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Competition for Railway Markets: The Case of Baden-Württemberg

**Rafael Lalive, University of Zürich, CESifo and IZA
Armin Schmutzler*, University of Zürich, CEPR and
ENCORE**

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Competition for Railway Markets: The Case of Baden-Württemberg

Rafael Lalive
University of Zurich
Institute for Empirical
Research in Economics
Blümlisalpstr. 10
CH-8006 Zürich

Armin Schmutzler
University of Zurich
Socioeconomic Institute
Blümlisalpstr. 10
CH-8006 Zürich

author 3
institution
city

Phone: +41-44-634-37-25
Fax: +41-44-634-49-07
email: rllive@iew.unizh.ch

Phone: +41-44-634-22-71
Fax: +41-44-634-49-07
email: arminsch@soi.unizh.ch

Phone:
Fax:
email:

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Abstract

This paper studies the effects of introducing competition for local passenger railway markets in the German state of Baden-Württemberg. We compare the evolution of the frequency of service on lines that were exposed to competition for the market and lines that were not. Our results suggest that competitive lines enjoyed a stronger growth of the frequency of service than non-competitive lines, even after controlling for various line characteristics that might have an independent influence on the frequency of service. Our results further suggest that the effects of competition may depend strongly on the operator.

Keywords

Competition for the market, liberalization, passenger railways, procurement auctions

1. Introduction

As a consequence of the railway reforms in the nineteen nineties, the former state monopolies in the industry are facing increasing competition in many European countries. The proponents of the reforms argue that this development will not only lead to decreasing transfers, but also to a better service quality.¹

However, this opinion is not undisputed. First, there are serious arguments that cast doubt on the hope that the potential efficiency gains from liberalisation in the railway industry are similar to those in other sectors, most notably telecommunications.² Second, it is not obvious that the institutional details in the liberalized railway industry have been chosen in such a fashion that potential efficiency gains are realized.³ From a-priori considerations, it is impossible to come to a definite conclusion regarding the pros and cons of liberalization as such, let alone the particular institutions chosen in the different European countries.

The empirical evaluation of the railway reforms is still in its infancy. A small number of contributions deals with the efficiency effects of various reforms in an international context on a highly aggregate level (Cantos et al. 1999, Friebel et al. 2003). Several contributions deal with the outcomes of the U.K. reform (Cowie 2002, Pollitt and Smith 2001). Our contribution concentrates on a concrete measure, namely the German Regionalisierungsgesetz, a law that was passed in 1993.⁴ This measure led to a massive change in the procurement of regional

¹ Unsurprisingly, a particularly optimistic perspective on the potential efficiency gains from competition comes from a report commissioned by MehrBahnen, the umbrella organisation of competitors of the state enterprise Deutsche Bahn (pspc 2004). The report estimates the potential reduction in subsidies from relying on competitive mechanisms for procuring regional passenger services at 18-38%, depending on the type of service.

² For instance, there is no reason to expect similar technological improvements as in the telecoms sector, as the railroad technology is comparatively mature.

³ For instance, there is no consensus as to the right extent of vertical separation. Also, it is not obvious how access prices should best be regulated, for instance in view of the implied investment incentives for network owners and operators. In the case of the British reform, both issues were hotly debated (see, e.g. Bühler et al. 2004).

⁴ Officially, the law is known as Gesetz zur Regionalisierung des öffentlichen Personennahverkehrs. It was passed on December 27, 1993 as Article 4 of the Eisenbahnneuordnungsgesetz, which contains most of the legal foundations for the German railway reform.

passenger transportation. Even though transfer payments from the central government are still used to finance short-distance trains and other forms of public transport, the role of the central state for procurement is indirect. Each year, it distributes a substantial amount of money (between six and seven million Euro in each year between 1997 and 2004) to the 16 states (Länder) who are now responsible for the procurement of regional passenger transport, and railway services in particular.⁵ The states, in turn, delegated this task to newly founded agencies. These agencies are now allowed to use competitive franchising to procure the services, which typically means that firms bid in the transfer payments required to carry out certain service obligations, with the lowest bidder having to supply the service in return for the transfer. Importantly, however, agencies are not obliged to use such procedures. On 20-25% of the passenger railway lines a substantial part of local passenger services is now procured in a (more or less) competitive fashion. On the remaining lines all services are still provided by the incumbent without any competition for the market. Typically, the service provider in these cases is DB Regio, a subsidiary of Deutsche Bahn AG, the successor of the former state monopolist; in much rarer cases, some other company carries out the service without having obtained the franchise in a competitive fashion.⁶

While DB Regio is still the dominant operator ten years after the reforms were introduced, its competitors, the NE-operators,⁷ have expanded their market share from about 3% at the beginning of the reform to 13.2% in 2004 (DB AG 2005).⁸ Moreover, in cases where competitive bidding is applied, the competitors are successful at least as often as DB Regio, suggesting that in the medium term this operator's dominance may well belong to the past.⁹

⁵ The development of the yearly transfer payments is reported in Deutsche Bahn (2003). Note, however, that only about 70-80% of the payments are devoted exclusively to rail transportation as other modes also obtain support.

⁶ As will be laid out in Section 2, a considerable number of small operators were already active before the railway reform.

⁷ "NE" refers to "nicht bundeseigen", that is, not belonging to the Federal Republic of Germany. The term contains both privately owned firms and firms that belong to the public sector (e.g., firms that are owned by local authorities).

⁸ This market share is expressed in terms of the services supplied (train kilometers). In terms of patronage, the competitors' market share is still below 6%.

⁹ It should be noted, however, that there is a recent tendency for agencies to write long-time contracts with DB Regio which put limits on the extent to which competitive bidding will be used in the future. For instance, in Baden-Württemberg such a contract was signed in 2003 (Stuttgarter Nachrichten 2003).

