



Competitor-Report German Railway 2008/2009

A summary of the most important points

The indefinite postponing of the IPO of Deutsche Bahn AG gives us a signal of a break-up. It opens up a time frame spanning several years, in which one can rethink the politics of railway transport. The Federal Government must decide whether the well-being of a globally active logistic company should continue to be used to measure political negotiations, or whether the time has come to focus on the growth prospects of the railway industry. This would fit in with a return to the goal of a railway reform, namely to put more transport onto the railway.

If rail transport performance is not only to further develop but also to grow then competition on the railway is the deciding control lever. As in all industries, the same applies to the railway: **Competition is not everything, but without it nothing runs.** If the framework conditions are correctly set then competition will reduce costs and increase the efficiency of all companies involved. Passengers, shipping agents and the taxpayer all win. Above all this increases the number of jobs in the railway sector.

The existing institutional parameter does not promote competition rather it effectively brings it to a halt. The result is that 15 years after the market opened there has only been a partial entrance into the railway transport market, be it long-distance, regional or cargo transport. DB AG **dominates the market** everywhere.

Regional rail transport (SPNV) – Status quo in figures

In 2008, the market share of competitor rail companies in transport services (in thousand km) was 10%. Measured by operational performance (in train km) it was 18.3%. By 2011, the latter will rise slightly to 22%. In the most lucrative sector – S-Bahn transport – third party providers reach a whole 2.9% and after the takeover in 2011 by Veolia of S-Bahn Bremen it will be 6%.

In contrast to the public tearful sentimentality of DB AG, the pressure of competition on the market leader is weak when compared on a nationwide scale. The cause of this is not a lack of performance from competitors but rather a "lack of opportunity". Since regionalisation in 1996, only 31.6% of services in the SPNV market were opened up for competition. Taking a period of familiarisation into account, this is approximately 20m train km a year since 2000. Approximately 12m of these remain for third parties. This is three to four medium sized partial networks a year shared amongst five to ten potential bidders. In contrast, 470m train km still remain with DB AG of which 35m train km are currently up for tender.

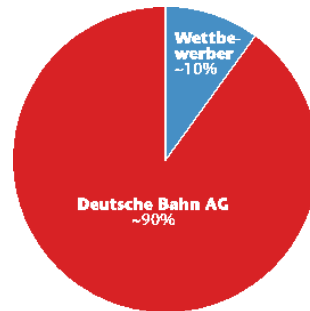


Figure 1
Market share of SPNV in 2008

In % of passenger km

Source: own calculation:

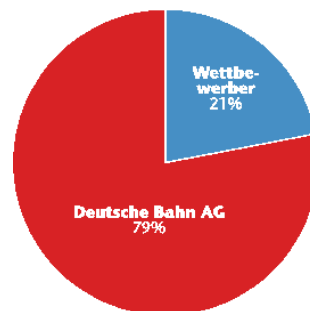


Figure 2
Market share of SGV in 2008

In % of train km

Source: own calculation:

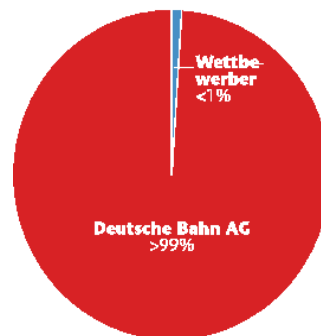


Figure 3
Market share of SPFV in 2008

In % of passenger km

Source: own calculation:

Potential given away: The hesitant introduction of competition means that the large allocation of DB AG services on the nationwide SPNV market (416m train km), which has never been put up for tender, shows an annual potential to enhance efficiency of over a billion euros. This volume comes from an analysis of the prices determined from competitions for 118 awards (of 201 since the market opened). According to this, DB AG's monopoly price could, on average, be **reduced by more than 26%** - with more efficiency at the same time (new vehicles, extension to services). Depending on the type of product, competition profits are subdivided into 47% RE (regional transport), 33% RE/RB (regional), 15% RB (regional) and 23% S-Bahn (urban railway/tram system).

