Railway Concessions—Heading Down the Right Track in Argentina

Argentina privatized many of its railway services by concession contract during the early 1990s. The reforms have been remarkable for their speed and innovation—despite the complexity of the issues and the lack of “off-the-shelf” models to follow at the time. The overall result has been positive. Many services have improved. Traffic has grown—up about 180 million passenger trips a year. Subsidies have been cut dramatically—down from US$2 billion or so a year to a little more than US$100 million. But as with any complex reform, there is an unfinished agenda. And with the Argentine approach becoming a model for other countries in Latin America, this review of the lessons starting to emerge from the reform experience is a timely one.

Strategy for reform

When the Menem administration set the railway reform in motion in 1990, Ferrocarriles Argentinos, the largest operator, ran a national network of about 35,000 kilometers, employed 92,000 people, and was losing about US$1.4 billion a year (1992 dollars). These losses were a big drain on the Treasury and the main motivation for reform. On top of this, the fixed assets were in poor shape—in 1990, 54 percent of the track network was in fair or bad condition, and only half the locomotives were available for service. As a result, the operator was losing traffic and market share.

The reform strategy the government adopted was to break up the network into monopoly franchises that combine track and service operations—identifying the profitable and unprofitable segments in the freight and passenger markets, awarding concessions to the private sector through competitive bidding, and transferring a sizable network to the provinces. This single-operator strategy means that competition will arise not from several operators using the same track but from several potential op-
operators bidding for the exclusive right to provide a service during the life of a concession

The freight network

The freight network was partitioned into six vertically integrated concessions, each for thirty years with an optional ten-year extension. Concessionaires are responsible for all operations and maintenance and for the investment program proposed in their bidding documents. Each concessionaire is free to introduce new working rules and practices. Because the fixed assets remain the property of the government, private operators must pay the state a fee for the use of the rail infrastructure and rent for the use of the rolling stock. Operators can offer intercity passenger service, but must allow other passenger operators access to the track in exchange for a toll. Freight tariffs have been deregulated, but operators must file maximum rates with the regulator for approval.

The commuter network

The government identified seven suburban railway services for privatization. The concession terms were set for ten years (twenty for the metro, or SUBTE, of Buenos Aires), and the model of concessioning was similar to that for the freight network, though it differed in two important respects. First, while freight concessionaires were expected to make a profit, it was accepted that suburban rail might need public subsidies for operation, rehabilitation, and investment. The government identified for each line the type and amount of investments needed, which the private operator was expected to undertake. The regulator would set the maximum fares—with automatic increases for rising quality of service. Concessionaires would also pay a nominal fee to the government for the use of the rail infrastructure.

Second, concessions were awarded on the basis of a single criterion: the lowest subsidy required to operate the line and undertake the specified investment and rehabilitation program. Bidders for the freight concessions had faced a complicated set of weights attached to the criteria used to select the winning bid—experience, investment plan, employment pledge, local investor participation, fees and rent, the access toll. The method for the commuter concessions was more transparent, and probably induced more rational bidding behavior from potential concessionaires (see below). In the end, the subsidy requested by the winning consortiums amounted to slightly more than US$1 billion (1992 dollars), spread over twelve years—most of it for capital investment and system upgrading, not operations.

The intercity passenger services

Viability studies of the intercity passenger services concluded that only one corridor, Buenos Aires–Mar del Plata, was commercially profitable. Low traffic levels prompted the government to decide not to subsidize any of them. Instead, the government offered the provinces the option to continue providing the services at their own expense. Most provinces rejected this offer, so the routes were closed. Provinces that accepted the offer entered into concession agreements with the state, which transferred to them the rolling stock and other equipment necessary to run the services. The provinces agreed to subsidize the services and run them over the network concessioned to the freight and commuter rail operators, paying a fee to these operators for access to and use of the track.

Impact

With only about three years having elapsed since the awarding of concessions, it is still too early to tell how much more successful the new operators have been. And concessionaires have been hampered by the unexpectedly poor state of the assets on transfer—maintenance and inventory seem to have been neglected during the final months of public ownership. But some preliminary conclusions can be reached. Excluding SUBTE, the commuter railway concessions show on average a healthy 75 percent increase in passenger traffic. Car kilometers increased only 25 percent, pointing
to more effective use of capacity. The SUBTE has experienced 28 percent passenger growth—perhaps in part because of worsening road congestion, but also in response to improved customer service, security, and safety, particularly at stations. Growth in revenue-passengers carried has also been impressive, in large part because of the measures against fare evasion that all private operators adopted.

Traffic has also grown in freight services, but the private operators are reaching on average only 60 to 70 percent of their projected traffic. Some estimates put revenues as low as 50 to 60 percent of projections. Part of the explanation for this is stronger-than-expected competition from trucks. But another part is overoptimistic demand projections—the bidding process prompted concessionaires to make unrealistic projections and investment promises to help them win concessions. The consequence is that freight concessionaires have not been fulfilling their investment promises, which amount to about US$1.2 billion over fifteen years. For now, the regulatory agency that oversees the freight concessions is filing the requisite penalties, but has problems enforcing both the payment of the penalties and the investments. Most suburban rail operators also are disinvesting in the network, failing to maintain lightly used lines. This presents the government with the following dilemma: If it enforces the letter of the contracts, making the concessionaires undertake the promised investments, they may go out of business, ceasing service. If instead the government does not enforce the contracts, it loses credibility, sets a precedent, and incurs a reputation cost. And even if the concessionaires could afford to comply with their contracts, making them undertake investments that might be commercially unnecessary is questionable from an economic perspective. What is needed is a mechanism for flexible yet fair renegotiation of concession contracts.

