 'promote the maintenance or development of effective management by the public service operator, which can be the subject of an objective assessment' (point 7 of the Annex). This implies that the compensation system must be designed to ensure at least a certain improvement in efficiency over time.

Efficiency incentives should nevertheless be proportionate and remain within a reasonable level, taking into account the difficulty in attaining the efficiency objectives. This may, for example, be ensured through a balanced sharing of any rewards linked to efficiency gains between the operator, the public authorities and/or the users. In any event, a system must be put in place to ensure that the undertaking is not allowed to retain disproportionate efficiency benefits. In addition, the parameters of these incentive schemes must be fully and precisely defined in the public service contract.

Incentives to provide public services more efficiently should not, however, prevent the provision of high-quality services. In the context of Regulation (EC) No 1370/2007, efficiency must be understood as the relation between the quality or level of the public services and the resources used to provide those services. Efficiency incentives should therefore focus on reducing costs and/or increasing the quality or level of service.

#### 2.4.6. Article 6(1). Circumstances under which the Commission will investigate whether a compensation scheme complies with Regulation (EC) No 1370/2007

Public service compensation paid in accordance with Regulation (EC) No 1370/2007 is exempt from the requirement to notify State aid before it is implemented as laid down in Article 108(3) TFEU. Nevertheless, the Commission may be asked to assess a compensation scheme for reasons of legal certainty if a Member State is not sure whether the scheme complies with the Regulation. The Commission may also assess a compensation scheme on the basis of a complaint or an *ex officio* investigation if it is aware of evidence pointing to the non-compliance of that scheme with the compensation rules of the Regulation.

#### 2.4.7. Article 6(1). Differences between the Commission's *ex ante* and *ex post* investigations into compensation schemes

The main difference between the Commission's *ex ante* and *ex post* investigations into compensation schemes relates to the time at which the Commission assesses the scheme, not in the method used for analysing whether overcompensation is present.

When assessing whether a compensation scheme prevents overcompensation *ex ante*, for example in the context of a notification, the Commission will assess, among other things, the precise compensation parameters. In particular, it will pay attention to the cost categories that are taken into account for the calculation of the compensation, as well as to the proposed level of reasonable profit. Furthermore, it will consider whether an adequate mechanism is in place to ensure that, in the event revenues from the provision of public services are higher than expected over the lifetime of the public service contract, the operator is not allowed to keep any excessive compensation over and above the actual net costs, a reasonable profit margin and any rewards for efficiency gains stipulated in the contract.

The public service contract must also in principle provide for regular checks during the lifetime of the contract in order to detect and avoid at an early stage clear overcompensation situations from arising, in particular in the case of long-term contracts. The competent authorities are obliged to verify compliance with the terms of the public service contract during the lifetime of the contract. Computerised tools can be developed to help perform these checks in a standardised manner. Overcompensation must be assessed separately for each public service contract to avoid excessive profits for individual public services that are averaged out across several contracts.

In the case of an *ex post* investigation, whether the compensation received exceeds the net financial effect of the public service as defined in the annex to Regulation (EC) No 1370/2007 can be assessed on the basis of actual financial revenue and cost data, since the compensation schemes have already been put in place. The method does not change however: compensation should not exceed the compensation amount to which the undertaking was entitled according to the parameters set out in the contract in advance, even if this amount is not sufficient to cover the actual net costs.

#### 2.4.8. *Article 1(1) and Article 6(1). Ensuring that competent authorities will pay operators 'appropriate' compensation for the discharge of public service obligations*

According to Article 1 of Regulation (EC) No 1370/2007, 'the purpose of this Regulation is to define how, in accordance with the rules of [Union] law, competent authorities may act in the field of public passenger transport to guarantee the provision of services of general interest which are among other things more numerous, safer, of a higher quality or provided at lower cost than those that market forces alone would have allowed. To this end, this Regulation lays down the conditions under which competent authorities, when imposing or contracting for public service obligations, compensate public service operators for costs incurred and/or grant exclusive rights in return for the discharge of public service obligations'. Moreover, according to point 7 of the Annex to Regulation (EC) No 1370/2007, 'the method of compensation must promote the maintenance or development of [...] the provision of passenger transport services of a sufficiently high standard'.

