

Railways

Tom Winsor
White & Case LLP

1. Introduction

Public-private partnerships (PPPs) in railways are significantly different from those in other industries, which makes them both difficult and special. There are two main reasons for this. The first is that railway projects are not as simple as schools, hospitals, prisons or even roads, tunnels or bridges. The difficulties and risks of work on the live, hot, operating railway put railway infrastructure works on a different plane from other types of infrastructure. The second is that, in the railway context, PPPs have a continuing political dynamic which places the industry on a different level of complexity.

Many commentators think of PPPs principally in the sense of the provision of public buildings or structures, frequently coupled with the provision of services relating to those assets. But there is a wider context and sense of the concept and it has particular relevance in the case of railways. It involves the partnership between the state and the private sector in the provision of essential services in which there is a heavy political interest, and probably a need for continuing public funding.

PPPs in railways are not only about building an asset and paying for it over time, although they are often certainly at least about that. They concern a long-term relationship which involves the delivery of complex, safety-critical services and where demand and other factors influencing their costs, stewardship and intensity of use will change over time.

2. Objectives

The most important thing for governments to decide when they embark on the design of a PPP is their objective. What do they want to achieve, and is it feasible on a sustainable, fair and affordable basis with private sector participation?

In many countries, railways are not economically viable without some measure of continuing public financial support. This is a function of their physical condition, their social importance in the national and regional economies which they serve, and the sometimes abstruse question of the structure of access charges. There will be ostensibly profitable parts of the railways, but their true economic health is sometimes obscured by other factors such as cross-subsidies or accounting treatment.

In many countries, networks and rolling stock have been neglected – sometimes severely – in the years of public ownership, with inadequate, usually annualised, financial settlements from cash-strapped governments. Operating losses have often reached a level which is simply no longer affordable. The years of decline in the

condition, capacity and capability of the railway's physical assets must be paid for one day if the railway is not to close. And closure – or substantial reduction – is often politically and economically unfeasible, especially in countries whose manufacturing and service sectors are growing and which do not have adequate available capacity in other transport modes. Failures and lack of capacity in infrastructure lead inexorably to deterioration in performance, and poor-quality rolling stock deters patronage. It is a vicious circle of decline. These malfunctions are often major restraining or decelerating factors in the development of an economy, and when economies are growing – as in India and China – such shortcomings cannot realistically be tolerated.

Often, the uncomfortable fact of putting right the neglect of years must be faced and tackled at the point of the industry's restructuring and the prospective establishment of PPPs which are intended to bring private money and expertise into the railway. By that time, usually the national treasury is exhausted or severely stretched, and other means must be found for the repair, renewal and expansion of the railway.

The need for public funding of operators – in contrast to the infrastructure provider – in a vertically separated railway will also be a function of the structure and level of access charges which the infrastructure company is allowed to charge for use of its network. This is true even of the railways in Great Britain, where it is only because of the direct funding by the government of a large part of the infrastructure provider's revenue requirements that passenger franchise holders can promise premium payments for their franchises, rather than receive public subsidies.

There will therefore usually be a need to access sources of finance available to the private sector because of national funding limitations. This was the underlying premise of the white paper on railways published by the European Commission in 1996, which led to mandatory radical reform in Europe's railways. It was also one of the main driving forces behind the restructuring and privatisation of the British railway industry. The same was true in Germany, Sweden and South America.

Government may wish to introduce competition into the railway. Separating infrastructure, where there can be no competition, from operations, where there can, is a major step which can bring very significant benefits in railway efficiency and the efficiency of other transport modes which compete with rail. Competition can come in two forms: competition for the market and competition in the market. Competition for the market is essentially franchising: contracts for the provision of railway services either in exchange for subsidy or accompanied by the payment of a premium. Competition in the market can take place in both passenger and freight sectors. It has, of course, been much more prevalent in freight. In Europe, for example, significant on-rail freight competition has developed in Britain and Germany, and is developing strongly in other member states. On-rail passenger competition has been more sluggish, but breakthroughs in open access passenger operations in Britain may herald stronger growth in the future and in other countries when it is realised that it is not always necessary to have a franchise or contract with the state to run passenger rail services.

