Competition Promotion in Transport Services: The Case of Railways in Peru

Submitted by: Peru
Competition Promotion in Transport Services: The Case of Railways in Peru

Gonzalo Ruiz D.
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1. Characteristics of the Industry

Upstream (Rails)

- Sunk costs, indivisible investment, scale economies
- Natural Monopoly Characteristics

Downstream (transport service)

- Some scale economies, specific costs depending on passenger or freight transport
- Potentially competitive market
Characteristics of the Railway Industry (2/4)

- Operation and maintenance of wagons and tractive equipment
- Complementary services (stations, signaling, telecommunication, services, etc.)

Characteristics of the Railway Industry (3/4)

¿Is competition possible in this industry?

- "Multimodal" Competition
  - Between a road and a railroad (frequent).
  - Between a railway and air or maritime transport (less frequent)

- Intramodal Competition
  - Between two different rail tracks parallel one each other (frequent in US)
  - Between two different operators in the same rail (model promoted in UK and New Zealand)
Characteristics of the Railway Industry (4/4)

- Given the natural monopoly characteristics of the rail infrastructure is broadly accepted that it should be subject to some type of economic regulation (tariffs, access, etc)
  
  BUT…

- When railways are subject to competition (intermodal or multimodal), the consensus about the necessity of economic regulation is not so clear…

2. The Vertical Integration - Competition Dilemma
The traditional model

Traditionally, in many countries, the railway industry organization—as in other industries—was characterized by the presence of a state-owned company, which vertically integrated the provision of rails and facilities, with the operation of transport services.

In a number of countries this structure still remains.

The reform of the railways industry (1/5)

- During the 80s and 90s, the crisis of the traditional model in industries like electricity, gas and telecommunication, in terms of quality of service, financial performance, efficiency; lead the governments to introduce reforms.
- Although later than in other industries, the railroad market was also subject to reforms.
The reform of the railways industry (2/5)

The main reforms introduced were:

- Promotion of private investment in the sector
  - In the case of railways, through concession and franchise schemes
- **Promotion of competition**
  - In the case of railways, the promotion of intramodal competition
- Recognition of the need to introduce economic regulation
  - Institutional change
  - Setting tariffs and access conditions

The reform of the railways industry (3/5)

- Ordover and Pittman (1994) ¹/ distinguishes two types of reforms:
  - Those which introduced regulations in order to protect captive shipers (followed in Europe) through promoting intramodal competition (in the common network of tracks); with open access obligations to the incumbent operator.
  - Those which relies more on vertical integration and competition between networks (US, Mexico and Argentina).

OECD (1997) 2/. “We have examined the experience of those countries which have carried out the most significant rail reforms in recent years. One thing is striking. Few of the reforms have actually had the effect of introducing any major increase in competition within the rail sector” p. 22


OECD (1997) Cont..

(…) “Attempts to stimulate open access operations must so far be deemed a failure. In large part this is no doubt to a lack of enthusiasm on the part of existing vertically integrated railways for generating competition with their own services. Their are perceived as having been slow to respond to request for paths and for price quotations, and deliberately obstructive in many cases.” p.22
The Dilemma (1/3)

- Is really feasible the promotion of competition of transport service “within the rail”?

  OR

- It is better to relie in a vertically integrated model, and promotion of other sources of competition?:
  - Other rail networks (US)
  - Other transport mode competition (roads)

- What to do when there are no other possibilities of competition?

The Dilemma (2/3)

Competition “within the rail”

Strengths
- Better incentives to reduce prices (allocative efficiency)
- Avoid the necessity of regulating tariffs in downstream markets

Weaknesses
- Increase transaction costs in planning investments and setting time tables and slot allocations
The Dilemma (3/3)

Vertically Integrated Model

Strengths
- Reduces transaction costs
- Integrated planning of operations

Weaknesses
- Lack of pressure for reducing X and allocative inefficiencies

3. The Peruvian Experience
Until 1999, the Peruvian rail network was operated by a state owned company ENAFER.

In July 1999, the rail network was franchised to two different private companies:

- Central Railway - Ferrocarril del Centro S.A.
- South and South East Railway – Ferrocarril Trasandino S.A. (FETRANSA)
The Peruvian Reform (2/3)

- In both cases, through a Concession contract, the Government awarded the right to build, operate, maintain and refurbish the rails for a 30 year term. The competition factor for the bid was the percentage of the revenues taken from the rail business offered to the Government.
- The Government not only awarded in Concession the rail infrastructure but also the tractive equipment and wagons, used before by ENAFER.

