

## CMA CONSULTATION ON COMPETITION IN PASSENGER SERVICES IN GREAT BRITAIN

### Who are we?

REGUTRAIN is the name of a research project of the Universidad Nacional de Educación a Distancia (UNED), funded by the Spanish Ministry of Economy and Competitiveness. The scope of the project is to design an effective regulatory framework for the liberalization of passenger rail transport services in Spain.

REGUTRAIN does not represent the interest of any undertaking interested in the provision of transport services in Great Britain.

Ten researchers are working in the project. Most of them have been working over the last years in the definition of a liberalization model for passenger rail services in Spain. In OPTIRED research project, financed by the National Plan on R+D+I 2008-2011, the different liberalization options were analyzed. Conclusions supported an innovative model for the gradual opening to competition through the creation of a duopoly. Such model was experienced in telecommunications but has no precedent in the railway industry. Act 1/2014 and Decision of the Government of July 13, 2014 have formally adopted this liberalization strategy. Duopoly will be gradually introduced, starting with the routes from Madrid to Eastern Spain.

The general objective of the Research Project is to improve the knowledge about the regulatory technics and to design instruments to intelligently regulate passenger rail services in Spain. In particular:

- I) Observatory of competition in commercial railway services: the objective is to establish an Observatory through the design and surveillance of key indicators to follow-up the evolution of competition in the liberalized routes and the potential extension to other routes;
- II) Regulation of public service obligations: as defined in the Fourth Package Directives, analyze measures for an effective introduction of a tendering model

- for the granting of exclusive right for the provision of services with public service obligations (competition for the market;
- III) Access regulation: the objective is to design a regulatory framework on access to rail infrastructures, rolling stock and other relevant facilities;
  - IV) Institution building: analyze the structure and competences of the National regulatory authority (CNMC) and the security regulator (AESF) to identify potential improvements for a better regulation;
  - V) Internationalization: consolidation of a team of experts in regulation.

A multidisciplinary and comparative approach has been adopted. The project is basically a legal research project, with leading experts in railway regulation, both academics with a solid scientific production and seasoned professionals. It is also necessary to take into consideration economic analysis, both for the evaluation of the results of the duopoly model as for the impact evaluation of the regulatory instruments. The research team includes academic economists as well as professionals working in railway companies.

### **Why is REGUTRAIN interested in the consultation?**

REGUTRAIN is following the leading processes of reform of the railway industries around the world.

Particular attention has been devoted to the UK and Italian experiences. Researchers based in the UK and Italy are participating in the research project. Other experiences are being closely monitored: the Swedish and Czech models, as well as the experience in Korea.

The UK model is particularly valuable as it is the country that has experienced the most innovative reform in the sector. Introduction of competition for the market, franchises, tendering, ROSCOs, they are all experiences that have helped other countries to innovate in their processes of reform of the sector.

A workshop was organized by the REGUTRAIN research group on October 14<sup>th</sup> to discuss the CMA consultation. While the positions of the researchers and the guests were varied, consensus was reached on some positions. This is the base for this contribution.

### **What can we offer?**

Our contribution to the consultation intends to provide some insights derived from the Spanish experience in the railway industry that could be helpful for the evolution of the industry in Great Britain. These are some of the distinctive traits of the industry in Spain:

### 1) New infrastructure vs. improvement of the existing infrastructure.

The Spanish experience with the gradual improvement of traditional networks shows that i) it creates a major disruption in the day-to-day operation of the network; ii) it takes very long to be executed; iii) it does not significantly improve the capacity of the network; iv) it does not significantly improve speed; and v) improvements can end up costing even more than the development of new infrastructure. This has been the experience with the line along the mediterranean coast and the Seville-Cadiz line.

This is the reason why Spanish authorities decided to create new infrastructure and in particular new high speed infrastructure: i) being a parallel infrastructure, it has a more reduced impact in the day-to-day operation of the traditional network; ii) it can be constructed in shorter period of times; iii) it improves very significantly the capacity of the network; iv) it improves very significantly the speed allowed by the infrastructure (the average speed in the Spanish HS network is 222km/h, higher than in Japan); v) it often ends-up costing less in total terms that up-grading the traditional infrastructure.

At the moment, the Spanish HS network has 3,100 km. The investment to develop such a network has been 45,120M euros (data published by ADIF, the HS infrastructure manager).