Private management can introduce efficiency and also find and grow new markets, unconstrained by public sector financial and other restraints. In turn, this

can reduce the drain on national and regional budgets, and can contribute to them. If costs can be reduced while maintaining the necessary levels of service, there may be more money to spend on enhancing that service – for example, for small or medium-scale capacity enhancement schemes such as platform lengthening, crossovers, freight loops and even resignalling.

Bringing in private sector parties can also enable government to transfer risks to the private sector, although this can entail severe difficulties if the risks are not adequately identified, understood or quantified at the outset.

Frequently there will be disagreements within government and the wider constituency of opinion as to which of these objectives – which ones and which blend – should be pursued. Vested interests, such as organised labour, will resist some of these options being objectives at all. The chosen solution may be complex and a compromise. But when it is confused – because decision-makers will not face up to some of the issues; because they do not properly understand them and the implications of adopting or rejecting them; or because they simply have not thought of them – potentially severe problems will be stored for the future, when their resolution will be painful and expensive.

The choice of solution is dependent on the government's objectives. If these are uncertain, the solution may well turn out to be the wrong one.

3. The political dynamic

Designing a transport partnership is fraught with difficulty. It is a complex field, and that complexity is in large part a function of the fact not only that there is a significant continuing political dimension in the railway sector, but also that transport planning horizons are much longer than political ones. The politician will usually be more concerned with the next election or his next move within government. Yet railway projects, including major renewal schemes such as the West Coast main line in Great Britain, take years to plan and commission. Politicians like cutting the ribbon at the opening ceremony, and not, years before, explaining to disappointed parties why funds are not available for favoured schemes because they have been committed to a railway purpose which will not produce tangible benefits (for which credit can be taken) in what, in political terms, is the distant future. There are, of course, exceptions, but the political dynamic must be recognised. Cynics have been heard to remark that political honesty in transport planning is a concept of the future, and always will be.

So in designing a PPP for a railway, it is first necessary to have a clear understanding of the nature of the forces at work and how those players will behave not only at the beginning of the enterprise, but throughout its life, which may be many years.

Transport is the business of government. And, in a private sector industry, it is just as much the concern of business. It is both their jobs. That must be recognised immediately.

It is the role of government to make decisions about what kind of transport should be provided for the benefit of the community, including the wider community which benefits from transport links. It is the role of business to deliver

transport services within that overall policy. Business will do this provided it can have the confidence and certainty necessary to come in and provide quality transport services at a fair and affordable price.

Getting the terms of that partnership between the public and private sectors clearly and properly established so as to meet the legitimate objectives and interests of both partners is essential. This is because when the partnership is not placed on such a secure foundation, it will become unstable and the partners will eventually fall out. Serious harm to the public interest and commercial interests may well follow, as was starkly apparent when Railtrack, the national railway infrastructure company of Britain, collapsed in October 2001 in the most controversial of circumstances.

So how do we establish a fair and sustainable partnership for the railways? To make a partnership work you must know, respect and, as far as possible, accommodate the essential objectives of both partners. It is no good the private sector complaining that governments are political. And it is equally pointless for government to complain that business wants to make money. If the public sector and the private sector are going to get along, each must acknowledge and accept the fundamental nature of the other partner in the relationship and work with that fact, not against it.

If the partnership is going to prosper and deliver its objectives, neither partner can be allowed to behave in an uncontrolled, arbitrary or destructive way which would do serious harm to the interests of the other partner. There must be some restraints, some ground rules, some fundamental precepts which must not be violated. And the way in which you establish those basic rules for living and getting along together is a compact or contract between the state and the private sector, sometimes policed by an independent institution which respects the terms of the contract and serves as a breakwater between the forces at work on either side to ensure stability. In the British railway industry, as far as infrastructure provision is concerned, the economic regulator does that job. In other countries, the state's relationship with the private sector is established in a contract, sometimes with special constitutional status. In the case of the operators of passenger and freight trains, the solutions are simpler, with franchising or concessioning of passenger services and often the outright privatisation of freight operations. In some systems there is a spectrum of models, reflecting the different circumstances and dynamics of each part of the railway.

