

## Further on the railway tendering path

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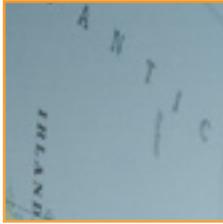
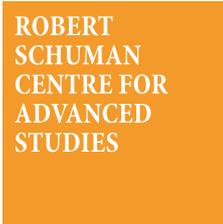
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EUROPEAN TRANSPORT  
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OBSERVER



## *Discussing the 4<sup>th</sup> Railway Package: which role for markets in domestic rail passenger transport?*

*Editors: Matthias Finger, Nadia Bert, David Kupfer*

### Highlights

*Although the 4<sup>th</sup> Railway Package was proposed by the European Commission in 2013, a consensus has not yet been reached. Recently, however, significant steps forward have been taken. Various stakeholders and prominent academics in the field gathered at the 9<sup>th</sup> Florence Rail Forum to reflect upon the latest developments in the legislative process.*

*Discussion at the Forum focused on the opening of competition in rail passenger transport and the changing role of the regulators at all levels. According to the provisions listed in the 4<sup>th</sup> Railway Package, the tasks of the national regulatory authorities are likely to increase, and, inevitably, new challenges will arise. Regulators will play a crucial role when it comes to resolving two major issues: on the one hand, how to harmonise the openness of the market of commercial lines so as to guarantee fair and open access to the network in all EU countries for all operators; on the other hand, how to deal with the provision of services under Public Service Obligations (PSO) and how to differentiate between directly awarded contracts and competitive tendering for PSO lines.*

## The 4<sup>th</sup> Railway Package: further challenges for the regulator

The aim of the 9<sup>th</sup> Florence Rail Forum was to discuss the proposed 4<sup>th</sup> Railway Package, especially the aspect of the opening of domestic rail passenger markets. Other elements of the package, such as the technical pillar and the financing components, had already been discussed previously in Florence.

To recall, the European Commission issued a Communication on the 4<sup>th</sup> Railway Package (COM(2013)25) in early 2013, only one year after the approval of the Recast. The European Parliament subsequently adopted its first reading position on the six legislative proposals in February 2014. But, as of today, a consensus on the different elements of the proposal has not yet been reached, and the Package is still in discussion.

Still it appears that on the so-called “technical pillar” (safety and interoperability Directives along with a new regulation on the European Railway Agency) the Council is supporting the Commission’s proposal which had already been voted by the Parliament. Overall, there seems to be a broad agreement on the need to remove existing administrative and technical barriers to enable the Single European Railway Area.

However, opening up the market in domestic rail passenger transport is more controversial, and two major issues are particularly under discussion, namely (1) the opening up of domestic commercial lines, where the main challenge is to guarantee fair and open access to the network (especially in those countries where vertically integrated railway undertakings operate) and (2) the complex relationship with services provided under Public Service Obligations (PSOs). Here, the 4<sup>th</sup> Railway Package actually amends Regulation 1370/2007 and the Commission foresees a differentiation between smaller scale contracts (which may be directly awarded to an operator) and larger contracts (which will have to be opened for competitive tendering).

In both cases, the national regulator will have to play a key role and will thus have to be considerably strengthened. Already in the Recast, the regulator had been given more powers, and the 4<sup>th</sup> Railway Package is further strengthening its role, especially when it comes to overseeing the independence, the transparency, the impartiality and the non-discriminatory behaviour of the infrastructure managers, as well as of the services facilities managers. This role is even more important in the case of integrated railway undertakings. What is new is the constantly growing powers of the regulator in this matter.

In addition, the 4<sup>th</sup> Railway Package raises a series of new and unprecedented challenges for the railway regulators worth highlighting, namely:

- A first challenge is to **regulate “reciprocity”**: as a matter of fact, the European Commission supports a ‘verification clause’ according to which integrated railway companies could be banned from operating abroad, if they do not guarantee free access in their home country (COM(2013)29). It is not clear, how this provision can be dealt with by the regulators.