Economic theory suggests that with competitive bidding it should be possible to achieve any given service quality with lower transfer payments for two reasons. First, competition puts pressure on firms to enter low bids; second, it helps to select the most efficient supplier. The partial introduction of competition in Germany greatly simplifies testing such a statement, because we can compare the evolution of the performance on the competitive and the non-competitive segment of the market. However, the data situation is not perfect. From an economic point of view, one would like to use a variable like transfer payments per train kilometer or preferably per passenger kilometer as an efficiency measure. Unfortunately, it is impossible to get data on the evolution of transfer payments at the level of individual lines. Instead, our analysis attempts to clarify whether the development of service quality in the competitive segment has been more favorable than in the non-competitive segment, where service quality is defined as the frequency of service on the railway line under consideration.¹⁰ Given the dearth of data that are publicly available for the German railway sector, even the compilation of the relatively modest data set on the frequency of service that we use for this project is a useful contribution to the empirical analysis of the issue. Obviously, however, even if we identify positive competition effects in this sense our analysis does not entirely preclude the possibility that the frequency of service on the competitive lines grew more rapidly than on their non-competitive counterparts because agencies systematically spent more money on the former than on the latter. However, our preferred interpretation is that agencies demand more of the potential contractors when they use competitive bidding than when they face a monopolist.

There are further reasons why we do not want to overstate the normative significance of our analysis. Most importantly, we do not analyze whether the level of federal transfer payments that flows into regional passenger railways is adequate from a welfare perspective. One might make a case that spending around five billion Euros per year on the operation of regional passenger trains is too much in a country with severe budgetary problems. One might also argue that, at least on the more congested lines, additional passenger services take away scarce capacities which are needed for freight or long-distance passenger transportation.¹¹ Our analysis is merely concerned with whether competitive procurement is a more effective way

¹⁰ See Section 3 for a discussion of this definition.

¹¹ However, it should be noted that on the majority of lines in our sample there are no severe capacity problems. Though the network in Germany is much less dense than it was in the heydays of railway transportation, there has been no equivalent to the 'Beeching axe' in the UK which led to the closure of most rural low-frequency lines in the nineteen sixties.

of achieving the goal of increasing regional passenger transportation than monopolistic procurement; we do not discuss the goal itself.

The paper concentrates on the state of Baden-Württemberg, one of the largest German states, where the fraction of railway lines that have been exposed to competition is clearly above average. Apart from the obvious reason that collecting the data for all of Germany is an arduous task, focusing on one state has the additional advantage of reducing within-sample heterogeneity.

Our data strongly suggest that there is a competition effect: The quality of service on those lines that were subjected to competition developed more favourably than on those that were not. This effect is robust to the introduction of control variables which could have an independent effect on the development of service quality, for instance, the remoteness of the line or the population of the communities served.

There also appears to be some evidence for ownership effects. On the one hand, NE-operated non-competitive lines tend to grow more rapidly than the corresponding lines operated by DB Regio. On the other hand, while the additional effect of competition is strong and significant, for DB Regio, it is mixed for the NE-operators. For the largest NE-operator, the AlbtalBahn-Verkehrsgesellschaft (AVG) near Karlsruhe, the effect of competition is even stronger, whereas the remaining NE-operators do not develop much differently than their non-competitive counterparts.

The remainder of the paper is organized as follows. In Section 2, we shall sketch some institutional background and develop our hypotheses. Section 3 describes the methods and the data set. In Section 4, we present our econometric results. Section 5 concludes and describes the next steps of the investigation.

2. Background and Hypotheses

2.1 Institutional Background

As in most other European countries, the railways in Germany were essentially run by state monopolies until the early nineteen nineties. In West Germany, Deutsche Bundesbahn owned most of the infrastructure and, at the same time, was the dominant operator for passenger and freight services. In addition, there was a considerable number of minor railroad companies (NE-Bahnen) which were typically also vertically integrated and carried out freight and/or passenger transportation on small networks. In East Germany, Deutsche Reichsbahn was the integrated operator of the railway system.

Major reforms of the railway system were introduced in Germany in the nineteen nineties. These reforms were induced by the EU-directive 91/440, but there was also some internal pressure to introduce changes to the system. First, after reunification, there was the obvious issue of integrating the East and West German railways. Second, the cumulated debt of the two state railways was immense, amounting to DM 67 Mrd. in 1993 (Greffrath and Lingenthal 1994).

On January 1, 1994, the railway reform became effective. Apart from creating Deutsche Bahn AG as a successor of Deutsche Bundesbahn and Deutsche Reichsbahn, the reform had several elements that were familiar from other countries. First, though Deutsche Bahn AG is generally regarded as a vertically integrated company, distinct sub-organisations were introduced at the upstream level (DB Netz for the network and DB Station & Service for the stations) and the downstream level (DB Regio for regional passenger transportation, DB Reise und Touristik for long-distance passenger services and DB Cargo for freight). Thus, at least a move into the direction of vertical separation was made.¹² Second, some degree of competition was introduced. Infrastructure owners, in particular DB Netz, are required to allow freight operators and long-distance passenger operators access onto their network.¹³ With respect to local passenger services, an entirely different avenue was pursued. Essentially, the reforms led to the introduction of competition for the market.

¹² In 1999, this separation was taken one step further. Deutsche Bahn AG is now a holding company, consisting of five corporations.

¹³ In practice, access is negligible for long-distance passenger trains, but substantial for freight trains.

More specifically, as a consequence of the railway reform, the Länder have created agencies whose task it is to procure local passenger services. In Baden-Württemberg, the most important agency is the Nahverkehrsgesellschaft Baden-Württemberg (NVBW); in addition, the Verkehrsverbund Rhein-Neckar (VRN) and the Verkehrs- und Tarifverbund Raum Stuttgart (VVS) are in charge of the services in the agglomerations of Heidelberg/Mannheim and Stuttgart, respectively. In principle, the agencies are free to use competitive bidding to allocate franchises for the local monopoly on a particular line. The extent to which this possibility is used varies considerably across agencies. Moreover, individual agencies like NVBW and VRN use different mechanisms to procure services on different lines within their sphere of influence. The two polar cases are most important. At one extreme, the agencies can negotiate directly with the incumbent supplier, without contacting any potential competitors. At the other extreme, they can resort to open competitive bidding for the market. In the simplest type of bidding procedure, the agency specifies detailed requirements about the level of service quality that it expects. The specifications include the frequency of service, the rolling stock, the prices charged to customers, etc.¹⁴ The contractors' bids are the subsidy levels required to carry out the expected services.¹⁵ The successful bidder is paid his bid and obtains the franchise for a period of typically 5-10 years. He then becomes the residual claimant for the operating profits of the line.¹⁶

Differences in contractors' bids reflect both differences in their relative efficiencies and in the quality of the estimations of the value of the franchise, which is driven for instance by the expected number of passengers. Thus, the auction has a private-value component as well as a common-value component. For this reason, it is not necessarily clear that the successful bid will come from the most efficient firm. The winner may simply have overestimated the

¹⁴ In Germany, regional public transport organisations (Verkehrsverbände) coordinate timetables, prices etc. on a substantial part of the network. In some cases, but by no means always, these organisations are identical with the agencies that procure services; often they are entirely separate institutions. Either way, the freedom of railway operators to set prices is limited by the existence of the public transport organisations.

