Working Party No. 2 on Competition and Regulation

RECENT DEVELOPMENTS IN RAIL TRANSPORTATION SERVICES

-- European Union --

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This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.
1. This contribution is based on the experience gained on the rail sector since 2004 by the Directorate-General for Competition of the European Commission. This experience stems from its enforcement activities of antitrust, merger and State aid rules and its advocacy for the major policy initiatives liberalising the rail sector in the EU.

1. **Introduction: Objectives of the European Union for the rail sector**

2. The rail sector is an important component of the transport industry in the EU. In 2010, the rail sector represented 10% of the EU transport sector and employed more than 0.7 million persons. The efficiency of the rail sector is also essential for the EU's competitiveness since it delivers significant input to many sectors of the economy (through freight transport services) and to consumers directly (through passenger transport services).

3. In the last 10 years, the European Union has considered the development of the rail sector as "an objective of utmost importance, not only of the EU transport policy, but also of economic policy at large". The EU has aimed at overcoming the decline of the rail sector before 2004 due to a decrease in public and private funding. Its objective is to realise the full potential of rail as an environmentally friendly mode delivering high quality, reliable, safe and secure transport services. The EU has focused on creating a genuine Single European Railway Area building on three major pillars: opening of rail transport markets to competition, improving the interoperability and safety of national networks, and developing rail transport infrastructure.

4. This contribution provides an overview of the main evolutions that have affected the EU rail sector on the regulatory and market fronts. Section 2 describes the major rail policy initiatives at EU-level since 2004. Section 3 describes the economic characteristics and market developments of the rail sector while Section 4 identifies the specific challenges for competition policy raised by these characteristics and developments. Section 5 concludes by outlining the contribution of competition policy to improving the performance of the EU rail sector.

2. **The EU regulatory framework for the rail sector**

2.1 **Principles of the EU regulatory framework for the rail sector**

5. The regulatory framework for the rail sector progressively introduced in the EU aims at creating a single European railway market along the following principles:

- Separation between the management of rail infrastructure and the provision of rail services: the manager of the rail infrastructure is independent from any railway undertakings for performing essential functions (such as the allocation of rail capacity or infrastructure charging), it must keep separate financial accounts and grant access to rail infrastructure in a non-discriminatory manner.

- Progressive opening to competition of railway transport services: any licensed EU railway undertaking with the necessary safety certification can offer rail transport services in opened markets.

- Harmonisation of national railway systems: the harmonisation concerns technical, safety and administrative differences across Member States to increase the inter-operability of national rail systems as well as their inter-connection.

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1 Eurostat database – latest data at rail sector level are only available for 2010.

2.2 **Successive EU Railway Packages**

6. Successive EU "Railway Packages" have implemented the key principles set out above. The First Railway Package\(^3\) of 2001 notably defines the separation between infrastructure manager and railway undertakings. In 2004, the Second Railway Package\(^4\) fully opened freight markets to competition as from 2007, and created the European Railway Agency to foster interoperability of the national rail systems. The Third Railway Package\(^5\) adopted in October 2007 introduced open access rights for international rail passenger services by 2010. In 2012, the EU simplified and improved existing rail legislation by recasting the first railway package\(^6\), notably improving access to rail-related services for freight and passenger trains and strengthening the power of national rail regulators.

7. In January 2013, the Commission proposed a Fourth Railway Package to finalise the evolution of the EU railway system towards a Single European Railway Area. The Commission's propositions include new resources and means to develop the inter-operability of national rail systems, stricter separation requirements between infrastructure managers and railway undertakings and the liberalisation of rail domestic passenger services by 2020\(^7\). These propositions are being discussed by the European Parliament and the European Council in the co-decision procedure.

2.3 **Fragmented national regulatory frameworks**

8. Within the EU regulatory framework, Member States have a margin of manoeuvre to implement the key principles set by the successive Railway Packages. This has led to the cohabitation of different levels of market opening and of different models for the separation between infrastructure management and rail operations.