- A second challenge pertains to **the role of the regulator in competitive tendering**, notably when exclusive franchises (so-called “competitive contracts”) are awarded (as opposed to open access). In this case, does the regulator have to ensure competitive tendering (and how would he do that concretely?) or should he simply serve as an appeal body in the case of complaints?

- Related to this is the third challenge, namely the **role of the regulator in performing the so-called “economic equilibrium test”**. This test must be applied by regulators in order to decide whether competition in the market (open access) or competition for the market (competitive tendering) has to be applied.

- Furthermore, the idea has emerged that a **combination of competitive and PSO contracts** could be awarded. This constitutes the fourth new challenge for regulators and raises in particular the question of how to “package” such competitive and PSO contracts together: what role exactly will regulators have to play when competitive and PSO contracts are combined?

In addition to these four very concrete new challenges for regulators, further questions arise from the 4<sup>th</sup> Railway Package as to their future role. These questions will inevitably have to be addressed at some point by the policy makers. They are as follows:

- As regulators will, sooner or later, get involved in PSO contracts, the question arises as to whether they should also tackle PSO financing. And how concretely they would do that.

- Another related question pertains to the future relationship between railway regulators and Transport Authorities, as it are these Transport Authorities that currently award the PSO contracts.

- Furthermore, the question will arise as to whether regulators should play a role in transport plans, infrastructure developments and other planning instruments, as they all have the potential of being discriminatory.

- Another question will pertain to performance, especially the performance of the infrastructure managers: should regulators oversee their performance? A question which is in direct relationship with the costs of using the infrastructure.

- Finally, the question remains as to which role regulators should play in ensuring passenger rights, the enforcement of which, has, so far, not yet been explicitly attributed to rail regulators.

We will discuss at least some of these broader questions during our upcoming Florence Rail Forums!

Matthias Finger

## 9<sup>th</sup> Florence Rail Forum - Summaries of discussions

Discussions during the 9<sup>th</sup> Florence Rail Forum were structured around three main elements:

- The 4<sup>th</sup> Railway Package under negotiation – where do we stand?
- Liberalization of national passenger markets – which way forward for competitive lines and PSO?
- What role for regulators?

### *The 4<sup>th</sup> Railway Package under negotiation – where do we stand?*

Several elements of the 4<sup>th</sup> Railway Package are still under discussion at the Community level, and the Commission, the European Parliament and the Council are still negotiating their position. In the debates at the Forum it became clear that the market pillar is still conflictual while agreement has largely been achieved on the technical pillar.

Several participants at the Rail Forum expressed criticism on some amendments introduced by the European Parliament, which were described as a watering down of the initial Commission draft in terms of providing for independent regulators and fair open market competition. The amendments of the plenary of the Parliament, which - as was pointed out - were taken against the recommendations of the Transport and Tourism Committee, would significantly weaken the “Chinese walls” which the Commission aims at introducing in order to guarantee independence between operator and network management in integrated rail companies. At the same time there were also other amendments that were received positively because they provided clarification.

Several concerns expressed by Member States (Council level) and associations were shared by the Commission, and the importance of mutual openness was underlined. It became clear that negotiations between Parliament, Commission and Council would go on. While there was agreement that the proposal should be less prescriptive it was the perception of the Commission and other stakeholders that the European Parliament with its amendments “had thrown out the baby with the bath water” by removing too many crucial elements. It was suggested that the focus should now be on making sure the regulation contains the necessary safeguards without being too prescriptive. This refers in particular to the governance rules for imposing Public Service Obligations (PSOs).

Some of the regulators expressed concern about the fact that the Parliament had limited the essential functions of the regulator to path allocation and infrastructure charging. Several also considered traffic management and maintenance as having a competitive impact and would like to see them included in the functions of the regulator.

### **Separating the technical and the political pillar?**

On the procedural side an important element is the question of whether the political and the technical pillar of the 4<sup>th</sup> Railway Package should be split up. During the Forum some pointed out that the Italian Council presidency failed to conclude the negotiations on the technical pillar, which will now be concluded under the Latvian presidency.