¹⁵ In typical textbook treatments of competition for the market (Viscusi et al. 2000), the procedure is slightly different. Contractors do not bid the required subsidy. Instead, they bid the price they want to charge to consumers and the lowest bid wins (Demsetz 1968).

¹⁶ There are also cases where the specifications of the auction are less detailed, leaving some scope for the contractors to compete in other dimensions than the required subsidies. As the exact weighting of the different dimensions is typically left unspecified, the allocation mechanism is closer to a "beauty contest" than to multi-dimensional auction in the sense of Che (1993) and Branco (1997).

potential gains from the market. To my knowledge, there is only one obvious case of competitive bidding in the German railway market where this kind of "winner's curse" phenomenon played an important role: The winner of an auction for the line Hamburg-Flensburg in Schleswig-Holstein was the newly founded *FlexVerkehrs AG* that went bankrupt within a year after taking up the service in 2002 (der Fahrgast 2003).¹⁷

As a result of the introduction of competition for the market, the market share of DB Regio's competitors has grown substantially. The pool of competitors consists of several types of firms. First, the above-mentioned pre-reform NE-operators play an important role. These firms typically still own their old infrastructure, but they often have expanded their operations onto the network of Deutsche Bahn where they are exclusively responsible for the provision of downstream services.¹⁸ Second, some entirely new companies have been formed. Third, some railway operators are joint ventures between other companies, in some cases including DB Regio.¹⁹ Finally, foreign firms have entered the market. Typically, they have taken over independent local operators; however, there are also examples of entry on lines that were previously operated by DB Regio.²⁰

¹⁷ A related case concerns the important line Hamburg-Westerland, also in Schleswig-Holstein. Here, the successful Nord-Ostseebahn entered a very attractive bid, but apparently finds it difficult to break even. As a remedy, it is playing with the idea of increasing ticket prices for some passengers (Hamburger Abendblatt, 14/10/2005).

¹⁸ In Baden-Württemberg, the main pre-reform operators were Südwestdeutsche Eisenbahngesellschaft (SWEG), Württembergische Eisenbahngesellschaft (WEG), Hohenzollerische Landeseisenbahn (HzL), AlbtalBahn-Verkehrsgesellschaft (AVG) and Oberrheinische Eisenbahngesellschaft (OEG). SWEG, HzL and AVG have expanded their operations onto the Deutsche Bahn network, partly in joint ventures. OEG still concentrates on its old network; WEG has been taken over by Connex.

¹⁹ In Baden-Württemberg, there are no examples of entirely new firms in the market. However, for instance, the Breisgau S-Bahn was founded jointly by SWEG and the Freiburger Verkehrs AG, the municipal transportation firm in Freiburg.

²⁰ An example of the former case is Connex, a multinational company based in France; an example of the latter case is the entry of Swiss firms on lines near the border: the state railway SBB near Basel and its subsidiary Eurothurbo near Lake Constance.

2.2 Hypotheses

In the following, we shall show empirically that the introduction of competition has had a positive effect on a suitable measure of service quality. Though we shall be more specific in the empirical analysis, it is useful for the moment to think of service quality in a very broad way, including the frequency of service, reliability, comfort and, in addition, ticket prices, which are often part of the arrangement between agencies and contractors.

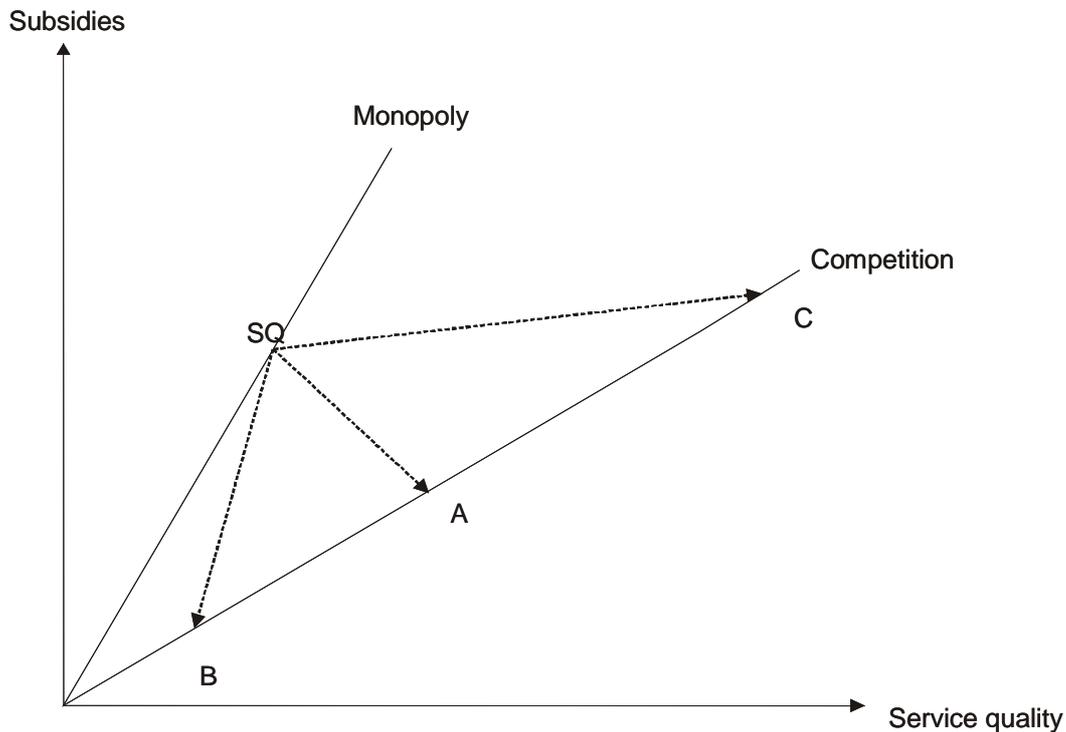
When there are direct negotiations with the incumbent supplier, there is usually no immediate threat for the supplier that asking for high transfers will mean losing the contract. Thus, the incumbent can be expected to have some bargaining power vis à vis the agency. Therefore, compared with the case of competitive bidding, we should expect the required transfers for each level of service quality to be higher. This not only reflects the competitive-pressure effect that all firms, whether incumbents or not, are forced to take the existence of competitors into account. In addition, there may be an efficiency effect: Usually, competitive bidding helps to find the most efficient bidder which should also lower bids.²¹

Figure 1 shows how the introduction of competition improves the position of the agency. The line denoted 'Monopoly' contains all feasible combinations of transfers ('subsidies') and quality for an agent facing a monopolist; the line 'Competition' is the analogous line for an agent that has introduced competition. Both lines are increasing, as higher quality will require higher transfers. However, the line 'Competition' lies below line 'Monopoly' to capture the hypothesis that competition reduces the required transfers.²²

²¹ However, as procurement auctions typically have private and common value components, relatively inefficient firms may win the bid when the uncertainty about the common value is large (see, e.g., Goeree and Offerman 2003 for a more thorough analysis).