Lessons

One objective for privatization was to minimize or eliminate the fiscal drain from the railway deficits, reducing subsidies to the minimum possible level by inducing the private sector to take over profitable segments of the freight market and to take over the commuter railway lines in exchange for the lowest minimum subsidy. Enough bidders competing for the right to operate the monopoly concessions would ensure that any subsidies would be kept to a minimum. Private sector control of operations and maintenance was expected to improve efficiency and service quality.

Competition for the market

How well has competition for the market worked? It is difficult to tell with precision. There were so few bids for the freight concession, for example, that it is reasonable to wonder whether the full benefits of competition have been realized. The answer is obscured in part by the flawed scoring system in this early bidding process. Nevertheless, government subsidies for railways have been significantly reduced, through increased labor productivity and cutting services. The reduction in employment on the services previously operated by Ferrocarriles Argentinos is particularly dramatic—from 92,500 in 1989 to about 17,000 now. The government went to considerable effort to ensure that severance pay would ease the layoffs. No more than half the labor savings were achieved by cutting services. The most significant cuts were in intercity passenger services, where the number of train kilometers operated fell by about three-quarters and the number of passengers by perhaps two-thirds.

Flexible contracts

The many freight concessionaires reportedly not meeting their investment promises are essentially disinvesting in the network, failing to maintain lightly used lines. This presents the government with the following dilemma: If it enforces the letter of the contracts, making the concessionaires undertake the promised investments, they may go out of business, ceasing service. If instead the government does not enforce the contracts, it loses credibility, sets a precedent, and incurs a reputation cost. And even if the concessionaires could afford to comply with their contracts, making them undertake investments that might be commercially unnecessary is questionable from an economic perspective. What is needed is a mechanism for flexible yet fair renegotiation of concession contracts.

Challenges ahead

As can be expected from a complex and challenging exercise, the railway privatization still has an unfinished agenda. An overall regula-
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The single-operator strategy shifts the burden of preserving effective competition to the contract and to the regulator. Once the concessionaire is selected, a specialized regulatory agency becomes responsible for any final contract negotiations, for contract enforcement, and in some cases for other regulatory functions. This system appears to work reasonably well, with three qualifications: The first, and most easily corrected, is that broad grants of discretionary regulatory authority to guard against monopoly abuse, such as that enjoyed by the freight rail regulator, are probably unnecessary and unwise. The regulatory commissions should focus on enforcing and monitoring contracts and not be distracted by issues of monopoly. Most of the modes already face strong competition. The freight railroads, for example, compete fiercely with trucks and with one another.

The second problem, at least as important but far more difficult to solve, is how to cope with the need to periodically renegotiate or modify the concession contracts. Renegotiation or modification may seem antithetical to the whole idea of concession contracting: the contract system is meant to protect both the public and the concessionaire by specifying all the terms of the concession in advance. The prospect of renegotiation could undermine potential concessionaires’ incentives to bid honestly and open the door to political interference. But Argentina’s transport concessions showed that it is probably impossible to specify all the conditions in advance, especially in an economic environment changing as rapidly as Argentina’s. So the contracts must be seen as living documents. Even carefully drawn contracts may become obsolete because the world changes quickly and in unexpected ways. Part of the problem may be that the rail concession contracts were poorly drawn. But in many ways the obsolescence of the contracts stems from the success of the economic reforms in Argentina.

If revisions are to be considered, they must be based on clear, agreed, preestablished criteria. Such criteria could include: How would overall efficiency be affected? Would investor and consumer interests be protected? To adjudicate disputes, one procedural option is to rely on normal commercial contract law and the incentives and opportunities it creates for the voluntary renegotiation of contracts that no longer serve the interests of either party. But courts tend to be better at enforcement than at renegotiation. Another option is to establish a special commission to arbitrate contract disputes using clear and fair rules. The challenge is to find such rules. One possibility is a rule that, in the event of a negotiating impasse, requires the arbitrator to choose one of the two parties’ best and final offers, without modifications. Allowing no modifications would give both parties (the government and the concessionaire) strong incentives to be reasonable and to recognize each other’s legitimate interests. This system has been used successfully with labor contracts in the United States.

A final, related concern is the proliferation of regulatory commissions. There is now one for each transport concession program. If arbitration commissions are to be used in addition, they should be independent from the enforcement commissions, otherwise, the arbitrator would also be one of the disputing parties to the contract. But some of these commissions could handle several sectors. Argentina does not need a large number of enforcement or arbitration commissions.


José Carbajo, Private Consultant, and Antonio Estache, Latin America and the Caribbean, Country Department I (aestache@worldbank.org)