It becomes more and more important for client bodies to increase their efficiency reserves because DB's strategy of skimming the profits with the help of infrastructure prices (tracks, station, electricity) causes the spending power of regionalisation funds to shrink consistently. If we are to ensure the existing level of offers in SPNV then winning competitions is essential.

This funding source is just as necessary for the development of offers so that the success story can continue on the passenger market.

Rail freight (SGV) – Status quo in figures

In 2008, the market share of competitor rail freight companies was about 21%. Although they were able to expand further despite the economic crisis which set in at the end of the year, DB Schenker Rail did suffer losses in Germany. This continues the trend that, in the last few years the growth in SGV has thanks to competitors. This success is all the more remarkable because it was achieved despite and not because of the adverse competition scale.

However, one can see that competition has only gained a foothold in certain freight groups of block train transport. Competition is strong in the sectors container/combined transport, chemicals, mineral oil and construction materials. At the top, third parties are aiming for a market share of 50%. Also in the sectors wood/pulp and waste, several NE-rail companies have entered the market. In contrast, the other freight groups – mainly in bulk cargo – remained unchanged and in the hands of DB AG. At the moment no third party is transporting ore. A similar situation applies to wagon load freight, which, apart from a small log-o-rail network, DB Schenker Rail operates almost alone - thanks to the critical mass in cargo volume and its financial power.

Potential given away: If one were to dispose of the invisible barriers which block the entry into the market, competition could bring significantly more tonnage onto the railway. The development of the last few years shows that NE-railway companies could acquire many new transport services for the railway sector. In contrast to the consistent SPNV market volume, opening the market to third parties does not mean that DB Schenker Rail would automatically lose revenue. From a transport and politics perspective the idle standing potential is particularly annoying. On a positive note, they bring hope for the future.

Rail passenger transport (SPFV) – Status quo in figures

Since the beginning of the rail reform in 1994, DB AG's market share has remained 99%. While the air transport market was revolutionised by the business model of "no-frills airlines", DB AG has been operating long-distance transport on the railways for the last 15 years with as good as no competition. Non-DB companies who entered the market can be counted on two hands. Of eight test balloons, four have already burst. All attempts at entering the market were limited to a maximum of two pairs of trains per day. Due to the risks involved, no third party dared attempt a scheduled system – namely a two-hourly timetable.

Potential given away: Since DB AG have been systematically optimising their long-distance offers to the capabilities of the capital market, the consequences of missing competition become increasingly visible. The strategy of focusing on a manageable number of high-speed connections between cities of more than 250,000

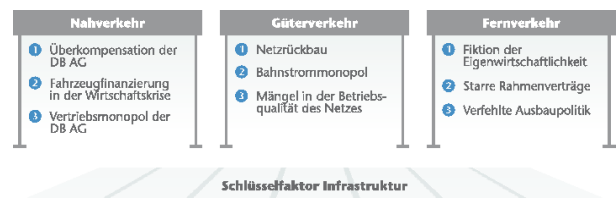
inhabitants comes at the expense of smaller cities and town. Cities like Mönchengladbach, Heilbronn, Chemnitz or Siegen are left behind. This focus – although legitimate from an economic point of view – is contrary to the disperse structure of urban development in Germany. If this continues, then nearby access to rail transport will remain permanently unavailable for a large portion of the population. Without organised competition there will be nobody to fill this gap.

Competition would also do DB AG's monopoly of ICE transport good. This would put the high price politics of the last few years to the test and give alternative concepts a chance.

What is halting competition?

Officially, entry into the German railway network has been open since 2004. In practice, however, there are numerous invisible barriers which make life difficult for competing companies. It is not misconceived that there has been considerable improvement. For example, those involved work together in a more professional way and the formation of a Federal Network Agency has given backing to regulations. Nevertheless, it would certainly be remote from everyday life to assume that the board of directors of an integrated company would not use every opportunity to protect its competing transport companies. It is even an obligation under stock corporation law.