Business wants to be able to make money. If the business in question is the monopoly provision of infrastructure services, then left to its own devices it will tend to abuse that position by charging unreasonably high prices, unduly discriminating against users, unreasonably denying access to the system and providing a poor quality of service. This is unacceptable, so the entity should be made subject to regulatory controls and accountabilities – the models of accountability vary, too – which hold in check the propensity to these excesses. Those accountabilities need to be strong and properly designed if they are to be effective. Insofar as they are monitored and enforced by a public authority, this must be done according to clear and conspicuous objective public interest duties. The issue of regulatory design and competence is discussed later in this chapter.

Governments want other things. They know that they cannot – or should not – run the operation in question. When government runs something, no one really knows what it costs. This is because governments do not manage according to profit incentives; they manage to administrative budgets. They often operate on unreliable information and, not knowing what something ought to cost, will usually decide to pay what they want and accept what comes back for that money. So, having given up on the idea of running the railway, government needs to know that its objectives – politically accountable and politically determined – will be respected.

In the contract between the state and the private sector, there must be clarity about what the state expects for its money. The contract between the two must be one in which the private sector can have confidence. Will it be honoured in all political circumstances? Will it withstand every political shock? Will government not try inappropriately to circumvent it, interfere with it or otherwise undermine or destroy it? It comes down to the sanctity of contract between the state and the private sector. That contract must be well designed so that both parties want to stay in the relationship and make it work. For that to happen, both parties must go into it with their eyes open and be good for the promises they make.

As discussed, governments work according to political cycles. Business does not want to, and proper and efficient transport planning and investment decisions find it extremely hard to. In the British railway industry, for a long time there was an absence of consistency or continuity of political thought and investment or business policy. That in turn prevented either any long-term planning or the completion of plans made in good faith. And so there is a need for long-term vision which outlives the political cycle. How can the system be insulated from this to the appropriate extent?

To put it another way:

- how do you give government the confidence that the public interest will be protected and promoted in decisions in the industry in question; *but*
- avoid an intensity of political intervention which will deter investment or drive its costs up; *and*
- allow long-term planning and consistency, so getting away from government's stop-start policies on direction, structure or funding; *and*
- prevent government from getting a disproportionate amount of blame when things go wrong?

Governments can so easily interfere to a damaging extent in the day-to-day affairs and operation of transport concerns, causing damage to confidence and raising the cost of finance. Yet when things are thought to be dysfunctional, or perhaps where there is simply a serious problem which is causing political trouble, governments often feel both so powerless and so afraid of the blame that they barge in, trying to impose their own solutions, sometimes ending up making the position much worse. In Britain, in the aftermath of the October 2000 Hatfield rail crash, caused by a broken rail, the integrity of the national network in large measure disintegrated. This led to a sudden rise in political intervention, when government mistakenly tried to supervise operational recovery. Then in April 2001, government

publicly forced Railtrack to appoint a public interest director in return for an acceleration of government funding, causing the sharpest-ever fall in its share price because of the perception of the manifestation of severe political risk. A few months later, in October 2001, Railtrack collapsed into administration – a special class of insolvency for railway companies – at the instance of the secretary of state for transport, in the most controversial and damaging of circumstances. These sorts of intervention can have serious and unintended consequences.

The answer to these questions is to have a properly designed and functioning, stable and respected regime of accountability of the private sector to the public sector. Such a system is a source of stability and protection for all concerned, especially when the industry faces severe difficulties. Its absence deters private investment or makes it more expensive and, over time, will cause the industry to malfunction, bringing further unwanted and usually damaging political interventions.

4. Structural reform – separation

The most radical structural reform a railway can undergo is separation of infrastructure from operations. This change is complex and must be done properly; if it is done well, the benefits in improving the operational and financial efficiency of the railway can be very significant.

The European Commission, through a series of directives for the railway sector, has moved a long way towards vertical separation. It began in 1991 with a requirement for separate accounting for infrastructure and operations, and has moved steadily in the direction of greater degrees of separation. It has done this because it is correctly convinced that railways will not be efficient if they remain monolithic, with cross-subsidies, uncertain or obscure accounting arrangements for internal transactions, and the ability to deter or destroy any competitive service which dares to materialise. One of the fundamentals of the EC Treaty is the promotion and protection of competition, and competition is least likely to develop and thrive in the old railway structures. The European Commission has been proved right in this, since the most successful railways in Europe – those in Britain and Germany – are those which have embraced liberalisation to the greatest extent. The poorest-performing, most economically inefficient railways are those which have been slow to reform and embrace competition.

