



State Comptroller of Israel | Annual Report 72a – Part Two | 2021

Ministry of Transport and Road Safety

Operation Agreement with Egged and its Structural Change

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Background

The majority of public transportation services in Israel are provided by buses – a sector that in the past was dominated by two cooperatives – Egged and Dan. In July 2019 the Egged cooperative became a private company – Egged Transport Company Ltd. (Egged). Egged operates bus lines by power of edicts, agreements and licenses awarded by the Ministry of Transport and Road Safety (the Ministry of Transport) as part of its role as the regulator of public transportation. Since the beginning of the 21st century, the Government has been promoting a reform designed to improve public transportation services by increasing competition. As part of the reform, several agreements have been signed over the years between the State and Egged. The purpose of these agreements was to enable gradual release of transport lines to competition and to allow Egged a period of reorganization in order to improve its preparedness for changes in the sector. Egged's operational costs are higher in comparison to the operational costs of the competitive operators, therefore as part of these agreements the Government subsidizes from the State budget Egged's excess operating costs. In November 2018 the State and Egged signed an operation agreement, applied retroactively from the beginning of 2016 and which is valid until 2029. The agreement deals with the issues of promoting competition in the sector, raising service standards and Egged's efficiency process. The agreement provides Egged with a long-term program and incentives for increasing efficiency and preparing to operate under competitive conditions. The agreement includes releasing approximately 27% of the Egged lines to competition during the agreement period (and, together with the lines released according to the previous agreement, a total of 33%) and releasing the remaining lines at the end of the period. In addition, the agreement includes the issue of retiring senior employees and implementing efficiency procedures; setting measures for improving service standards; regulation of the use of infrastructures owned or managed by Egged by other operators; altering the ownership and incorporation structure including turning Egged into a limited company; and payment of 25% of the Company's monetary value to the State.



Key figures

NIS 10.2 billion

The total operating cost of public transportation in buses in 2019.

NIS 2.5 billion

Egged's annual operation costs, as determined by the agreement (without participation in purchasing).

32%

Egged's portion in the bus public transportation sector in 2020, in terms of travel distance, compared to 75% pre-reform and compared to the 25% target at the agreement termination date (2029).

NIS 1.3 billion

Estimated value, as of 2018, of Egged shares received by the cooperative members upon its becoming a company.

14 years

The operation agreement period.

NIS 400 to 700 million

The range of evaluations of the gap between Egged's annual operation costs including the purchase of buses and the retirement of senior employees in comparison with the competitive operators. The gap derives also from cluster characteristics.


NIS 868 million

The State's portion in financing the retirement costs of senior Egged employees in the agreement period.







NIS 181 million

The average annual participation of the State in the purchasing costs of Egged buses for 2016–2020.

Audit actions




 From September 2020 to May 2021 the State Comptroller's Office audited the signing process of the operation agreement between the State and Egged, its implementation and the supervision and control by the Ministry of Transport on adherence to its terms. Egged's financial performance and its operating efficiency were also examined. The audit was performed at the Ministry of Transport and Egged. Complementary audits were performed at the Budgets Department and the Accountant General Department in the Ministry of Finance.

Key findings

-  **Releasing Egged lines to competition** – the Ministry of Transport has not yet released the lines operated by Egged for competition according to the operation agreement, and there is a risk that it may not complete releasing all Egged lines by the end of the agreement period, end of 2029. The audit found that in order to fulfill the goal of Government decision 4148 to release all Egged lines for competition by 2030, the Ministry of Transport will have to publish over 20 tenders from 2027–2030. Over recent years the Ministry of Transport has published two to three tenders annually.
-  **Egged's operational efficiency** – Egged has not fulfilled all of its commitments and goals set by previous agreements. At the beginning of 2019 its operational efficiency was still low compared to other operators, mainly due to high personnel costs and use of an old vehicle fleet, and its operation costs for city and intercity clusters were high. According to the State Comptroller's Office estimate, the cost per km travel by Egged in 2019 was approximately 30% higher for city services and 10% higher for intercity services, compared to competitive operators.
-  **Egged's financial performance** – in 2016–2017 during which there was no valid agreement between the State and Egged, most of the company's financial performances (profitability, financial resilience and liquidity) were lower than the multi-year average. For example: there was a sharp drop in gross profit and in EBITDA; the debt ratio to EBITDA in 2016 was 2.6 times higher than the ratio in 2010 and 3.2 time higher than the 2019 ratio; the immediate liquidity ratio in 2018 was defiantly lower compared to the average in 2010-2019. Therefore, Egged received retroactive payments from the State at the time of signing the operation agreement.
-  **Egged's long-term financial forecast** – Egged has provided the Ministry of Transport with a forecast for the agreement period, and presented an efficiency program. Egged also presented the effect of the efficiency program and the outline for the release of lines to competition on its profitability and operation costs. At the same time, the forecast did not show the effects on balance sheet items and cash flows and did not include sensitivity analyses.
-  **The involvement of the Ministry of Transport and the Ministry of Finance in preparing Egged's valuation** – although the State is entitled to a payment of 25% of Egged's rights, the Ministries of Transport and Finance were not involved in Egged's preparations towards the company's value estimate.
-  **Government financing for employee's retirement** – according to the operation agreement the government participates in the retirement financing costs for employees



