

# **9<sup>TH</sup> CONFERENCE ON COMPETITION AND OWNERSHIP IN LAND TRANSPORT**

## **LOCAL RAILWAY TENDERS IN ITALY: THE IMPOSSIBLE COMPETITION**

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### **SUMMARY**

The Italian local railways should have been tendered in 2004, according to the public transport (PLT) reform of 1997. The "competition for the market" was - in the view of the reform supporters - the best way to improve the effectiveness and the efficiency of such a neglected public service.

The management of these tenders was in charge of the Regional Governments, according to the decentralization brought by the reform (see also Stanta in Thredbo 8).

As a matter of fact, till today only three Regions in Italy have tendered their PLT railway services and nowhere more than one admissible tender was submitted. Everywhere the incumbent kept the control of the market, sometimes by means of defensive alliances.

The paper investigates the competitive and regulatory framework of the Italian PLT railway reform. The successes and the failures in the tenders of Veneto, Liguria and Lombardy - the first exploited in Italy - are then discussed.

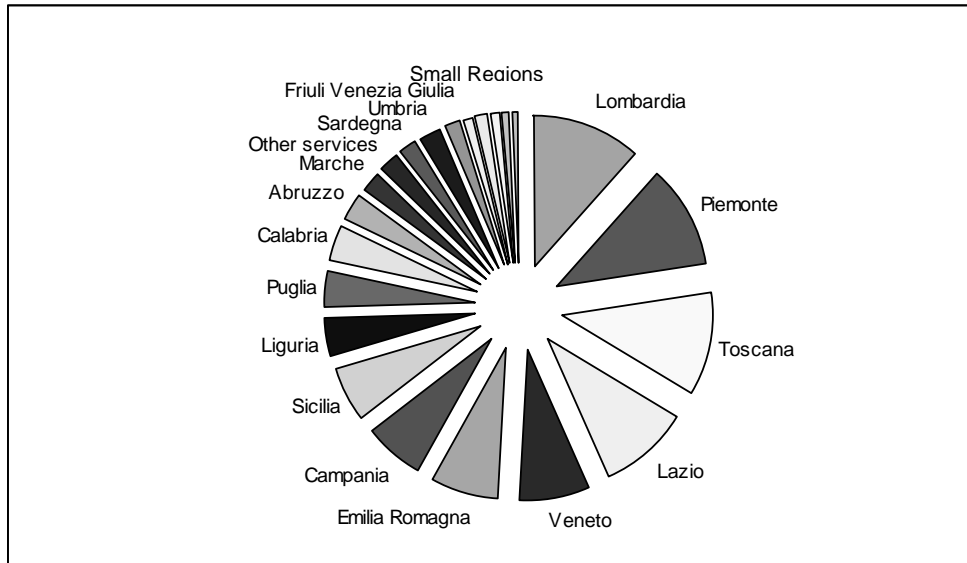
### **FRAMEWORK**

The reform of the Italian public transport system in 1997 created a new scenario for the local railway system. In early 2001 a decentralisation process took place, resulting in Regional Governments rather Central Government regulating local-rail services.

The regional services are provided by about 30 train operating companies (TOCs).

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Trenitalia – the former national rail company that is owned by the Central Government – produced in 2002 about 175 ml kilometres per year travelled by trains (train\*km), carrying about 20 billion passengers\*km on local-rail services. This amount is more than 80% of the whole production of local-rail services in Italy.



*Figure 1: Trenitalia's services split among the Regions*

The remaining 29 TOCs are mainly very small regional companies, each of them is usually owned by a Regional or Provincial Government. They carry, as a whole, every year about 3.7 billion passengers\*km (18.5% of the market).

Five of the twenty Italian Regions reach more than half of the Trenitalia's production. The main regional TOCs are located in these leading Regions too. Lombardy hosts both the biggest Trenitalia's service and the larger Regional TOC, called Ferrovie Nord Milano (FNM), that recorded, in 2002, 7.5 millions train\*km and 1.2 billion passengers\*km.

As regards the subsidies, the Regions partially depend upon the Central Government for getting local-rail budget. In fact, the Central Government decided to pass a lump sum to the Regions every year from the year 2001 on. This sum was fixed at the level of expenditure of the year 1999: 1.9 billion Euro for the fifteen Regions – called "Statuto Ordinario" Regions –, listed in the following table, that accepted the decentralisation. The remaining five – called "Statuto Speciale" Regions – temporary refused the decentralisation.

The subsidy was then shared among the Regions as shown in the table.

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REGION	SUBSIDY TO TRENITALIA [ml Euro]	SUBSIDY TO OTHER TOCs [ml Euro]	TOTAL SUBSIDY [ml Euro]	POPULATION (1991) [ml Inhab.]	SUBSIDY PER INHABITANT [Euro]
Lombardia	173.1	137.6	310.6	8.8	35.1
Campania	120.9	156.1	277.1	5.6	49.2
Lazio	164.4	61.0	225.4	5.1	43.8
Puglia	42.8	170.1	213.0	4.0	52.8
Piemonte	161.9	20.4	182.3	4.3	42.4
Toscana	148.2	9.8	158.1	3.5	44.8
Calabria	64.2	43.8	108.0	2.0	52.2
Emilia-Romagna	69.5	38.1	107.7	3.9	27.5
Veneto	89.9	4.7	94.6	4.4	21.6
Liguria	65.8	3.7	69.4	1.7	41.4
Abruzzo	31.7	29.2	60.9	1.2	48.7
Basilicata	20.6	20.1	40.6	0.6	66.6
Umbria	27.1	13.4	40.5	0.8	49.9
Marche	28.3	0.0	28.3	1.4	19.8
Molise	17.7	0.0	17.7	0.3	53.6
TOTAL	1,226.0	708.0	1,934.2	47.9	34.1