This means that not only do the rules of Regulation (EC) No 1370/2007 aim to prevent any possible overcompensation for public service obligations, but also that they aim to ensure that the offer of public services defined in the public service contract is financially sustainable to reach and maintain a high level of service quality. The public service obligation should therefore be appropriately compensated so that the operator's own funds under a public service contract are not eroded in the long run, preventing the efficient fulfilment of its obligations under the contract and the maintenance of the provision of passenger transport services of a high standard as referred to in point 7 of the Annex to Regulation (EC) No 1370/2007.

In any event, if the competent authority does not pay appropriate compensation, it risks reducing the number of bids submitted in response to a competitive tendering procedure for the award of a public service contract, creating serious financial difficulties for the operator if the public service contract is awarded directly and/or reducing the overall level and quality of the public services provided during the lifetime of the contract.

## 2.5. Publication and transparency

The interpretative guidance provided in this chapter covers the obligation of competent authorities to publish annual reports on the public service contracts they are responsible for, as well as their obligations to ensure transparency about the award of public service contracts before and after the award procedure.

#### 2.5.1. *Article 7(1). Publication obligations of competent authorities with regard to their annual reports on public service contracts under their responsibility*

Article 7(1) requires each competent authority to publish an aggregated report once a year on the public service obligations for which it is responsible, the selected public service operators, and the compensation payments and exclusive rights granted to public service operators by way of reimbursement. This report shall distinguish between bus transport and rail transport, allow the performance, quality and financing of the public transport network to be monitored and assessed, and, if appropriate, provide information on the nature and extent of any exclusive rights granted.



The Commission understands the term ‘aggregated report’ in the sense that a competent authority should publish a comprehensive report about all the public service contracts it has awarded, while these contracts should all be individually identified. The information provided should therefore, besides the total values, refer to each contract, while ensuring the protection of the legitimate commercial interests of the operators concerned.

The public transport operators must provide all information and data to the competent authority in order to enable the latter to comply with its publication obligations.

To achieve the objective of this provision, which is to enable the monitoring and assessment of the public transport network in a meaningful manner allowing for a comparison with other public transport networks in a transparent, structured framework, the Commission encourages Member States and their authorities to voluntarily ensure ease of access to this information and to allow useful comparisons to be made. This could mean, for instance, that the information is published on a central website, such as that of an association of competent authorities or that of the transport ministry. The information and data should also be prepared in a methodologically consistent manner and presented in common units of measure.

2.5.2. *Article 7(2) and (3). Possibilities of competent authorities to discharge their publication obligations concerning public service contracts pursuant to Article 7(2) and (3)*

Competent authorities have certain obligations under Article 7 of Regulation (EC) No 1370/2007 to publish the intended (and concluded) award of public service contracts in the *Official Journal of the European Union*.

Article 7(2) states that at least one year before the publication of an invitation to tender or the direct award of a public service contract, competent authorities shall publish certain information on the contract envisaged in the *Official Journal of the European Union*.

Article 7(3) states that within one year of the direct award of a public service contract for rail services, competent authorities shall publish certain information on the awarded contract.

The Commission services have developed model forms and procedures that allow competent authorities to comply with these publication requirements. Through the possibility to reuse data, the forms and the publication procedure should also allow competent authorities, if they so wish, to reap synergies with the publication of a public tender for services pursuant to Article 5(3) of Regulation (EC) No 1370/2007.

The forms have been designed to fulfil the following requirements:

- to allow authorities easy access to the web application, to navigate the web application and to be comprehensible and clear;
- to clearly distinguish the publication requirements under Regulation (EC) No 1370/2007 from publication requirements under Directives 2014/23/EU, 2014/24/EU and 2014/25/EU;
- to request a level of detail of information that is not perceived as burdensome and thus can be acceptable to authorities;
- to be suitable for generating useful statistics on the award procedure of public service contracts and hence on the effective implementation of Regulation (EC) No 1370/2007.

During 2013, the Publications Office made an online publication procedure available on ‘eNotices’<sup>(1)</sup>. The procedure is based on these model forms for publication in the *Official Journal of the European Union*, in accordance with Article 7(2) and (3) of Regulation (EC) No 1370/2007. The publication of information about directly awarded public service contracts for rail transport in the *Official Journal of the European Union* according to Article 7(3) is done on a voluntary basis.

