

Héritier, Adrienne

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## Regulator-regulatee interaction in the liberalized utilities: Access and contract compliance in the rail sector

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## **Gemeinschaftsgüter: Recht, Politik und Ökonomie**

Preprints  
aus der Max-Planck-Projektgruppe  
Recht der Gemeinschaftsgüter  
Bonn  
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### **Regulator-Regulatee Interaction in the Liberalized Utilities: Access and Contract Compliance in the Rail Sector**

von  
Adrienne Héritier



## **Regulator-Regulatee Interaction in the Liberalized Utilities: Access and Contract Compliance in the Rail Sector**

Adrienne Héritier

August 2001

## **1. Introduction: Regulator –Regulatee Interaction After Liberalization**

In the last decade the industrial landscape and regulatory structures of the network industries such as telecommunications, energy and rail transport, have undergone a profound transformation. Liberalization has fragmented the former natural monopoly sectors; new players with new preferences have emerged. New regulatory institutions have been created to regulate the market at the national and the European level to foster competition, and at the same time to compensate for the negative consequences of market integration in order to protect services of general interest. This altered regulatory environment raises many important research questions such as: How were the new regulatory structures shaped and how do they function? What is their impact on market creation and service provision (Héritier/Schmidt 2000)? In this article I focus on one specific aspect which has not yet been analyzed much: How do firms in these sectors interact with the newly created regulatory bodies at the national and European level? To whom do they seek access and why? And, inversely, how do the newly created regulatory authorities at the national and the European levels deal with the regulated firms in order to secure compliance? Is the much cited informational asymmetry between the regulator and regulatee used by the regulatee to interpret the regulatory contract so as to save costs, and if yes, how does the regulatory authority cope with it? And inversely, is there a law of “increasing regulatory intrusiveness”, possibly linked to the size and number of regulatory bodies? I examine the interaction between the regulator and regulatee from two different systematic perspectives: firstly by focusing on the attempts by firms and industrial associations to gain access to and influence “ex ante” regulation, i.e. by focusing on their attempts to influence the setting of rules for businesses at the national and the European level, and secondly by examining “ex post” regulation, i.e. regulation that monitors behaviour and attempts to resolve disputes that arise in implementing the existing regulation at the national and European level in the day-to-day interaction between firms and regulators. The analysis focuses on regulator-regulatee interaction in the British and German rail sectors.

## **2. Theoretical background**

In examining regulator-regulatee interaction, theoretical approaches have to be discussed separately according to whether the analysis under discussion focuses on access and policy influencing, on the one hand, or contract compliance, on the other: In posing the question about firms’ and associations’ possibilities for gaining access to regulatory authorities and influencing their decisions, interorganizational resource dependence theory, as developed by Aldrich and Pfeffer (1976) and Pfeffer (1982), proposes answers in which, in view of external restraints, the survival of an organisation is described as necessitating the process of exchanging resources. These authors argue that since organizations do not dispose of all resources necessary to maintain themselves and to fulfil the task(s) assigned to them, they must enter into transactions and exchange resources with other organisations in order to function. However, at the same time they have some autonomy and seek to influence their environment by changing specific exchange strategies (Aldrich and Pfeffer

1976). The most important resource available to firms wishing to access and possibly influence the decision-making of a regulatory authority responsible for an issue of interest are information, expertise, and experience in production and market processes. The firm offers expertise, while the regulator grants easy access<sup>1</sup> and, possibly, the opportunity to influence on decisions. The higher the expertise which can be offered, the easier it is to gain access to the regulator and the more frequent such access is gained. Over time a reliable and mutually-advantageous exchange relationship may develop, which implies reduced costs<sup>2</sup> and the acquisition of asset specificity; as such, it has an increased value for the interacting partners. In order to increase their possibilities for access and influence, firms organize themselves into associations. In their exchange with the regulator, the associations can also offer to secure the regulatory compliance of their member firms (*Verpflichtungsfähigkeit*, or governability: Streeck/Schmitter 1985).

The exchange process between the regulator and the regulatee, conceived of as an exchange of resources available to the individual actors, is shaped by two factors: the specific nature of the regulatory 'target structure' and the structure of the sector. The first aspect, the specific institutional arrangement of the regulatory structure – including courts – addressed by firms and industrial associations (Lehmbruch 1987) is an important factor in determining the strategies employed by firms. Thus, strategies are likely to vary depending on whether a firm/association is dealing with a sole authority or dealing with several national ones, and whether authorities can be addressed at several levels, such as the national and European level, or at just one level. The opportunity to address multiple authorities opens up new action strategies for firms and associations. If the attempt to gain easy access fails with one authority, it may succeed with another. In the language of resource exchange we can say that with multiple authorities the resources of the individual company increase in value vis-à-vis individual regulators. Or put differently: if various authorities are responsible for regulating, be it at the horizontal or vertical level, the relative power of the individual authority is smaller than if there were just one authority.

Not only does the multi-level and cross-arena context imply a greater number of potential target authorities, it also implies the opportunity to find more coalition partners in an attempt to influence regulatory decisions. Firms occupying the same integrated sectoral market and the same regulatory space are affected similarly and may thus be willing to join forces in seeking to influence a regulatory decision. In doing so, they may increase the value of the resource exchanged with the regulator. This

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1 Peter Bouwen (2001) explains the degree of access to European institutions in terms of a theory of the supply and demand of access goods. He conceives of the resources offered by firms and associations in terms of their expertise and national and sectoral 'encompassingness', and argues that this allows large organizations (in this case, banks) easy access to the Commission, which depends on this expert input to draft regulation. National associations are more likely to gain access to the European Parliament, because the Parliament is interested in input into the legislative process from those with nationally-encompassing views as well as from large groups of voters. Similarly, as a target institution, for its decision-making needs, the EP is interested in member-state-wide encompassing views; it thus tends to be more open to associations' 'bundling' sectoral and cross-sectoral information.

2 On the part of the regulatee, there are efforts to put together valuable information, but they also forfeit short-term advantages by offering biased information to the regulator.

is even more clearly the case if national sectoral associations join forces with other national associations.

Secondly, the value of the resources available to the regulator depends on the nature of the regulated sector. Thus, the regulator's strategies to gain information will vary depending on whether the regulatory decisions are to be made for a monopolistic or duopolistic sector, or for a sector with numerous competitive market players. The degree of dependence on one or two actors decreases when other market players are able to be addressed for additional information on how the market is functioning and "yardstick competition" can be used as a source of information. Hence, if there are multiple players around, the regulator's resources increase in value with respect to the individual firm.

In brief, I use inter-organizational resource-exchange theory to account for companies' attempts to gain access to a regulator and to account for the regulator's willingness to grant easy access. By applying this theory to a given regulatory institutional set-up (with single, double or multiple authorities at the horizontal and vertical level) and a specific sectoral structure (with single, limited or multiple players in the deregulated sector), I come to the following propositions:

- firms offering special expertise or information to regulatory authorities are more likely to have a high degree of access to those authorities;
- firms commanding large market shares are likely to have a high degree of access;
- incumbents have a higher degree of access;
- firms backed by strong associations are more likely to gain access to regulatory authorities;
- a regulatory target structure with multiple access points (multiple regulatory authorities) and overlapping competences offers a firm/an association greater strategic possibilities for attaining high access;
- a sectoral market with several players offers multiple sources of information/expertise to the regulator and makes the regulator more powerful.

