UNIVERSITY OF NAIROBI
SCHOOL OF LAW
LL.M. 2010/2011

LL.M. THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF LAWS

The Pitfalls of Inadequate Regulation in Kenyan Concessions – The Kenya Railways Concession Case

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WRITTEN BY: **KIUMI EUNICE WANJIRU - G62/64543/2010**

SUPERVISOR: **YASH VYAS**

October 2011

DECLARATION

I, **KIUMI EUNICE WANJIRU**, do hereby declare that this thesis is my original work and that it has not been submitted for consideration for an academic award in any other university.

Signature......Kiumi......................   Date.....13/11/2011..........

KIUMI EUNICE WANJIRU
STUDENT

I, **YASH VYAS**, do hereby declare that this thesis has been submitted for examination with my approval as university supervisor.

Signature..................................   Date.....18/11/11..........

YASH VYAS
SUPERVISOR

DEDICATION

I dedicate this research Paper to my husband, John, for his support and encouragement.

ACKNOWLEDGEMENTS

I thank the Almighty God for bringing me this far, my family for their support and encouragement, my employer and colleagues for their understanding and accommodation, my supervisor for guiding me through this work and to the University of Nairobi's Faculty of Law for facilitating my academic pursuits.

TABLE OF CONTENTS

THE PITFALLS OF INADEQUATE REGULATION IN RAILWAY CONCESSIONING THE KENYAN CASE

ABBREVIATIONS

ADB	Asian Development Bank
AfDB	African Development Bank
BBO	Buy –Build-Operate
BLOT	Build-Lease-Operate-Transfer
BOO	Build-Own-Operate
BOOT	Build-Own-Operate-Transfer
BOT	Build-Operate-Transfer
BPO	Business Process Outsourcing
COFER	Rail Transport Federal Commission
CVRD	Companhia Vale de Rio Doce
DB	Design-Build
DBFO	Design-Build-Finance-Operate
EFC	Estrada de Ferro Carajás
EFVM	Estrada de Ferro Vitória a Minas
ERDB	European Bank for Reconstruction and Development
ESTU	Executive Secretariat and Technical Unit
FEPASA	Ferrovias Paulistas, Sociedade Anônima
GDP	Gross Domestic Product
IBEA	Imperial British East Africa Company
IFC	International Finance Corporation
ITF	International Transport Workers' Federation
KAPS	Kenya Airports Parking Services Limited
LAC	Latin America and the Caribbean
MDGs	Millennium Development Goals
MoF	Ministry of Finance
MoT	Ministry of Transport
NARC	National Alliance Rainbow Coalition
NEPAD	New Partnership for Africa Development
NGO	Non-Governmental Organization
PFI	Private Finance Initiative
PPP	Public-Private-Partnerships
PPIAF	Public-Private-Partnerships-Advisory Facility
PRPC	Parastatal Reform Programme Committee
PSO	Public Service Obligation
RFFSA	Rede Ferroviária Federal, Sociedade Anônima (Federal Rail Network Corporation)
RVR	Rift Valley Railways (Kenya) Limited
SOEs	State Owned Enterprises
SSA	Sub-Saharan Africa
UN	United Nations
UNECE	United Nations Economic Commission for Europe
UNESCAP	United Nations Economic and Social Commission for the Asia Pacific
UNCITRAL	UN Commission on International Trade Law

TABLE OF STATUTES

1. The Constitution of Kenya 2010
2. The Public Procurement and Disposals Act No. 3 of 2005
3. Public Procurement and Disposal (Public Private Partnerships) Regulations, 2009
4. The Public Procurement and Disposal Regulations, 2006, Legal Notice No. 174 of 2006

ABSTRACT

Despite the central role that transport plays in the economy of a country, many nations do not have efficient infrastructure for the transport of goods and persons. This is largely due to insufficient funding for laying down the transport infrastructure, which often requires huge amounts of money. For developing countries where funding for such basic needs as food and health services are not available, investment in efficient transport becomes a secondary objective of the government.

In order to fill these gaps in funding for infrastructure, many governments are now initiating reforms in the transport sector, primarily aimed at opening the space for private investors to finance transportation infrastructure. The most widespread feature of infrastructure reforms in developing countries and emerging economies over the past 15 years has been the establishment of new regulatory laws, institutions, contracts, regimes, and processes. These regulatory systems are designed to respond to natural monopolies and market failures associated with network industries such as electricity, gas, water, telecommunications, and transport. The aim of regulation is to encourage efficient, low-cost, and reliable service provision while ensuring financial viability and new investment.

This paper looks at the various options for private sector participation in infrastructure, with a focus to concessions in railway infrastructure. Looking at the concessioning of the Kenya-Uganda Railway, the paper concludes that the main reason behind the numerous challenges that faced the concession (during negotiations and after signing the agreement) can be traced to the lack of a proper legal and regulatory framework for concessions in Kenya. Using a comparative analysis, the paper investigates international best practices for the legal and regulatory framework for the negotiation and management of railway concessions which can be adopted by Kenya.