²² The linearity of the two lines is immaterial for the argument.

Figure 1 Feasible subsidy/quality-bundles



In principle, there are three distinct possibilities for the agency to reap the harvest of competition. Relative to the Status Quo (SQ), the agency could obtain:

- (i) higher quality, lower transfers (Point A)
- (ii) lower quality, much lower transfers (Point B)
- (iii) much higher quality, higher transfers (Point C)

Without further assumptions about the agency's objective, it is not clear whether it opts for an improvement of the quality of supply after the introduction of competition, that is, whether one of the cases A or C will obtain. Clearly, however, the agency possesses the option to improve quality without necessarily having to resort to higher transfers. Whether it actually makes use of this option is precisely the question that this paper attempts to solve.

Thus, we formulate the main hypothesis of this paper:

Hypothesis 1 *Competition increases service quality.*

This hypothesis does not necessarily presuppose that the competitors are more efficient than the incumbent. In principle, competitive pressure alone could force DB Regio to improve its offer so that it wins the bid. Nevertheless one might ask whether it is important for quality what kind of operators provide the service. For instance, one might expect that private firms are more efficient than DB Regio, the successor of the former state monopolist Deutsche Bundesbahn. Modifying the argument described above, an agency that faces an NE-operator might ask for higher quality than when he faces DB Regio. The following hypothesis is clearly distinct from the first one:

Hypothesis 2 *Other things equal, firms that are not state-owned supply higher quality.*

Thus our investigation of the two hypotheses can also be regarded as an attempt to contribute to the clarification of the open question whether competition or privatisation is decisive for quality improvements in the public sector (Vickers and Yarrow 1988, ch. 1).

3. Data and Methods

To test our hypotheses, we first require a measure of service quality. Ideally, such a measure should aggregate all relevant aspects of quality, that is, the frequency of service, safety, comfort and prices. A good candidate for such a measure would be the number of passenger kilometers traveled on a line. This measure reflects the conceived service quality from the perspective of the passengers. Unfortunately, however, we only have rudimentary data on passenger kilometers, so that we used a less satisfactory measure, namely the frequency of service. We measure this frequency as the ratio between train kilometers per year (tkm) and the length of a line (lkm).²³ The frequency of service is an important aspect of service quality, but obviously not the only one.

To identify competition effects, we compare the evolution of the frequency of service in the group of competitive lines and the control group. We first introduce a definition for a competitively served line. To understand this definition, it is important to note that agencies do not necessarily procure all services on one line in the same fashion. For instance, in some cases, the agencies use competitive bidding for higher-level services (Regionalexpress), but procure lower level services on the same level directly from the monopolist.

Definition 1 *A line is served competitively if, for at least 20% of the train kilometers that were provided on these lines in the year 2003/2004, one of the following conditions holds:*²⁴

- (i) The services were procured using open competitive bidding.*
- (ii) The services were procured on the basis of offers from at least two firms that were approached directly by the agency.*
- (iii) Apart from the incumbent, at least one firm approached the agency directly by offering a contract without having been asked to do so.*
- (iv) For reasons other than those given under (i)-(iii), the services were carried out by another firm than the former incumbent DB Regio.*

²³ Thus, the frequency of service corresponds to the average number of trains per year on each kilometer of tracks.

²⁴ The 20% cut-off value is somewhat arbitrary; as, on most lines, the following conditions (i)-(iv) hold either for a very small number of services or for a large number of services, the results are likely to be robust to the exact choice of the cut-off level.

Case (i) is the most important in quantitative terms. The largest auction in Germany to date was carried out by VRN. DB Regio cast the successful bid for the S-Bahn Rhein-Neckar, a new metro system in the Heidelberg-Mannheim agglomeration, amounting to approximately 6 Mio. tkm per year (Die Welt 2001). Other major cases of competitive bidding in Baden-Württemberg included metro lines near Freiburg, Karlsruhe and Offenburg and the Ringzug, involving 1.258 Mio. tkm/year in the eastern part of the Black Forest (Hohenzollerische Landesbahn 2001).

Case (ii) is quite common in general, but not in Baden-Württemberg.²⁵

Case (iii) is rare in general, but it happened in Baden-Württemberg on one occasion: Starting from 2003, the lines Basel SBB -- Zell im Wiesental and Weil am Rhein -- Stetten were initially supposed to be served by the incumbent DB Regio jointly with SBB, the Swiss state railway company. Then SWEG submitted an unsolicited bid for both lines to which SBB reacted by submitting a bid without DB Regio (Wirtschafts- und Sozialdepartement Basel-Stadt 2002).

We included category (iv) because it appears plausible that a firm that takes over the duty of operating a line instead of DB Regio believes it can carry out the service more efficiently than the incumbent. A typical example is the line Schorndorf-Rudersberg near Stuttgart. In 1996, this line was "sold" for DM 1.- from the infrastructure operator DB Netz to the Württembergische Eisenbahngesellschaft (WEG) which now belongs to the Connex group. The new infrastructure owner also carries out the services on this line.²⁶

Finally, we should point out that the group of competitive lines was not exclusively served by competitors of DB Regio in the year 2004. When the incumbent DB Regio won the bid, the line was obviously also included in the competitive category.

We first start with a simple descriptive approach to the problem. To identify the effect of competition, we compare the difference between the distribution of the frequency of service on the competitive lines in 2004 and 1994 with the corresponding frequencies for the control group. Essentially, we speak of a positive competition effect when the growth in the frequency of service is larger in the competitive group than in the control group. Underlying

25 For instance, in nearby Bavaria, the agency Bayerische Eisenbahngesellschaft asked five operators directly to submit bids for about 1 Mio tkm on the line Munich-Oberstdorf (Bayerisches Staatsministerium 2003).