Turning to the second perspective of regulator-regulatee interaction: when implementing existing rules, principal-agent theory may be helpful in accounting for the mode of interaction (Moe 1984; 1990). Principal-agent theory posits the existence of a contract between the principal (regulator) and the agent (firm), containing specific incentives to perform, but also imposing costs on the regulatee. The latter, while enjoying the benefits offered by the contract, must also honour obligations regarding her market behaviour, e.g. she must refrain from distorting competition and comply with social regulation in matters such as pricing and service performance. Given these costs, the regulatee has an incentive not to fully comply with the contract and is instead likely to interpret it in a way which best serves her goals; in other words, she will try to avoid full compliance with all aspects of a well-specified contract or she will seek to interpret a vaguely formulated contract in a manner that saves money for the firm. This is possible because, through her day-to-day activities and relation-

ships with clients, the agent (regulatee) has more knowledge of the details of the work process (informational asymmetry).

The regulator, by contrast, is uncertain about the agent's behaviour. She will try to control it "to keep him on target" (Moe 1990:225). She will monitor the maintenance of the contract, and, like the regulatee – but with an informational disadvantage – she will attempt to interpret it according to her own interests. These interests are defined by the statutory regulatory goals. Redefining these goals may create an additional area of conflict between the regulator and regulatee. The regulator may seek to alter the contract when the performance of the regulatee is not satisfactory. Or under the effect of political guidance, she may be encouraged to adjust contractual obligations to changing economic and political circumstances. Regulatees, by contrast, with their long-term investments in the network infrastructure, prefer a stable contract with terms which are not subject to change and which avoid the risk of "administrative and political expropriation" (Veljanovski 1991). If regulatees develop expectations which are not fulfilled or there is continuing uncertainty about what can be expected, "then it becomes impossible for business to plan with confidence and regulators' actions amount to expropriation of shareholder wealth" (Veljanovski 1991:59/69). Hence, it is understandable that firms prefer an independent regulator who may be expected to guarantee a more stable contract to a regulator who is subject to strong political guidance.

As mentioned, non-compliance in the contractual relationships is facilitated by the informational asymmetry of the firm in relation to the regulator. The regulatee has detailed information about the market's functioning, the network infrastructure's production technology, the provision of services and client relations. Since regulation imposes costs on the regulatee, the latter will use this informational asymmetry in order to reduce these costs, whereas the regulator will seek to mitigate the informational asymmetry by using hierarchical control. Where this is not possible, she will try to gain more information by introducing additional information mechanisms that induce the agent to reveal as much information as possible (Moe 1984). This is done in a number of ways: By creating monitoring systems and employing systems of "fire alarm", information may be gained about affected groups (such as customers organizations) and used to compare agents' performance(s), (Mc Cubbins/Schwartz 1984). The regulator may also turn to the regulatee's competitors for information, or build up her own internal expertise in order to compensate for this asymmetry. Once again, the structure of the regulatory institutional arrangements plays a role in fulfilling the contractual relationship between the principal and the agent. To grasp this influence, principal-agent theory in its classical form, as a bilateral contractual relationship of one regulator and the (incumbent) regulatee, needs to be modified to include the other public and private actors involved (Prosser 1999), be they regulatory authorities or other market actors; it then needs to analyse the logic(s) of interaction against the background of a horizontally and vertically multiple regulatory-authority structure as well as a multiple-player market. Faced with several regulators, a company may try to play them off against each other, and if dissatisfied with the interaction with one regulatory body, it can turn to another in order to solve a conflict. In much the same way, a regulator will be able to collect more information on rule implementation if the implementation can be compared among a number of market players rather than being assessed in reference to a sole actor.

From these theoretical considerations I derive the following propositions:

- to reduce informational asymmetry the regulator seeks devices to gain more information by creating additional monitoring and “watchdog” mechanisms;
- if the level of performance of the regulatee is judged to be unsatisfactory, the regulator seeks to change the terms of contract (the instruments provided for by the contract);
- a change in political guidance may cause a change in the terms of the contract.

With respect to the regulatory structure I propose that:

- a regulatory structure with multiple authorities (including courts) on the vertical and horizontal level offers the regulatee more strategic possibilities for reducing regulatory costs;

a market structure with multiple players facilitates regulatory monitoring by offering additional information sources and more possibilities for comparing the performance of various players.

### **3. Methodology**

In trying to account for how firms access regulators and how regulators seek to ensure compliance, I proceed in two steps. For each question I first use the size/type of a firm as an explanatory variable and then the type of regulatory structure. Hence, in each analytical step there is one explanatory variable and two cases, Britain and Germany. The dependent variables to be accounted for are the “degree of access” in policy formulation and the modes of securing compliance with the regulatory contract.

The variables are operationalized as follows: In the first step, where access is investigated, I first look at the firm-oriented variable with the values of size and type. Company “size” is characterized as small/medium and large in reference to the national market share; “type” is distinguished as incumbent and market accessant. Since incumbents are always large market players, in their case size and type is collapsed into one category.

The independent variable used in the second step is the institutional structure of the sectoral regulatory authorities: here I distinguish between a sectoral-multiple or single-authority structure at the horizontal and vertical levels, and a single- or multiple-authority structure across sectors.

For the dependent variable, the degree of access is measured formally and informally. At the formal level official consultation procedures are conducted: there are fora for exchanging information and working groups at the European level, which are instituted by the regulatory authorities. At the informal level, regulators are contacted personally, by telephone or in writing.

Looking at the interactions at the level of implementation/contract compliance I use the same two explanatory variables as in the first and second step; the dependent variables are the extent and the



type of control used by the regulator and/or the extent of the regulatee's compliance or non-compliance.

The comparison is based on a literal replication across the two cases: In both cases, Britain and Germany, there are multiple regulators; and the sectoral structure at the network level is organized as a monopoly. In other words similar results are to be expected regarding the incumbents' access to the regulators and their compliance. In service operation, by contrast, there is variation in the independent variable across the two countries, hence a logical replication of cases (Yin 1994). In Britain there is competition in the license tendering process, while in Germany the former state monopolists clearly dominate service operation. Hence, in British service operation it should be easier to control compliance, because it is possible to compare performance.

The empirical results presented here are based on the preliminary findings of the first phase of explanatory research. In the course of this research, interviews have been made with 21 actors in Britain and Germany.

## **4. The new regulatory structure in the rail sector**

### **4.1 Great Britain**

The railway act of 1994 fundamentally changed the regulatory structure of the British railway sector (Knill 2001) by subjecting the former natural monopoly to a process of market liberalization. The vertically-integrated state enterprise, British Rail, was divided up into a system of contract-linked private enterprises. A private monopoly, Railtrack (RT), runs the network and the stations, and the Rolling Stock Companies (ROSCOES) own the rolling stock, which it leases to the twenty-five private train-operating companies (TOCs). The latter run passenger services throughout the country.

The different private enterprises offering passenger services are linked by contracts: The TOCs signed contracts with Railtrack, which stipulate details concerning the access and the use of the rail network and which lease rolling stock from the ROSCOES. The sector is subject to two regulatory authorities: the Rail Regulator (RR) and the Strategic Rail Authority (SRA, formerly the Office of Rail Passenger Franchising or OPRAF). Under the contract regime, the RR monitors the functioning of the newly-created market and stipulates and guarantees access to the network via the contracts between the TOCs and Railtrack (contract regime). He watches over the implementation of the contract by individually controlling and approving the access agreements between RT and the TOCs. If he does not like it for capacity allocation reasons, for instance, or because of discriminatory levels of charges, it can be sent back to be rewritten. Under the license regime, the RR controls the concrete operation of the assets of the railways such as trains, stations, tracks. This power is shared with the franchise director (formerly the OPRAF, now the SRA). RT has a license which obliges it not to discriminate against network accessants; another license relates to renewing and maintaining the network (Interview RT, November 1999). The former OPRAF concluded the contracts with the TOCs, allowing operational services on the individual lines to be opened up for

competitive bidding on the open market (yardstick competition). Under the terms of the franchise contracts, specific dimensions of the subsidies granted to the TOCs, together with the stipulated performance, are defined; for example, the number of trains run, standards of punctuality and reliability, as well as the fines to be paid if these conditions of service are not met. Moreover, the Rail Inspectorate (RI) of the Health and Safety Inspectorate is responsible for checking and maintaining the safety levels.