Almost all competition obstacles have one combined core: the dominance of DB AG over railway infrastructure. He who, like the DB group, is allowed to be market player and referee at the same time has a privileged place regardless of the number of or competence of the umpire (regulating authority).



Relating to the individual segments of the rail industry, there are several different obstacles to bear: In SPNV the overcompensation of DB AG with the in-house awards from 2002 to 2004 continue to have an effect. Fable yields of 11.2% of operating turnover or 19.3% over the whole added value of the group (2008) are a nice cushion to be able to compete with dumping prices. Indications of abusing their market dominating position have induced mofair e.V. to push for a further complaint before the European Commission. Monopoly prices ease up investment in new vehicles with which the market leader can hardly be beaten in first tenders of still protected networks. Since profits in SPNV flow straight into the company profits without appropriation, DB AG are able to distort competition in, for example, freight transport, according to how and where they spend their money.

A further obstacle preventing entry into the SPNV market is vehicle funding, above all during the economic crisis. Already in normal times, private companies enter the race with the handicap of having to pay more for vehicles due to a worse credit rating than the state railway DB AG. This disadvantage increases during the crisis which is why even listed international companies fail on the financial front. Medium-sized newcomers more than ever haven't a chance.

The sales monopoly of DB AG forms the third significant competition barrier in local transport. Although DB AG are losing more and more transport, they are still allowed to organise the sale of tickets alone. Competitors have no insight into the many tariff systems.

For this reason they are at a particular disadvantage in tenders where the revenue risk is that of the operator. However, there is a confident trend towards client bodies aiming for operator neutral solutions for the question of sales.

There are other obstacles for competitors in freight transport. Their opportunities for development suffer significantly under DB AG's considerable dismantling of infrastructure. For a long time, the company had planned an IPO with infrastructure so that its business sectors were subject to profitability pressure similar to the transport sectors. Subsequently, DB Netz removed numerous overtaking, parking and loading tracks as well as points, which seemed expendable in the immediate economic P&L statement of the company.

The basis for this decision is alone the current and planned operating programs of their subsidiaries and not those of competitors. Their need for the future is ignored although, in the past few years, it has been they who have put more transport onto the railways. The result is that many routes no longer have any reserve capacity. Each transport won is a danger to operational stability. A ray of hope comes, however, from the Federal Railway Authority who has recently been speaking out against the reduction of capacity.

The abuse of the monopoly of railway electricity has had the worst effect. The competing railway companies are blatantly discriminated against in that only DB transport subsidiaries enjoy the ample volume and contract term discounts. These can add up to 14%. Further pinpricks are caused by the weakness in operational management (e.g. lack of planning for road works), the difficult access to shunting stations and the fact that DB Netz do not offer important services as operator neutral.

In the – ostensibly – long-distance rail transport without subsidies the causes of the lack of competition are split: the economically lucrative part of the existing DB AG offer (ICE connections, IC Hamburg – Cologne) is not attacked because the chances of success of a newcomer are too low. The fixed framework agreement deadlines make it pretty much impossible to set up the necessary vehicle fleet for a competitive synchronised

transport service. Here one has to factor in the risk premiums which discourage private investors.

The fact that competitors are not filling those gaps left by the InterRegio being disposed of between the medium-sized cities is due to a system error. The parting line between long-distance transport without subsidies and commissioned local transport is artificial. Since it is the integrated operator, only DB AG is – at present – able to extend long-distance transport sufficiently. This will soon change because investment in vehicles will be needed. Then a further reduction in long-distance offers is on the cards unless the Federation jumps in.

Outlook: How will competition develop up to 2015?

Since the in-house awarded contracts of DB AG will terminate between 2013 and 2016, more and more train km will come onto the market annually from 2013 onwards. Announcements of an annual 70 or 80 million train km are, however, exaggerated because the client bodies will be forced to postpone a part of the volume backwards, namely until after 2020. Realistically, there will be an award volume of 30 to 40m train km p.a. One can state positively that, in the meantime, the client bodies have come to see competition as an instrument to increase efficiency. Hereby the risk of renewed in-house awards which further delay the opening of the market is reduced.