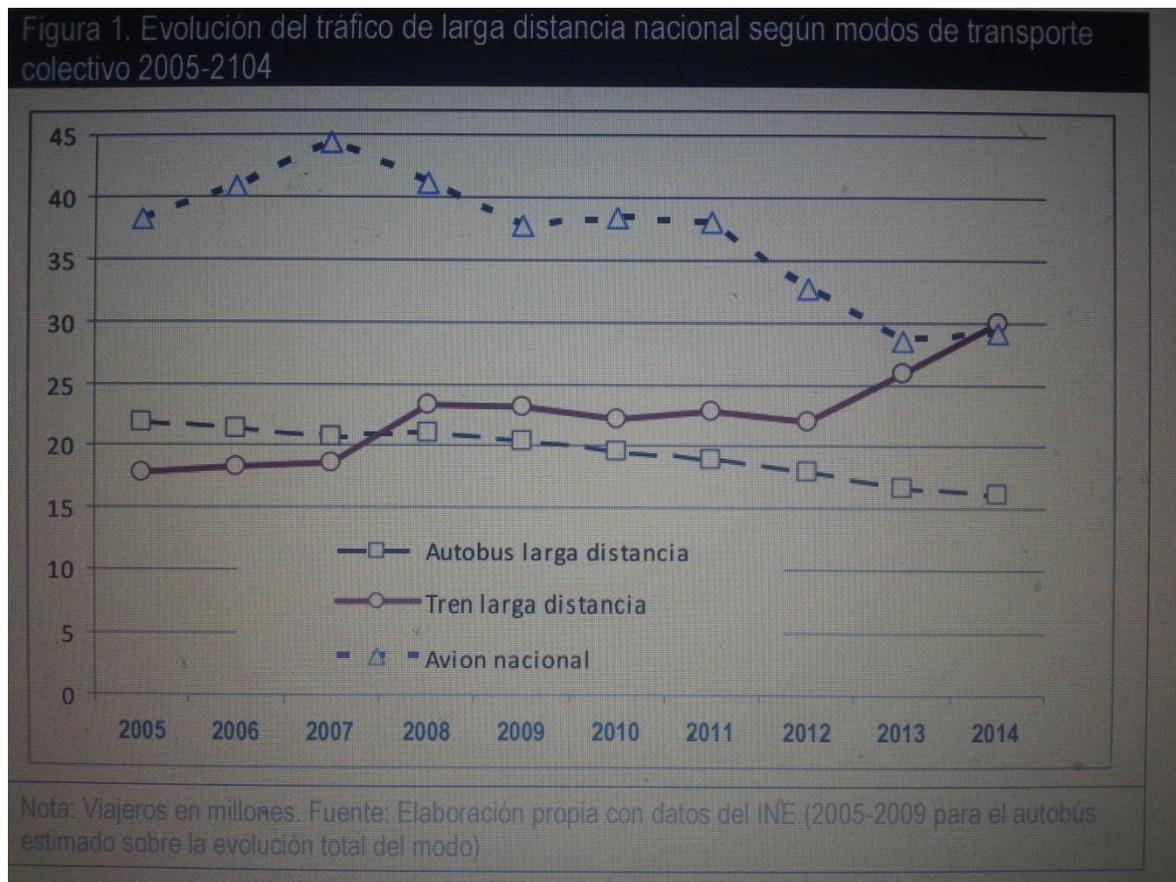
At the moment, the challenge in Spain is not to manage scarce capacity in the network. On the contrary, the challenge is to increase the use of the existing HS network and the revenue generated for the exploitation of the network.

## 2) Intermodal competition

In Spain there is a long tradition of competition between railway and road transport, particularly services provided with coaches. A very developed system of franchises allows operators to provide coach services both for long-distance and for commuting services. As a result, coaches have traditionally enjoyed a larger volume of passengers than railways. Coaches have always posed a very real competition to railway services.

The development of the high-speed network has allowed railway services to effectively compete with air transport.

A major shift has taken place in the last 10 years in the marketshare of the different modes of long distance transport in Spain:



Source: FERNANDEZ JANEZ (2015).<sup>1</sup>

<sup>1</sup> FERNANDEZ JANEZ, Judith (2015): "Una visión actualizada de la competencia entre el tren de alta velocidad y el avión", in 360 Revista de alta velocidad, p. 23.

### 3) Duopoly

Spanish legislation has already defined a strategy for the introduction of competition in long-distance passenger rail services. The strategy is based on the gradual introduction of duopolies in long-distance routes. The first route will be Madrid-Mediterranean Coast (Valencia/Alicante). A tender procedure has been defined for the granting of the title to compete with RENFE, the incumbent, for a seven years period. After such period, it is expected that full competition will be introduced. There is no specific date for the tender, but it will take place after the elections on December 20<sup>th</sup>, 2015. A change in Government might delay or even discard the tender and the whole process.