The Peruvian Reform (3/3)

- In order to ensure the continuity of the provision of the service, the Concessionaire was permitted to use this equipment and operate in the downstream market, but through a separated company.
- With the aim of promoting competition in the downstream sector, the contract established that the Concessionaire was obliged to guarantee open access to the rail. The access rate and its adjustment formula was set in the contract.
Institutional Context

The concession process required the creation of new public organizations:

- Ministry of Transport and Communications
- Agency of Promotion of Investment
- Transport Infrastructure Regulator
- Competition Policy Agency

Sources of Competition

- The Central Railway faces competition from the Central Highway (Carretera Central) which runs almost parallel to the rail.
- The South Railway faces competition from the “Puno Arequipa Maratani” – Highway and from the “Ilo-Desaguadero” road
- **The South East Railway, specially from Cuzco to Machupichu, does not face multimodal competition.**
The wonders of Cuzco and Machupichu (one of the seven wonders of the World), each year attracts more than 400 thousand of foreign tourists from different countries.

*The Cuzco – Machupichu route does not face multimodal competition*

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**The South East Railway (1/2)**

**Upstream**

FTSA

- The Concessionaire of the South East Rail
  - Pays a fee for the use of the rail
  - Pays a rent for the use of the tractive equipment and wagons

**Downstream**

PeruRail

- The railway operator
  - Majority of FTSA and PeruRail shares belong to the same international enterprise
Concessionaire obligations

- Build, Maintain and Operate the rail, complying with international service standards.
- **Permit the access to the rail of operators, paying an access fee on a non discriminatory basis**
- Rent the tractive equipment and wagons to operators on a non discriminatory basis
- Maintain the tractive material and wagons which are property of the State.

### South and South East Concession: Main Characteristics

<table>
<thead>
<tr>
<th>Objective</th>
<th>Build, operate, maintain and exploit rail infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duration</td>
<td>35 years from the signature of the contract: September 1999</td>
</tr>
<tr>
<td>Payment to the Government (“Retribution”)</td>
<td>Principal Annual Retribution: 37.25% of gross earnings&lt;br&gt;Special Semester Retribution: 50% of semester earnings from the commercial use of tractive equipment and wagons</td>
</tr>
<tr>
<td>Regulated Tariffs</td>
<td>Access to the rail (Maximum tariff applied on a Kilometer-Wagon basis)</td>
</tr>
<tr>
<td>Tariff adjustments</td>
<td>Automatic annual adjustment according to the New York Consumer Price Index</td>
</tr>
</tbody>
</table>
The improvements in the performance of the railway (1/3)

South and South East Railway

<table>
<thead>
<tr>
<th>Year</th>
<th>Pass. - Km. - employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>0.08</td>
</tr>
<tr>
<td>2002</td>
<td>0.20</td>
</tr>
<tr>
<td>2003</td>
<td>0.28</td>
</tr>
<tr>
<td>2004</td>
<td>0.35</td>
</tr>
<tr>
<td>2005</td>
<td>0.33</td>
</tr>
<tr>
<td>2006</td>
<td>0.24</td>
</tr>
</tbody>
</table>

From the beginning of the Concession Productivity Indicators increased significantly

The improvements in the performance of the railway (2/3)

South and South East Railways: Number of Accidents

Fuente: Enafel, Ferrocarril Transandino S.A., Peural S.A.