26 In this example and several related cases, the new operator is vertically integrated, which is typically not the case in the other examples. There, the infrastructure is owned by DB Netz, whereas the services are provided by other firms (except when DB Regio is the successful bidder).

this approach is the assumption that, without the introduction of competition, there would have been no systematic difference between the evolution of lines in the competitive group and those in the control group. However, the approach does not require the initial distribution of frequencies in the two groups to be similar.

For the simplest version of our investigation, we require the following information:

1. A division of the passenger railway network in Baden-Württemberg into disjoint lines.
2. The length of each line.
3. The total train kilometers for each line in the years 1993/94 and 2003/04.²⁷
4. For each line, information on whether it belongs to the competitive group or to the control group.

Items (1)-(3) were calculated from DB timetables, which involved substantial effort. We included those lines that were predominantly in the influence sphere of the agencies NVBW and VRN. The division of the network into lines follows the 2004 timetable. Some adjustments were necessary, however, to avoid double-counting of trains. Lines that were closed down between 1994 and 2004 were not included.

Table 1 summarizes the data. There are 80 lines, 28 of which belong to the competitive

Table 1: Local Passenger Lines in Baden-Württemberg

| | Number | Percentage of Lines | Line-Kilometers | Percentage of Line-Kilometers |
|---------------------|--------|------------------------|-----------------|----------------------------------|
| Without competition | 52 | 65 | 2478 | 61 |
| With competition | 28 | 35 | 1565 | 39 |
| Total | 80 | 100 | 4043 | 100 |

category. In terms of length, 35% of the network are served competitively.²⁸

Next, we consider the evolution of frequencies between 1994 and 2004. We observe:

²⁷ The train categories that were included were S-Bahn, Regionalexpress and Regionalzug in 2004. In 1994, the respective categories were S-Bahn, Regionalschnellbahn, City-Bahn, Eilzug and Nahverkehrszug.

²⁸ Recall from our definition of a competitive line that on lines that are served competitively, not all the services are necessarily procured in a competitive fashion.

1. a 29% increase in total transportation
2. a much stronger increase in the competitive group (45% vs. 22% in the control group);
3. an increase in the number of lines operated at least partly by competitors of DB Regio from 19 to 39;²⁹

The aggregate results in Table 2 suggest an increasing importance of competitive procurement mechanisms. It is unclear, however, whether this effect merely reflects that a growing number of lines have been exposed to competition or whether the lines that have been subjected to competition have actually grown faster than others.

Table 2: The Evolution of the Market (Overview)

| | 1994 | 2004 | %-change |
|---|-------|-------|----------|
| Total tkm (/1000) | 65857 | 85255 | 29 |
| tkm on lines without competition (/1000) | 43769 | 53199 | 22 |
| tkm on lines with competition (/1000) | 22089 | 32057 | 45 |
| tkm with competition (%) | 34 | 38 | 12 |
| number of NE-lines | 19 | 39 | 105 |
| percentage of NE-lines | 24 | 49 | 105 |
| lkm on which NE-operators are active | 719 | 1888 | 163 |
| % of lkm on which NE-operators are active | 18 | 47 | 163 |
| number of AVG lines | 3 | 12 | 300 |
| tkm supplied by AVG (/1000) | 3839 | 15386 | 301 |

Notes: NE refers to all operators except Deutsche Bahn (DB). AVG is a NE operator.

²⁹ It might seem contradictory that 39 lines were partly operated by competitors of DB Regio in 2004, whereas Table 1 only indicates 28 lines as being competitive. Note, however, that of the 39 lines just mentioned, 19 were already run by NE-operators in 1994 which have not been challenged by competition since then. Thus, there are only 20 NE lines in the competitive category, the remaining 8 lines in this group are run by DB Regio.

4. Results

We now present our main observations about the evolution of the frequency of service. Before describing the estimation results, we present our results using simple tables and figures.

4.1 Descriptive Statistics

First, we describe the evolution of total transportation.

Result 1 *In the period under consideration, the frequency of service in Baden-Württemberg has increased substantially.*

Table 3 compares the main indicators of the distribution of the frequency of service for 1994 and 2004. The table shows a clear increase in the various percentiles and the mean.

Figure 2 confirms this result. It shows that the density function for the frequency of service has moved to the right between 1994 and 2004.³⁰

Obviously, this shift of the density of the frequency of service only reflects an expansive policy; in itself, it says nothing about an effect of competition. Figures 2 and 3 are more helpful in this respect. Figure 2 compares the estimated densities of the frequency of services for the competitive group and the control group in 2004. The figure suggests the following result.

Result 2 *The frequency of services in the competitive group was higher than in the control group in 2004.*

The result corresponds to the observation that the density for the competitive group lies further to the right than for the control group. Obviously, this observation does not necessarily imply a competition effect in itself. It is conceivable that it merely reflects a selection effect, namely that more attractive lines are exposed to competition more often than less attractive lines. In the concrete example, this natural suspicion turns out to be unjustified, even though on a considerable fraction of lines in the competitive group the frequency of service in 1994 was already substantial, for instance on those lines that were subjected to the competitive bidding for the Rhein-Neckar metro system or on most of the lines that were taken over by the

³⁰ Here and in the following, the graphs were obtained using Epanechnikov kernel density estimators (with bandwidth $0.9\hat{\sigma}n^{-1.5}$ where n is the number of observations, $\hat{\sigma}=\min\{S,((IQR)/(1.349))\}$, S is the standard deviation and IQR the interquartile range).

AlbtalBahn-Verkehrsgesellschaft (AVG) in the Karlsruhe area. This effect was counterbalanced by the fact that many lines in the competitive group had a very low frequency of service in 1994. The most spectacular example is the line from Schorndorf to Rudersberg, on which DB Regio supplied only 4607 tkm/lkm in 1994, while Connex supplied 15.558 tkm/lkm in 2004.