Although formally independent, the RR is nonetheless subject to political guidance from the government. "The RR has to take into account what the government says, but it does not have to do what the government says" (Interview RR, January 2000). The SRA is explicitly dependent upon some ministerial guidance. The SRA receives public funding, which is transferred to the TOCs in the form of subsidies.

In short, the British regulatory model is designed for a completely privatized industry: a private monopolist owns the network, private companies lease rolling stock, and yardstick competition exists among twenty-five train operators in the provision of services. The regulatory structure comprises three sectoral regulatory authorities in charge of basically different, but partially overlapping tasks, two of which are subject to political guidance (SRA and RI), and a third which remains formally independent (RR).

Following my theoretical considerations, I expect that the British model, in which a numerous sectoral regulatory authorities with partially overlapping functions are targets of access, makes for a high degree of access. At the same time, because of the multiplicity of actors in service operation, the regulatory authorities are less dependent on the information of an individual operator.

In network operations with one actor, access to the multiple sectoral regulators should be even easier because of the RR's, SRA's and RI's significant dependence on RT's information and expertise. In regard to non-compliance, the competitive situation in service operation makes it more difficult because "yardsticking" can be employed; by contrast, in the case of the private monopoly, RT, one may expect non-compliance to be easier. However, the partial overlap in the multiple authority structure creates more strategic possibilities for operators to play authorities off against each other; it also facilitates non-compliance.

## **4.2 Germany**

The German railway sector has not been liberalized to the same extent as its British counterpart (Teutsch 2001). The network, stations, the rolling stock and the operation of services are in the hands of the Deutsche Bahn AG (DBAG), a legally private joint stock company with the German government as the sole stock owner; the government-owned company is run according to market principles. The government took over the debts of the former Deutsche Bahn and Deutsche Reichsbahn; it guarantees pension funds for a defined generation of railway employees. The government is also responsible for major decisions concerning infrastructure. Hence, political

influence is still considerable, in spite of the advocacy of the formal commercial independence for the railway management. Although the network is formally accessible to other network operators, long-distance services are exclusively offered by the DBAG. The regulatory authority admitting private operators to the network with the DBAG lies with the Ministry of Transport. De facto access is negotiated with the DBAG. The Federal Cartel Office – as a cross-sectoral actor – is responsible for market supervision. The Federal Railway Office has mainly been in charge of technical supervision, and only to a lesser extent involved in market supervision.

At the regional level, the *Länder* are responsible for service operation. Here other train operators besides the Deutsche Bahn Regio, which holds 95% of the regional service market, have access to the network.

Hence at the cross-regional level, Germany is still characterized, de facto if not de jure, by a public monopoly, albeit one that is supposed to operate according to commercial principles. Additionally, the structures of the sectoral regulator are not very well developed, and a strong element of political guidance remains. As a consequence, according to the general considerations one would expect, the sectoral mono-structure in Germany at the network and service operation level facilitates access for the DBAG; the incipient market competition at the regional and freight level should facilitate compliance control for the regulatory authorities. Given the multiple authority structure, access should be easy for the regulatees to attain, and possibilities for addressing two regulatory authorities should make non-compliance easier.

### **4.3 The European Regime**

The European regulatory structure (Kerwer and Teutsch 2001) is of relevance in two senses. First, the European directive, 1991/440, prescribes separate accounting for the operation of the infrastructure and for services, and in order to train operators it recommends opening the access to the network. Second, more recent European legislation, from 1995, also requires that regulatory functions be separated and that networks and services be operated. It also provides for the possibility of operating international freight lines and for a specific regime to grant licenses for the international services. Here there is an institutional arrangement that the two parties in question conclude their contract on their own and that the regulator (in this case the national regulator) only steps in if the two parties disagree (Interview RT, November 1999).

The most recent legislation, the infrastructure package directive, provides for common capacity allocation and charging processes in each member state. It also proposes a regulatory body in each member state; however, as of yet there has been no agreement on which regulatory body should do this. The other part(s) of the infrastructure package directive consist of the extension of the licensing directive of 1995 and amendments to the 91/440 directive seeking to extend open access and separation.

## 5. Empirical findings

### 5.1 Britain

Formal and informal access at the national and European level:

Focusing on policy formulation, first, the exploratory empirical findings show that the most relevant level of regulation is still considered to be the national level, where “a lot is on the plate” to be re-regulated (Interview RF, November 1999).

Formal access to the national regulator is guaranteed through participation in extensive consultation processes conducted by the RR in which the network company and the train operators take part. These procedures may impose quite a workload on firms. “I had actually engaged solicitors to prepare a response to the regulatory document ... the regulator’s proposal to use the model clauses for the next generation of track access agreements... There is so much at the moment” (Interview TOC, January 2000)

European authorities can be accessed both formally and informally. There are frequent consultation processes in which all sectoral actors are involved. There is some preliminary confirmation of the proposition that incumbents and large firms with a dominant market position have the highest degree of access to the Commission. Thus, the private network monopolist, RT, with a permanent office in Brussels, has established good working links with the Commission and regularly comments on legislative drafts (Interview RT, November 1999).

Access through associations:

Access is facilitated by forming associations, but it is not facilitated to a similar degree for all types of firms. The expectation that larger players more successfully access European regulators through associations than the small players is confirmed. Thus the network infrastructure managers have been active in creating new associative structures which reflect the changed preferences of the sectoral actors since liberalization. They have founded the European rail infrastructure managers association to represent their interests (Interview RT, November 1999). By contrast, the smaller firms, like the train operators whose subsector has been divided up into 25 companies, are much less active in taking such steps.<sup>3</sup> Service operators are still represented by the old European railway associations.<sup>4</sup> The “old” associations, however, such as the Community of European Railways (CER) and the Union Internationale des Chemins de Fer (UIC), which were founded by the formally-integrated railways, do not reflect the change in preferences brought about by liberalization,

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3 They arguably have little interest in the European integration programme (Interview RT, November 1999), and according to the available information, as staff of the former BR they still have the mind-set of the former vertically-integrated railways: “they don’t see railways as a business, but as a career” (Interview RT, November 1999). For them – the management by contract, introduced with liberalization, was “a totally alien idea. They interpret a contract line by line, with the same rigid approach. This stifled a bit this implied incentive regime...” (Interview SRA, January 2000). Additionally, after having been accustomed to managing a sector in decline for 20 to 30 years, they now have to get used to managing a growing sector (Interview SRA, May 2000).

4 “It will take a long time before they take the gloves off and organize themselves as operators at the European level” (Interview RT, November 1999).

where network managers and service operators have conflicting interests. Rather, CER seeks to accommodate the interests of both parties; and that makes it difficult to actively influence European legislative proposals. Thus, in 1988, when the Commission was drafting the directive on access charging and capacity allocation, a UIC working group tried to come up with proposals, but failed to do so because of conflicting interests.<sup>5</sup> By contrast, the network operator did some work on it and presented a detailed critique of the draft; and as a consequence he could safely say, "... There are things in that draft which reflect our views" (Interview RT, November 1999).