The Commission does not want to “hold the technical pillar hostage” to achieve progress on the political pillar. Nevertheless there is the fear of “losing momentum” if the technical pillar is voted on separately. It was recalled that it is currently the European Parliament that wants to achieve progress on the political pillar. The discussion often came back to where a possible compromise could lay between the sometimes divergent positions of Council, Commission and Parliament.

## Further on the railway tendering path

Didier van de Velde | Delft University of Technology; Faculty of Technology, Policy and Management; Section Policy, Organisation, Law and Gaming

Only Great Britain has chosen for a regime that is almost entirely based on competitive tendering in the rail sector. After its introduction passenger numbers gradually rose to an all-time maximum and from a burden to the public purse the sum of all franchises can now be provided with almost no subsidy. Despite this, the McNulty study published in 2011 by the British government and Rail Regulator found the network as a whole (i.e. including the infrastructure) to be inefficient with costs 30% in excess of its peers, with misalignment of incentives between players as a main cause after the vertical separation introduced in the 1990s. Alliancing between infrastructure management and train operations was suggested (and is currently tried) as a way to solve part of these problems; tendering of vertically integrated franchises was suggested but not tried yet (see also the article by Prof. Nash in this Observer).

No other country has chosen to introduce a similar regime. Those that have introduced competitive tendering in their railway sector have done so on regional routes (often branch lines) or local services on the main network, and did this in rather small contracts compared to the British practice. This is best exemplified by Sweden, Germany and the Netherlands. Efficiency gains of around 20% are often reported, as are innovations: new rolling stock, higher frequencies, more attractive services, better integration with local and regional public transport services, etcetera.

Thorough studies reviewing these practices remain scarce, and in depth European comparisons close to inexistent. Nevertheless, the measures included in the 4<sup>th</sup> Railway Package suggested by the EC ask for tendering all PSO services, together with open access on commercially viable services. This is backed by an impact assessment report, the quality of which has been criticized. The Impact Assessment Unit of the European Parliament even writes (May 2013): “Assumed impacts of the different options are well illustrated and described, but the reasoning as to why these impacts

occur as a result of a specific policy does not appear to be based on facts, academic literature or existing evidence.” So is this policy dogmatic and unfounded? Several remarks should be made to inform the debate.

Competitive tendering outside the UK often came with decentralising services from national to regional tiers of government who took this opportunity to force new operators to provide service characteristics that incumbent state monopolists often were reluctant to provide, or could not fund without added public money. Note that in many cases regional authorities even chose to bear themselves the revenue risk of those services. Many observed innovations are therefore the direct result of shifts towards more voluntaristic regional rail policies focussing on expansion, improvement and better integration with local public transport as input to – and not as outcome of – competitive tendering.

The competitive nature of tendering did indeed lead to efficiency improvements in productive terms: higher staff and rolling stock productivity, new maintenance practices, etc., even though this was to some extent the result of the possibility (or even obligation) given to winning operators to adopt simplified working practices (such as using no conductor in the Dutch case). However, note also the cost increases observed in Great-Britain.

As passenger transport services are characterised by strong consumer side network effects, splitting large networks into smaller tendered parts will therefore require coordination. Balancing contract size, operator freedom and central planning will therefore be a challenging task when continuing on the tendering path. The danger is that the desired-for entrepreneurial freedom of the operator gets – paradoxically – replaced by a large share of central planning.

Finally, the growing discussion and growing body of evidence showing that vertical separation might increase costs due to incentive misalignments (McNulty study), in particular under high-density traffic (EVES-Rail study) is also important. While the EC takes the position

that vertical separation is necessary to guarantee fair competition and that competition is necessary to guarantee customer focus and market innovation, practice shows that tendering can be large and growing even in the absence of full vertical separation (Germany). Therefore, a growingly relevant question is whether over the longer run vertical separation could be a costly obstacle to sector-wide optimisation. Shake-ups and management reforms of old railways were long overdue but the resulting performance improvements – often attributed to vertical separation – may well have been realised under different institutional configurations. Inspiration from the long-term system-wide (train/infrastructure)

optimisation commonly realised by the Japanese private and vertically integrated railways could usefully be taken here and one desirable step in that direction would be to implement cases of vertically integrated franchises to see how that model could combine benefits from competition with those from vertical integration.