The European directives do not require member states to privatise their railways. Determining the ownership of railway assets is not part of the European Commission's remit. But the commission insists that there be transparency and objectivity in the operation of the market and in many of the decisions which affect it. In fact, as with most, if not all, public sector infrastructure assets, it does not matter whether railway assets are owned in the public sector or the private sector. They will be tied to the national railway and there will be physical or regulatory restraints on the ability of anyone to take them out of the jurisdiction. What matters most is how they are operated, and whether that achieves or facilitates the public sector's legitimate objectives. That is a function of the design of the railway PPP, and of the mechanisms and instruments of accountability which are put in place to

protect both the public interest and the interests of private sector players which depend on fair treatment.

5. Accountability

A variety of accountabilities need to be properly established in a railway PPP. These are a function of the dynamics of the relationship between the public and private sectors, and between the industry's participants. All of them matter.

The interface between the public and private sectors is, of course, very significant. Striking the right balance between the power of the public and private sectors is essential. That not only means clarity about where the boundaries between the public and private sectors are drawn; it also means coming up with a division of roles which is going to be respected by both sides, not assaulted. If the dividing line is fuzzy, there will be territorial encroachments by both sides. If it is radically misplaced, it will eventually be subject to severe pressure. Brittle, fragile and significantly unbalanced structures will eventually break. When they do, it will be expensive. This applies with equal force to the relative jurisdictions of the agencies and institutions of government, particularly the ministry of transport and the regulatory body.

The propensity of the public sector to try to intrude into the proper domain of the private sector – political interventions borne of frustration and impatience – will be a direct function of the performance of the industry in the private sector. If things are going well, operational performance is as good as or better than projected, financial efficiency is on track and passenger satisfaction is at sufficiently high levels, political pressure should be next to non-existent and the partnership will be secure.

It is when things go wrong – especially when there is a severe failure – that the dividing line comes under strain. This happened in spectacular fashion in Britain when Railtrack's failures in its stewardship of the network led to the multi-fatality Hatfield crash and months of operational disruption afterwards because the company had inadequate knowledge of the condition of its assets. Railtrack was in a complex PPP established by licence, contract and regulatory oversight, but it was a PPP nonetheless. Despite that status, and the need for stability and predictability in the dynamic between the public and private sectors, politicians intervened immediately and did immense harm, eventually causing the company to collapse and necessitating financial rescues of a large proportion of the passenger train operators which suffered considerable losses as a result of the failures. This episode also involved a major threat to the independence and jurisdiction of the economic regulator for the railways, because politicians were intolerant of the ability of the regulator to advance additional funding to what they saw as a failing company. The British government at the time had never been in favour of rail privatisation, and certainly not of the model chosen by its predecessor, and some members of the governing party saw the severity of Railtrack's problems as an opportunity to renationalise the infrastructure without compensation. In short, the system was subjected to enormous adverse forces which necessitated the restructuring of the infrastructure provider – the creation of Network Rail as the successor to Railtrack as a company without shareholders – on a radically different and unforeseeable basis.

It also caused major difficulties in the capital and equity markets in relation to PPPs generally.

This shows that when things go badly wrong in a PPP, strong forces will collide violently and the system can fracture. It is essential that every possible step be taken to avoid this happening. And it can be avoided by ensuring that the remainder of the railway industry architecture – the matrix of economic, legal and regulatory instruments of accountability and incentivisation – is well designed and functions well.

In designing the accountabilities of the railway to the public interest and to one another, it is necessary always to bear in mind the risks which the industry faces and to ensure the efficient allocation of those risks.