The TOCs' view on this is not quite as critical. According to one train operator, TOCs are working through ATOC (Association of Train Operating Companies) at the European level. This TOC is also convinced that the largest sectoral player – the network operator, with its office in Brussels – is helpful to them: "They regard themselves, where appropriate, as at least keeping an eye out for the interests of the wider UK rail industry" (Interview National. Express, March 2000).

#### Multiple authorities:

In the interplay between firms with multiple sectoral regulatory authorities situated at different levels, the preliminary evidence confirms the claim that a multi-level authority structure indeed widens the strategic possibilities of individual national actors. One indicator is that the various public and private actors from the rail sector do not speak with one voice when they address European bodies; instead, they pursue their individual strategies. RT addresses the Commission directly in order to oppose the regulatory goals of the RR at the national level. The main reason is that RT considers the Commission's regulatory goals to be closer to its own regulatory objectives. It even emphasizes that it would hesitate to pass on information about its communication with the Commission to the British regulatory authorities (RR or SRA) (Interview RT, November 1999). "As an industry we have a very individual relationship with Europe. There is no sense of common purpose (of the industry, A.H.). There is a lot of confrontational behaviour, misalignment of incentives. It does not make us work hand in hand with our regulators to get the best deals in Brussels" (Interview RT, November 1999). SRA, by contrast, indicates it has not yet been active in seeking influence at the European level, but has sought to become well-informed of RT's activities in Brussels (Interview SRA, 1999).

These attempts of private national sectoral actors to by-pass their national regulators by collaborating with Brussels could be pre-empted by co-ordinating the actions of public actors, that is, by co-ordinating activities between the national and European regulatory authorities.

The preliminary findings suggest that this sometimes occurs. The RR basically has two links with European bodies: a direct link to the Commission to offer its expert view on regulation, and a political route through the Department of Transport to influence Council decisions, i.e. political decisions. Additionally, one can observe the first signs of co-ordination between national regulators

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5 "It is important for the Commission to talk to that group because it includes so many different interests. When Kinnock (showed, A.H.) the draft to the CER, it contained some elements which were anathema to the French, the Belgians and some others, so CER decided not to engage in any dialogue with Kinnock" (Interview RT, November 1999).

by means of a new observatory body, the European Rail Observation System (EROS), chaired by the Commission. It functions as a forum for the exchange of information on how the infrastructure package is applied and how the traffic on railways is developing. It is chaired by the Commission; and while this is welcomed by the UK (“otherwise we would have endless discussions in EROS on issues” - Interview RR, January 2000), France, by contrast, would prefer more member-state control. While functioning as a forum at present, it might gradually turn into a policy-making body making recommendations to the Commission (Interview RR, January 2000), and possibly into a proper regulatory body (Interview RR, November 1999).

#### Lack of compliance:

Turning to contract compliance and the mode in which regulators deal with it, the findings show that there is indeed dissatisfaction with the performance of Railtrack and the TOCs. The regulatory bodies do think that there has been non-compliance (see also Héritier and Schmidt 2000). “We have been very critical of RT. We don’t think that they have been delivering on a number of fronts. We do recognize that they need an incentive. But we do not want them to make lots and lots of profits and not invest enough. That’s fine for the City and the shareholders, but not for the Government and the taxpayers. So it is a question of the right balance” (Interview RR, January 2000). The performance of the TOCs in providing services has been mixed as well (see Héritier and Schmidt 2000).

Non-compliance – it as been argued – is facilitated by informational asymmetry, which the regulator seeks to compensate for; additionally, the empirical findings point to a factor of non-compliance which has not been anticipated on general grounds: namely, inconsistent incentives in the contractual regime. The preliminary data show that to prevent non-compliance, measures are taken in both directions: to compensate for informational asymmetry, the regulator seeks to improve his information, simultaneously, instruments are redesigned to improve compliance and to make the regulatory regime in general more consistent.

From the viewpoint of firms, the existing license system gives the regulator a lot of possibilities. RT argues: “The revision of the RT license haunts us every year. If a TOC has difficulties in coming to an agreement with RT, it can object to the RR, and the latter can impose an access contract on RT” (Interview RT, November 1999). The review of RT’s access charges, which takes place every five years, is another important instrument of control. Similarly, under their license contracts, the TOCs are obligated to provide specific services, which are then monitored by SRA. From the viewpoint of the regulator, however, the existing possibilities for sanctioning the TOCs and RT need to be improved. “Taking action against a possible breach of the license takes too long and is too complicated. At the moment the RR can only take action if he thinks that it is a continuing problem and that the breach will occur again. This [improvement, A.H.] is provided for by the new bill in Parliament” (Interview RR, January 2000).

## Informational asymmetry and remedies

### ✍ **Regulatory “intrusion”:**

Both the regulator and the regulatee agree that there is informational asymmetry in favour of the regulatee in the day-to-day monitoring (Interview RT, November 1999). As a consequence, as theoretically claimed, the regulator seeks modes to gain additional information about regulatees' behaviour. One strategy is to develop internal structures of expertise in order to cope with monitoring tasks. The preliminary findings show that there are some initiatives of that sort. The SRA plans to take more technical experts on board in order to be able to deal with technical aspects of controlling TOCs. “We are recruiting people who are experts in operating technical engineering and signalling so that they can make informed assessments and offer advice on the credibility of the statements of the underlying performance and on the extent to which propositions are credible in their view” (Interview SRA, 2000). Another representative of SRA questions this view by saying: “Up till now we have tried to stay out of detailed decisions. We would need a fairly large organization in order to second-guess all that [such as the details of an important service from Manchester to York, A.H.]. A key issue for us is to put the right incentives and the right framework in place and to leave it to the RT and TOC managers to make the right decisions to produce the right product of the right quality” (Interview SRA, May 2000).

Firms, for their part, view the monitoring efforts critically, as attempts “to get inside the organization” (Interview RF, January 2000). They complain that the regulator progressively “sucks in more information, but in an ill-targeted and scatter-gun approach” (Interview RT, November 1999) and that there is “a law of increasing regulatory intrusiveness” at work, implying that regulators tend to ask more and more questions and that regulation tends to take the form of “micro-management” in a company (Interview RF, November 1999). For small companies it is difficult to deal with all the information queries, which often do not have their own regulatory director. Thus a rather large TOC has two persons who spend about 25% of their time dealing with the regulatory authorities (Interview TOC, January 2000). “We are big in our sector. There are substantially smaller companies ... but we don't have regulatory departments; we are not that size, not only in terms of financial cost, but [in terms of] the opportunity cost, [that is, in terms] of [the] directors' and managers' time” (Interview TOC, January 2000). Another interview partner deplores the imbalance between the regulator's and the regulatee's personnel: “The relationship between one smaller company and the regulator is that in the firm there are three people answering the telephone, while, [by contrast], thirty people are asking questions at the rail regulator's, questions which don't appear to make sense. At the top of the regulatory body, they understand this. But if you move down the line, it gets more difficult. You get this guy sitting in his office, reading the paper and asking ‘what's going on there!’ and then becoming active. It created a dynamic which is difficult to stop” (Interview RF, January 2000). In response to this “regulatory intrusiveness”, regulatees work with a strategy of counter-information, supplying “large packages of information” to the regulator. “That is motivated out of self-interest at a moment where he feels entitled to ring us and to ask, ‘Can I have this, can I have that?’” (Interview RT, November 1999). One TOC admits that “an intrusive type of product specification is necessary” if the market is local and not profitable, that is, depending on subsidies.

By contrast, it is deemed inappropriate for most of the interurban services that are operated (Interview National Express 2000).