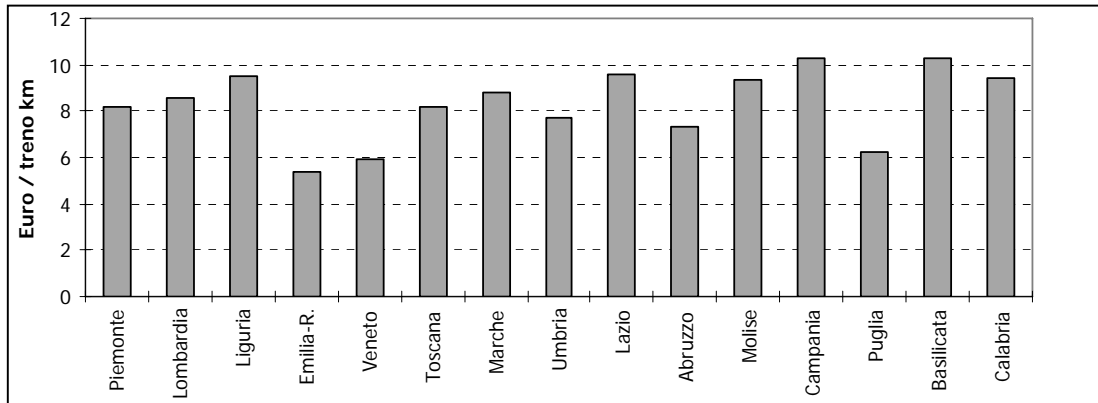
*Figure 2: Budget for local-rail services transferred by the Central Government to the Regions (2002)*

Additional needs or increased services must be paid by each Regional Government by its own.

The whole subsidy was shared by the Central Government among the Regions according to the existing gap between costs and passengers revenues, which depends mainly on the load factor of each route.

Therefore the Central Government gave more funds to the Regions responsible for a set of less profitable routes, as the subsidy per inhabitant distribution in Figure 3 shows. In such a way all services produced at the decentralisation day were preserved. Meanwhile, the Regions were lacking in any financial incentive to improve the service in the most populated areas and to reduce costs or services elsewhere.

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*Figure 3: Subsidy per inhabitant distribution among the fifteen "Statuto Ordinario" Regions*

According to the reform, each Regional Government must pay the TOCs – using the transferred subsidies – the compensations due for the public service obligations set in appropriate contracts, like the following:

- connections,
- timetable,
- frequency,
- punctuality,
- reliability (number of trains to run, compared to the total planned),
- cleaning of trains,
- information to passengers.

The Regions can plan freely the service – i.e. by spending the assigned subsidy as best as they can –, but the Central Government asked them not to reduce the kilometres produced at the decentralisation day.

From 2004 on the Regions are then asked by law to put out for tender all local-rail services.

### **THE EXPERIMENTAL TENDERS**

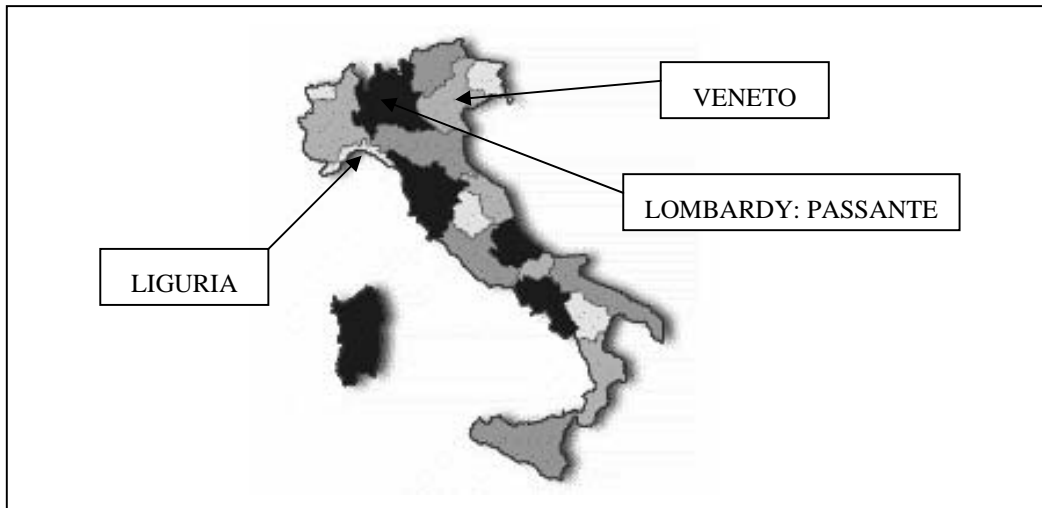
#### **Only three tenders**

Competitive tendering started really in 2004 – as asked by the reform –, but on a smaller scale. Only three Regions called for tenders for their local-rail services:

1. Veneto, in January,
2. Liguria, at the end of February,
3. Lombardy, in April.

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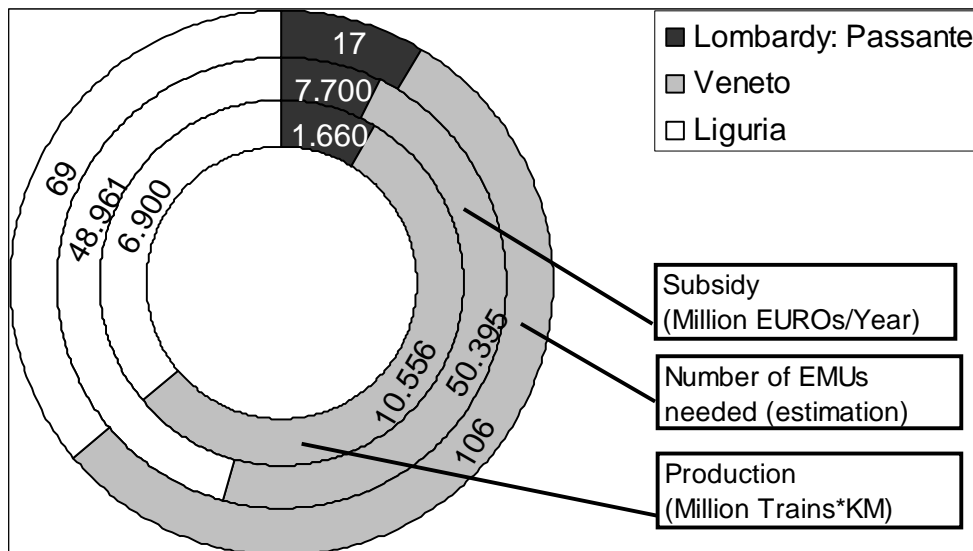
Such a slow start of tendering can be explained with the uncertainty brought by a debate on the barriers still affecting competition in the Italian rail market, as better explained in the following paragraphs. So, one can really call these first attempts “experimental tenders”.



*Figure 4: The Regions that carried out the experimental tenders*

The experimental tenders are rather different (see Figure 5):

1. Veneto tendered out a 10.5 ml train\*km lot, that included all local-rail services except those



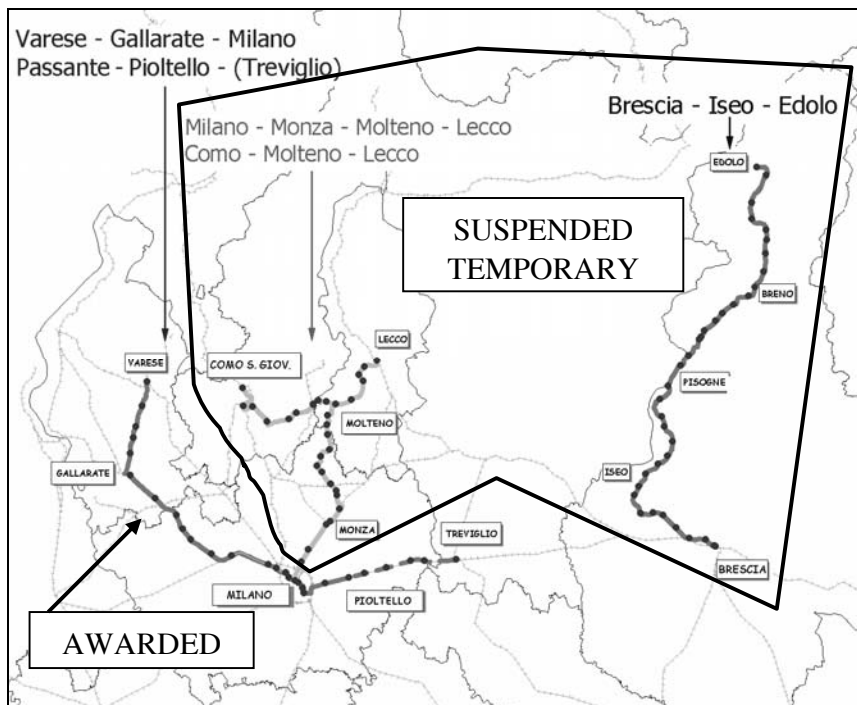
*Figure 5: The main figures of the experimental tenders*

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in the Venice metropolitan area. The auction started from 4.77 Euro/km, plus 1.89 Euro/km for track-access toll;

2. Liguria called for tender for its whole local-rail service: 6.9 train\*km, starting from 7.09 Euro/km, plus 2.40 Euro/km for track-access toll;
3. Lombardy called for tender only for three small lots – 3.7 ml train\*km –, 12% of the whole service (see also Stanta in Thredbo 8). One of them – called “Passante” – was awarded in March 2005; the others are still suspended.

The Passante lot weights 1.66 ml train\*km and it was called for 4.64 Euro/km, plus 2.17 Euro/km for track-access toll.



*Figure 6: The three experimental lots in Lombardy*

All tenders gave the contractor the right to collect the fares (“net cost” contract).

