

The McNulty report in the European context

A simple comparison of the UK and German rail model

SUMMARY

There has been a lengthy debate in the EP TRAN about the benefits and drawbacks of the UK model where the infrastructure manager (IM) is entirely separate (both legally and operationally) from railway undertakings (RUs), as opposed to the German “holding company” model.

This paper compares the published outputs of the main comparators between the UK and the German arrangements and concludes that the UK model leads to better results than the German integrated model.

This paper also takes into account the report of the “Rail Value for Money Study” (also referred to as the “McNulty Report”), published by Sir Roy McNulty in May 2011¹. It acknowledges the significance of the study as well as useful ideas in the study to reduce railway costs and to improve the efficiency of railways. At the same time, it warns about the fact that discussions in the UK centre around issues such as how to improve value for money in the rail sector, how to attract private investment and how to meet increasing demand. Unfortunately, this is a discussion that the majority of countries in Europe cannot yet afford, and certainly even less so Germany where a level playing field does not yet exist, neither for passenger nor freight traffic.

CONCLUSIONS

The following conclusions have been established:

- **The UK model performs better than the German integrated model:**
 - Passenger satisfaction – UK well ahead of Germany (and France)
 - Punctuality and reliability - UK well ahead of Germany (and France)
 - Growth in passenger and freight traffic – UK well ahead of Germany

- Passenger liberalisation - UK ahead of Germany
- Competition – UK well ahead of Germany
- Costs – not comparable
- There is **every reason to link the UK position to the structure of total separation of track and train**, creating, as the UK model does, full transparency and competition in a much more effective single market, more akin to the air or road freight markets.
- The UK Government is seeking ways to reduce costs and encourages IMs and RUs to work more closely together, but there is no suggestion of any ownership link or lack of transparency between them. Besides, whilst welcoming many of the conclusions of the McNulty Report, **the UK Government is not supporting all the measures the report proposes.**
- The McNulty Report and separation **address two completely distinct issues:** while the McNulty deals with **barriers to efficiency**, the issue of separation relates to **barriers to market entry**. Unbundling is an issue the UK solved already back in 1993.
- The Report **does not advocate reintegrating IMs and RUs**, but rather encourages closer co-operation between all parties. Vertical integration was examined as a remote possibility among the various options to ensure alignment between RUs and IMs, and only in the **specific context of franchises** attributed through competitive tendering. This specificity does not apply to the majority of EU countries and certainly not to Germany.
- **The arguments for full separation of IM and all RUs remain as strong as ever**, and we hope that it will feature strongly in the Fourth Railway Package.

¹ McNulty Report – ‘Realising the Potential for GB Rail’, May 2011 <http://www.dft.gov.uk/publications/realising-the-potential-of-gb-rail/>

1 Background

There has been a lengthy debate in the EP TRAN about the benefits and drawbacks of the UK model where the infrastructure manager (IM) is entirely separate (both legally and operationally) from railway undertakings (RUs), compared to the German “holding company” model.

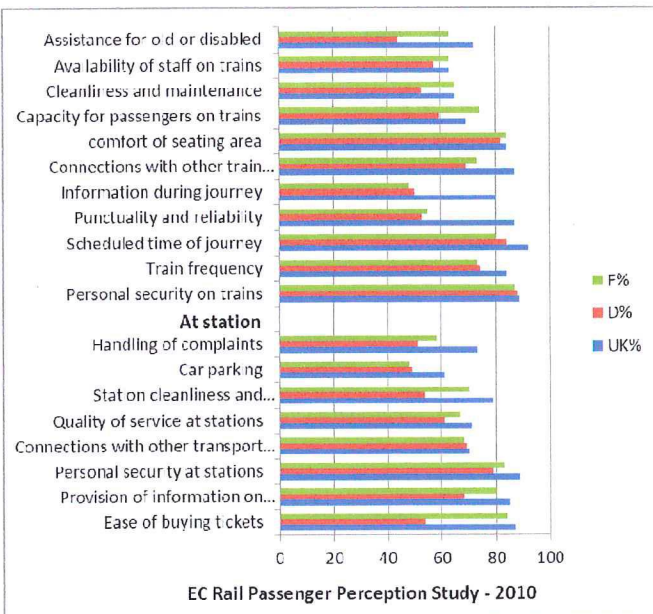
The EC’s draft of the Recast of the First Railway Package generally followed the UK structure of total separation, but there is pressure to allow for the option of a “holding company” model.

This paper compares the published outputs of the main comparators between the UK and the German arrangements, and summarises the current UK Government thinking on structure.