Several factors have recommended the creation of duopolies as a the strategy to introduce competition:

- I. Competition is introduced in order to increase efficiency, dynamize the industry and increase the volume of passengers in the new high speed network which offers a lot of new capacity.
- II. Duopoly rights should reinforce the position of the new comer for a transitory period, as it excludes contestability in the market.
- III. Duopoly rights should reduce the impact of competition for a transitory period, allowing the incumbent to adapt to competition (eliminate internal cross subsidies, reduce costs, etc.).
- IV. Asymetry in the position of the incumbent and the new comer should reduce the risk of concerted practices.

### **General assessment of the consultation**

The research group agreed on a very positive assesment of the discussion document possed for consultation. These were the most positive elements identified by the researchers:

- I) Identification of the specific benefits that can be generated with an increase of competition in the industry. Competition is not identified as an end in itself, but as a tool to increase efficiency and general welfare.
- II) Long-term planification.
- III) Effort to identify the existing equilibrium that result in a stable industry (cross-subsidies between franchises, proportion between public and private funding, percentage of infrastructure costs covered by access charges, etc.).
- IV) Analysis of the impact of further competition in the existing equilibrium. The discussion document identifies how competition would reduce the price paid

by the passenger in the high yield franchises. As a result, it would not be possible to cross subsidize franchises which do not cover costs. At the same time, it would be possible to introduce an alternative cross-subsidy scheme inspired by the universal service schemes in other industries such as telecoms. It could also be possible to increase access charges.

- V) Open proposition of a set of different options.
- VI) Transparency in the definition of policies.

While the overall consideration is that the discussion document is very valuable, researchers have identified some points that could receive further consideration.

### Multimodal dynamic analysis

The discussion document pays little attention to the effect of intermodal competition in transport. Competition posed by other modes of transport plays an important role in rail services.

Great Britain, as other countries, has experienced the impact of low-cost airlines in rail long-distance services.

Competition from coaches seems to be limited in Great Britain, despite full liberalization, but coaches would discipline potential price increases in rail services, at least in non-congested areas.

Competition from new sharing-economy models could also have a strong impact in long-distance transport. The Spanish association of coach operators (Confibus) has sued Blablacar for unfair competition and it claims that Blablacar volumes have reached 25% of the coach capacity in specific routes in peak-time (particularly week-end trips). It is interesting to point that, at the same time, Confibus has sued the rail incumbent, RENFE, for unfair competition for the reduction of prices in high speed services.

The Spanish experience shows that dramatic shifts can occur in short periods of time. Just in 10 years (2005-2014), the share of rail services in long-distance collective transport has passed from 23% to 40%, at the expense of coaches and, particularly, air travel.<sup>2</sup>

Competition from other modes of transport should be taken into consideration when analyzing the impact that further competition could have in the rail industry. It seems clear that increases in efficiency should always increase the competitiveness of rail services against other modes of transport. However, the increase of the access charges or

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<sup>2</sup> FERNANDEZ JANEZ, Judith (2015): "Una visión actualizada de la competencia entre el tren de alta velocidad y el avión", in 360 Revista de alta velocidad, p. 23.

the introduction of universal service charges would directly increase the price of rail services. As a consequence, increases in access charges and universal service charges might not always ensure a proportionate increase in the overall revenue of the railway undertakings. Increases might just expulse customers to other transport modes, particularly if no parallel charges of the same nature are imposed on them (tolls for highway use to coaches and universal service chages for planes and coaches).

In Spain, where competition from coaches is particularly strong and no toll exists in most highways, access charges for the use of rail infrastructure are severely disciplined by the retail prices of coach services.

### **Investment in new infrastructure**

It was agreed by the researchers that little attention is devoted to the impact of the cost of investment in new infrastructure in the equilibrium of the industry.

Reference is made in the discussion document to the the development of new high speed infrastructure. However, no analysis is made on the impact of the cost of deployment of such infrastructure in the access charges, the proportion of public/private funding in the industry and the overall impact on liberalization.

Telecommunications provide an interesting reference on the impact of the development of new infrastructure on the regulatory framework. Liberalization of the telecom industry has been quite a success all around Europe. Sector specific regulation was dessigned to allow new comers to have access to the old copper network at low prices. As investment for new optic fibre networks is necessary, existing regulation is challenged. Growing pains are identified in most jurisdictions as investment is not sufficiently incentivized by the existing access regulation. It is easier to regulate an already existing network, with mostly amortized assets, than a network to be developed.

The discussion document might be too focused on the capacity constraints of the existing network, and might not take into consideration the forward looking challenges posed by the development of new and expensive infrastructure, in particular high-speed infrastructure. Congestion should not be an issue in the new infrastructure. On the contrary, regulation will have to be defined in order to make a more intensive use of the free capacity in the infrastructure. At the same time, a new equilibrium between public and private funding for the system might be necessary.