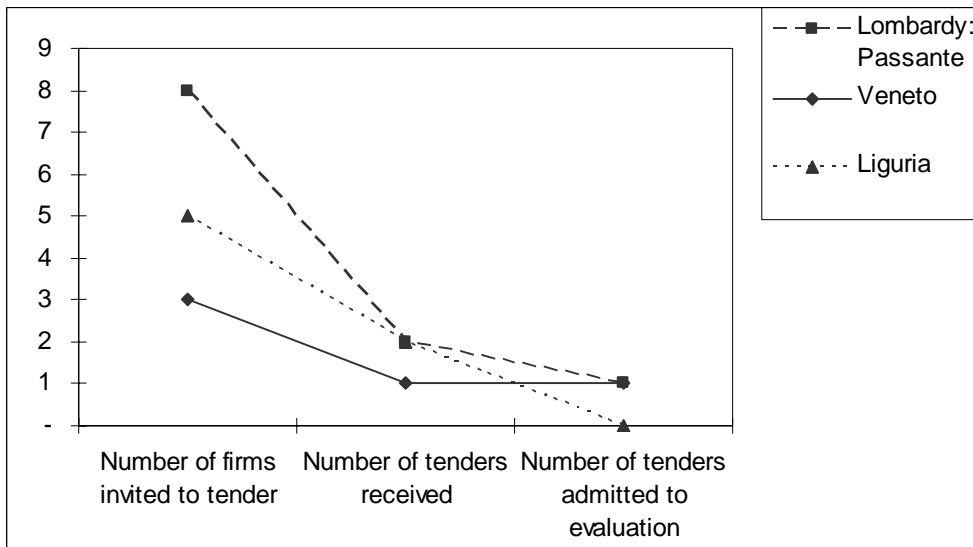
### Steps of the procedures

The procedure to award the tenders had to be chosen among those listed in the EU 1993/38 Directive, co-ordinating the procurement of entities operating in the water, energy, transport and telecommunications sectors.

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Veneto, Liguria and Lombardy chose the “restricted” procedure, that require the contracting entity to select a list of qualified competitors before inviting them to tender. Direct negotiations between the contracting entity and the competitors are not admitted.

Eight companies were invited in Lombardy, five in Liguria and three in Veneto, but everywhere the competitors decreased quickly when asked to submit their tenders (see Figure 7).



*Figure 7: Number of competitors during the procedures*

**Tender specifications**

The experimental tenders followed a similar approach in the tender specifications.

As regards the design of service, at first, the competitors were asked to submit a project, following the requirements of the contracting entity.

In practice, they were allowed to propose only minor variants. The dominant role of the contracting entity was due mainly to the agreements between it and the Infrastructure Operating Company RFI that came before each call. Through these agreements the contracting entity booked enough capacity on tracks to make it possible for the winner to produce the minimum service asked by each call.

If the competitors offer variants, they must sign an additional agreement with RFI to book the capacity. Such a burden of bureaucracy is necessary because the tendered services will share the tracks with other trains operated by other companies.

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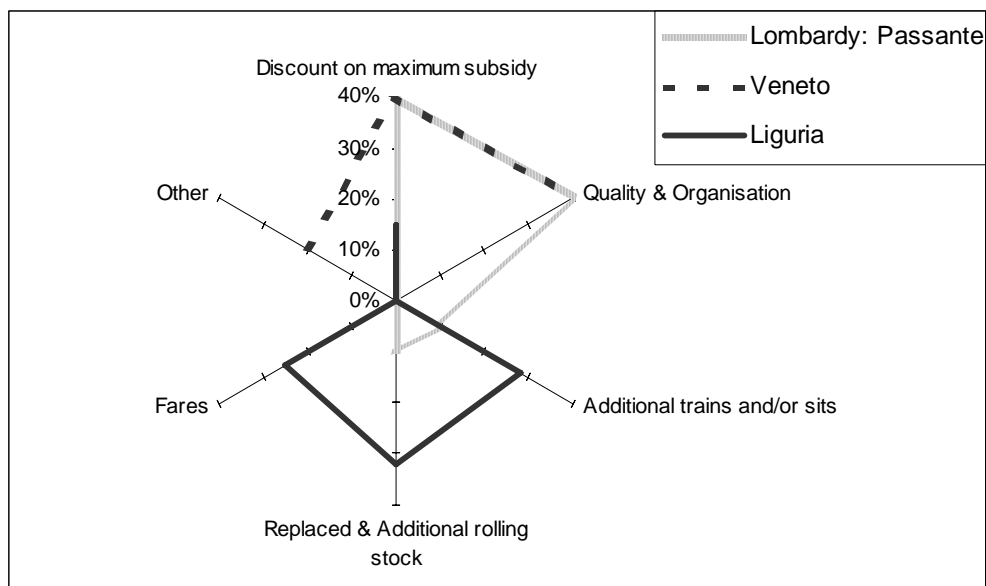
Then, in the same manner, as regards quality the tender requirements fix the minimum obligations and the competitors can offer improved levels of service.

One can find more differences in the tender specifications about the availability of the rolling stock and the infrastructure actually owned/used by the incumbent. This issue – that can be a barrier for the new entrants – will be discussed in a following paragraph.

Finally, the basic fares are set by the contracting entity in Lombardy and Veneto. In Liguria they are instead decided by the competitors within a range established by the contracting entity.

### Award criteria

In the following figure we summarise the criteria used in each experimental tender to award the contract.



*Figure 8: The award criteria in the experimental tenders*

The discount on maximum subsidy had the same weight in Lombardy and Veneto (40%). It weighted less in Liguria (15%), where the contracting entity preferred to reward reduced fares (25%), replaced rolling stock (32%) and additional trains or trains offering more sits than the minimum requirement (28%).

After many years of poor quality and reliability Lombardy gave to quality 40% of the available points. Each tender had to show in a plan how the service will be managed and how the commercial issues will be performed. The plan was evaluated by a technical board of experts.