### **Competition – a goal in itself or a strategy for efficiency?**

It was generally well received that the discussion on the 4th Railway Package has moved from a rather ideological approach to a more constructive approach. In the current discussion, at least at this 9<sup>th</sup> Florence Rail Forum, there is a clear focus on the cost of the rail system. One of the central statements was that competition or any governance approach in itself does not have a purpose if it leads to an increase of the overall cost of the rail system. One very concrete example that was given refers to the provision of separating IT systems between operator and infrastructure manager where there may be less costly alternatives to the current approach: instead of forcing rail companies to invest several hundred millions for the set-up of new IT systems the same goal can be achieved with an audit and corresponding penalties in cases of noncompliance.

There are different opinions on the effect of market elements in the rail system as also divergent experiences were made in different countries. It was pointed out that stakeholders need to accept that competition is the chosen strategy to achieve efficiency in the EU – even though it is not excluded that efficiency can be achieved by other means as well. It was clear that there are many instances that question any direct relation between open markets and cost savings. Yet the focus of European Rail policy lies on addressing the inconsistencies yet sticking to making use of competition as an instrument to achieve efficiency.

### ***Liberalization of national passenger markets – which way forward for competitive lines and PSO?***

In the discussion about the effects of competition – both on open access lines and for contracts in PSOs in competitive tendering procedures – many references were made to the British example and what conclusions to draw from it. Britain was described as “15 years ahead” with reforms the EU is currently advocating.

In this regard the McNulty report was often referenced. One suggestion was that there has to be a different view on railway governance as a whole. Given the high costs of the system in Britain today, what is needed is better coordination. Access charges alone are not sufficient as an instrument for coordination. Also the coordination that can be achieved through non-binding mechanisms does not extend beyond issues that involve the allocation of funds. It was concluded by some that, in order to achieve such coordination, integration between operator and infrastructure manager was needed – in spite of this being in contradiction to the principle of vertical separation.

It became clear that the relationship between competition, on the one hand, and overall network coordination, on the other, is especially acute in densely used networks and in smaller countries. As regards the question of whether Member States shall be allowed to contract entire networks or whether a certain minimum amount of contracts shall be

mandatory, the Commission acknowledges the risk of fragmentation in smaller networks. A compromise could be to allow a differentiation depending on the size of the network.

### **Tendering of PSOs**

An important aspect of the discussion was the role of markets in PSOs. While there is general agreement on introducing competitive tendering, different views were expressed on the how and why. For instance, direct award should be limited to exceptional situations, and on this point the Parliament's amendments were considered as too permissive. However, another opinion expressed was that the competence to decide whether or not to impose a PSO has to remain with the local transport authority: even in cases of commercially attractive lines a city or a region should have the possibility to offer more or better services than the market would provide on its own. It became clear that there was some opposition to the new definition of Public Transport Authorities (PTAs), which some consider as too narrow. A possible outcome may be that the current definition will not be changed. There was a general agreement on the question whether mandatory tendering would bring down costs. Many cases spoke in favor of the assumption that the process of tendering would reduce costs and thus the burden for the tax payer. Yet also several caveats to this assumption were presented. Competition may sometimes come at a price that is higher than the actual cost savings achieved by it. While in many ways unique, the British case illustrates this problem as in spite of a relatively smoothly working system of tendering overall system costs are too high.

### **Level playing field and legacy costs**

It was stressed by some operators that fair conditions were needed not just for new entrants but also for incumbent operators. It was pointed out that incumbent operators, unlike new entrants, are burdened with significant legacy costs. It was pointed out that with their current debt resulting from retirement schemes

and employee friendly work time arrangements, several operators are not able to compete with companies that do not face such costs. There were different views and different experiences on that issue. In some countries such as GB the winner of a competitive tender takes over the operating company including its staff, so the age of staff and pensions cost are not an issue in the competition. However, it was also stressed that in other cases tenders were frequently won by the companies with the youngest workforce as they could offer the lowest wage costs. To date there are no uniform rules on the obligations of a new operators vis-à-vis their predecessors. The availability of rolling stock was mentioned as one of the biggest remaining issues.