9. Some Member States have notably chosen to go "faster" on the liberalisation route than the requirements set out by the EU framework by opening domestic markets ahead of the common deadline. Some Member States have for instance opened rail freight market to competition up to 10 years before the EU deadline (Germany, UK). Similarly, domestic passenger markets are currently opened to competition, either in full or in part, in several Member States\(^8\), despite it not being required at EU level.

10. In addition, Member States have adopted different governance models for implementing the separation obligation between infrastructure manager and railway undertakings. A common model is full institutional separation, where the infrastructure manager is an independent undertaking fully separated from any railway undertakings\(^9\). Another model is the "vertically-integrated" holding, where the infrastructure manager and the incumbent railway undertakings are part of the same structure with internal

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7 The liberalisation of domestic rail passenger services covers both open access rights for any passenger services provided it does not compromise the economic equilibrium of existing public service contracts and common rules for the competitive tendering of public service contracts for passenger transport by rail. See COM(2013) 25 final, 30.1.2013, Communication from the Commission on the Fourth Railway Package.
8 Austria, Denmark, Germany, Italy, Netherlands, Sweden and the UK.
9 Notably in Denmark, the Netherlands, Sweden, Finland, Spain, Portugal and the UK.
separation rules. A range of intermediate options, with different levels and means of separation between infrastructure management and railway undertakings operations can be found in other Member States.

3. Characteristics and developments of the EU rail markets since 2004

Despite the important evolutions in the rail regulatory framework since 2004, the overall performance of the EU rail sector has been mixed, as measured by the evolution of rail inter-modal shares in total transport. In the freight sector, it decreased from 10.5% in 2005 down to 10.2% in 2010. In the passenger sector, rail transport position has on the contrary slightly increased from 6.1% to 6.3% over the same period. This limited take-up of the rail sector can be related to its key characteristics that still frustrate the full realisation of the liberalisation benefits and the development of intra-modal competition. However, the limited growth in inter-modal rail market shares also indicate that rail transport services are constrained by competition from other transport modes such as air, road and maritime transport (inter-modal competition).

3.1 Unique and costly infrastructure

As a network industry, rail services require an infrastructure which is generally unique and historically developed and financed – and still is to a large extent – by public funds. Tracks, stations, or freight terminals are generally considered as non-replicable by the market and there is thus no "side-by-side" competition of rail infrastructure in the EU. This requirement to "share" infrastructure naturally frustrates the development of intra-modal competition and the creation of new services. Indeed, intra-modal competition has increased significantly but remains limited – in 2010 non-incumbent railway undertakings operated 25% of the rail freight services (up from 14% in 2006) and 20% for passenger (up from 13% in 2006). Using rail infrastructure also creates significant economies of scope and scale as well as network effects which provide a competitive advantage to larger undertakings – and make initial growth in market shares more difficult for new entrants. This is highlighted by the constant fragmentation of the rail services market beyond the incumbent since liberalisation. Even in the most advanced markets in terms of liberalisation, the challenger rarely reaches market shares above 5%.

3.2 High barriers to entry

The rail industry requires high upfront investments (rolling stock, licensing) that should be recouped by low future margins in an uncertain environment regarding the maintenance and development of rail infrastructure by the State. In addition, technical and safety requirements hinder entry by new market players (cross-border differences in signalisation or gauge, lack of cross-border connections) and limit the economies of scale and scope that could be gained by operating in an integrated EU internal market. This has been highlighted by the very limited level of entry so far in the long distance passenger

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10 This model is for instance adopted by Austria, Germany, Italy or Poland. The Commission initiated Court actions against this model since it considered that it did not adequately transposed the separation requirements set out in the first Railway Package. The Court rejected the Commission's argument by mentioning that vertically integrated models per se did not infringe separation requirements. See notably Case C-556/10 Commission v Germany (not yet published).

11 Intermodal market shares by volume transported, respectively in tonne-kilometre (freight) and passenger-kilometre (passenger). Eurostat database on transport.

market despite its liberalisation in 2010. The number of new international services opened has been very limited, and the number of new services opened by new actors even more so.