Whether five of the ten largest European local transport companies will continue to stay away from the German market cannot be predicted. What will be decisive is the transparency and bindingness of the award calendar. One or two foreign state railways could push onto the market. In contrast, two state railways could be up for sale.

Intense competition will remain in freight transport. There are good opportunities for competitors to grow more than the market leader DB Schenker Rail over the next few years. Nonetheless there is no reason for euphoria. Apart from the effects yet to come from the economic crisis, access to the bulk cargo market will remain arduous until 2015. A key position is held by the uncertain future of SBB Cargo. If they were to fall into the hands of DB AG, then this would be a disservice to competition in Germany and Europe.

Also in long-distance transport, DB AG will remain pretty much unchallenged until 2015. As long as the current competition obstacles remain, only gamblers in synchronised transport will enter into the German market. This does not exclude individual experiments. The consequences of opening up the market for cross-border transport in 2010 is very much underestimated. The state run railways will continue to rely on each others cooperation instead of disputing each others secret domains.

Requests to railway politics from 2010 onwards

The railway transport market can only function in an unlimited way if the operators of infrastructure operate reliably and independently. Risk capital from private investors will only flow into the system if the success of their own business model is not steered 50% (infrastructure!) by direct competitors.

The second best competition policy is the strengthening of the regulatory bodies. The legal basis for regulation must be sharpened and the personnel resources of the Federal Network Agency improved. One must consider whether the railway sector should receive its own decision board, as in other network sectors. A yardstick regulation for infrastructure fees must be introduced immediately. The Ministry of Economics must supervise this regulation.

The newly elected Federal Government must take the following transport issues on board:

- The development and extension policies of railways must concentrate on the most important things (network shortage, intersections). Flagship projects which are of no use to freight or local transport should be parked.
- The service and financing agreement for the existing network must be improved significantly. Quality specifications must be defined (one must record indicators like "capacity" and "age of facility", "route specific analysis"), and instruments to enforce this to be put in motion.
- The responsibility for infrastructure of regional networks must be decentralised in the medium term. Without an improvement in efficiency through competition these networks will not be maintainable.
- The safeguarding of the future of long-distance transport must be recognised as a Federal Government issue. One must discuss whether cities with less than 250,000 inhabitants have the right to a basic transport offer. If yes, the market must be organised in a different way. An obvious suggestion would be an assigned competition modelled on the local transport.

Competition in figures

SPNV

Market share of competitors in Germany

SPNV.....	10%	of passenger km (2008)
SPNV.....	18.3%	of train km (2008)
SPNV.....	22.3%	of train km (2011)
S-Bahn.....	2.9%	of train km (2009)
S-Bahn.....	6.0%	of train km (2011)

Biggest market players

1. DB AG.....	508.0 m	train km (2009)
2. Veolia Verkehr.....	29.4 m	train km (2009)
3. Arriva.....	21.5 m	train km (2009)

Ratio of first tenders to market volume

SPNV	31.6 %	of train km (2009)
S-Bahn.....	18.7%	of train km (2009)

Savings per 118 competitive awards

Total.....	26.0%
S-Bahn.....	22.6%
RE services.....	47.3%
RE/RB services.....	32.9%
RB services.....	14.8%

Savings potential for the monopoly of 435m train km

.....> 1 bn Euro

SGV

Market share of competitors in Germany

SGV - 21% of train km (2008)

Biggest market players

1. DB Schenker Rail...	91.0 bn	train km (2008)
2. rail4chem.....	4.2 bn	train km (2008) (Veolia Cargo)
3. SBB Cargo.....	3.9 bn	train km (2008)

SPFV

Market share of competitors in Germany

SPFV..... < 1% of passenger km (2008)

Attempts to enter the market

Since 1994	8
Failures	4