CHAPTER 1

INTRODUCTION

1.0. PREAMBLE

Infrastructure is vital to the development of an economy. The availability of essential infrastructure such as water, sanitation, transport, electricity, telecommunications and health services is not only important to the living conditions of the people in the economy, but they are also necessary conditions for investment in and development of the economy.[1]

Despite the central role that transport plays in the economy of a country, many nations do not have efficient infrastructure for the transport of goods and persons. This is largely due to insufficient funding for laying down transport infrastructure, which often requires huge sums in investment. For developing countries where funding for such basic needs as food and health services are not available, investment in efficient transport becomes a secondary objective of the government.

In order to fill these gaps in funding for infrastructure, many governments are now initiating reforms in the transport sector, primarily aimed at opening the space for private investors to finance transportation infrastructure. Through these reforms, the railway industry is undergoing a transformation in many countries from being a poorly managed public utility in decline with mounting financial losses to a more efficient market-oriented industry with a more commercial outlook and increased competition.

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[1] UNESCAP, *"Public Private Partnerships- A Financier's Perspective."* Available at http://www.unescap.org/ttdw/ppp/trainingmaterials/PPPs_A_Financiers_Perspective.pdf Accessed 20th August 2011

The most widespread feature of infrastructure reforms in developing countries and emerging economies over the past 15 years has been the establishment of new regulatory laws, institutions, contracts, regimes, and processes. These regulatory systems are designed to respond to natural monopolies and market failures associated with network industries such as electricity, gas, water, telecommunications, and transport. The aim of regulation is to encourage efficient, low-cost, and reliable service provision while ensuring financial viability and new investment.

This thesis is primarily concerned with the success or otherwise of the Kenya Railways Concession. Concessions agreements are a type of public-private partnerships (PPPs) that are used in financing infrastructure.[2] PPPs offer alternatives to attract funds for financing public infrastructure while at the same time ensuring there is public presence in the ownership and strategic policy-setting.[3] The nature of PPPs in general and concessions in particular call for strong regulation and expert advisory opinions to cushion the public in the development and tendering process.[4] Without proper regulation, concession agreements are doomed to fail and may see the wastage and misuse of public resources. This has been the main challenge facing concessions in the developing world particularly the Sub-Sahara Africa and concessions have been but altogether abandoned in this part of the world.[5]

1.1. Background to the Study

Kenya is no stranger to concessions. The establishment of the Kenya colony in itself started as a concession granted to the Imperial British East Africa Company (IBEA) in the final

[2] Delmon J., Private Sector Investment in Infrastructure, (London, 2nd ed., 2009) pp. 251-269
[3] *Ibid.*, at p. 4.
[4] *Ibid.*, at p. 9.
[5] PPIAF, "*A PPP against the Odds: The Kenya – Uganda Rail Concession Fights for Survival.*" (March, 2010) available at www.ppiaf.org

decades of the 19th century.[6] However, concession agreements with regard to public infrastructure development are a new phenomenon and perhaps the Kenya rail concession is one of a kind in the country.

Sub-Sahara Africa governments have since the early 1990s engaged in the privatization of state owned and operated infrastructure.[7] This has been partially motivated by pressure from the donor community and partly out of the realization that the private sector has better capacity in terms of both the financial ability as well as the know-how to finance and operate the infrastructure systems. Railway concessioning in Sub-Sahara Africa was heralded by the 1995 Ivory Coast and Burkina Faso 'affermage'.[8] Affermage refers to a species of concession agreements whereby the operator leases assets from the grantor public authority while the operator provides financing.[9] This concession was followed in quick succession by Gabon, Madagascar, Zambia, Zimbabwe, Mozambique and Senegal/Mali.[10] Kenya and Uganda would later join the fold a decade or so after the first concession in Sub-Sahara Africa.

Throughout the Sub-Sahara Africa, a number of challenges have been identified as facing railways concessioning. Key among these challenges is the absence of effective and efficient regulations.[11] The Kenya rail concession coming a decade after the first such concession in this part of the world would have been expected to be less challenging since it would benefit from the lessons learnt from the earlier concessions. The concession is said to have had the entire tale-tell signs that had doomed the earlier concessions in Africa. The rail utility was

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[6] Singh C. "*The Republican Constitution of Kenya: Historical Background and Analysis,*" The International and Comparative Law Quarterly, Vol. 14, No. 3 (Jul., 1965), pp. 878- 949 for a fuller analysis.
[7] Di Borgo et al, Review of Selected Railway Concessions in Sub-Sahara Africa (Washington, 2006)
[8] *Ibid.*
[9] Guislan P., The Privatization Challenge: A Strategic, Legal and Institutional Analysis of International Experience, (Washington DC, 4th Ed, 2001)
[10] *Supra.*, note 6.
[11] *Supra.*, note 6 at p. iii.

insolvent and heavily indebted, there was an enormous need for infrastructure investment as well as other operational challenges such as institutional corruption and political interference.[12] There was need to carefully think through the concessioning process and put in place all the requisite regulatory and procedural guidelines to ensure that the process was flawless right from inception. However, in the characteristic style of reactive legislation in Kenya while laws and regulations follow the event as opposed to proactive legislation where regulations would foresee events, it was not until after the concession had been concluded that regulations were promulgated to govern and guide concessioning processes in Kenya.