due for compulsory retirement, which comprises an additional benefit to Egged and does not constitute an incentive for efficiency. The government portion in financing retirement costs totaled NIS 868 million during the agreement period.






-  **Granting company shares without payment to Egged members** – at the time of changing the form of incorporation, the Egged members received a commitment for payment of the full value of their shares in the cooperative and company ltd. shares without payment. The company shares' value is estimated at NIS 1.3 billion according to an estimate as of 2018. These actions were taken without the involvement of the Ministries of Transport and Finance.
-  **Regulating the use of public transportation facilities** – the Ministry of transport did not issue licenses for transportation facilities that were supposed to deal with terms for holding and operating the facilities, including the issue of shared use by different operators, despite the shortage of such facilities and their necessity for operating public transportation services.
-  **The Ministry of Transport supervision of the standards of services by Egged** – the Ministry of Transport calculates a score for measuring the service standards of operators which serves as one of the criteria for selecting tender winners. For many years Egged was not entitled to bid for tenders to operate service lines, and therefore the mentioned score had no effect on its chances for winning future tenders; therefore, the incentive the score provided Egged to adhere to the predefined service standard was weak compared to competitive operators. This situation remains the same as long as Egged is not entitled to bid for tenders to operate service lines. Moreover, the Ministry of Transport's supervision of the service standard that Egged provides along a travel route is unsatisfactory. For example, in 30% of the total bus fleets there is a passenger counting system that enables checks during travel, but the Ministry of Transport does not yet use it to monitor crowding in buses.



Since the beginning of the reform in public transportation over the past two decades, new operators have entered the sector of public transportation, and they are operating service lines by virtue of winning competitive procedures.

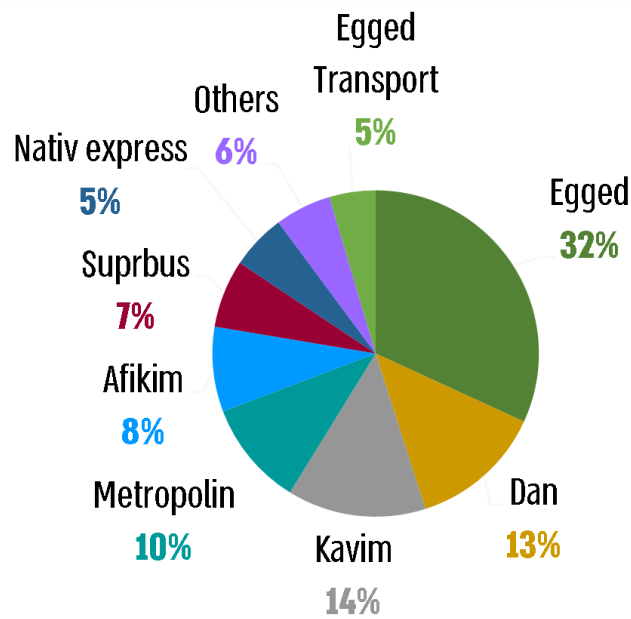
Over the years Egged has improved its efficiency in certain aspects, among others due to retirement of senior employees and changing the nature of employment in the company, as well as by increasing the number of drivers while decreasing the number of administrative workers.

Key recommendations

-  It is recommended that the Ministry of Transport prepare in advance a multi-year program that includes goals and milestones for releasing the remaining lines operated by Egged to competition, in order to prevent continued financing of Egged's excess costs out of the State budget.
-  It is recommended that the Ministry of Transport monitor Egged's activity regularly to ensure implementation of the operation agreement and continue to develop means for supervising adherence of public transportation operators to all requirements determined in their agreements.
-  It is recommended that Egged expand the financial forecast presented to the Ministry of Transport to include the aspects of balance sheets and cash flows as well as various scenarios concerning the retirement forecast and the operational forecast to enable defining the steps to be taken so that at the conclusion of the agreement period the company's expenses structure will enable it to contend with a competitive market without needing the State to finance its excess costs. It is further recommended that Egged set efficiency goals and formulate a multi-year plan to stabilize its financial coverage and leverage ratios in order to improve its financial resilience and fully prepare it for competition. It is recommended that the Ministry of Transport examine the efficiency goals formulated by Egged and monitor their realization in order to verify that the company improves its financial resilience and prepares for competition.
-  It is recommended that the Ministries of Finance and Transport examine the implications of granting company shares without payment to the founders on the company's financial situation, taking into consideration the payments the State has transferred to Egged, and be involved in the various processes of changes in the corporate or the organizational structure of the Company, so as to verify that its members are not being given excess proceeds without examining the implications.
-  It is recommended that the Ministry of Transport examine means for realizing its authority to promote shared use by different operators regarding the use of public transportation facilities and create a mechanism for supervising management of the facilities in order to enable efficient use that will support competition. It is also recommended that the regulation of the transfer of the facilities to management of public entities or local authorities be examined.