Competitive pressure is however an important driver for change and can facilitate a process of making the railway companies more efficient. However, it was recalled that railways are very different from other industries. Because of its nature, the principle of "creative destruction" where new and agile companies replace old incumbent inefficient ones, does not apply to railways: size and age can be a good thing in railways also from an efficiency perspective. This is why it is necessary to help the change process of the incumbent operators before introducing competition.

### **Public Transport Plans and Network Statements**

Some concerns were raised over the level of detail and prescriptiveness required of Public Transport Plans and Network Statements. Yet from the Commission side it is clear that the plans serve as a means to address the crucial issue of gradually defining common rules for the imposition of PSOs.

Also, the importance of introducing more reliability of financing was stressed from several sides. The Network Statement should clarify what kind of major disruptions will impact the network over the upcoming five years. Such information is needed by all operators to make business decisions. Many believed that the way this is managed in Great Britain is exemplary.

# Back To Basics

Juan J. Montero UNED University, Madrid

The overall policy objective of the European Union for the railway industry has traditionally been the creation of the Single European Railway Area. The full exploitation of economies of scale at a continental level will ensure significant benefits to European citizens. Cross-border services are only an example. A more efficient provision of national services, even of regional and suburban railway services, could be reached if large European-wide service providers would compete in the market or for such markets. The consecutive Railway Packages have tried to eliminate obstacles for the creation of railway transport providers with a European-wide scope.

The Fourth Package could finally eliminate the most basic and structural obstacle to the Single European Railway Area: the national monopolies for the provision of national railway services. 30 years after the first intervention of the European Union, the traditional market structure of the industry could be finally transformed. However, the elimination of national monopolies is only a precondition for the creation of the Single European Railway Area.

As in most network industries, the vertical integration of network and transport services is rightly perceived as an obstacle to competition. As railway networks are natural monopolies that require significant support from public budgets, national monopolies seem to be the only choice for the management of the railway infrastructure. Vertical integration could automatically extend the national monopoly over networks to the downstream market of transport services. As a result, railway services would still be defined along national borders.

Vertical separation was the preferred remedy for the European Commission. However, it has been severely opposed by some of the most relevant players in the industry. Furthermore, uneven implementation of vertical separation has created unacceptable asymmetries between vertically separated players in some member States and vertically integrated players (even if as a holding) in other Member States. Too much energy might have been consumed in the debate over vertical separation. Behavioral remedies have proved successful in other network industries. The adoption of a full regulatory framework on access to vertically integrated networks has allowed vibrant competition in the telecommunications industry. It has allowed market entry to new postal players.

Competition law has proven to be an effective safety network for those occasions where the regulatory framework has not

ensured fair access and a level playing field for competition. Intervention against margin squeeze by vertically integrated network operators has resulted in major fines of the European Commission and the National Competition Authorities for abuse of dominant position by traditional monopolies in the telecommunications and postal industries.

Another obstacle for the emergence of European players are specific national policies for the provision of services of general economic interest. National monopolies exploiting cross-subsidies and benefiting of state aids for the provision of other services are an obstacle for the Single European Railway Area. However, general economic interest can be protected through other instruments which are just as effective and are fully compatible with the creation of European-wide operators. The general regulatory framework designed by the European institutions for the services of general economic interest (Altmark and the subsequent application of the state aid rules by the European Commission) allows Member States to define their own policies to support railway services. Such framework unbundles the key elements of the public policy (objective identification of public service objectives, of the best provider of the service, and of the cost of the provision of the service) in such a way that public intervention does not require a national monopoly and therefore is not an obstacle to the European Area. The full development of the 1370/2007 Regulation is necessary to complete the process.