If the condition of the infrastructure is either poor or uncertain (or both), it is unrealistic to expect the private sector to take the risk that it will require substantial, and possibly early, increases in maintenance and renewal. If the state is responsible for the assets' decline, it should assume the responsibility for putting this right, unless it is prepared to pay the private sector a handsome premium for doing so. If taxpayers have taken a maintenance holiday during the years of public ownership, they cannot expect the private sector to take on the consequences without complaint or compensation. That said, the costs can be very large indeed. In the case of Railtrack and Network Rail, the British rail regulator increased the company's five-year budget by 50% in October 2000 (from £10 billion to £15 billion) and in December 2003 increased it by a further 50% to £22.2 billion. This was principally to allow the company to recover the condition and capacity of the network from its decline during the years of nationalisation. Train operators needed the infrastructure provider to be fully and efficiently funded for this work because they depended on the proper performance of the network to run their trains. However, because of indemnities in their franchises with the state, they were financially neutral in the substantial increase in access charges payable to the infrastructure provider. If they had not been protected, it would have been impossible for the state to have let the franchises, since the private sector train operators were even less able than Railtrack to take the infrastructure condition risk.

In Eastern Europe, much of the rolling stock fleet is life expired and urgent investment is needed simply to maintain a reasonably functional service. In such cases the problem is easier to solve, because rolling stock replacement or refurbishment is a simpler and less costly concern than infrastructure renewal.

So the infrastructure provider must be assured of the necessary revenues so as to be able efficiently and economically to operate, maintain and renew the network on which everyone in the industry depends. When the infrastructure provider fails in its stewardship obligations, almost all parts of the industry – and the public interest – will suffer. That assurance of funding must come from the state, whether directly or through access charges paid by operators, which in turn will recover an appropriate proportion from public sources. The nature of the assurance can be in the form of a contract between the infrastructure provider and the national treasury or ministry of transport, or through the jurisdiction of an economic regulator with sufficient powers.

The contract model is favoured in most European countries, but it has its drawbacks. The infrastructure provider is at a negotiating disadvantage with the state because its leverage will often be weak – it cannot force the state to give it money,

although it can point out the consequences of inadequate provision in terms of operational performance and network integrity. The alternative is to confer on the regulatory body the job of assessing what an efficient network operator should require for the operation, maintenance and renewal of the railway in light of the expected demands on the system, netting off its income from other sources such as property and advertising. The regulatory body may or may not have a budget to fund the infrastructure costs; in the British model, it did not, but it did have the power to set access charges at higher levels and, as explained, rely on the state's indemnity contracts with the train operators to secure the necessary funding for the higher charges payable to the infrastructure provider. Following the significant regulatory increases in the revenues payable to the infrastructure provider in Britain, in 2005 the law was changed to impose a financial limit on the regulator's jurisdiction. In future regulatory settlements, if the national treasury wishes to resist increases or impose cuts, the regulatory body will be required to determine where the railway will be reduced in its capacity, condition or performance.

Once the infrastructure provider has the financial settlement, it is important that it spends it wisely, and that it fully meets its obligations to its customers (the train operators) and to the public interest. The design and establishment of these obligations, and how they may be changed over time, are therefore crucial.

In Britain, at the time of privatisation, in several respects the matrix of accountability was deficient – in some cases, seriously deficient. The right approach in restructuring an industry in preparation for getting private sector skills and money into it – through PPPs of any variety – is to get the design right at the beginning and then avoid making material changes afterwards, when the private sector has come in. In 1993 to 1997, Britain did things differently. Through a combination of neglect, inability and political pressure, the railway industry was endowed with a contractual and regulatory matrix of extraordinary weakness. The company's network licence was made deliberately weak and was in no fit state for a private sector Railtrack. And the contracts and industry-wide codes were in too many respects unspecific in their requirements, lacking in their procedures and weak or uncertain in their remedies.

If a railway is to be able confidently and competently to do its job of operation, maintenance and renewal of the infrastructure, and the punctual and reliable provision of passenger and freight train services, it needs a sound framework which is capable of providing the answers and the remedies when questions arise or things go awry. Britain's original privatisation model did not have that. The system malfunctioned in many respects, and it was necessary to carry out major reforms.

In 1999 the British rail regulator set about improving and enhancing the accountability of the railway companies to the public interest and to one another, using the flexibility and utility of the existing system: the mechanisms for evolutionary change built into the matrix by its architects 10 years previously when they saw the shortcuts which were being taken and the weaknesses which were being established in the initial regime. In 2004, that reform programme was virtually finished, and the results – in terms of operational performance, financial efficiency, network quality, safety and passenger and customer satisfaction – have been spectacularly good.