2 Comparators

a. Passenger satisfaction

In a recent EC study² on passenger perceptions in each Member State, including 18 measures, the UK is ahead of Germany (and France) in all but one case (see chart below). One can conclude from this study that the German structure certainly does not bring the same benefits to passengers as the UK structure.



b. Traffic volumes

Between 1995 and 2009, passenger kilometres have grown by about 13% in Germany and by over 50% in the UK. Hence both countries have shown higher growth than many other Member

² EC Survey of Passenger Satisfaction. http://ec.europa.eu/transport/rail/studies/doc/2011_06-survey-passengers-satisfaction-with-rail-services.pdf

States, but the UK has experienced a considerably greater growth. The DB Competition Report 2011² states that the UK passenger market grew by 6.7% in 2011, compared with a growth rate of 2.2% in Germany. Comparable freight growth volumes are more difficult to come by, and in recent years these growth rates have varied significantly between sectors. In the UK, rail freight tonnes.km increased by about 70% between 1994 and 2006², and since 2008, intermodal traffic has grown by about 29%⁶. In Germany, the increase between 1994 and 2010 was about 21%³.

The EU’s RMMS report⁴ confirms this trend of freight and passenger volumes having grown faster in the UK than in Germany since 2000:

	Freight	Passenger
UK	+30%	+43%
D	+5%	+39%

c. Liberalisation Structure

The 2011 IBM Rail Liberalisation Index Study⁴ shows that the overall leaders of the rail liberalised index are Sweden and the UK – both of which have independent infrastructure management (as do four of the top five countries in the Study). The study concludes: “Generally speaking, there is a distinctly positive correlation between the results of the LIB Index and those of the COM Index. This can be seen as an indicator that lowering barriers to market access promotes the entry of newcomers into the market.” Liberalised railway markets occupy the top three slots in the competitive index; “Great Britain leads the COM Index with a clear margin. There, a high degree of competitive dynamics has taken hold since the liberalisation of the rail market and the breakup of the incumbent in 1994. However, it is worth noting that a prime driver in Great Britain’s high score on the COM Index is the large share of the market operated by external RUs.” In fact, all RUs are independent of the IM.

d. Passenger liberalisation

The 2010 EU-commissioned report on ‘Regulatory Options on further market opening in rail passenger transport’⁵ found that a UK-style ‘Model G’ (universally Public Service Contracts with open access permitted under regulatory control)

³ MDS Transmodal - UK rail freight forecast http://www.rfg.org.uk/userfiles/file/Rail%20Freight%20Demand%20Forecasts%20to%202030_ver2.pdf

⁴ EU’s 2009 RMMS http://eur-lex.europa.eu/Result.do?T1=V5&T2=2009&T3=676&RechType=RECH_naturel&Submit=Rechercher

⁵ IBM Rail Liberalisation http://www.deutschebahn.com/site/shared/en/file_attachments/position_papers/study_rail_liberalisation_index_2011_presentation.pdf

performed better than all other models. It concludes (page 290) that “Model G scores better against more of the impact assessment criteria than any of the other models, and in most cases Model H comes second, followed by Model E and then Model B.” Model G is effectively the model adopted in the UK.

e. Competition

Competition in passenger services is achieved by different means in Germany and the UK. In the UK, 100% of passenger operators are independent of the IM; in Germany, operators independent of the IM account for 21.6%⁶ of the regional market, but only for a very small share in the long distance market.

In freight, theoretically, fair and open competition exists between operators, but whereas the largest one in Germany has a share of 75% of the market⁷, the largest operator in the UK has a share of only 49% of the market. Most importantly, in the UK there is no link between any of the five RUs and the IM. Hence, in the UK, the independent freight operators have a share of 100% of the market; in Germany their share is 25% of the market.

The existence of a dominant position in a market tends to reduce competition; any company with a share of more than 30% of a market may be subject to investigations by competition authorities if it is seen to be abusing its dominant position. In both the UK and Germany, the market share of the largest RU is well above this threshold, but it is significantly higher in Germany, and the largest German RU is part of the same holding company as the IM, with no transparency of financial flows between them, and with a strong likelihood of special treatment by the IM of its ‘own’ RU. The total separation of RU and IM leads to a potentially much better competitive environment.

f. Costs

The McNulty Report⁷ on UK rail costs, jointly commissioned by the UK Government and the independent Office of Rail Regulation (ORR), suggested that UK rail costs were up to 40% higher than continental comparators. The Report does not specify which Member States this comparison relates to. However, a UK Government Treasury organisation called Infrastructure UK has reported⁸ that UK

construction costs for projects including rail, road, airports, energy projects are on average 60% higher than in Germany. Furthermore, the ORR’s more recent report⁹ concludes that, ‘comparing labour, plant and material input costs with Northern European countries indicates that the UK is generally comparable’. It suggests that ‘project management, working practices, quality of engineering solutions, relative skills levels, and approaches to safety may drive some of the differences.’ We suggest that this indicates that it would not be reasonable to attribute any significant differences in costs between the UK and German railways to any structural difference.

g. Investment in the railway

Investment in the railway is a political decision by the Governments concerned. Whereas it was higher in the UK than in Germany² in the last ten years, in the UK that reflected a need to improve the quality of the UK network. Germany’s major spend was in the 1990s following reunification and restructuring of the railway.

h. Safety

The ORR’s Safety Report (July 2011)¹⁰ shows that railway safety is generally improving, and that the UK’s safety record for the period between 2004 and 2009, in terms of fatalities per million train kilometres, at 0.008, was 50% better than comparable figures for Germany, at 0.012.