Finally, European-wide players can only emerge through consolidation of the existing national players. The same process has been identified in most industries. In other network industries, former national monopolies are expanding around Europe: a Spanish telecom operator is a relevant player in several countries, a Dutch express mail operator is active in most Member States, an Italian electricity operator is a leading player in other Member States, etc.

It is important to ensure that the consolidation process evolves in objective and fair terms. No artificial obstacles should be posed to the process, and no artificial advantages should be given to specific players. The rules on state aids should be strictly applied to avoid discrimination.

The reform of the railway industry will not be completed with the elimination of national monopolies. Competition has to rely on a clear and fair regulatory regime for legal certainty: Clear and fair rules on network access, rules on services of general economic interest and rules on state aid.

Another question discussed was whether tendering PSOs would increase investments in innovation and improvement of service. While the case of Sweden was often presented as a positive example for this, it was also pointed out that those innovation activities were not actually the result of entrepreneurial decisions by the private operators but rather the reaction to direct and prescriptive orders by the transport authority. Here the discussion also touched upon the power relationship between operators and transport authorities. Transport authorities may use the tendering requirement as leverage to impose decisions on the operators.

### **Competition and competitive lines**

The discussion focused on competitive tendering and competition “for the market”. It is clear that open access competition (“competition in the market”) still remains an exception. As open access systems develop it emerges frequently that the “rules of the game” have yet to be defined for such situations.

### **The cost and the benefit of vertical separation**

As often before opinions were divided on the question of railway governance and unbundling. With regard to the different experiences made it was pointed out that vertical separation increases the need for external coordination, which increases overall costs. It became clear that there will be different models in the future and fully integrated Railway Companies will continue to exist as well as fully separated ones. While it is still controversial, the discussion on this issue in the European policy debate is about to come to an end: there is political agreement on the principle of leaving it up to Member States to decide on the organizational model for their railway companies. Closely related to this topic was a discussion on **reciprocity**: in its proposal the Commission had foreseen the possibility to exclude railway companies with insufficiently open markets in their home country from operating on other markets. It remained open if and in what form this principle will stay in the final text. The most important open question concerning this is by which body and based on which principle this would be decided on.

The point was raised that the “price to be paid” for abandoning the aim of full vertical separation will be enabling fully competent and independent regulators. This issue was discussed in more detail in the last session.

### ***What role for regulators?***

Overall, among the stakeholders present at the 9th Florence Rail Forum there was agreement on the need for strong regulators. To operate effectively they need clear rules, legal certainty and sufficient funding. Furthermore clarification is needed on the role of the regulators vis-à-vis other actors. Also discussed were the key functions of the national regulators. Going beyond what is already foreseen by current legislation, the 4th Railway Package would introduce the task of:

- Insuring the independence of the infrastructure manager and the compatibility of the appointments in key positions of infrastructure managers and operators;
- Performing the economic equilibrium test in the context of the imposition of PSO services.

Regulators in the Member States are at very different stages of their development, and this element was very prominent in the discussion already in the past Florence Forums<sup>1</sup>. In Italy a fairly new regulatory body is beginning to take an important role in the regulation of competition of railways. This is a unique example as open market competition for high speed train services does not exist in other countries in the EU. Here the regulator has to lay out rules for a fair system of capacity allocation, which can be a sensitive issue in particular where highly requested paths and times slots are concerned. A way to go about this is to increase the transparency of the capacity allocation process and the coordination process in particular. This includes disclosing information to interested parties about paths requested by other applicants and operational details on the allocation procedure followed.

1. [7th Florence Rail Forum](#) (Florence, 29th November 2013) Current Challenges of Rail Regulation in Europe: The European Regulators’ View

# Rail passenger market competition in Britain

Chris Nash - Institute for Transport Studies University of Leeds

Britain is the country with the most experience of rail passenger market competition in Europe. Virtually the entire network is subject to competition for the market through franchising, and this has been the case since 1994-7 so most franchises have been let more than once. It also has a limited amount of competition in the market, both where franchises overlap and also because open access competition is permitted as long as the regulator judges it will bring significant new traffic to the railway rather than simply abstracting traffic from the franchisee.