### ✍ **Firebell ringing:**

As expected, “Firebell ringing” (Moe 1984) has become quite prevalent as a mode of providing information from affected third-parties about the regulatees market behaviour. Since liberalization there has been a lot of public attention directed towards the privatized railway and its performance. “If you have 20 to 30 million customers, like in rail and energy and water, there is no way of keeping out of politics” (Interview RF, January 2000). The empirical evidence shows that, paradoxically, privatization has made the system more transparent and has increased the public attention. Precisely because the railways are private, yet simultaneously receive public funds, the public is critical when shareholders make profits and, at the same time, the service performance is poor. Because of the fragmentation of the service-operating sector in question, responsibilities can be allocated more easily; and this provides for an additional accountability-enhancing factor (Interview RR, January 2000). However, it has also been pointed out that, “Thanks to the Passenger Charter under which performance statements were made available, there was transparency prior to privatization. I do not think that there is more officially published data. There is relatively *little* officially published financial data.... What has changed is that [as a result of privatization; A.H.] there is a lot more of what I would call quite good ‘second-guessing data’” (Interview TOC, November 2000). “Because there is a lot of demand for data, all investment houses in the city now have their transport departments ‘create’ and ‘invent’ data that is publicly available. And because they are so clever and good at it, they get quite close....They are creating pseudo-data” (Interview TOC; November 2000).

### Government influence on compliance control:

It has been claimed that a change in political guidance may make an impact on a regulatory regime. This is indeed confirmed by the preliminary findings. The regulators’ practice of compliance control has been influenced by the change in government. After the the Labour Government came into office, the regulator and the franchise director were to some degree forced to more strictly check implementation and overcome information asymmetry. Labour appointed a new rail regulator, who had been active in developing Labour’s rail programme, calling for tougher regulation of the rail industry (Interview RT, November 1999). “The government is progressively intervening more. Labour has ostentatiously sacked two regulators (the RR and the Franchise Director A.H.). They were hounded out of office. The new regulator claims to have written the Labour rail transport manifesto. He is a Labour party member. He was appointed by the Deputy Prime Minister. He can talk to him any time. He does not do what regulators normally do, that is, to demonstrate their independence. He emphasizes that he is the right arm of government policy” (Interview RT, November 2000). As a consequence, the regulatory style has arguably changed from being consensual and confidential to being confrontational and keen on publicizing the behaviour of companies and “aggressively” seeking more and more information (Interview RT, November 1999; Interview RF, January 2000). It is also keen on using the available instruments more pro-actively. As of the end of 1999, two draft-enforcement orders had been sent to RT, whereas the previous regulators had not sent them any (Interview RT, November 1999).



### **✍ Anticipated license renegotiation:**

The decision to anticipate the renegotiation of licenses is an expression of the political discontent with the original terms of regulatory contracts and the resulting non-compliance. It has been argued that the early franchise agreements with the TOCs were too loosely written, and that is why they are now being tightened (Interview RT, November 1999). At the moment 6 franchisees are being renegotiated in a competitive process. Six to nine bids have been put in for each of the franchises, including the old franchisees. The new bidding process is conducted in such a way as to encourage investment. In order to get onto the bidding list “the first question when you sit down (after passing through the regulator’s door) is: ‘How much can your balance sheet stand?’ So one outcome of this process will be ... upfront commitment to invest” (Interview TOC, January 2000). Whereas, in the first round, franchising was directed by the notion that “it is currently 20 trains a day, so that’s what was being franchised, and the bidder who asked for the lowest subsidy got the bid, this time there is much emphasis on the bidders coming forward with proposals to enhance the service by running more train services, by running more miles, by improving performance and rolling stock and by increasing investment in infrastructure. This time around, instead of asking them to bid for fixed service levels, SRA asks them to continuously explore higher and better service levels and more investment” (Interview SRA, May 2000). As one TOC said: “There is a strong political thrust on performance as measured by ... punctuality and reliability ... TOCs are required to sign up to much higher standards and benchmarks.... They are looking for output” (Interview TOC, January 2000). One TOC remarks critically: “In the second round of franchise bidding ... the contracts have become even more complicated, because not only are there the potential scams that there always were, but there are also the scams that nobody ever thought that they have got to be protected from” (Interview TOC, November 2000).<sup>6</sup>

In the attempt to strengthen the TOCs’ incentives to invest, they are offered longer franchises in the renegotiation of contracts (Interview RF, January 2000). “So we will get a much longer time frame in which we can operate more like a conventional business and less like a management contractor” (Interview TOC, January 2000). Another central objective is to form “joint project management teams” between the TOCs and the RT in order to gain some control over the very large investments that will go into the new franchises. Under the new contracts, the TOC is asked to specify what infrastructure it needs to increase the capacity of the network in order to deal with increasing passenger transport. Thus they can invest specifically to upgrade separate junctions, or to get more platforms or tracks and better signaling ... The design risk is with the TOC ... RT will then implement it ... while we pay a ground rent and take on the ... responsibility for the development, maintenance, cleaning and retailing” (Interview TOC, November 2000).

Another factor accounting for the lack of compliance, which was not anticipated theoretically, but emerges from the empirical information, is the arguable inconsistency of the entire regulatory regime.

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<sup>6</sup> In the view of some TOCs, some present contract holders have been “kicked out” demonstratively for political purposes to encourage bidding against the incumbents (Interview TOC, Nov. 2000).

Inconsistent incentives in the overall regulatory regime:

The incentives created by the reform are judged to be partially conflicting with each other and with the basic given conditions. Thus, it has been pointed out that the competitive bidding processes for franchises have resulted in upward bidding to run extra-trains, the franchise going to the highest bidder. This did not take into account the network's reduced capacity, and it inextricably led to train delays and overcrowding (Interview SRA, January 2000).

Conflicting incentives were also created between the train operators and the network operators. Both tend to shift the blame for a lack of investment back and forth when there is under-performance. If one invests, the other need not. "One problem with the contractual regime is that once train operators have their franchises, they know what they are going to pay to RT. They know that we have a large expenditure programme. Therefore, they do not really have any incentive other than to argue that all the money should be spent on making their business better. Everything we do on maintenance and repair, they argue, they are already paying us for. The end result is that the operators are not spending enough either. Our interest is not to spend more than we have to. The operator's interest is to extract as much as they possibly can. There are conflicting economic incentives" (Interview RT, November 1999). In the TOCs view, with two sources of revenue – passenger revenue and the subsidy – under conditions of more passenger demand (and higher revenues but stable subsidies), to increase capital expenditure is not very attractive. If it is [increased], leasing charges for rolling stock and RT charges increase, too (Interview TOC, November 2000).

Another inconsistent incentive is that the length of RT's and the TOC's licenses differ. This thus creates different planning horizons.

However, some sectoral actors challenge the view that the regulatory regime as such is ill-conceived. These actors emphasize that it is not the system as such that is problematic, but the fact that the political goals and the economic context of the sector changed after the present contractual regime was set up. "There are no structural mistakes. These regimes with their incentives to perform and to invest work pretty well as intended. The problem is that their *intentions* (emphasis added, A.H.) are not what the new government would like them to be. They are basically designed to leave things broadly (as good or as bad) as they were before – and [only] slightly improve them. They were not designed to *transform* (emphasis added, A.H.) the service. But government wants transformation, it does not want [things just] 'a bit better than last year'. I do not think that it is a problem of inconsistent incentivization, I think it is a problem of a fundamental change in objectives" (Interview TOC, November 1999). Incentives to invest were not provided for when the system was set up. "The basic philosophy was that this is an industry which [is loosing] the basic economic drive ... [and] that will contract fast. So most of the incentive regime is about cropping up and keeping things going. But three things have happened since [then]: [firstly], industry has changed its attitude towards growth and marketing; secondly, the price regulation within the franchise agreement<sup>7</sup> has stimulated significant growth (within 4-5 years); and thirdly the political thrust of the government –

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7 RPI-1 on regulated fares on [basically] all travel to work to London and the Southeast.

of the modal shift, fuel prices, the abandonment of the road programme, congestion – were all pushing [for] change. The issue is now whether we are talking about 15 or 20% growth in the next 15 years. That is the nature of the debate. And there are no mechanisms at all within the present regulatory structure to give anybody incentive to invest and actually deliver that growth. So there is no imbalance within the regime of incentivization, but the environment has changed” (Interview SRA, May 2000).