## **Results**

All tenders ended in an unsatisfactory way, from the point of view of competition:

1. the Regional Government of Veneto received only one tender from a consortium of the incumbent Trenitalia and the small regional TOC owned by the Regional Government itself. The contract was awarded at the end of December 2004;
2. the Regional Government of Lombardy received two tenders, but only one was admitted to evaluation, because of a formality omitted by the second tenderer. The contract was awarded in March 2005 to a consortium of the incumbent Trenitalia, the urban metro&bus operator ATM, owned by the Municipality of Milan, and the regional TOC FNM, owned by the Regional Government itself.

The excluded TOC – CONNEX – complained and appealed to the anti-Trust Authority;

3. the Regional Government of Liguria received two tenders, but they both were not admitted to evaluation, because they did not conform to the requirements of the contracting entity:
  - Trenitalia did not accept a clause asking it to transfer its rolling stock to the incoming contractor at the end of the contracting period;
  - FNM was lacking of essential information in its tender. FNM managers also stated that it was for them impossible to provide enough rolling stock – about 70 EMUs – in time to the starting date – only 21 months after the call.

In a few words, nowhere more than one admissible bid was submitted and the incumbent succeeded in keeping the control of the market, usually by means of defensive alliances.

The following paragraphs, therefore, try to underline some facts that can explain why competitive tendering in Italy did not work at this early stage.

## **RAIL TENDERS: WHO DOES WHAT**

The flow-chart in Figure 9 well summarises the relationships among the key actors in the Italian local-rail market. The connections by lines show the hierarchical links, such as ownership, regulation, appointment of managers; the connections by arrows show the functional links.

Some highlights:

1. about ownership:
  - the both Governments – National and Regional – own one of the Italian competitors;
  - the national railway company – FS – owns both the main incumbent – Trenitalia (TrIt) – and the Infrastructure Operating Company (IOC) – Rete Ferroviaria Italiana (RFI);

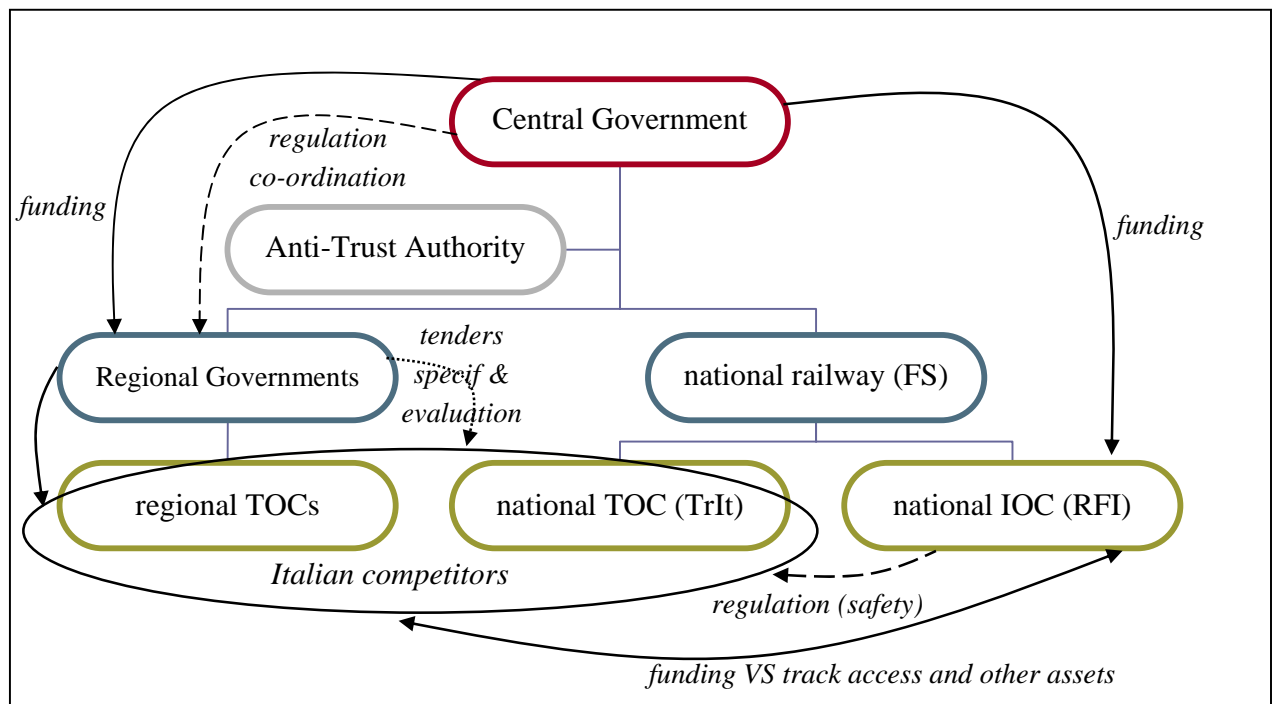


Figure 9: Structure of the Italian local-rail market

2. about functions:

- the Central Government pays for the local-rail services tendered by the Regional Governments (except for additional services, as told before);
- the Central Government also regulates the competition in the rail market. These regulations are enforced through an independent anti-trust authority, that imposes ex-post penalties for collusive agreements or abuses;
- the IOC issues the safety certificate required by the EU directive 2001/14 to access the tracks;
- the IOC pays its costs both by Government funds and tolls paid by the TOCs.