### Special status of incumbent railway undertakings

14. In all Member States but the UK, rail incumbents – the former State monopolies – play a special role in their domestic market. They are the only railway undertakings active in all rail markets and segments: single wagon freight, block wagon freight, inter-modal transport, regional passenger and long distance passenger. Incumbents generally also have privileged knowledge and access to rail infrastructure and rolling stock as well as to rail-related services. This factor is compounded when rail incumbents are also active as the infrastructure manager, either within a holding or as the sole providers of rail-related services. Last, incumbents have generally inherited a large volume of operations secured through directly awarded long-term public service contracts. This special status explains that market shares of incumbents have remained very high in most Member States despite constant erosion.

### Public service nature of certain rail services

15. The rail sector is characterised by the importance of the State support for its functioning. Beyond its reliance on public funding to finance infrastructure, the rail sector fills certain public service obligations as defined by national or local authorities for the transport of passengers within Member States in accordance with EU legislation. Member States (generally local authorities) finance the operation of public service contracts by railway undertakings to ensure the continuation of services that would not be operated commercially. In 2009, this amounted to € 20 billion in government payments for public services obligations (PSOs) and € 26 billion in public investment for infrastructure. Moreover, the amount of subsidies granted to the rail sector has increased since 2004 in the EU faster than total passenger kilometres.

### Key competition enforcement priorities for the EU in the rail sector

16. The economic characteristics of the rail sector described in Section 3 may hamper the development of intra-modal competition. Competition authorities at national and EU levels complement the regulatory framework to ensure that new entrants overcome the difficulties created by these characteristics by leveraging the entire "toolkit" of competition policy.

#### Preventing integrated incumbents to leverage infrastructure to foreclose competitors

17. Vertically-integrated holdings create a risk that the incumbent leverages its position as infrastructure manager to hamper the entry of competitors on the rail transport services market. Vertical integration indeed creates perverse incentives for the incumbent to favour its own downstream subsidiaries. Competition policy can complement the non-discriminatory access requirements imposed by EU regulation to prevent such situations. Practices by an integrated rail incumbent that would prevent or degrades access

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13 A 2012 study identified only 9 open access long distance service by new entrants. See Steer Davies Gleave, Further Action at European Level Regarding Market Opening for Domestic Passenger Transport by Rail and ensuring Non-Discriminatory Access to Rail Infrastructure and Services.

of railway undertakings to indispensable infrastructure could constitute an infringement of Article 102 of the Treaty on the Functioning of the European Union (TFEU) on abuse of dominant position.

18. The Commission has initiated proceedings in two such cases in 2012 and 2013 in the rail sector. In the Deutsche Bahn case, it is investigating whether the prices of traction current charged by the vertically integrated Deutsche Bahn do not lead to a margin squeeze for its competitors in the freight and passenger markets. In the Baltic Rail case, it is investigating whether the removal of a track by the vertically integrated Lithuanian incumbent would not constitute a refusal to supply its potential competitors.

4.2 Lowering barriers to entry through merger or cooperation

19. The high administrative, technical and financial barriers to entry in the rail sector create incentives for a new entrant to cooperate with an existing market player to lower these barriers. This "cooperation" can take a large range of forms, from operational and technical agreements to operational and commercial alliances such as in the high-speed international market. It can also involve acquisition. From a competition perspective, such cooperation may create efficiencies and foster competition by enabling market entry and the development of new services. However, it may also raise competition concerns by restricting the level of competition between actors that could be direct competitors.

20. Some incumbents have for example "purchased" entry in recently opened markets. In 2010, Deutsche Bahn acquired Arriva, a European rail and bus operator to enter several Member States (notably the UK and Sweden). It offered to divest Arriva's German activities to remedy the Commission's concerns on the impacts of the acquisition for competition in the German market, where Deutsche Bahn enjoyed very high market shares and Arriva Deutschland had become one of the major competitive forces. Arriva's German activities were purchased in 2011 by the Italian incumbent Ferrovie dello Stato (FS) and Cube Transport, highlighting the importance of acquisition for incumbents' entry in their non-domestic markets. Entry has also taken the form of joint-venture between incumbents and new entrants, such as in 2011 between Trenitalia, the passenger division of FS, and the private French rail and bus operator Veolia Transport for the provision of international rail passenger transport services. The deal was cleared in particular since Veolia Transport was a newcomer to the markets concerned.