1.2 Statement of the Problem

The development of successful PPP investments is influenced by a number of issues, in particular the legal framework[13] and the availability of sufficient private enterprises with the know-how to perform the required works.[14] Thus, from a government agency's perspective, there are two fundamental problems inherent in privatization and PPPs. The first is the problem of adverse selection, which results from selecting the wrong private sector partner. For example, the government agency may inadvertently select a private partner that is unable to produce the desired output or outcome.[15] This may result both from a lack of specific criteria engraved in legislation for the selection of a partner, as well as in instances where such criteria is stipulated but government officials involved in the selection are compromised to award the concession to a less qualified investor. The second problem is the government agency's inability to observe at all times the behavior of the private partner.

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[12] *Supra.*, note 2.

[13] Akitoby,B et al, (eds) Public Investment and Public-Private Partnerships: Addressing Infrastructure Challenges and Managing Fiscal Risks. (London, 2006)

[14] Van der Geest,W and Nunez-Ferrer, J, "*Appropriate Financial Instruments for Public-Private Partnership to Boost Cross-Border Infrastructural Development-EU Experience.*" ADBI Working Paper Series Available. P5. at http://www.adbi.org/working-paper/2011/05/13/4531.financial.instruments.ppp.infrastructural.dev.eu/ Accessed 23rd September 2011

[15] Juita-Elena et al., "*Privatizing Transport Through Public-Private Partnerships: Definitions, Models and Issues.*"(2006) Accessed through http://www.ktc.uky.edu/Reports/KTC_06_09_SPR_302_05_2F.pdf on 12th September 2011

All these concerns have manifested themselves in the Kenyan scenario where there was no law governing PPPs and concessions in the period when the Kenya Uganda Railway was concessioned. The process of concessioning can be traced as far back as the late 90's, a time when there was no law covering concessioning. Due to this lacuna in the law, the concession has been the subject of several problems which are directly linked to poor selection of a concessionaire and lack of a strong and efficient regulatory framework for monitoring of the concession.

This lack of a proper law gave leeway to political meddling with the process where key decisions were influenced by powerful politicians in and outside of the transport ministries of both countries. The meddling resulted in a compromise in the selection of the best candidate for the concession since there was no proper due diligence done on the bidders. In the end, we ended up with a concessionaire who lacked the financial and technical capability to manage the concession. A few months into the concession it emerged that the private partner did not have the requisite expertise to run the railway as promised at the contract stage, nor was there any improvement in service delivery. If there had been a legal framework to stipulate stringent selection criteria then it is very likely that such a situation could have been avoided.

But even after the concession was done, the Public Procurement and Disposal Act (PPDA)[16] that was enacted in 2005 did not in itself contain sufficient guidelines on PPPs especially concessioning. The Act only defined concessioning at section 92 (2) (a) as "a procurement that encourages the mobilization of private sector resources for the purpose of public

[16] Act No. 3 of 2005.

financing, construction, operation and maintenance of development projects...". This meant that the much needed regulation on concessioning was left to subsidiary legislation and rules to be enacted under the Act.

To date, some six years after the concession and even in the face of the PPDA and the PPP Regulations passed thereafter,[17] the Kenya Uganda Railway concession has not lived up to its promise. Not a single inch of extra railway has been added by the concessionaire who is still using the same old carriages that were inherited from Kenya Railways. There are also incessant battles for control between the shareholders in the concession, and this has greatly hampered the improvement of the railway line.

It is quite clear, therefore, that if Kenya were to embark on another concession today then these same problems that have plagued the railway concession will be experienced, unless some serious legislative and regulatory framework for concessioning is put in place.

1.3 Justification for the Study

Kenya is experiencing an infrastructure boom as the government endeavours to expand the road network and set in place basic facilities. One apt mode of infrastructural growth has been identified as PPPs. In the transport and other essential services sectors, PPPs take the form of Concessioning, Build Own Operate Transfer, among others. This study is therefore topical and would provide fodder for thought whenever concessions are undertaken to navigate through the pitfalls of the past.

[17] The first batch is contained in Legal Notice No. 174 of 2006 and came into operation on 1st January 2007. The second is much later in time being Legal Notice No. 38 of 2009 published on 10th March 2009.

Generally, there is a shortage of focused literature in the sphere of regulation of PPPs. The dearth is more acute in Kenya where PPPs are not well developed. There is no known local literature that has focused attention on the Kenya rail concessioning process with a view to giving a critique and analyzing its success or otherwise.