The British experience is often claimed to be a big success (ATOC, 2013) and indeed passenger traffic has grown by more than two thirds since 1997. However, Wardman (2006) finds a large part of the growth to be due to external factors: strong economic growth over much of the period at a time of only slowly growing car ownership and increasing car journey times and cost (unlike earlier times when rapidly growing car ownership, the construction of the motorway network and reducing car operating cost offset the benefits to rail of growing incomes). Even where growth was due to improved services and new rolling stock, much of this was specified for and paid for by the government. Nevertheless he did find a small positive residual effect of the introduction of franchising.

What is less encouraging is that overall real cost per passenger train kilometre is 25% higher than it was in 1997, with most of the increase being in infrastructure cost but a small increase even in train operating cost (Smith and Nash, 2014). The McNulty report (McNulty, 2011) found a major cause of this increase to be a lack of alignment of incentives to optimise system cost between infrastructure manager and train operating companies, and advocated closer working together, including alliances or joint ventures between the two. The most extreme example of this to date is that of South West Trains, where an alliance involves complete sharing of staff (other than the most senior) and of changes of revenue and cost from that foreseen at the time of the alliance, thus completely aligning incentives.

But other problems have been clear. Although franchise length has varied, it has typically been less than 10 years, and it appears

that this has been too short to incentivise train operating companies to seek major changes in operating practices or to look for major innovations in rolling stock (Nash et al, 2014). Financial problems of franchisees have in some cases been met by renegotiation or – worse – putting franchises on short run management contracts. Many of the franchises have been too large, whilst splitting services on a particular route between operators (whether by overlapping franchises or by open access competition) loses economies of scope (Wheat and Smith, 2015). Competition between train operators for skilled staff has led to labour cost for train operators rising much faster than in the economy as a whole.

One particular aspect of franchising in Britain which is different from any other European country is that the process was started by creating 25 companies from the British rail passenger network; whoever wins a franchise takes over this company, rather than assembling their own staff and assets. This leads to a relatively fast and trouble free handover compared with other countries where handovers have sometimes been characterised by severe shortages of labour and many cancelled services. Doing anything else when franchising is practiced on such a large scale as in Britain may be problematic. But it does remove the pressure of a potential newcomer entering with lower labour costs or higher productivity.

British experience seems to suggest two alternative ways forward suitable for different types of service. Firstly small short tightly controlled gross cost franchises may be suitable, where there is a relevant authority able efficiently to undertake service planning, pricing, marketing and procurement and it makes sense for them to do so as part of an integrated network for all modes. Such contracts focus attention on meeting the requirements of the franchising authority at minimum cost. The sole (to date) example of this in Britain is the London Overground – a 6 year franchise. The second is medium sized long franchises with a lot more freedom to invest and to develop services themselves. Chiltern, with a 20 year franchise is a good example of this. What is clear is that franchising involves a lot of choices for the franchising authority and getting these wrong can seriously damage the outcome of the process.

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Adequate financing of regulators needs to be ensured. The risk was mentioned that ever more tasks are conferred upon regulators which can however not be carried out sufficiently due to a lack of resources.

In the discussion there were also some challenging opinions on the future role of regulators and transport authorities. Many of the tasks carried out by regulators or transport authorities touch upon important entrepreneurial decisions of the railway companies. Furthermore according to some the experience in Britain leads to no other conclusion as that efficient coordination in an unbundled system is not possible without extensive coordination by the state level. This leads to a paradox that, what was meant as a program to restrict the role of the state and unleash the productive energy of private operators might lead to (or necessitate) an even bigger state bureaucracy to counterbalance the undesired effects.

## Further readings

[Florence School of Regulation Transport Area, 2014, 9<sup>th</sup> European Rail Transport Regulation Summary: Discussing the 4<sup>th</sup> Railway Package: which role for markets in domestic rail passenger transport?](#)

This document summarises the content of the presentations delivered during the 9<sup>th</sup> Florence Rail Forum, offering short summaries of each presentation, and illustrating the main points made and matters treated.