The principal focus of the reform programme was on the monopoly provider of infrastructure services – Railtrack, now Network Rail. In the original blueprint for the railway, Railtrack was meant to have been the powerhouse of the railway industry. It squandered that role. In the years after privatisation, it underperformed in too many respects. Track quality declined and rails broke. Its investment in new capacity was sluggish, and its performance on infrastructure-caused delays and cancellations to passenger trains was poor. Its relationships with its dependent customers – train operators, local authorities, freight facility developers and others – were marred by frustration and unresponsiveness. That record and culture needed to be turned around quickly, in order to make the company responsive, competent and effective. Although there were some encouraging signs that progress was being made in the way Railtrack managed its business, the company fell back after the Hatfield crash and the struggle was lost.

The financial framework of a railway industry needs to provide the companies concerned with a stable and sound environment for investment. That means improving the incentives to invest in new capacity and better services, and ensuring that they have certainty and predictability in how that investment will be treated in future regulatory reviews. This is essential if the industry is to raise the finance needed to deliver the required level of investment in the network. The 2000 regulatory review of access charges established a much greater degree of incentivisation of the interested party to grow the capacity of the railway to meet projected demand, and to attract traffic and improve the condition of its assets.

The 2003 regulatory review of access charges built on that regime of incentivisation, and determined that Network Rail should deliver significant improvements in network outputs and sharp falls in delays caused to passenger and freight train operators. At the same time, Network Rail was required to ensure that asset condition improved across a broad range of measures contained in a new asset stewardship index. The index includes measures for broken rails, temporary speed restrictions, signalling, structures and track geometry.

The interested party's licence – enforced by the rail regulator and its principal means of accountability to the public interest – was not fit for its purpose. The reform programme amended the licence, introducing nine new conditions which established obligations on the infrastructure provider in relation to the proper and timely use of access charges and taxpayers' funds, with the ability to check on the progress and quality of spending and work, and to correct shortcomings before they become serious. The reforms involved the use of independent reporters on Network Rail's stewardship of the network, restraints on the disposal of its assets (including land) which may be needed for railway uses in the future, and the establishment of a reliable and comprehensive register of the condition, capacity and capability of the company's assets. They also involved much better, clearer and stronger relationships between Network Rail and its train operator and other customers, to ensure clarity, stability and empowerment, with mutual interest and a clear drive for success.

The reforms also dealt with the most important interface of all – the track-train connection. New forms of freight and passenger track access contract were devised and have now been implemented across the industry. In both cases, the objective of

the work was clarity, simplicity, streamlining and strengthening. Operating a multi-user railway on which capacity is full or near to full is no easy matter. There are many interdependent things which need to be done to ensure that the railway operates well on a day-to-day basis. This is especially so for one which is having to cope with both current and future demands, including those associated with considerable maintenance and renewal programmes. The new contracts between Network Rail and its train operator customers acknowledge this fact and the need for railway companies to work together, not against one another. They recognise the intensity of the interdependence of the infrastructure provider and the infrastructure user, and create a true joint venture of aligned objectives, clarity of specification and simplicity of remedies so that, when things go wrong, recovery can be achieved as quickly and efficiently as possible.

Long-term relationships of this kind which are properly established and clearly understood, with a fair balance of risks and responsibilities between the parties, are far more likely to succeed than those which are one-sided or inequitable.

Railways need operational rules which, in some respects, are the same for all players. In Britain, the common rules are established in the network code, which is the central instrument incorporated into every access contract dealing with:

- timetable development;
- the handling of operational disruption;
- changes to the network (both enhancements and deteriorations);
- changes to rolling stock and the introduction of new trains onto the system;
- local accountabilities;
- the provision of information; and
- changes to access rights themselves, to prevent ossification of the timetable.

In 2004, the network code was substantially reformed to correct many of the deficiencies of the original privatisation settlement and is now contributing to an intensification of a true joint venture spirit in an interdependent railway.

With increasing harmonisation of Europe's railways, it may be speculated that in perhaps 10 years' time Europe will have a single network code and a single economic regulatory body, to ensure legal and economic as well as technical interoperability.