The criticism addressed to the overall structure of the regulatory field defined by the contractual relations is underlined by the particular, imbalanced nature of the market structure of the sector.

Multiple authority structure:

There is some evidence, but also some counter-evidence, for the claim that a multi-authority structure makes monitoring compliance more difficult. There is indeed a certain overlap between the RR's and the SRA's monitoring functions (Interview RR, January 2000). The RR oversees RTs' licenses *and* the TOCs' licenses, while the SRA is only responsible for the latter. Thus in consumer protection the overlapping functions are thought to confuse consumers because they do not know who to address; hence their ability to press for contract compliance is reduced (Interview RR, January 2000). “Some consumer issues are dealt with in franchise agreements, some are dealt with through licenses issued by the regulator. Some are dealt with by both. The public does not know which person they should write to. When they want to complain about fares, they need to write to the Franchising Director. If they want to complain about passenger information, they need to write to the RR” (Interview RR, January 2000). The revised legislation of 2000 put all consumer protection into the hands of the SRA (Interview RR, January 2000).

Another area of split responsibility is safety: at the moment competencies are split among the private network monopolist and the safety regulator, the Health and Safety Executive (HSE), and within the framework approved by the latter; the monopolist's licenses in turn are issued by the RR. In case of an accident, the HSE does not act on its own; instead, it relies on RT to undertake action, and it will ask the regulator to take licensing action if necessary (Interview RR, January 2000). Additionally, RT has regulatory functions vis-à-vis the TOCs: “they regulate our safety policy and the standards by which we operate. So they can blow the whistle on the train operating company for operational misdemeanours, i.e. for not running by the rule book, and they have their own auditing department as well” (Interview TOC, November 2000)

Whereas there is some evidence of split responsibilities between the regulatory authorities, there are also statements indicating that the RR and the SRA have not been played off against each other much in the past in order to avoid compliance (Interview RF, January 2000; Interview TOC, November 2000). In part this is due to the co-ordination of “cases” between the different responsible bodies. In the words of a TOC, “I don't think it's a case of playing them off”. The likeliness of non-compliance is thus not stronger.

A further piece of evidence disconfirming the claim that a multi-authority structure invites non-compliance consists in the firms' conviction that the more regulatory bodies there are, the more

frequent the regulatory activities, and the higher regulatory burdens for the firm. “What slightly worries me is that with two regulatory bodies, they will generate twice or three times as much work if you don’t keep them under control” (Interview RF, January 2000).

Sectoral structure:

It was argued that a market structure with multiple players facilitates regulatory monitoring, whereas a Sectoral structure with one player renders it more difficult. The preliminary evidence corroborates this claim. The sectoral structure is seen to lack balance and to favour RT to the disadvantage of the 25 train operators. RT, as a monopolist, is not pressed by competition. This imbalance has arguably led to network-access contracts that are unfavourable for the TOCs. By negotiating 25 to 30 contracts, RT has gained a lot of experience, whereas a TOC [in the same time period] negotiates just one contract. In order to compensate for that weakness, the RR passes information on to the TOCs that includes expertise on how to negotiate contracts (Interview RR, January 2000). As one TOC said “If we didn’t have the ORR (Office of the Rail Regulator), our negotiating powers with RT would be almost non-existent ... They are so large, so monopolistic, that without a regulator to say, ‘No, we will change your license conditions’, then we would not get any movement ... We, as the biggest single unit in the UK, ... did at least have some power with them, some buying power. But many of the small ones really didn’t and were just brushed aside” (Interview TOC, November 2000).

As a response to the imbalanced sectoral structure, there are now attempts during the license renegotiation to reduce the number of market players, particularly to reduce the small ones (Interview TOC, January; November 2000).

Conversely, there is some confirming evidence that a multiple player sector – which exists in service operation – facilitates the control of contract compliance. With many players (24 TOCs), “yardsticking” can be applied, and used by the regulator to gain considerable information on performance. The SRA does collect comparative data. “A year ago we divided them [the service operators] up by classes, depending on performance. That generated quite a bit of correspondence with the train operators, particularly the ones who found themselves at the bottom edge of the scale” (Interview SRA, May 2000). By contrast, the private network monopolist, RT, presents its own issues to the RR.

## **5.2 Germany**

National or European level:

The rail industry seeks its most relevant level of access with national authorities, that is, with the Federal Cartel Office (FCO) and the FRO (Federal Railway Office). This is where the important decisions in interpreting the sectoral legislation are made. The informal access to both authorities

seems to be unproblematic for all market actors, i.e. for the incumbent as well as for the small market actors.

The European level of access does not play a prominent role for sectoral players. For the small railway undertakings and new market accessants, informal meetings which serve to exchange views and information on market behaviour and technological innovation are regularly organised by the Commission. The FRO has few contacts with the European bodies (Interview TOC Freight, September 2000).

#### Access through associations:

The claim that access is facilitated is not confirmed. Rather what emerges is that the role of associations in guaranteeing access and influence has been subject to change for three reasons: First, liberalisation and the new opportunities associated with it have brought about a differentiation of interests among the various regional operators. While some operators have used the new opportunities to develop new transport business activities and to acquire new costumers, as well as to enlarge their own networks, others have remained closely attached to the DBAG. Second, the Association of German Transport Industry used to include all German public transport enterprises and railways except the DBB (Deutsche Bundesbahn); now the formally privatized DBAG has joined the association. Hence the latter has to represent very heterogeneous interests, including the interests of this large incumbent. With interests having thus become much more diverse, the consensus in the association has dwindled. Thirdly, the association's activities have been weakened because the DBAG seeks to settle all relevant issues of cooperation in bilateral negotiations with the regional railways (Interview TOC Freight, September 2000). Due to these factors, the association does not play an important role in enhancing access and in expanding the influence on regulatory decision-making.

#### Lack of compliance:

The domains in which compliance is expected in the German railway sector are those allowing for market access, that is, allowing for possible discrimination in network access and in the market operations in general. Competition has increased as a whole: about 150-160 railway companies – other than the DBAG – offer services on the railway network (Interview DBAG, September 2000). However, in terms of market shares in network and service operation, DBAG is still by far the largest player. Thus, the DBAG, with DB Network, DB Regio, and DB Freight, has a very strong position: in long distance passenger services it has a de facto monopoly; in regional passenger transport and freight transport it is the largest player.

Given the overpowering position of the DBAG, it is not surprising that there are many complaints – that is, “firebell ringing” – from new market accessants and other small competitors, accusing the former state monopoly of trying to impede market access and of discriminating against them in the market.