Presentations were delivered by representatives of different types of stakeholders, who reacted to the same initial questions that have been addressed in the present Observer:

- The Fourth Railway Package under negotiation – where do we stand?
- Liberalisation of national passenger markets – which way forward for competitive lines and PSO?
- Tendering of PSOs: what are the remaining challenges?
- Which role for national regulators and competent transport authorities?

[McNulty, Roy, 2011, Realising the Potential of GB Rail: Report of the Rail Value for Money Study](#)

The Value for Money Study was commissioned jointly by the Department for Transport and the Office of Rail Regulation. According to the Report, lessons should be learnt from history. Therefore, on the basis of the British experience and with the scope to address the British authorities, a wide range of recommendations focused on creating an industry environment which encourages cost reduction, changes which deliver new efficiencies, and mechanisms to drive implementation are put forward. The Study estimates that implementing these recommendations could deliver savings between £700 million and £1 billion annually by 2019.

[van de Velde, D., C. Nash, A. Smith, F. Mizutani, S. Uranishi, M. Lijesen and F. Zschoche \(2012\) “EVES-Rail – Economic effects of Vertical Separation in the railway sector”](#)

The goal of this study is to assess the potential impact of various forms of partial or total vertical separation in the rail sector in the European context. A main policy question is whether a limitation in the choice between structural railway regimes is recommendable or not. Existing economic studies draw mixed conclusions about the impacts of various reforms – hence the need for a thorough assessment of key impacts

and mechanisms in order to guide policy-makers ahead of discussions pertaining to the Fourth Railway Package.

[Montero, Juan J., 2014, Rail Transport: A Balance Sheet, EUI Working Paper RSCAS 2014/115](#)

The creation of a single European railway area is the overall policy objective of the European Union for the railway industry. Rail infrastructure management is seen as a natural monopoly to be operated at a national scale. Competition is possible downstream in the provision of rail transport services. A European-wide market of rail transport services would benefit from larger economies of scale, and competition would ensure such efficiencies are passed down to European citizens and businesses. However, the reform process has been set back by Member States that disagree with the full vertical separation of infrastructure management and transport service provision, as well as by Member States that want to delay the full liberalization of the industry. As a consequence, inconsistent national models are emerging and non-sustainable asymmetries between Member States are creating tensions. The Fourth Railway Package is the opportunity to conclude the European railway reform process, both for commercial services and for public contract services. Imaginative solutions are necessary to reach a workable consensus.

[Knieps, Günter, 2012, Competition and the railroads: A European perspective, Discussion Paper, Institut für Verkehrswissenschaft und Regionalpolitik, No. 142](#)

The reform of European railroads is a time-consuming process strongly characterized by its path-dependency. In this paper, Prof Knieps firstly provides with a short outline of the historical roots of the controversial debates on the role of the state and the markets, focusing also on the organization of competition in European railroad industries. Secondly, he presents the opening of the market for train services in the context of the liberalisation of European transport markets since 1985. Thirdly, he analyses the evolution of track access regulation in Europe during the last decades, differentiating between the period of negotiated third party access since 1991, the introduction of ex ante regulation by the first railroad infrastructure package in 2001, and the danger of overregulation posed by the Draft Directive of July 2012 establishing a single European railway area. Fourthly, the role of competition on the markets for rail services and the reform process of interoperability requirements are considered. The paper concludes with an evaluation of competition on the markets for rail services and public subsidies for rail infrastructures as well as subsidies for train services.



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## FSR-Transport

The Florence School of Regulation (FSR) is a project within the European University Institute (EUI) focusing on regulatory topics. It works closely with the European Commission, and is a growing point of reference for regulatory theory and practice. It covers four areas: Communications and Media, Energy (Electricity and Gas), Transport and Water.

The FSR-Transport Area's main activities are the Florence Transport Forums, which address policy and regulatory topics in different transport sectors (Rail, Air, Urban, Maritime, Intermodal transport and Postal and delivery services). They bring relevant stakeholders together to analyse and reflect upon the latest developments and important regulatory issues in the European transport sector. These Forums inspire the comments gathered in this European Transport Regulation Observer.

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