This study is also of particular importance because it comes at a time when the country is seriously considering entering into various other concessions for the construction and management of roads. The government has spoken indicted on several occasions that it intends to concession Mombasa Road. In the meantime, plans are underway to open the Northern Transport Corridor through the construction of a huge port in Lamu and connecting it to Ethiopia and South Sudan through a rail and road network. These are projects which require massive investments which the government may not have, so concessions will be the way to go. Before embarking on these concessions, however, it is important that such a study is conducted to identify the pitfalls experienced in the Kenya Railway Concession so that the same mistakes are not done with these much bigger projects.

1.4 Theoretical and Conceptual Framework

There is need to examine the concept of regulation of PPPs in general and concessions in particular so as to properly contextualize and forum set this study. Public-Private Partnership has become one of the most widely used words in recent discussions on international development strategies.

Fundamentally, PPPs represent an approach to problem solving where resources or capacities of different organizations are pooled for common purposes. In a typical PPP, a private sector partner usually invests in a capital asset and is responsible for maintaining and operating it over the life of the contract. The focus of the partnership is on the services provided and not on the assets used to provide the services. Additionally, risk transfer is also a key element of a PPP. Government assets are often transferred or made available to the private sector. The contract arrangement specifies that the private partner will take responsibility for and assume the risks for all or part of the public sector function. Finally, value for money, which is critically dependent on the way the risks are allocated between the parties, must be demonstrated to justify private sector involvement.

In the last two decades there has been an important increase in the use of public private partnerships. The driver of these partnerships is often limited public funds combined with an increasing acceptance that the private sector is often better able to handle many of the traditional tasks of the public sector. Often the private sector has shown better ability in increasing quality and efficiency of services, due to the need to integrate risks into the planning process.

Some of the reasons for implementing PPPs include the fact that they provide additional capital provide better management and implementation skills, provide more added value, they aid in more efficiently allocate risks, thus improving the identification of needs and the optimal use of resources over the whole life of a project.[18]

PPPs in this context are employed in the provision of public utilities which perform a structural role. Public utilities are outstanding elements in social and economic organization, similar in importance to monetary, credit and educational systems. Existing systems for

[18] *Supra.*, note 14

organizing, production and population centers would be inconceivable without efficiently run, mass scale, public utilities.

Public utilities have a number of characteristics which have made them a highly important area of the law. They are activities in which competition is not always present, and are usually subject to government regulation designed to protect the public interest.[19] Some utility industries seem to operate more efficiently when they are monopolies, such as water and sewerage. However, in such cases public utilities often must be compelled, by means of regulations, to contribute to the general welfare rather than doing so voluntarily.[20]

Regulation is one of the state's core functions, indeed one of its classical functions.[21] In a historical perspective the state engaged in regulation long before government also took upon it to provide welfare services to its citizens. Regulation defines the border between state and society, government and market. Therefore, regulation represents government's attempt to set limits to the scope of private activities. As broad as this conception is it has one important implication - if the government produces a good or service under its own auspices, for example by a state-owned enterprise or a public hospital it is not reasonable to speak of regulation. But if a private firm provides the same service, say railroad transportation or hospital treatment within confines defined by legislation, we have to do with regulation.[22]

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[19] Phillips Jr., Charles F.: The Regulation of Public Utilities. (Arlington, VA, 1993) p. 3

[20] Kaysen, C and Turner, D. Antitrust Policy: An Economic and Legal Analysis. (Cambridge, MA, 1959) pp. 48-49

[21] Christensen,J.G, *"Public Interest Regulation Reconsidered: From Capture to Credible Commitment."* Paper presented at "Regulation at the Age of Crisis", ECPR Regulatory Governance Standing Group, 3rd Biennial Conference, University College, Dublin, June 17-19, 2010 Available at http://regulation.huji.ac.il/papers/jp19.pdf Accessed 23rd September 2011

[22] *Ibid.*

The regulation of public utilities is a result of the public interest associated to their activities; and is mainly expressed in the control of rates and services.[23] Conflicts often arise between public and private interests as they relate to public utilities. They stem from the difference between private firms' main objective (profit maximization) and the public interest (adequate service at the lowest possible price).

Public interest theory is developed from classical conceptions of representative democracy and the role of government.[24]

Although regulation is certainly a characteristic of public-utilities, its content and scope is not fixed, but instead tends to undergo adjustments as time passes and as circumstances and needs change.[25] At the same time, some authors contend that regulation has not served its purpose and that, in practice, it has become "the haven of refuge for all aspiring monopolists who found it too difficult, too costly or too precarious to secure and maintain a monopoly" under a deregulated system.[26]

Some activities have the potential to affect general welfare, public health, collective security and other social concerns. They are subject to government control in order to safeguard the general welfare. Regulation is justified by the monopolistic nature of many such activities, by their importance as essential consumer services, by their relevance to socioeconomic organization and by the absence of other alternatives.