These reforms were not about command and control of the industry. Nor did they contemplate any transfer of management responsibility of the companies concerned. They were concerned with establishing a better, clearer and fairer balance of responsibility and obligation in the industry, to allow the companies to deal with one another from positions of broad equality of bargaining position, in a cooperative and mature way, as interdependent commercial companies do in other fields of activity. They created a virtuous circle of effective incentive-based regulation, strong and empowered management, clear contracts and sound accountability. They focused on empowerment of both sides of the track-train interface relationship, so as to ensure cooperative working and shared understandings. With empowerment comes the need for commercial maturity and competences.

In designing a PPP for the railways, the correct design of these interfaces is essential. It is the best way to avoid undue interventions from the public sector partner.

6. **Regulatory design and competence**

Some railway PPPs will be established purely or principally on the basis of a contract between the state and the private sector. That will be the constitution of the partnership and, as a long-term contract, will require considerable flexibility so that it can be adapted over time to meet changed circumstances. That is a very difficult thing to do, and means must be established for the resolution of differences when the unforeseen happens. That may involve resort to mediation, arbitration or some other neutral tribunal. In some cases, it will involve a separate, independent regulatory body.

In Europe, the railway directives require the establishment of a regulatory body with appropriate powers to deal with abuses of monopoly power, anti-competitive behaviour, capacity allocation and charging. Some regulatory bodies – such as those in Britain – go further than that and invest in the regulator powers in relation to the stewardship of the network.

In every PPP in the railways, the regulatory regime must be flexible enough to deal with changes in circumstances in a predictable and objective way. Ideally, the regulatory body will have a large measure of operational, perhaps even legal, independence from central government. The greater the degree of regulatory independence, the happier business will be because that autonomy provides a high degree of insulation of regulatory decisions from political criteria and undue political intervention.

If the regulatory body is to be independent of central government, that independence needs to be sustainable. If politicians will not tolerate substantial power in the hands of the regulator – for example, the power to determine public sector spending on the railway – it would be far better if those powers were denied to the regulatory body in the first place. The greatest harm is done when the juggernaut of government later tries to withdraw such powers from the regulator after the private sector has come into the market on the faith of the regulator's jurisdiction.

The pivotal role of the regulatory body is often underestimated, or misunderstood, by government, by industry and, in some EU countries, by the infant regulatory bodies themselves. A sound and durable regulatory regime is a protective measure for everyone in the industry, including the infrastructure manager. European directives provide supranational stability for the regulatory regimes of member states, provided they are honoured. It is fundamental to the development of the European Union's railways that networks are operated, maintained and renewed in a timely, efficient and economical manner. To ensure sustainability, this means that infrastructure managers must be assured of fair remuneration for their efficiency and competence. When infrastructure is subsidised from public funds, access charges can be lower than the system's long-run sustainable cost. When there is no subsidy, there is no alternative to access charges which meet the total efficient cost of the system. Anything lower will inevitably cause the network to deteriorate, contrary to the fundamental purposes of the directives. Regulatory bodies which do not respect and implement that basic part of the regime, which side with vested interests and allow improper and extraneous pressure to prevail, serve only to pervert

the system and deny its primary purpose. And in doing so, they forfeit their integrity and do great harm to the system they are supposed to nurture and protect. The European Commission has powers to investigate any such failures, and the European Court of Justice can correct them.

As well as being properly empowered, regulatory bodies must discharge the very important roles entrusted to them with professionalism, competence and courage. The best way for a regulatory body to secure and then hold onto the trust and confidence of industry players is to establish clear and objective criteria for decisions which match and promote its policy and legal remit, and then to apply them consistently and fairly in accordance with processes which are demonstrably fair. This means consulting first on the criteria, and then on individual decisions, hearing all sides of the argument with a truly open mind, ensuring that viewpoints are properly and fully understood and that everyone has a proper opportunity to make representations and objections. In major cases, a draft decision should be made available to the affected parties, and when the final decision has been made it should be accompanied by full, published reasons. If all this is done, while there will always be some who dislike the decision, they will know that they have been listened to and understood, and that full weight has been given to their arguments. The importance of this in establishing regulatory legitimacy, and therefore confidence, in the system cannot be overstated.

Certain passages of this chapter are adaptations from speeches delivered by the author in 2004 while he held office as the UK rail regulator.