Thus, we conclude that one of the main reasons behind the Commission’s proposals for total separation of IM from RU was to enable the rail services market above tracks to develop in an environment of fair and open competition, as competition will lead to innovation, efficiencies and better customer service.

3 The McNulty Report

The UK McNulty Report set out some useful ideas to reduce railway costs and encourage closer co-operation between IM and RUs, but the evidence on comparative railway costs is not supported by other reports – see above. McNulty also recommended trials of several structures, but the only a full vertical integration scheme thought likely was a metro system called Merseyrail; even here the operator withdrew because of the high risks of infrastructure management. The UK Government has no plans to allow for a complete reintegration of RU and IM, preferring to support the regionalisation of some of Network Rail’s

⁶ DB Competition report 2011 http://www.deutschebahn.com/site/shared/en/file_attachments/publications_broschures/competition_report_2011.pdf

⁷ DB Competition report 2011 http://www.deutschebahn.com/site/shared/en/file_attachments/publications_broschures/competition_report_2011.pdf

⁸ Infrastructure UK (IUK) Report http://www.hm-treasury.gov.uk/iuk_cost_review_index.htm

⁹ ORR – Periodic Review 2013 – Establishing Network Rail’s efficient expenditure, July 2011 www.orr.gov.uk

¹⁰ ORR Health and Safety Report. http://www.rail-reg.gov.uk/upload/pdf/health_safety_report_2011.pdf

functions, the retention of a national system operator role (IM) and to encourage a much greater degree of co-operation between all parties. This is quite different from Vertical Integration.

The McNulty report and separation are two completely different issues. While McNulty deals with barriers to efficiency, the issue of separation relates to barriers to market entry, and it is not appropriate to quote McNulty in this context. Discussions in the UK centre around issues such as how to improve value for money in the rail sector, how to attract private investment and how to meet increasing demand, which is expected to double by 2030.

Unfortunately, this is a discussion that the majority of countries in Europe cannot yet afford, and certainly even less so Germany, where a level playing field does not yet exist, either for passenger nor freight traffic. This is a problem the Commission wants to address in its proposal for separation: to ensure that market entry is possible and not undermined by the conflict of interest which is inherent when one and the same company owns both infrastructure and service operations. This issue is not addressed in the McNulty report, which encourages closer co-operation between all parties but certainly does not advocate for a reintegration of IMs and RUs. This is a problem that the UK solved already back in 1993.

The McNulty report sets out useful ideas to reduce railway costs which, at a time of financial constraints and in a sector highly dependent on public funding, are to be commended. These include measures to create an enabling environment such as clarifying rail policy, clarifying the purpose of subsidies, improving industry leadership etc. The Recast already contains some important proposals in this regard

CONCLUSION

The UK's railway is well ahead of the German railway in passenger satisfaction, competition and traffic growth, passenger and freight.

There **is every reason to link this with the structure of total separation** of track and train, creating, as it does, a much more effective single market, more akin to the air or road freight markets.

– multi annual contracts certainly go in the right direction, but the issue of accounting separation needs more attention.

Other key McNulty proposals include changes in terms of asset management, programme and project management and supply chain management. These are the changes that the sector desperately needs and customers expect from market players. However, as is well illustrated by the UK case, willingness to change and improve only exists in competitive markets.

The former UK Secretary of State for Transport, Philip Hammond MP, commented that the Government 'is seeking to modify the present structure by 'evolution and not revolution' to maximise competition, to strengthen regulation and thereby reduce overall costs through efficiency savings.' **What is not on offer in the UK is for one train operator, especially one with close and non-transparent links with Network Rail, to control the overall timetable, and therefore effectively receive commercial advantage over other operators.** The UK is learning from experience rather than moving to a "holding company" structure for which the benefits are not evident.

Thus, the UK Government, whilst welcoming many of the conclusions of the McNulty Report, is not supporting all the measures proposed in the report. The UK Government is indeed seeking ways to reduce the costs of the railway. The ORR has succeeded in reducing Network Rail's costs by 50% in ten years whilst at the same time improving the quality of the network. The ORR's role will be enhanced now that the IM has set up regional subsidiaries for maintenance and renewals that can be benchmarked against each other. Importantly, unlike in Germany, the ORR has powers to obtain any information it needs from Network Rail.

There is still more to do, and the **McNulty Report has brought a welcome new incentive on the industry and Government to improve efficiencies**, reduce costs and work more closely together. The report does not address the barriers to entry inherent in a structure where infrastructure and most train operations are in the same ownership.

The **arguments for full separation of IM and all RUs remains as strong as ever**, and we hope that it will feature strongly in the Fourth Railway Package.

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