(1) <http://simap.europa.eu/enotices/choiceLanguage.do>

2.5.3. *Article 7(4). Right of interested parties to request information on public service contracts to be awarded directly before the actual date of award*

Article 7(4) provides that a competent authority, when so requested by an interested party, shall forward to it the reasons for directly awarding a public service contract. Recital 30 states that 'directly awarded public service contracts should be subject to greater transparency'. This needs to be read in conjunction with recital 29, which states the need to publish the intention to award a contract and to enable potential public service operators to react. A competent authority must determine its intention to award a contract directly at least one year in advance, since this information must be published in the *Official Journal of the European Union* (Article 7(2), in particular point (b)). Thus, interested parties are placed in a position to formulate questions a long time before the contract is awarded, which will be one year later at the earliest. In order to grant effective legal protection, the information requested in accordance with Article 7(4) should be provided without undue delay.

Making contracts more transparent is, by definition, also related to the procedure for awarding a contract. The greater transparency required by recital 30 therefore not only implies transparency after the award of the contract, but also relates to the procedure before the contract is actually awarded to the public transport operator concerned.

## 2.6. Transitional arrangements

This chapter provides interpretative guidance on some aspects of the provisions on transitional arrangements concerning contracts awarded before the entry into force of Regulation (EC) No 1370/2007 and those awarded during the transitional period from 2009 until December 2019.

2.6.1. *Article 8(2). Scope of application of the transitional period of 10 years starting from 3 December 2009*

Article 8(2) states that, without prejudice to its paragraph 3, 'the award of public service contracts by rail and by road shall comply with Article 5 as from 3 December 2019'. During this transitional period, Member States shall take measures to gradually comply with Article 5 to avoid serious structural problems, in particular relating to transport capacity.

Article 8(2) refers to Article 5 in its entirety. However, the Commission considers that only Article 5(3) concerning the obligation to apply open, transparent, non-discriminatory and fair procedures when granting public service contracts seems pertinent in this context. As stated in recital 31, the objective of the transitional provisions is to give competent authorities and public service operators enough time to adapt to the provisions of Regulation (EC) No 1370/2007. The obligation imposed on Member States to gradually comply with Article 5 is reasonable only if it concerns the obligation to apply open, transparent, non-discriminatory and fair procedures when granting public service contracts. It does not make sense that Member States 'gradually' apply the notion of internal operator or the exceptions defined in paragraphs 4, 5 and 6 of Article 5 of Regulation (EC) No 1370/2007 as they introduce more lenient provisions compared to the general Treaty principles and corresponding case-law. It does also not seem reasonable to say that the legislator wanted to postpone the full application of Article 5(7) concerning procedural guarantees and judicial review until 3 December 2019.

2.6.2. *Article 8(2). Obligations of Member States during the transitional period until 2 December 2019*

Article 8(2) states that within six months of the first half of the transitional period (by 3 May 2015), 'Member States shall provide the Commission with a progress report, highlighting the implementation of any gradual award of public service contracts in line with Article 5'. This clearly indicates that Member States cannot wait until 2 December 2019 before starting to comply with the general rule of ensuring competitive tendering procedures for public service contracts that are open to all operators on a fair, transparent and non-discriminatory basis. Member States should take appropriate measures to gradually comply with that requirement during the transitional period to avoid a situation in which available transport capacity in the public transport market will not allow transport operators to satisfactorily respond to all competitive tendering procedures that would be launched at the end of the transitional period.

2.6.3. *Article 8(3). Meaning of 'limited duration comparable to the durations specified in Article 4'*

Article 8(3)(d) states that public service contracts awarded 'as from 26 July 2000 and before 3 December 2009 on the basis of a procedure other than a fair competitive tendering procedure [...] may continue until they expire, provided they are of limited duration comparable to the durations specified in Article 4'.

The Commission considers that the term 'comparable to the durations specified in Article 4' should be interpreted restrictively, so as to ensure that Member States work towards achieving the objectives of the Regulation from the date of its entry into force on 3 December 2009. The Commission therefore takes the view that it would be sensible to consider that the duration of public service contracts should be similar to those indicated in Article 4.

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