These are the kind of challenges faced in Spain after the development of 3,100km of high speed infrastructure at a cost of 42,500M euros.

The incumbent has decrease retail prices for high speed services as a way to increase the number of passengers and reach a more intensive use of the infrastructure. Such reduction is only possible if access charges are kept at a low level which of course cover variable costs, but not a significant share of the fixed costs generated by the infrastructure. This is particularly the case as rail services have to compete with coach services which pay no charge for the use of highways. Public funds are therefore necessary to cover a very high share of the construction of the high speed infrastructure.

It is in this environment that the duopoly model for the introduction of competition has been defined.

### Duopoly

The establishment of duopolies has been the strategy for the introduction of competition in long-distance passenger services in Spain.

Legislation has been adopted that foresees tenders for the assignment of a second title for the exploitation of rail services in competition with the traditional public monopoly, RENFE. Such titles will be granted for a seven years period and for specific routes. The first route to be open to competition will be the Madrid-Mediterranean coast (Valencia/Alicante). The conditions for the tender have already been defined in a Ministerial Order adopted on September 30, 2015. No specific date for the tender has been defined. There is no schedule as for the introduction of competition in other routes.

Researchers in REGUTRAIN have raised doubts about the competitive impact of a duopoly at the stage of reform of the sector in Great Britain.

Competition in Spain has as its main goal to increase the intensity of the use of new high-speed infrastructure. The situation in Great Britain is very different, as the traditional network is very congested. Some researchers suggest that the management of the congested network will be less efficient with more than one service provider. Other researchers agree coordination will be a challenge, but understand that it might be compensated by innovation and efficiency by the new comers.

Competition is considered in Spain a tool to increase efficiency in the management of the incumbent. However, after decades of competition in the market in Great Britain, there should be limited scope for efficiencies generated by a mere restructuration of the operators.

Competition in duopoly markets tends to be less intense than in open markets. This is perfectly identified in the discussion document. This is a point also identified in Spain.

However, such a mild degree of competition in Spain will already be an improvement as currently there is no competition whatsoever in the passenger rail market. Furthermore, such mild competition would allow the incumbent to restructure its operations and at the same time will allow the new comer a softer landing in the market. Duopoly is only conceived as a temporary measure, for a period of seven years, after which full competition should exist in the market.

The situation is very different in Great Britain, where competition for the market is already mature. Duopolies do not seem a good solution to effectively increase competition. New comers would just break all the existing model of cross-subsidies between franchises, will make the management of a congested network more difficult and will probably pose little effective competition, as the risk of tacit collusion is very high. The two operators would have a very similar cost structure, as the two leading costs of operation (access charges and rolling stock), both provided by third parties and with little possibility of differentiation, would basically be the same for both competitors.

While the creation of duopolies might be an interesting model for the introduction of competition in markets such as the Spanish, where no competition exists, it does not seem a good strategy to increase competition in markets where some degree of competition already exists.

### Universal service charges

The discussion document takes into consideration the introduction of charges to railway undertakings for the funding of public service operations. We will refer to them as universal service charges. While this is a standard system to substitute internal cross-subsidies in liberalized markets, it is important to take into consideration the limitation of this tool.

Experience with universal service charges in other industries such as telecoms or postal services is not limited to other continents (Africa, Asia or Latinamerica). Such experience exists also in Europe, particularly in Southern Europe. Universal service schemes have been defined in telecoms or postal services at least in countries such as Spain, France and Portugal. The experience in Spain can be of interest.

The operation of the postal service in Spain requires major contributions for the provision of the so called universal service. The burden on the universal service provider, the traditional public monopolist, is so heavy, that it was never considered to share all the burden with competitors, which have a very small market share. As a consequence, it was always considered that the contribution to the universal service fund by new comers would always be marginal and the main burden would be assumed by public funds.

The operation of the universal service in telecommunications, on the contrary, represents a very small fraction of the overall turnover of the industry. As a consequence, such burden is exclusively assumed by the industry and no public funds have been provided. It is important to note that the cost has always been very limited, so it has posed a small burden on new comers:

<b>Year</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
<b>Amount</b>	71.09M€	74.85M€	46.78M€	43.57M€	31.93M€

Source: Ministry of Industry.

The universal service fund has been managed by the independent regulatory authority (CNMC) for a limited cost and with no significant disruption for the industry. It can be claimed that it has been a success. However, it is doubtful whether such a scheme can be extrapolated to become a substitute to the very significant cross-subsidies implemented under the franchise model in the rail industry in Great Britain

Madrid, October 15, 2015

REGUTRAIN

Leading researcher

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