4.3 Preventing incumbent railway undertakings to reinforce their market power

21. Given their high intra-modal market shares, incumbents may exert market power on their domestic rail markets if there are no competitive constraints from other transport modes. The definition of the relevant markets is thus an important element of competition enforcement in the rail sector, since it will directly impact whether the strong intra-modal position of rail incumbents translates into a dominant position. Provided that some incumbents are dominant on their domestic rail markets, competition authorities shall monitor the potential exclusionary effects that their market practices may have. Exclusionary practices that could be employed by rail incumbents include tying or bundling (across segments of a market for instance) and predatory pricing on specific submarkets. The Commission has not

Such practices could be qualified as refusal to supply or margin squeeze. See Guidance on its enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings. (OJ C 45, 24.2.2009).

See IP/12/597 of 13.6.2012 for the Deutsche Bahn case and IP/13/197 of 6.3.2013 for the Baltic Rail case. The opening of proceedings does not prejudge the outcome of the investigation; it means that the Commission treats the case as a matter of priority.

See cases M.5885 DB/Arriva, M.6124 Ferrovie dello Stato/CUBE Transport/Arriva Deutschland and M.6150 Trenitalia/Veolia Transport/JV.
recently conducted such cases, which generally concern domestic markets, contrary to national competition authorities.\(^\text{18}\)

22. In the long distance passenger transport sector, the Commission has generally defined the relevant markets as point-to-point travel (Origin & Destination route), in line with its practice in other transport sectors such as air, bus and ferry services. Such market definition corresponds to the demand-side perspective whereby passengers usually do not readily substitute destinations but can substitute transport modes.\(^\text{19}\) On this basis, the potential dominance of a railway undertaking would depend on the respective inherent advantages of air, rail and bus services on each O&D route. In the case of regional passenger transport, where services are generally operated under public service contracts, there is no competition between operators of public passenger services by rail on the different O&D markets. The competitive analysis thus focuses on the market for granting public transport contracts, where the competitive process actually takes place, such as was for instance the case when the Commission assessed the competitive tendering of rail franchises to operators in the UK.\(^\text{20}\)

23. In the rail freight sector, specialised transport activities (either by products transported or by type of services offered) may constitute separate markets due to limited demand and offer substitutability. For instance, when assessing the acquisition of the Swiss Compagnie Financière Ermewa (Ermewa) by Transport et Logistique Partenaires SA (TLP), the Commission considered that a relevant market for assessing the transaction was the transport of cereal by rail.\(^\text{21}\)

4.4 State aid issues and public services obligations

24. Railway companies can benefit from State support which is compatible with the internal market, in particular for their public services obligations, the financing of investments and the coordination of transport activities. The Commission has thus developed a framework to assess when State aid to railway undertakings may distort competition in the internal market.\(^\text{22}\)

25. Two main issues regarding potential distortion of competition through public support have recently aroused: the transfer of infrastructure to transport undertakings under non market conform conditions and the undue transfer of State aid to the incumbent railway undertaking. In the case of vertically-integrated holding, transfers of infrastructure from the infrastructure manager to railway undertakings may occur. While infrastructure managers are currently not subject to competition and therefore can legally receive State funding, such transfers would imply incompatible aid to the railway undertaking by reinforcing their market position. Public support can also take the shape of cross financing

\(^{18}\) See notably the French Competition Authority Decision against SNCF of 18.12.2012.

\(^{19}\) See for example case M.2446 Govia/Connex South Central.

\(^{20}\) See cases COMP/M.3273 First/Keolis/TPE JV. See also M.4806 DSB/First/Öresundstag for rail services operated between Sweden and Denmark.