Security and safety indicators increased significantly with the Concession
The improvements in the performance of the railway (3/3)

Financial indicators also improve substantially

The roles of the competition agency and the regulator

- OSITRAN regulates the access to the rail infrastructure and enforces the Concession Contract.
- REMA: Regulation of the Access to the Infrastructure (procedures, access fees, etc)
- Clause 7.6 of the Concession Contract establishes that the Concessionaire shall not discriminate between transport operators and shall not implement abuse of dominant position conducts
- INDECOPI applied the Free Competition Law (DL 701*)
- Abuse of dominant position
  - Unjustified refusal to deal
Since 1999, there were three attempts to get access to the South East Rail in order to provide passenger transport service between Cuzco and Machupichu:

- The FERSIMSAC Case
- The Andean Railways Case
- The Inca Rail Case

The FERSIMSAC Case (1/4)

- On August, 2004 FERSIMSAC (Ferrocarril Santuario Inka Machupichu) acuse FETRANSA of abuse of dominant position at INDECOPI, Competition Policy Comission.
- Specifically, the accusation was that FETRANSA refused to rent to FERSIMSAC the tractive equipment and wagons for providing passenger transport service between Cuzco and Machupichu.
The FERSIMSAC Case (2/4)

- FETRANSA denied the request arguing that all the concessioned tractive equipment and wagons was rented to PeruRail.
- The central controversy in this case was related to
  - Market definition
  - Demonstration of the presence of entry barriers
  - The existence of Dominant Position

The FERSIMSAC Case (3/4)

- Market Definition
  - The market definition was stated as the service of renting tractive equipment and wagons for providing the transport service in route Machupichu-Cuzco.

- Entry barriers
  - Technological characteristics of the South East rail
    - Narrow gauge (914 mm or 3 feet wide of the rail). Today the use of standard gauge in the world is generalized, being less frequent the use of narrow gauge.
    - Converting tractive equipment and wagons from standard gauge to narrow gauge may be costly.
The FERSIMSAC Case (4/4)

- Through the Resolution Nº 064-2006-INDECOPI/CLC the Free Competition Commissions declared not founded the accusation of FERSIMSAC.
- However, through the Resolution Nº 1122-2007/TDC – INDECOPI, the Tribunal of Indecopi (Second Instance) declared founded the accusation setting a fine of aprox. US$180 thousand and ordering the cease of the conduct: do not refuse to rent the tractive equipment and wagons concessioned by the State.
- This decision was appealed to the Judicial Courts (and its still pending).
- FERSIMSAC authorization from the Ministry of Transport to provide the transport service in this route has already expired.

The Andean Railways Case

- On February 2008, Andean Railways Corp. requested access to the rail for providing transport service between Urubamba and Machupichu.
- On May 2008, FETRANS informed to Andean Railways that given that the timetables requested were the same currently used by Perurail, according to the Clause 7.6 of the Contract, the mechanism for allocating this timetables shall be a contest (bid).
- The process has not finished yet. There is controversy about the participation of PeruRail in the Bid.
On March 2008, Inca Rail S.A.C. requested access to the rail for providing transport service between Ollantaytambo and Machupichu.

On May 2008, FETRANS informed to Andean Railways that given that the timetables requested were the same currently used by Perurail, according to the Clause 7.6 of the Contract, the mechanism for allocating this timetables shall be a contest (bid).

The process has not finished yet. There is a controversy about the participation of PeruRail in the Bid.

4. Concluding Remarks
Concluding Remarks (1/3)

- Must be recognized that during the last years the performance of the Peruvian railway sector has improved substantially.

- Despite that one of the objectives of the Peruvian Reform in the railway sector was the promotion of competition; in the case of South East Railway nine years later from the Concession lease, no competitor other than the incumbent, could get access to the rail.

Concluding Remarks (2/3)

- Still remains the problem of dealing with the market power of the incumbent operator: claims of local population and tourists about high prices.

- Is competition “within the rail” possible? This question probably will be answered after the process followed by Andean Railways and Inca Rail.
Concluding Remarks (3/3)

- The Peruvian experience seems to corroborate OECD conclusions about the limits of promoting competition in the railways sector.

Thank You

gonzalo.ruiz@terra.com.pe