Many instances and modes of discrimination have been pointed out:

- ✍ The DBAG has a de facto monopoly in maintenance operations – i.e. it is too costly for new market entrants to run their own maintenance shops. This means that market competitors of the DBAG need a contract with the DBAG for maintenance work. These contracts often entail lengthy negotiations, and sometimes no agreement is met at all. The DBAG argues that it lacks maintenance capacity, even for its own rolling stock (Interview Federal Cartel Office (FCO), September 2000).
- ✍ In another case, where DB Regio, an enterprise of the DBAG, lost the tendering process for running trains on a line, the DBAG now refuses to properly maintain the tracks. It argues that it lacks the funds and has to give priority to its own lines. Instead of repairing the tracks, they ask the new operator to run its trains at low speeds (30 km) across bridges. “Now is this an abuse of a market position by DBAG?” (Interview FCO, September 2000). It is even suspected that by not maintaining the line, it aims to make it less and less attractive, so that it carries less and less traffic and finally can be closed down (Interview FRO, August 2000).
- ✍ The prices charged for market access to non-DBAG train operators have also been discriminatory. The DBAG Network is free to charge the prices it deems fit for access to the network. There have been many complaints, particularly in regional passenger transport, because prices charged to DB Regio (belonging to DBAG) were up to 40% lower than the prices asked by other market players. The reason is that DB Regio was given a discount for long-distance transport, which – by definition – can only be offered by a large player such as DB Regio (Interview FCO, September 2000). The FCO considered this to be discriminatory behaviour on the part of the DBAG and an abuse of market power. “We did not accept the argument that more volume leads to lower prices...and [we] asked for a different pricing system for regional passenger transport” (Interview FCO, September 2000). As a result, the DBAG proposed a new price system under which each kilometer costs the same. However, it maintains that under existing railway legislation, a price reduction based on distance is possible (Interview DBAG Sept. 2000). At the end of 2000, train operators did not see any progress in the pricing question. “We do exchange information among non-DBAG train operators as regards prices that DB Cargo have to pay” (Interview TOC Freight, Sept. 2000).
- ✍ Another train operator complained that under national freight transport legislation, freight leadership lies exclusively with DB Cargo.<sup>8</sup> In international freight transport, instead of this, there is a joint freight contract for all shippers participating in a system of single wagon transport. As a consequence, under the German system those freight transport operators with no direct contact to the customer see themselves as in danger of being eliminated from the market because they are losing all knowledge of the changing market conditions (Interview TOC Freight, Sept.2000).

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8 The DBAG also is the only one who has the necessary know-how and the logistics to put together an entire system of single-waggon-transport. (Interview TOC Freight, Sept. 2000).

- ✍ The same effect occurs because of the fact that contracts between DB Cargo and the new market accessants are made in terms of a unified price system per unit of rolling stock, no matter what good is transported. This cuts the other market participants off from the chain of value production, and from costumers, because there are price differences with respect to the type of transported good, chemicals being more expensive than coal or mineral oil (Interview TOC Freight, September 2000).
- ✍ Another element of discrimination consists in the fact that the DBAG has leased all freight infrastructure, such as shunting stations and shunting tracks, to DB Cargo. “Each time another market participant – and this is frequently – does not just need the line, but an additional track, to reposition a train, you have to go to DB Cargo ... that is, to your competitor, in order to rent the necessary additional infrastructure ... It just may so happen that there is none available or that it is very expensive” (Interview TOC Freight, September 2000).
- ✍ A further point of conflict have been station access prices, which have varied greatly. Some regional railway operators have argued that they are discriminated against by the DBAG (Network) because the prices at some stations are 800% higher than in other stations. The DBAG has argued that the high charges are due to a high number of employed staff (Interview FRO, August 2000).

In sum, as the FCO points out: “There are endless possibilities for the DBAG to discriminate against new market accessants, and these are very hard for the cartel office to pinpoint: maybe DB-Network does not have time to work on an application for market access; it may charge higher prices; they may offer lines which are more difficult to run; there may not be enough experienced locomotive drivers available (which are exclusively with the DBAG) who could train the market competitors’ drivers; or maybe the training locomotive driver is ill over an extended period of time ... so that the new market accessants are not able to give their drivers jobs. All this is so differentiated and difficult ... that you can never prove it” (Interview FCO, September 2000).

The above described multiple possibilities for market discrimination by the DBAG and the frequent subtlety of these possibilities indicate a considerable degree of informational asymmetry between the regulator and the regulatee in favour of the regulatee(s), that is, the DBAG. In other words, it is difficult to substantiate the lack of compliance. Various means have been devised to compensate for the informational asymmetry.

Informational asymmetry and remedies:

The complaints addressed to the Federal Cartel Office from actors in the rail sector have increased dramatically since privatization. Since the reform is quite recent, “the involved sectoral actors simply do not yet know what the rules of the game are, what is allowed and what is not allowed” (Interview Federal Cartel Office, September 2000). When there is a complaint, the FCO intervenes. The abuse often can be stopped without a formal ordinance (Interview FCO, September 2000). That is, many individual cases are solved informally “with two telephone calls or a letter, rather than through formal complaint and investigation procedures” (Interview FCO, September 2000). Formal FCO

procedures are very lengthy because courts have to confirm them. Until corroborated by a court, they do not come into effect, except in the special cases, where there is “immediate application”, which again has to be confirmed by a court (Interview FCO, September 2000). Informality is also convenient because of the lack of personnel at the FCO. At present there is just one person responsible for rail transport, and this is not even his exclusive function. In particularly busy times, two more staff members can be temporarily recruited from other divisions (Interview FCO, September 2000). In view of this lack of personnel, it would be difficult for the FCO to simultaneously conduct several “large” procedures. One such procedure was the earlier-mentioned case of price system scrutiny, in the course which the FCO formally asked the DBAG to provide detailed information on eight concrete tendering projects (Interview FCO, September 2000).

The FRO is a much larger, although less powerful, organization than the FCO. With its 1,200 person staff (mostly consisting of former DBB employees), it defines its role as an authority for supervising technical matters and the discrimination to market access. It does not see itself as a regulatory authority. It initially had very limited competences: its own initiatives were restricted as were its rights of scrutiny and sanctioning power. As one official put it: “We are a toothless tiger” (Interview FRO, August 2000).

The number of complaints addressed to the FRO has increased since it was established. Many complaints are made informally, communicated by telephone; and most decisions are made informally before the official decision is taken. “The network operator often offers a compromise solution and the (formal) complaints are withdrawn; the DBAG makes extraordinary offers to its competitors. That’s how many conflicts are dealt with” (Interview FRO, August 2000).

Since being instituted, the FRO has sought to expand and consolidate its powers. For this purpose, in some instances it has proceeded very strictly. The station price case provides one example. In that instance it demanded a lot of specific information from the DBAG concerning pricing. “We did it on purpose to clarify whether they are obligated to give us information” (Interview FRO, August 2000). The latter refused to do so and instead only offered data giving a general overview.

In another case, where a competitor accused the DBAG of not properly maintaining a regional line that DB Regio had lost in a public tendering process, the FRO required detailed information from the DBAG, too. Again, the latter denied the FRO’s right to information altogether. The FRO took the case to court and obtained a ruling in its favour (Interview FCO, September 2000).

In order to reduce informational asymmetry and to make it more powerful, the competences of FRO have been extended. If the FRO sees a case of discrimination, it can now intervene without having to wait for a complaint to be filed by an operator. Additionally, it has been given more effective sanctioning instruments, such as the possibility to impose fines up to one million DM; further, it has also been given access to documents and the regulatees’ premises (Interview Fed. Ministry of Transport, August 2000). “This was important because there is little formal whistle blowing when there is market discrimination by the DBAG. [This is] because the new market accessants still have and want to cooperate with the DBAG” (Interview FRO, August 2000). Now



complainants can remain anonymous, and the FRO can engage in supervising activities on its own (Interview FRO, August 2000), for instance, to prevent the company from gradually preparing to close down a line. It can now intervene when it observes that the capacity of a line has been significantly reduced, and that trains run at a much lower speed over longer periods of time (Interview FRO, August 2000).