Table 3: Frequency of Service (Service quality)

| | 1994 | 2004 |
|--------------------|--------|--------|
| 10th percentile | 6.045 | 6.784 |
| Median | 12.815 | 17.367 |
| 90th percentile | 28.827 | 49.413 |
| mean | 16.015 | 21.963 |
| standard deviation | 12.145 | 15.508 |
| Number of lines | 80 | 80 |

Figure 2 Change in the frequency of services (all lines)

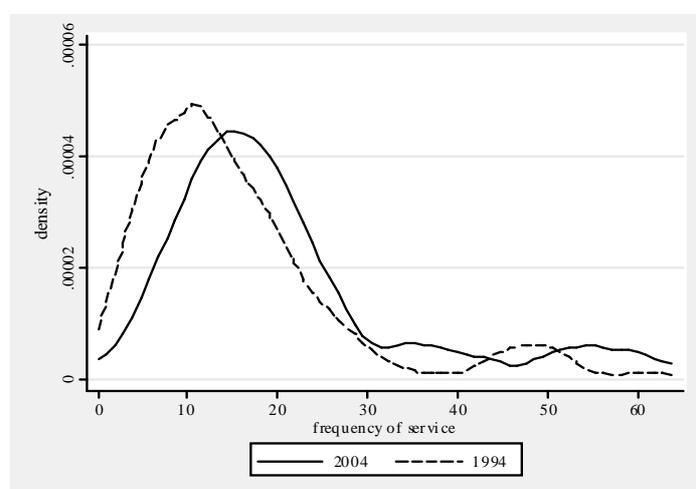


Figure 3 The frequency of services on competitive and non-competitive lines (2004)

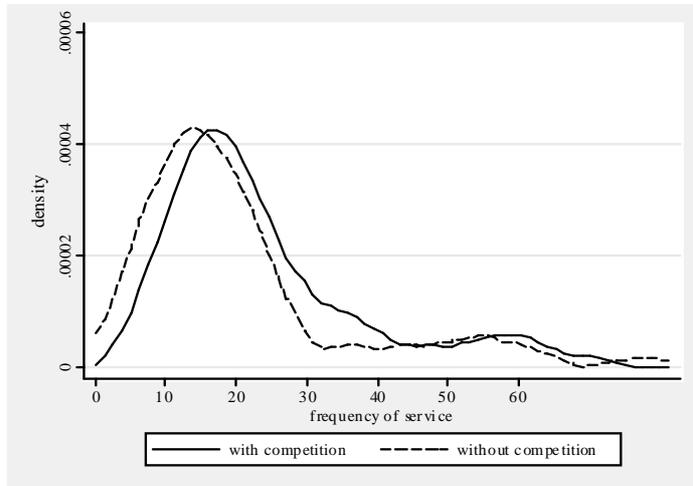


Figure 4 Change in the frequency of services on competitive and non-competitive lines

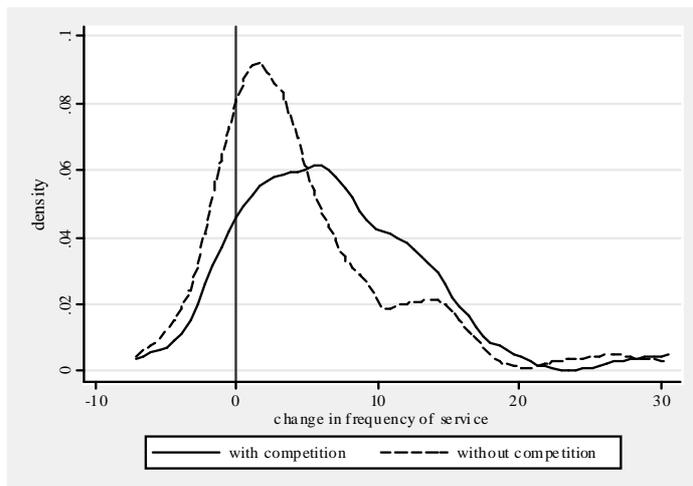


Figure 3 displays the densities of the change in the frequencies of service between 1994 and 2004 for the competitive and non-competitive lines. Clearly, competitive lines enjoyed stronger growth in service quality than non-competitive lines. This means that competitive lines were not characterized by higher service quality in 1994. Rather, the fact that the

frequency of service is higher on competitive lines compared to non-competitive lines appears to be a competition effect.

Result 3 *In 1994, the frequency of services in the competitive group was hardly larger than in the control group.*

The next observation is an immediate corollary of the last two results.

Result 4 *On lines that were exposed to competition between 1994 and 2004, the frequency of services grew more strongly than in the control group.*

As argued earlier, we interpret this as a competition effect. When faced with a set of potential contractors rather than with a monopolist, agencies can ask for better service quality without necessarily having to pay high transfers.

Several caveats concerning this interpretation are in order. First, from a theoretical point of view, one might ask why agencies do not apply the competitive mechanism more often if it is so successful. One explanation might be that there is value to experimentation with a relatively unfamiliar allocation mechanism.³¹ Second, it is worth bearing in mind that our analysis lacks subsidy data. Thus, we cannot provide evidence for greater "value for money" in the procurement of railroad services. For instance, if for some reasons agencies associate service quality with competition, they might simultaneously opt for competitive procurement and high transfers on lines that they want to expand, whereas they procure from the incumbent on lines where they want to keep low service levels, which makes low transfers possible.

³¹ Alternatively, one could cook up political-economy stories about regulatory capture of the agencies by the former state monopolist.

5. Econometric Analysis

In the following, we shall investigate whether the competition effect suggested by Result 4 survives under closer scrutiny. We shall first analyze more carefully whether the lines subjected to competition are different from the lines in the control group. We shall then use these insights to carry out an econometric analysis of the determinants of the change in service quality. Finally, we consider the effects of ownership.

5.1 Selection of Competitive Lines

Observers of the German railway industry frequently complain that the lines that are procured competitively tend to be "lemons", that is, unattractive lines with low service quality and low growth prospects. Our descriptive analysis in the last section suggests that this is not true for the special case of Baden-Württemberg. Nevertheless, we now analyze more carefully whether the lines in the treatment group are indeed systematically different from those in the control group.

Most of our explanatory variables relate to the attractiveness of the lines, which is mostly determined by geography. Specifically we consider the geographic distance to the nearest city with at most 100,000 inhabitants as a measure of remoteness. Further, we include the size of both the biggest and the second-biggest city in 1994. Next, to deal directly with the idea that there might be a systematic trend difference between lines in the competition group and the remaining lines, we consider the population growth between 1994 and 2004 in the two major cities. In addition, we include a dummy variable to check whether a line is electrified or not. The prime motivation for doing so is that electrified lines are likely to be more attractive than lines that are not. Also, one might imagine that agencies are more reluctant to subject electric lines to competition because one would imagine that successful bidding by entrants is less likely on these lines. Finally, we include three agency dummies, taking values of one when the line in question is procured exclusively by one of the three agencies; the reference case where all agency dummies are zero thus relates to the situation that several agencies procure the services.