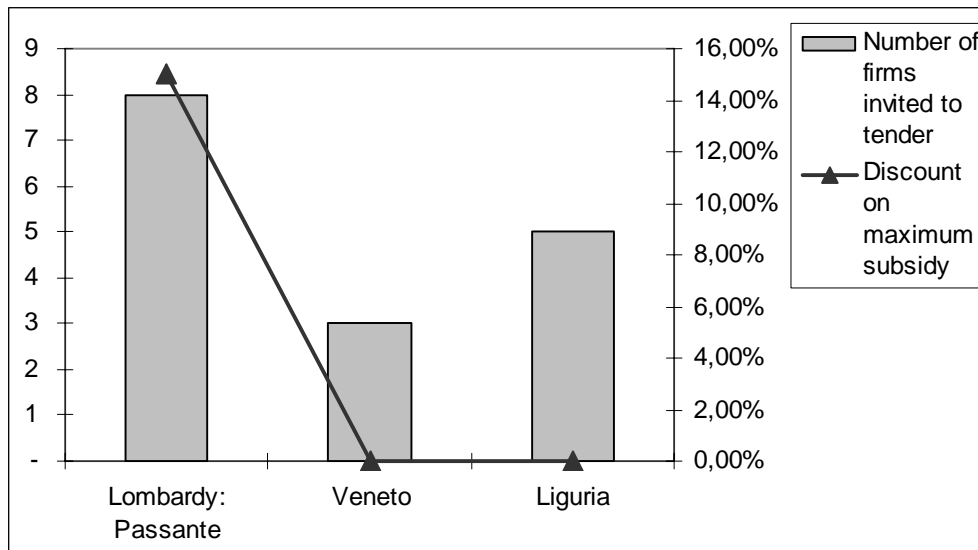
Such a design is affected by several weaknesses:

- the regulator – mainly as regards competition – and funds provider (the Central Government) is not independent from the incumbent Trenitalia;
- many auctioneers (Regional Governments) are not independent from some competitors (regional TOCs);
- the incumbent Trenitalia can influence both track access and the use of other infrastructural assets through the parent company FS;

- the safety regulator (RFI) – that also certifies the TOCs, according to directive EU 2001/14 – is not independent from the incumbent Trenitalia.

## A COMPETITIVE MARKET NEED HOME-BASED COMPETITORS

It seems obvious this statement: “competition needs competitors”. In other words, a successful competitive tendering – in terms of discount or better quality – needs more than one potential winner. If one has a look to Figure 10, the Regional Government of Lombardy – that attracted the maximum number of competitors – gained the maximum discount.



*Figure 10: Comparison between number of firms invited to tender and the discount*

This result benefits by a set of tender requirements in Lombardy – especially about the rolling stock and about some infrastructural asset – that gave to every competitor good chance of victory. But this is not enough when – as shown in Figure 7 – the contracting entity fails to receive more than one void tender.

The history of competitive tendering in the world shows that more domestic competitors can ease that task.

Home-based competitors – in fact – can know better the environment and the local procedures. They can also manage better the vital relationships with the contracting entity.

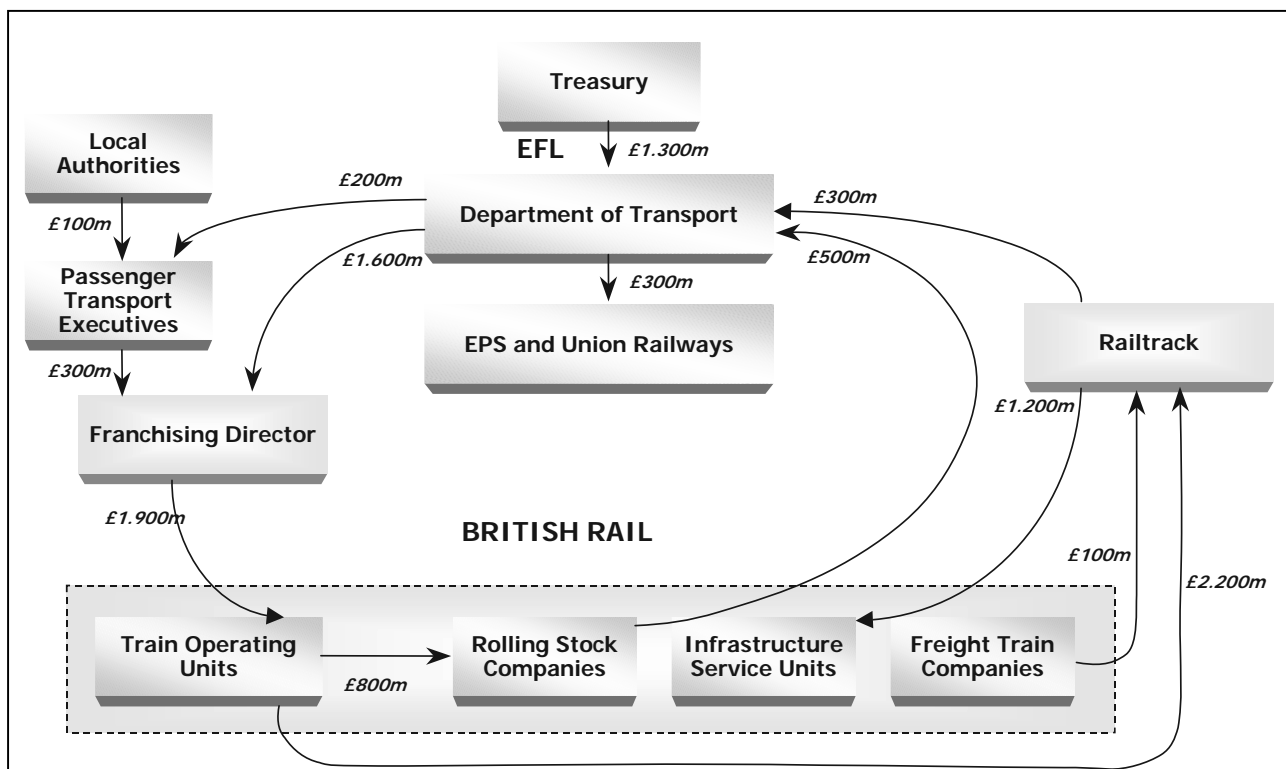
Somewhere abroad a domestic market was “created” by the regulator by reducing the incumbent’s size:

- in Holland (see Van de Velde and Pruijboom, 2005) the bus incumbent Connexxion had to sell some subsidiaries to foreign companies before competitive tendering started;

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- in Great Britain (see Glover, 1998) British Rail was shared in about 100 pieces and each piece was sold out by competitive tendering – a procedure called “franchising”.

Both Holland and Great Britain had – before competitive tendering – no other competitor than the incumbent.



*Figure 11: The “One hundred pieces railway” (Murray, 2001) in Great Britain (Hope, 1994)*

Italy, instead, did not see till now such a “Company reform”. So, the incumbent Trenitalia was faced by several small Italian regional TOCs – rarely associated – or by bigger multinational companies based abroad (CGEA Connex, Arriva, First, and Keolis through the subsidiary Citypendeln Sverige). The greatest regional TOC – Ferrovie Nord Milano –, for example, is 25 times smaller than Trenitalia.

Most of them therefore abandoned after having received the invitation to tender. On the other hand, ATM Milano – the new entrant of the Passante tender, coming from the bus sector – joined the winning consortium after the invitation.

At this stage of the reform, the National Government should promote changes in the rail market, with the aim to encourage the growth of consistent competitors to Trenitalia.

Useful politics can be:

- reduction of Trenitalia's size (i.e. by mandatory subcontracts);
- mergers and acquisitions, as regards the existing regional TOCs.

These politics could also be accompanied by a privatisation program with the aim to overcome the present public ownership of both the incumbent and its Italian competitors. The day by day story of the experimental tenders in fact showed how public ownership of the TOCs is an obstacle to fair competition.

## **TOO MANY BARRIERS**

A natural monopoly arises when the cost and/or the time to acquire some key assets make it not feasible – from the economic point of view – to come into a market. That happens sometimes about railways.

As regards local-rail, the main barriers to come into the market can be:

1. tracks;
2. depots and maintenance facilities;
3. stations;
4. selling machines and real-time information devices;
5. rolling stock;
6. the incumbent's personnel.

A few comments about the above listed issues:

- to use the existing tracks (issue n.1) is nowadays not avoidable. The access to tracks is therefore a barrier, especially if the competitors must operate trains together with other non-tendered services – freight, Intercity, – on the same tracks, as happens usually in Italy;
- on the contrary, the incumbent's present depots, workshops and rolling stock (issues n.2 and n.5) can be replaced by new ones owned by the competitors, but this is often not feasible, due to the tender specifications. So, they can become severe barriers.

For example, rolling stock is certainly a barrier if:

- the service is awarded to the cheapest tender,
- the contract lasts less than the pay off of the assets, 20 years, at least,
- only a few months are available between the end of the procedure and the start of the service.

The above outlined tender specifications make the incumbent's tender invincible, because:

- it does not exist in continental Europe a market where the new entrants can buy second-hand rolling stock well suited for the services tendered in Italy;
- it is not relevant the better quality of the new entrants' new rolling stock, compared to the incumbent's old one, and the pay off of the new rolling stock hangs only over the new entrants' balance sheets;

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- the incumbent's mixed fleet - as regards the age - is partially paid off, while the new entrants must pay off their new fleet wholly within the contract duration;
- if winner, a new entrant can not start its service on time, due to the long time needed to receive enough rolling stock: as regards the Veneto tender, for example, we estimated that the industry could deliver that fleet in about four years, at least.

Moreover, the rolling stock industry will not give priority to orders coming from many TOCs that take part to a competitive tender until it is awarded.

Besides, the European incumbents - i.e. the national rail companies - can control the supply of rolling stock in each country through their big orders of rolling stock - often with technical specifications that make them not interoperable. In such a way they can saturate the capacity of the rolling stock makers.

- the stations and other land facilities for ticketing and information (issues n.3 and n.4) are key contents of the quality&patronage oriented net-cost tenders. They can become barriers when the incumbent benefits of a preferred access to them;
- many tender specifications ask the incumbent's personnel to be moved to the winner; usually the wages and the contract rules must be maintained too. The new entrants, in this way, can not succeed in asking lower subsidies than the incumbent. In fact, cost savings in a labour-intensive industry, like the railway, come mainly from the personnel (reduction of surplus and/or improvement of efficiency).

How the contracting entities faced these problems in the experimental tenders?

It should be noted, at first, that the Regional Governments had no powers to remove most of the above listed barriers. In fact, it was soon clear that the key choices about how the services should be tendered were still in the hands of the National Government, as Figure 9 shows very well:

- tracks, depots, workshops, stations and the communication net are under control of the IOC RFI, that is owned by the National Government and that is not independent from the incumbent Trenitalia;
- as matter of fact, at present the rolling stock is owned by the incumbent Trenitalia. Only the National Government – that is both the owner of Trenitalia and the regulator (as regards competition) – can remove this barrier. One can follow the British approach – the rolling stock is moved to some ROSCOs that lease it to the TOCs – or something else.