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[23], *Supra.*, note 19 at p.4
[24] *Supra.*,note 21
[25] *Ibid.*, p.7
[26] Gray, H.,, *"The passing of the public utility concept,"* (1940) Journal of Land and Public Utilities Economics, No. 16. Pp.8-20

With regards to railroads, by the late 19th century, it had become clear that free market competition was not providing sufficient checks on the growing influence of railroads and utilities.[27] Many of these businesses were natural monopolies because of economies of scale. A single supplier can serve the market at lower cost than multiple suppliers. Once such a company exists in a market, entry by a newcomer cannot occur without building an entire new infrastructure. The customer has little or no opportunity to switch suppliers if prices rise or service quality declines. Recognizing the need to protect consumers from utilities' economic power, states began to regulate utilities.

Not only is monopoly a problem, but companies providing public services are a substitute for the State in the performance of public services, thus becoming a public servant, in the performance of a function of the state.[28] Therefore, they are subject to regulation. The argument is that the public interest of the activities of such a corporation and its importance are such as to create a common burden upon the citizens.

Broadly stated, regulations may address a wide variety of issues, including the quality of the service provided, its scope and coverage, frequency or consistency, price and environmental impact. Moreover they can address market structures, contracting practices; ownership and transfer of stock; access to infrastructure and related conditionalities and procedures; separation or prohibition of activities; transfer pricing, information, accounting, disclosure of profits and dispute resolution.

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[27] Swartwout, R.L.,*"Current Utility Regulatory Practice from a Historical Perspective,"* (1992) 32 Natural Resources Journal. Pp. 289, 295–314.

[28] In the United States, the Supreme Court stated that "The company is the substitute for the state in the performance of the public service, thus becoming a public servant." Per Justice Louis Brandeis in *Missouri ex rel. Southwestern Bell Tel. Co. v. Missouri Public Service Commission, 262 U.S. 276, 291 (1923)*

1.5 Literature Review

Few scholars have delved into the field of PPPs law specifically the regulation of concessions aspect of the law. There is particularly a shortage of focused literature with respect to the Kenyan practice in concessioning as the sampling of some of the literature below reveals.

Delmon J., Private Sector Investment in Infrastructure, 2^{nd} edn. (2009) (Kluwer Law International, Alphen aan den Rijn) is arguably the most comprehensive literary works in PPPs. The text is analysis a wide range of issues affecting PPPs. These range from PPP inception, financing of PPPs, PPP contractual structures to how PPP risk allocation works in practice. Chapter nine of the text is of particular relevance as it deals with the various aspects and dimensions of concession agreements.

OECD, Investment for African Development Roundtables: Joint Concessioning of Kenya Railways and Uganda Railways (2005) is a case example document table at the roundtable meetings organized under the joint auspices of Organization for Economic Co-operation and Development and NEPAD(New Partnership for Africa Development). It is an incisive summary of the then on-going process of negotiating the railway concession for the railways in the two countries of Kenya and Uganda. The paper of is of relevance to the study as it enumerates the steps taken and the challenges faced in the conclusion of the concession agreement for the railroad.

PPIAF, A PPP against the Odds: The Kenya-Uganda Rail Concession Fights for Survival (2010) is most recent critique of the fight for survival of the concession deal. The paper traces the background to the concession agreement, analyzes the pre-concession preparations then proceeds to give a brief account of how the concession was finally arrived at. It winds up by forecasting the success or otherwise of the concession and paints a gloomy picture for the concession's future. The paper concludes that only time will tell whether the deal was a worthwhile venture. This paper is of immense importance to the study as it analyzes albeit in a summary form pertinent issues to be addressed by the study.

Pozzo di Borgo P. et al, Review of Selected Railway Concessions in Sub-Saharan Africa (2006) is a report prepared for the World Bank by a team of transport specialists and consultants. The report has deep insights into some of the key issues affecting concessions in Sub-Saharan Africa. It analyzes the common factors that have impeded the successful performance of railway concessions this part of the world. It gives an appraisal the performance of the concessions and rates it rather poorly. The report concluded by giving recommendations over how to improve concessioning in developing world especially Sub-Sahara Africa given the unique challenges identified in the report that are common to the countries therein.

ITF, Railway Privatisation through Concessions: The Origins and Effects of the Experience in Latin America (2002) is a report commissioned by the International Transport Workers' Federation (ITF) that resulted from a consultative conference held by the body in Durban South Africa in October 2000. The report focuses on railway concessions in Latin America mainly because it was in Argentina that the first major modern railway concessioning was undertaken in the developing world and a good number of Latin America countries have followed suit. The report examines the experience of Argentina and Brazil. It also but to a lesser extent analyzes the situation in Mexico. The focal point of the report is the cons of privatization through concessions. The report supplies good material for the comparative case study. Lessons can also be drawn from the pitfalls identified by the study.

World Bank, Multidimensionality and Renegotiation: Evidence from Transport-Sector Public-Private-Partnership Transactions in Latin America (2008) is yet another of the studies that focus attention on the Latin America jurisdictions. It seeks to analyze the award criteria used in selecting successful bidders for PPPs in Latin America and why the resultant contracts invariably end up being renegotiated. The report delves into the underlying factors that influence the award criteria and posits that multidimensional approach to award of PPP contracts increase the need to renegotiate the contracts at later dates. The report is geared towards a better understanding and examination of the efficiency and effectiveness in public infrastructure procurement processes. The report will be of use to the study in so far as comparative analysis is concerned.