Table 4 gives simple descriptive statistics. The results suggest that there is little reason to believe that lines with competition are systematically less attractive than lines without competition in terms of exogenous characteristics. On the one hand, the lines in the competitive group tend to be somewhat less attractive in the sense that they are less populated and show less population growth. On the other hand, the competitive lines tend to be less remote, and a much greater percentage of the lines in the competition group is electrified

(64.3 as opposed to 48.1% in the control group). A profit analysis reported in Table A1 in the Appendix gives a similar picture.

We should hasten to add that the picture presented here is likely to be specific to Baden-Württemberg, where in essentially all of the major cities a substantial part of the "S-Bahn" (Metro) traffic is procured competitively. This is highly unusual in the rest of Germany, where there seems to be clearer evidence for the "lemons"-hypothesis.

Table 4: Characteristics of Lines by Competition Status in 2004

| | With competition | Without competition | Difference (abs z-Value) |
|--|---------------------|------------------------|-----------------------------|
| Distance to nearest city (km) | 7.857 | 18.135 | -10.277 (-1.838) |
| Population in community 1 (1994; 1000) | 166.640 | 214.781 | -48.141 (-1.017) |
| Population in community 2 (1994; 1000) | 41.614 | 52.099 | -10.485 (-0.774) |
| Population growth in community 1 (%) | 2.400 | 2.970 | -0.570 (-0.585) |
| Population growth in community 2 (%) | 3.475 | 3.446 | 0.029 (0.029) |
| Electricity | 0.643 | 0.481 | 0.162 (1.386) |
| Length (km) | 55.893 | 47.654 | 8.239 (0.863) |
| Agency (Other) | | | |
| VVS | 0.036 | 0.115 | -0.080 (-1.199) |
| VRN | 0.179 | 0.212 | -0.033 (-0.348) |
| NVBW | 0.571 | 0.442 | 0.129 (1.097) |
| Lines | 28 | 52 | |

Notes: Community 1 is the largest community, and community 2 is the second largest community along the railway line.

The results in Table 5 extend the point just made, and they cast even more doubt on the idea that competitive lines are systematically less attractive than non-competitive lines. They allow us to understand what the explanatory variables just discussed have to say about differences in ex-ante service quality. The first column in the table shows that there is hardly

any ex-ante difference between lines with and without competition. The second column uses the additional independent variables discussed in Table 4 as controls. After introducing them, there is a mild tendency in the direction that competitive lines are slightly more attractive than those in the control group, but this tendency is weak.

Also, the effects of the additional controls on ex-ante service quality are plausible. First, the significant coefficients suggest that electrified lines and lines that are in the agglomerations of Stuttgart (VVS) and Heidelberg-Mannheim (VRN) have substantially higher service quality. Second, though the population-related variables are not significant individually, they are jointly significant, and their effect is plausible: The greater the population of each of the two biggest cities on the line, the higher the ex-ante service quality. Also, the role of the interaction term between population in community 1 and the length of the line is interesting. Though the coefficient is not significant, it suggests that the influence of the population in the largest community on service quality is smaller when the line is longer. This clearly corresponds to intuition: A line that connects the largest city in the country, Stuttgart, with some remote part of the Black Forest should be expected to be served less than a line that lies

Table 5: Explaining ex ante differences in Service quality
Dependent variable: Service quality in 1994

| | | |
|--|-----------------|--------------------|
| With competition | 0.040 (0.02) | 0.936 (0.35) |
| Distance to nearest city (km) | - | -0.034 (0.86) |
| Population in community 1 (1994; 1000 inhabitants) | - | 0.023 (1.21) |
| Population in community 2 (1994; 1000 inhabitants) | - | 0.036 (1.51) |
| Pop. in comm. 1 * length (/100) | - | -1.046 (0.57) |
| Electricity | - | 4.807 (1.71)* |
| Length (km) | - | 0.017 (0.59) |
| Agency (Other) | | |
| VVS | | 15.026 (2.19)** |
| VRN | | 9.214 (2.88)*** |
| NVBW | | 4.705 (1.83)* |

almost entirely in the agglomeration.

5.2 Competition Effects

We now use the control variables just introduced to explain the differences in the changes in service quality better. Table 6 contains the results. The first column essentially restates our

earlier observation suggesting the existence of a positive competition effect (Result 4). The remaining columns show the effects of introducing control variables.

Consider the second column. Most importantly, lines with high initial population in the largest community experience higher growth, and this effect is more pronounced for shorter lines. The remaining coefficients are insignificant. By adding two variables relating to the population growth in the biggest and second-biggest city, the model presented in Column 3 deals with the conjecture that changes in the service quality demanded by the agencies may reflect actual and expected population changes. Though indeed service quality seems to grow slightly more rapidly on the lines in the competition group, the effect is both insignificant and negligible in size. A one percentage point increase in population growth is associated with an increase in service quality of 90 train kilometers per line kilometer.

As the first row of Table 6 clearly shows, both of the extended models suggest that the competition effect is remarkably robust, with the size and significance of the competition coefficient being almost unchanged in the three different models.

Table 6: The effect of competition on Service quality
 Dependent variable: Change in Service quality 1994 to 2004

| | | | |
|--|--------------------|-------------------|-------------------|
| With competition | 3.319 (1.77)* | 3.758 (2.20)** | 3.825 (2.20)** |
| Distance to nearest city (km) | - | 0.022 (0.83) | 0.024 (0.89) |
| Population in community 1 (1994; 1000 inhabitants) | - | 0.021 (2.18)** | 0.022 (2.28)** |
| Population in community 2 (1994; 1000 inhabitants) | - | -0.003 (0.14) | -0.001 (0.03) |
| Pop. in comm. 1 * length (/100) | - | -0.015 (1.42) | -0.017 (1.49) |
| Electricity | - | 2.356 (1.40) | 2.518 (1.54) |
| Length (km) | - | -0.025 (1.08) | -0.020 (0.83) |
| Agency (Other) | | | |
| VVS | - | -5.049 (1.30) | -5.572 (1.34) |
| VRN | - | -0.468 (0.14) | -0.291 (0.09) |
| NVBW | - | -1.062 (0.39) | -1.250 (0.45) |
| Population growth in community 1 | - | - | 0.099 (0.63) |
| Population growth in community 2 | - | - | 0.119 (0.80) |
| Constant | 4.786 (5.19)*** | 3.233 (1.03) | 1.245 (0.44) |
| F-test, pop. in comm. 1 and 2 | - | 2.45* | 2.73** |
| Observations | 80 | 80 | 80 |
| R-squared | 0.04 | 0.25 | 0.27 |

Notes: Absolute z-Value in parentheses (based on robust Huber-White standard errors).