The DBAG views the relationship with the FRO as a good working relationship. The process of licensing a new locomotive by the FRO is considered to be relatively speedy (Interview DBAG, Sept. 2000). Other train operators, however, criticize the double role of the FRO, as an authority supervising market discrimination, on the one hand, and a body licensing rolling stock, on the other. They think a conflict of interest is involved. They consider the FRO to be too strict in the admission of locomotives: “Locomotives which have been used a thousand times by others are scrutinized as though they were entirely new developments ... You do have the impression that this is not only to guarantee smooth transport and safety, but rather that the access to the network for a new market entrant is not meant to be easy” (Interview TOC Freight, September 2000). Further, since the FRO administers its own budget on admission fees, it has – in the view of one operator – incentives to make licensing processes long and costly (Interview. TOC Freight, September 2000).

#### Government influence:

It has been claimed that government influence has an impact on regulatory strictures in compliance control. This does not hold for the FCO, which is a truly independent body. The FRO is much more susceptible to political influence. So far, however, it has not seen itself as having been subject to governmental influence (Interview FRO, August 2000). To the contrary, the DBAG’s attempts to convince political decision-makers to reduce the FRO’s competences have been to no avail (Interview FRO, August 2000). Rather, the FRO’s powers have been extended.

#### Multiple regulatory structure:

It has been argued that multiple regulatory authorities enhance the possibilities of regulatees to avoid compliance, because various bodies can be addressed and may be played against each other. The preliminary empirical evidence does not bear out this claim, given the close coordination of activities between the two authorities. However, the precise division of labour was still being shaped at the time of writing, and it is challenged by regulatees.

In the German case, where there is one sectoral regulatory authority, the FRO, and one cross-sectoral regulatory authority, the FCO, there is a double structure. While the division of labour between the Federal Railway Office and the Federal Cartel Office is basically clear, it is still in the process of being fine-tuned. While the FRO is dealing with technical questions such as individual access contracts and the licensing of rolling stock, the Federal Cartel Office is responsible for competition and general questions (such as the price system question) (Interview FCO, September 2000; Interview Fed. Ministry of Transport, August 2000). When complaints addressed to the FCO imply technical questions, they are handed on to the FRO. Similarly, all generally relevant information is passed on (Interview FCO, September 2000). “So far the coordination has functioned well at an informal level” (Interview FRO; August 2000).

In contrast to the FRO, the FCO can only prohibit certain activities. It cannot prescribe positive activities. It can only intervene if discrimination is above a specified threshold of importance and if competition in general is at risk. And – as mentioned – in the past the FRO could not take action on its own initiative. This initially left a gap regarding managerial and technical questions, which was neither covered by the FCO nor the FRO. However, with the amended legislation and widened powers of the FRO, the FRO has been empowered to take action in individual questions that the FCO is not allowed to intervene in (Interview FRO, August 2000). One such decision was made about station prices.

The DBAG largely sees the same division of functions between the FCO and the FRO, with the FRO being responsible for technical questions and the FCO dealing with questions of competition and price formation. However, it emphasizes that the division of labour is not as clear-cut as it should be, and it is critical of the fact that their market competitors may engage in “regulatory shopping”, that is, they can first they turn to one authority and then – if they do not like the outcome – they can turn to the other (Interview DBAG, September 2000). As we have seen, the incumbent has also questioned the decision-making competences of the FRO on grounds of principle. When, in the station price question, the FCO handed the issue on to the FRO, the DBAG challenged the latter’s competence on the issue, hoping for a judicial ruling in their favour (Interview DBAG, September 2000).

In sum, the empirical evidence indicates that the dual structure of the regulatory authority in Germany (FCO and FRO) does not invite actors to mutually play off authorities – and this is mainly because the coordination between the two authorities functions well on an informal basis.

Sectoral structure:

The preliminary evidence confirms that – in spite of the overpowering position of DBAG – the existence of multiple actors at the margins of the market facilitate control of compliance. The supervisory functions of the FCO and the FRO are rendered easier. As mentioned above, the non-DB market players are very active in “ringing the firebell” and drawing the attention of the FCOs and the FROs to any discriminatory behaviour on the part of the DBAG.

Regulatory regime:

However, the imbalance in the overall sectoral structure, with the dominant position of the DBAG, in which DB Network, DB Regio and DB Freight hold the largest shares in all subsectors of the market, gives rise to questions about the rationale of the regulatory solution. As we have seen, there are many possibilities for the DBAG to discriminate against new market accessants, and these are hard to corroborate. Hence from the various competition-oriented perspectives, separating network and train operation institutionally seems advisable. “There is no real competition between the railway undertakings, because the power relations are too lopsided. There is the power of DB Cargo. The other new market accessants depend on the willingness of the DBAG” (Interview FCO, September 2000). On the other hand, the advantages of this solution would have to be weighed against the need for a close technical linkage between the infrastructure and train operation

(questions arise concerning “which switches you need for which speed”, technical compatibility, etc.).

## **6. Conclusion**

Both countries share the same regulatory structure: there is more than one regulatory/market-supervisory authority. The sectoral structure at the network level is organized as a monopoly in both countries. There is competition for the service market in Britain, but no competition in long-distance services in Germany.

Comparing the two cases from the viewpoint of access, the empirical evidence indicates that in both countries the national level is the most important level of interaction between the regulator and the regulatee. The European level is only of secondary significance. In Britain formal modes of access, such as consultation organized by the regulatory authority, play a much more prominent role than in Germany. Informal modes of access seem equally important in both countries.

The large incumbents in both countries seem to have easy access to regulatory authorities. The same holds for new market entrants and smaller firms which maintain good relationships with the authorities. The latter seem to intentionally cultivate their relationships to smaller market actors in order to gain information about the behaviour of the incumbent.

Association-based access in both countries has been subject to change in the course of the liberalization of the sectors. New preferences have emerged, cleavages have changed. The resulting heterogeneity of interests within the old railway associations has weakened its possibilities for access.

The substance of compliance control differs in the two countries. In Britain both market-creating regulation and market-correcting regulation is fixed in the contracts and controlled by the regulatory authorities. They watch over competition and the provision of services under the new regime. In Germany the authorities only supervise non-discrimination and technical aspects of licensing.

In both countries authorities battle with multiple modes of non-compliance, as measured by the defined contract objectives. In both countries the informational asymmetry in favour of the regulatees makes it difficult to substantiate non-compliance. Both make attempts to improve the competences and instruments in order to deal with this asymmetry. It has been claimed that a multiple sectoral structure in service operation would facilitate compliance control in Britain. It would make yardstick regulation possible. But given the fact that the contracts require so much more from British service operators, the sheer volume of what has to be regulated leads to considerable regulatory problems. In both countries there is pressure from the government to improve the performance of railways.

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Actors interviewed 1999-2001:

### **Great Britain**

Train Operating Companies (TOCs): Interviews with 4 persons.

Rail Forum (RF): interview with 1 person.

Railtrack (RT): interviews with 3 persons.

Strategic Rail Authority (SRA): interviews with 3 persons.

Rail Regulator (RR): interviews with 2 persons.

### **Germany**

Bundesministerium für Verkehr, Bau- und Wohnungswesen (Federal Ministry of Transport): interviews with 2 persons.

Eisenbahnbundesamt (Federal Railway Office (FRO)): interviews with 2 persons.

Bundeskartellamt (Federal Cartel Office (FCO)): interview with 1 person.

Deutsche Bahn AG (DBAG): interview with 2 persons.

Train Operating Company Freight (TOC Freight): interview with 1 person.