Lesley Davies, KathrynWright and CatherineWaddams Price, Experience of Privatisation, Regulation and Competition: Lessons for Governments ESRC Centre for Competition Policy, University of East Anglia, UK. CCP Working Paper 05-5

This policy paper offers a synthesis of research on privatisation and its impacts on the utilities sector in different countries. It identifies issues to be considered by policy makers concerned with economic reform, including the implications of sequencing privatisation together with competition, regulation and industry restructuring; the role and importance of an independent regulatory agency; and the impact of introducing competition into utility markets. In addition to assessing reform through the more conventional method of examining productivity gains, it considers the distribution of the broader benefits from reform among key stakeholders – government, investors and consumers.

Willem van der Geest and Jorge Nunez-Ferrer. 2011. Appropriate Financial Instruments for Public-Private Partnership to Boost Cross-Border Infrastructural Development-EU Experience[29]

The member states of the European Union (EU) and the EU institutions have increasingly been using public-private partnerships (PPPs) to accelerate the development of trans-national infrastructure. This paper argues that in the EU (i) private sector partners remain risk-averse; and (ii) risk-pooling across a larger number of tax-payers tends to reduce the cost of risk to zero, making EU funds highly desirable and sought after for public infrastructure development. This paper argues that private equity has not been forthcoming to the extent that had been expected by those propagating this method of finance. In those instances where private non-publicly guaranteed resources have been used, the distribution of risks between public and private partners remained asymmetric, with public governmental bodies carrying the financial risks, which ultimately may become a contingent liability for the country's public finances. However, EU and European Investment Bank (EIB) public funding is used not simply because the risks are spread more widely, but rather because EU rules and regulations for using such funds lead to better preparation of projects and greater efficiency gains in project implementation and delivery.

Kessides, I. Reforming Infrastructure: Privatisation, Regulation and Competition. World Bank[30]

This paper acknowledges that whereas the links between infrastructure reforms and subsequent performance are complex, several conclusions can be drawn. *First*, reforms have significantly improved performance, leading to higher investment, productivity, and service coverage and quality. Prices have become better aligned with underlying costs. And services

[29] Supra., *note 14*
[30] Kessides, I., *Reforming Infrastructure: Privatisation, Regulation and Competition.* (Washington, D.C., 2003)

have become more responsive to consumer and business needs and to opportunities for innovation. *Second*, effective regulation—including the setting of adequate tariff levels—is the most critical enabling condition for infrastructure reform. Protecting the interests of both investors and consumers is crucial to attracting the long-term private capital needed to secure adequate, reliable infrastructure services and to getting social support for reforms. Regulation should clarify property rights, allocate them sensibly, and assure private investors that their investments will not be subject to regulatory opportunism. Crafting proper regulation is the greatest challenge facing policymakers in developing and transition economies. *Third*, for privatization to generate widely shared social benefits, infrastructure industries must be thoroughly restructured and able to sustain competition. The benefits from privatizing infrastructure monopolies are much smaller than those from introducing competition. It is often hard or costly to change structural choices—such as the degree of vertical and horizontal integration—after privatization. Thus restructuring to introduce competition should be done before privatization, and regulation should be in place to assure potential buyers of both competitive and monopoly elements. It argues, however, that reforms should not be pursued blindly in a specific country or industry without carefully assessing the institutional and structural prerequisites and without explicit attention to the concerns they raise.

Andrea Goldstein and Josè Claudio Linhares Pires, "*Brazilian Regulatory Agencies: Early Appraisal And Looming Challenges.*"[31] This paper acknowledges that Brazil is going through an institutional transition in the provision of public services, which had historically been supplied by State monopolies. A core element in this process is been the creation of a new form of public sector institutions – regulatory agencies with operational and financial

[31] Goldstein, A and Pires,J.C.L *"Brazilian Regulatory Agencies: Early Appraisal And Looming Challenges."* Centre on Regulation and Competition, Institute for Development Policy and Management, University of Manchester

autonomy. The paper identifies the most important decisions of these institutions and provides detailed analysis of the economic and political context in which they have been taken. The authors then compare Brazil with some of its peers and argue that its regulatory performance has been rather satisfactory so far, although four main problems must be solved, i.e. clear governance inadequacies in the coordination between different bodies, unclear definition of their respective competencies, lack of regulatory sovereignty; and inadequacies in design of the new antitrust agency.

Harris, C. "Private Participation in Infrastructure in Developing Countries. Trends, Impacts, and Policy Lessons"[32] According to this paper, over the last decade, governments around the world pursued policies to involve the private sector in the delivery and financing of infrastructure services. The scale of this move away from the hitherto dominant public sector model was far more rapid than had been anticipated at the start of the 1990s. By the end of 2001, developing countries had seen over $755 bn of investment flows in nearly 2500 private infrastructure projects. This report aims to distill the experience with the private provision of infrastructure over the last 15 years. It looks at the growth that occurred during the mid 1990s, and the subsequent declines. The main factors driving this are examined. The report assesses the impact that the private provision of infrastructure has had on service delivery, and what the consequences for other important goals have been. Finally, it looks at the main policy lessons that can be drawn, and what governments have to do moving forward if they are to ensure that the supply of infrastructure services does not become a bottleneck to growth.