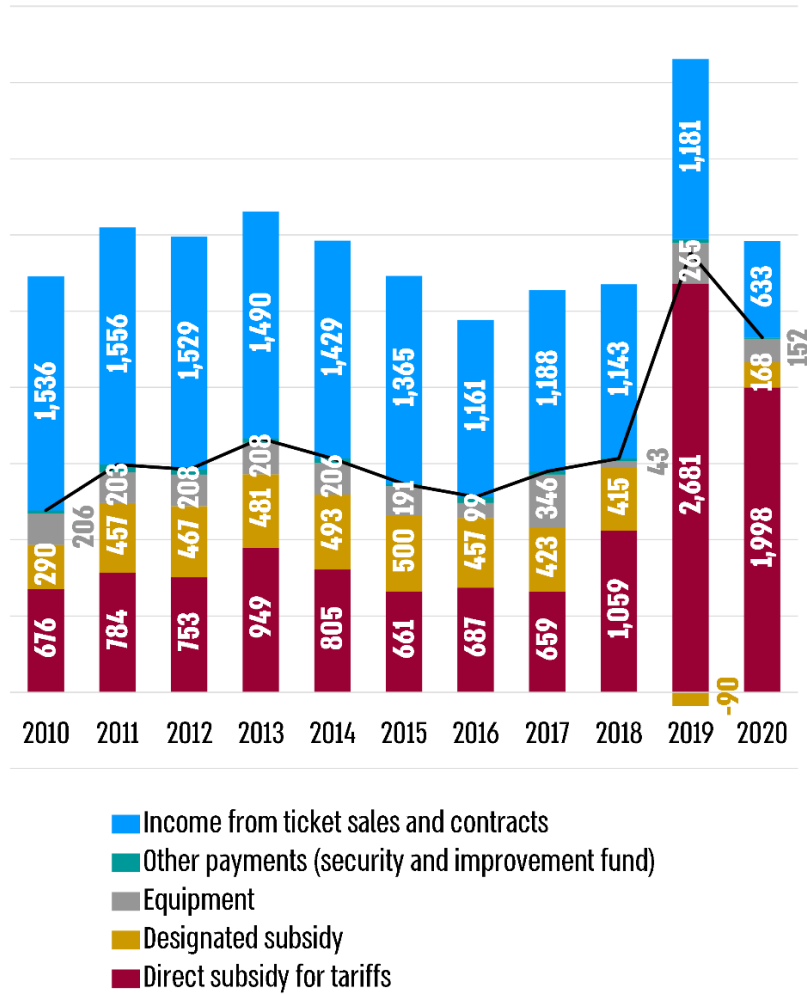


Market shares in the bus public transportation sector, by distance traveled, 2020 (in percentage)



According to Ministry of Transportation data, processed by the State Comptroller's Office.

Egged incomes for 2010–2020 (in millions of NIS)



According to Ministry of Transport and Egged data, as processed by the State Comptroller's Office.



Summary

Since the beginning of the 21st century the government – through the Ministry of Transport – has been promoting a reform to improve public transportation services and increase competition in the sector. At the audit completion date, Egged remains the largest operator in the sector, and its market share in terms of distance traveled was 32% as of 2020. Egged has become more efficient over recent years, but at the beginning of 2019 its personnel costs and operating costs of its service lines were still high compared to competitive operators, and it continues to be dependent on receiving subsidies from the State, which also covers its excess costs. The State Comptroller's Office recommends that the Ministry of Transport prepare in time for release of the remaining lines operated by Egged to competition, in order to fully implement the reform in public transportation according to the determined schedules. In addition, the Ministries of Finance and Transport should monitor Egged's fulfillment of its obligations according to the operation agreement, particularly in terms of standards of service provided to the passengers and its efficiency procedures. Egged should prepare for the conclusion of the agreement period the structure of its expenditures will enable reasonable profitability and capacity to contend with a competitive market without needing the State to finance its excess costs.