Given such a regulatory framework, what the Regional Governments wrote in the tender specifications is shown in Figure 12. In a few words:

- moving from the principles in EU Directive 2001/14, the Regional Governments asked the IOC to agree with them, before the call for tenders, the terms under which its asset can be used by every competitor – the incumbent or a new entrant.

An agreement was signed for each tender. In these agreements the Regional Governments booked the capacity on the tracks needed for each tender. The IOC and the Regional

	rolling stock	present depots and workshops	depots and workshops for this tender	stations	electronic ticketing	information	personnel	capacity on tracks	present rolling stock	rolling stock for this tender	present depots and workshops	depots and workshops for this tender	stations	information	personnel	capacity on tracks	present rolling stock	rolling stock for this tender	present depots and workshops	depots and workshops for this tender	stations	information	personnel	capacity on tracks	
	LOMBARDY: PASSANTE								LIGURIA								VENETO								
NATIONAL GOVERNMENT																									
REGIONAL GOVERNMENT	X							X									X								X
INFRASTRUCTURE MANAGER			X	X		X						X		X						X	X	X			
INCUMBENT		X			X		X		X	X	X		X		X		X	X	X					X	
COMPETITORS										X								X							

Figure 12: Placement of some key assets in the experimental tenders

Governments also agreed some terms to use the RFI’s assets. The Regional Governments, however, did not succeed in giving the new entrants the same rights of the incumbent: RFI did not accept to rent them the same depots and workshops where the local trains today are maintained and stay when out of service. Therefore, in Lombardy RFI gave the new entrants part of an abandoned workshop; in Liguria and Veneto the use of the present depots should be asked to the incumbent by the winner.

Everywhere the right to use the stations – somewhere shared with other TOCs – was instead given to every competitor.

- on the other hand the tender specifications in Lombardy differed from the others mainly as regards the size of the lots and the rolling stock. In fact, the Regional Government tried to encourage the participation by reducing some barriers:





- a) small lots – 2 millions train\*km p.a. maximum – to ease the take-over;
- b) public ownership of the rolling stock: the Regional Government bought 15 new double-deck EMUs for the Passante lot (a 110 million Euros investment); these EMUs are given for free to the winning TOC, that must guarantee its maintenance.

The Governments of Liguria and Veneto, instead, preferred to ask each competitor to provide its own rolling stock and the size of the lots was four to six times bigger than in Lombardy.

- everywhere the interval between the end of the procedure and the start of the service was similar – from 18 months in Liguria to 24 months in Veneto, with different implications on competition, as the size of lots differs so much.
- everywhere the evaluation criteria encouraged quality improvements and the provision of the best rolling stock – where asked to the competitors. Less than half of the available point were awarded to the cheapest offer, as shown in Figure 8. Each call for tenders established checks to prevent dumping.

## **DO WE REALLY NEED COMPETITION?**

Some auctioneers of the experimental tenders probably asked this question to themselves before the tenders started in their Region.

At that time the main problem faced by the Regional Governments was in fact the relationship with the incumbent Trenitalia. That incumbent – like almost every monopolist – did not want to be regulated by anyone else, especially by newcomers, as the Regions were at that stage of the railway reform.

So, we can argue that many Regional Governments chose competitive tendering as a way to increase their power: they were able in this way to set freely the service requirements in the tender specifications, instead of negotiating them with the incumbent. They did not need – in their thoughts –, therefore, to attract more than one competitor – by reducing the above mentioned barriers, for example –, because they relied only on the fear that the incumbent will lose its present service if competition will be really established.

The experimental tenders showed that this statement is not true: the incumbent did not accept the tender specifications where enough barriers remained in the tender specifications. For this reason in Liguria the call had to be withdrawn (in fact the second competitor – FNM – had no chance to win, due to the costs and the short time to provide the required rolling stock).

Better results were instead gained by Lombardy, that wrote tender specifications able to attract also the new entrants.

The fear of competition is therefore not enough to gain service improvements. It fails for sure when tenders are called for the second time.

## **THE NEED TO AVOID COLLUSION**

The story of the experimental tenders teaches us also that there is the need to prevent collusion. Everywhere the incumbent invited the regional TOCs to join it and submit the winning tender. This happened also in Lombardy, where the regional TOC FNM was big enough to compete. Also the big Italian metro&bus operator ATM chose to come into the rail market together with the incumbent.

The Regional Governments need therefore regulations to avoid collusive agreements among the TOCs invited to submit tenders. It will be important especially when the services are tendered for the second time.

The Italian anti-trust Authority suggested not to admit agreements among companies if each of them alone is big enough, compared to the volume of the tendered service.

Only the National Government is at present entitled to introduce such a regulation.

## **CONCLUSIONS**

Only three, of the expected more than twenty call for tenders, happened in Italy till now. All them ended in an unsatisfactory way, from the point of view of competition.

The author's finding is that the Regional Governments failed in building a really competitive environment. This failure is mainly due to the regulatory framework of the PLT reform, in charge of the National Government.

Some key changes should be introduced to avoid the final end of competitive tendering in Italy in the rail sector:

1. the present barriers to attract competitors – especially as regards the rolling stock – should be removed;
2. the establishment of a second (at least) home-based competitor should be encouraged;
3. many existing links should be released:
  - between the National Government and the incumbent;
  - between the incumbent and the national infrastructure operating company;
  - between the Regional Governments and the regional TOCs;
4. regulations to avoid collusion should be introduced.

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