[32] Harris, C. *Private Participation in Infrastructure in Developing Countries. Trends, Impacts, and Policy Lessons.* (Washington D.C., 2003)

UNESCAP, The Economic Regulation of Transport Infrastructure and Services – Principles and Issues[33]

In this paper, regulation is defined as the sustained and focused control, normally exercised by a public agency, over activities that are valued by a community. The paper states that in recent years, many countries have introduced economic reforms including competition policies, de-monopolization, commercialization, and privatization. Such economic reforms have given rise to new regulatory requirements and regulatory reform in the provision of infrastructure facilities and services. Guidelines on the design and implementation of programmes for effective regulatory reform and new regulatory institutions for the infrastructure industries have been provided.

The paper reviews the basic principles that underpin the development of sound regulatory policies and institutions, and enumerates and evaluates the rationale for economic reforms and the introduction of competition in the provision of infrastructure facilities and services, the justification for government intervention, and the main instruments and institutions for creating and regulating competition and monitoring the implementation of economic reforms. It then examines a number of key regulatory issues encountered in the infrastructure industries, including price regulation and developments in globalization and international competition. It also describes regulatory practice in the transport industry and provides recommendations for regulatory policy and its implementation.

1.6 Research Questions

This research has attempted to answer the following questions;

[33] UNESCAP, *The Economic Regulation of Transport Infrastructure and Services – Principles and Issues.* (New York, 2001)

1. What is the relationship between a sound regulatory framework and a successful concession deal?
2. What are the specific provisions in the Public Procurement and Disposals Act, 2005 and Public Procurement and Disposal (Public Private Partnerships) Regulations 2009 that could have eased the Kenya rail concessioning process?
3. What are the international best practices from which lessons can be drawn for improvement of the Kenyan law and practice in concessioning?
4. What issues need to be addressed to ensure effectiveness in concessioning deals in the Kenyan infrastructure development?

1.7 Research Objectives

The main objective of this study is to examine the use of concessions in Kenya's PPPs. In so doing, it will critically examine, so as to identify shortcomings, the concessioning process of the Kenya Uganda Railway juxtaposed with the best case practice in a selected successful jurisdiction. It will analyze the international practices and seek to draw lessons that can be applied to improve the Kenyan future concessions in Kenya.

The specific objectives of the study are:

1. To provide an overview of the specific provisions in the legal and regulatory framework for concessioning in Kenya.
2. To identify specific gaps in the legal and regulatory framework for concessions in Kenya that existed before and after the concessioning the Kenya Uganda Railway.
3. To assess the effect of the gaps in the regulatory framework that was in place at the time of the Kenya Uganda Railway concession and how they have impeded the success of the concession.

4. To examine international best practices in the regulation of concessions.
5. To propose recommendations on how to improve the legal and regulatory framework for concessioning in Kenya.

1.8 Research Methodology

Library and electronic research methods will be used in the collection of secondary information from sources such as publications, documentation centres, archives and information resource centres. The study will involve desk analysis of various texts and materials. Select comparative case studies will be adopted for identifying international best practices. Internet research will also form a useful source of data for analysis in the study.

1.9 Hypotheses

The study is based on the following hypotheses, which shall be tested:

1. Proper public procurement guidelines are essential for the success of any public infrastructure concession.
2. At the time of the concessioning of the Kenya Uganda Railway there was no proper and adequate legal and regulatory framework for concessioning.
3. The lack of a proper legal framework resulted in gross failure of the concession, demonstrated, for instance, by lack of due diligence in the process and the resulting selection of an unqualified investor.

1.10 Scope of the Study and Limitations

This study has concerned itself with PPPs regulation. PPPs in general cannot be effectively and comprehensively dealt with in a study of this magnitude. The study will therefore specifically, limit itself to the concession agreements aspect of PPPs. The study will mainly focus on the Kenyan practice with particular regard to the Kenya rail concession although a comparative study of the practice in select jurisdictions will also be undertaken primarily for the purpose of putting into perspective the local practice and drawing lessons on best practices.

1.11 Chapter Breakdown

This study has been broken down into five chapters.

Chapter One - Introduction

This chapter will introduce the research problem to be interrogated and investigated, the theoretical and conceptual framework of PPPs and concession agreements, the appropriate methodology to be employed in the study, the major hypothesis to be tested, the literature review, objectives of the study and the broad chapter breakdown.

Chapter Two – The Scope and Nature of PPPs and Concession Agreements

This seeks to explain the scope, nature and goals of PPPs in general and concessions in particular to an appreciable depth. The process of arriving at a concession agreement right from the selection of a suitable private player to the execution of the concession contract will also be interrogated further. The objective of the discussion will be to lay a basis for the study of concession agreements in other jurisdictions and the analysis of the Kenyan practice which forms the gist of the study.