\(^{21}\) See case M.5579 TLP/Ermewa.


\(^{23}\) The Community guidelines cover the public financing of railway undertakings by means of infrastructure funding, aid for the purchase and renewal of rolling stock, debt cancellation with a view to the financial rejuvenation of railway undertakings, aid for restructuring of freight divisions of railway undertakings, aid for the needs of transport coordination and State guarantees for railway undertakings. Regulation 2007/1370/EC defines the criteria with which the competent authorities shall comply when contracting and providing passenger public transport services. Article 93 TFEU is directly applicable for establishing the compatibility of aid not covered by Regulation 2007/1370/EC.
between infrastructure managers and incumbent railway undertakings. In such cases, the railway undertakings also benefit from the State support granted to the non-competitive activity of the infrastructure manager, and such public support could distort competition on the rail transport markets.

26. Railway undertakings may also benefit from compensations for their public service mission. However, such compensations should be used exclusively for this mission and should be limited to its actual costs (no over-compensation). In this context, the Commission enforces a level playing field between railway undertakings by ensuring that their commercial activities do not actually benefit from over-compensations granted for public service obligations. The Commission has for example been conducting such investigations on compensations granted in Germany to DB Regio for the operations of the regional passenger transport in Berlin and Brandeburg.

5. Conclusion

27. The EU rail sector regulatory and competitive environments have dramatically evolved since 2004. Major initiatives have been implemented at EU-level to liberalise the market and spur the uptake of competition. This de jure liberalisation has been complemented by the work of competition authorities, both at EU and national levels, which have increased their oversight of the rail sector to monitor that entry in the rail market was not unduly deterred.

28. This dual approach to liberalisation has led to an increase in intra-modal competition. Ever more railway undertakings are active in Europe and their combined market shares keep on increasing despite the adverse economic climate. Moreover, competition between railway incumbents in each other's domestic markets is also accelerating, following several important acquisitions. This increase in competition has however yet to transform into significantly improved performance of the rail sector compared to other modes. Despite the progress achieved – as mentioned in the Communication on the development of a "Single European Railway Area", the rail sector remains poorly perceived by consumers and rail prices increase faster than other transport prices.

29. Looking forward, while the important regulatory changes brought about by the Recast and the Fourth Railway Package set in, the role of competition enforcement will increase to ensure a level playing field in the Single European Railway Area. This role may also evolve, from mainly monitoring practices of the railway incumbents, to assessing more consolidation and cooperation on the markets.

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25 "Following a long period of decline, since 2000 the European railway industry has managed to increase passengers and freight volumes transported and to stabilise modal share. [...] Safety has also improved significantly". COM(2010) 474 final, 17.9.2010, Communication from the Commission concerning the development of a Single European Railway Area.

26 Rail services are ranked 27th out of 30th in terms of consumer satisfaction (see Consumer Market Scoreboard 2012). In 2011, prices of rail services for passenger have increased by 29% since 2005 (compared to +20% by air and 21% for transport services in general.
## Overview of the Commission’s competition enforcement activities in the rail sector

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                                           ▫ Margin squeeze                                                                                                                                                     | ▪ Article 102 TFEU on abuse of dominance                                                                 | ▪ DB  
                                           ▪ Baltic Rail                                                                                                                                                    |
| High barriers to entry           | ▪ Cooperation between railway undertakings to overcome barriers to entry  
                                           ▪ Mergers involving incumbent railway undertaking  
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                                           ▪ EU Merger Regulation                                                                                                                                                                                     | ▪ DB/Arriva  
                                           ▪ FS/CUBE/Arriva  
                                           ▪ Veolia/Trenitalia                                                                                                                                             |
| Special status of incumbent      | ▪ Foreclosing practices of dominant railway incumbents on rail transport markets:  
                                           ▫ Tying or bundling or services  
                                           ▫ Predatory pricing                                                                                                                                                  | ▪ Article 102 TFEU on abuse of dominance                                                                 | ▪ No EU level case  
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| railway undertakings             | ▪ Overcompensation of public service obligations  
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