5.3 Ownership Effects

The results sketched so far suggest a positive competition effect. However, we have not yet shown whether this effect is driven by ownership or by competitive pressure. As a considerable number of the lines in the competitive group are operated by DB Regio, it is not clear whether a change of ownership from DB Regio to an NE-operator is necessary for an improvement in service quality. Interestingly, the data allow discussing this issue in detail. Out of the 28 lines subject to competitive bidding, 8 lines were won by DB Regio, 7 lines

were won by AVG -- the largest NE-operator in Baden-Württemberg that operates in the Karlsruhe area -- and the remaining 13 lines were won by smaller NE-operators.³²

Table 7 is a first step towards disentangling the effects of competition and ownership. The left-hand column is identical with the last column in Table 6, that is, there are no controls for ownership. The right-hand column controls for ownership. The reference case is a line operated by DB Regio in 2004. In addition, we use two dummies to distinguish between two types of NE lines, those operated by AVG and those run by the remaining NE lines. The motivation for doing so is that the AVG is a particularly large operator, the expansion of which was pushed by local policy. Our results show that it is important to take ownership into account. First, the positive signs of the pure ownership dummies (AVG and NE other than AVG) suggest that, in the absence of competition, both types of lines saw stronger growth than the DB Regio lines; note, however, that neither effect is significant. Second, the interaction terms show that competition effects are heterogeneous, though the effects are again not quite significant. For lines operated by AVG, the competition effect is much stronger than for the baseline case of DB Regio. For the remaining NE-operators, there is essentially no competition effect.³³

³² Given the small size of our sample and specifically the fact that there are only 28 members of the competition group, it is impossible to draw far-reaching conclusions about the relation between ownership and performance. However, the following observations suggest why such an analysis might be instructive at the national level.

³³ The positive overall competition effect of 3.595 and the negative effect of -3.687 captured in the interaction term "With competition*NE, excl. AVG" essentially cancel out.

6. Summary

The preceding preliminary results of our study on competition for passenger railway services suggest that there are positive effects of competition for the market on service quality. There are several reasons to criticize our approach. For instance, one might argue that the lines in the control group are also subjected to some degree of competition, because DB Regio might fear that uncooperative behavior induces the agency to resort to competition in the future, or that it reduces its chances to succeed on the competitive lines. However, this would suggest that our analysis underestimates the effects of competition.

In addition, we are thinking of several other extensions. First, one could extend the analysis to the entire country. This is possible in principle, but labor-intensive. Second, we would like to consider alternative quality measures. In particular, we shall try to supplement our analysis at least partly with data on passenger kilometers. This would not only be useful to improve the analysis of the effects of competition on service quality; it would also help to understand more about the relation between supply quality and patronage. At the present, however, we are skeptical about data limitations. Third, we would like to use efficiency measures rather than pure output measures. From a policy perspective, it would be interesting to use data on transfers per line-kilometer. It will be impossible to obtain data on the changes in transfers at the required geographical level. Nevertheless, some information on the effects of competition can be obtained by exploiting the relation between required transfers and the extent of competitive procurement at the state level.

Table 7: Competition vs. ownership
 Dependent variable: Change in Service quality 1994 to 2004

| | | |
|--|-------------------|-------------------|
| With competition | 3.825 (2.20)** | 3.595 (1.94)* |
| With competition * operated by AVG | - | 6.851 (1.30) |
| With competition* operated by other NE (excl. AVG) | - | -3.687 (1.20) |
| Distance to nearest city (km) | 0.024 (0.89) | 0.060 (1.96)* |
| Population in community 1 (1994; 1000 inhabitants) | 0.022 (2.28)** | 0.028 (2.61)** |
| Population in community 2 (1994; 1000 inhabitants) | -0.001 (0.03) | 0.000 (0.00) |
| Pop. in comm. 1 * length (/100) | -0.017 (1.49) | -0.016 (1.35) |
| Electricity | 2.518 (1.54) | -0.991 (0.54) |
| Length (km) | -0.020 (0.83) | -0.008 (0.33) |
| Agency (Other) | | |
| VVS | -5.572 (1.34) | -3.519 (0.88) |
| VRN | -0.291 (0.09) | 1.977 (0.63) |
| NVBW | -1.250 (0.45) | -0.963 (0.37) |
| Population growth in community 1 | 0.099 (0.63) | -0.094 (0.52) |
| Population growth in community 2 | 0.119 (0.80) | 0.359 (1.84)* |
| Operator (DB) | | |
| AVG | - | 4.735 (1.32) |
| NE (excl. AVG) | - | 3.642 (1.23) |
| Constant | 1.245 (0.44) | -1.413 (0.42) |
| Observations | 80 | 80 |
| R-squared | 0.27 | 0.39 |

Notes: Absolute z-Value in parentheses (based on robust Huber-White standard errors). * significant at 10%; ** significant at 5%; *** significant at 1%. Service quality is train kilometers per line

7. Appendix

Table A1: Determinants of Competition (Probit Analysis)
Dependent variable: With competition

| | Coeff. (z-Value) | M.E. |
|--|---------------------|--------|
| Distance to nearest city (km) | -0.023 (1.86)* | -0.008 |
| Population in community 1 (1994; 1000 inhabitants) | -0.003 (1.80)* | -0.001 |
| Population in community 2 (1994; 1000 inhabitants) | -0.006 (1.60) | -0.002 |
| Pop. in comm. 1 * length (/100) | -0.057 (0.27) | -0.020 |
| Electricity | 1.219 (2.85)*** | 0.407 |
| Length (km) | 0.007 (1.33) | 0.002 |
| Agency (Other) | | |
| VVS | -0.800 (1.06) | -0.229 |
| VRN | -0.430 (0.83) | -0.142 |
| NVBW | -0.284 (0.62) | -0.101 |
| Constant | 0.190 (0.27) | |
| Lines | 80 | |
| log Likelihood | -41.39 | |

Notes: Absolute z-Value in parenthese (based on robust Huber-White standard)

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