Chapter Three –The Kenya-Uganda Railway Concession Agreement

Chapter three is the main focus of the proposed study. The chapter will delve into the process that culminated in the Kenya rail concession agreement. It will critically analyze the legal framework and guidelines that formed the backdrop of concession agreement. It will interrogate the interlink between the regulatory framework and the outcome of the concession deal.

Chapter Four - Concession Agreements in Other Jurisdictions -- Brazilian Case Study

Chapter four will sample the practice of regulation of concessions in the Latin America country of Brazil which has been selected as a case study due to its widely recognized success with railway concessioning which is attributed to its effective legal framework for concessions. The chapter will seek to offer an appraisal of the practices in Brazil for purposes of comparison with the Kenyan situation, eventually with a view to drawing lessons that can be learnt from their practices.

Chapter Five - Conclusion and Recommendations

This chapter will conclude the study by way of a concise summary tying up the hypothesis with the findings. It will also outline important lessons that can be learnt from the comparative case studies to improve the process of future concession agreement in Kenya in a manner that would ensure their success while protect the public resources from waste and ensuring maximum returns for the public good.

CHAPTER 2

THE SCOPE AND NATURE OF PUBLIC PRIVATE PARTNERSHIPS AND CONCESSION AGREEMENTS

2.0. Introduction

Traditionally, governments have built, maintained, and rehabilitated the physical infrastructure such as roads, ports and airports, telecommunications and electricity networks, without which most economic activity would be impossible. In fact, investment spending, particularly on infrastructure, used to be one of government's main activities.[34]

The provision of these services and laying the required infrastructure require huge amounts of capital investment yet it goes without saying that governments' resources are not unlimited. Indeed municipal and national budgets are frequently insufficient to finance directly necessary and desired facilities.[35]

Over the past three decades, however, public spending on infrastructure, as a share of GDP, has been on the decline worldwide. In times when the government's own resources are inadequate in meeting the expenditure needs, the government needs to find innovative ways of filling the gaps in resources required. One of the ways of filling this gap is to invite the private sector[36] to participate in the provision of services and infrastructure, a role

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[34] *Supra.*, note 13

[35] UNECE, *Guidelines for Public Private Partnerships for Infrastructure Development*, (Geneva, 2000)

[36] For this study the private sector is defined to include for-profit formal commercial organizations as well as business coalitions or business alliances. Using this definition, private sector includes a) For-profit commercial enterprises or businesses, b) Business coalitions and alliances (cross-industry, multi-issues groups; issue-specific initiatives and industry-focused initiatives)

traditionally played by the government. Such arrangements are what are commonly referred to as Public Private Partnerships, or PPPs[37].

2.1. Defining Public Private Partnerships

The term PPP has entered the public-sector economic development lexicon and generally connotes a positive and innovative approach to strengthening the local economy. However, the definition of PPP is not standard and clear. This is likely due to the many different purposes and objectives of PPPs, the many forms such partnerships can take, and the many ways risks, costs, and benefits can be apportioned in ways not well understood by many practitioners.[38] For this reason, various definitions of PPPs have been offered by different authors on the subject as well as institutions undertaking studies or which are engaged in PPPs - after all, Public-Private Partnerships, like many things, are defined in the eye of the beholder.

According to J. Delmon, PPPs are 'arrangements between public and private entities for the delivery of infrastructure services and are seen as a way of raising additional funds for infrastructure investments but more importantly as a means to extend or leverage better budget funding through efficiency gains'.[39]

The U.S. Department of Transportation has provided this widely adopted definition of PPPs:

> A public-private partnership is a contractual agreement formed between public and private sector partners, which allows more private sector participation than is

[37] These arrangements are known by various names, for instance in Ontario, Canada they are referred to as "alternative financing and procurement" (AFP) while England uses "private finance initiative" (PFI). However, in this paper they will be referred to as Public Private Partnerships, abbreviated as PPPs.
[38] Mullin, S.P, *Public-Private Partnerships and State and Local Economic Development: Leveraging Private Investment*.(Washington, 2002)
[39] *Supra.*, note 2

traditional. The agreements usually involve a government agency contracting with a private company to renovate, construct, operate, maintain, and/or manage a facility or system. While the public sector usually retains ownership in the facility or system, the private party will be given additional decision rights in determining how the project or task will be completed.[40]

A second definition—this from legislation passed in Puerto Rico in 2009—notes similar characteristics, and further emphasizes issues of mutual benefit and public interest:

> A public-private partnership is an entity that couples the resources and efforts of the public sector with resources of the private sector by means of a joint investment that results in the benefit of both parties. Such partnerships are sought with the purpose of providing a service for citizens, as well as building or operating a facility or project that is held in high priority by the government… These partnerships shall be vested in high public interest, that is, the Commonwealth is neither relinquishing its responsibility of protecting such interest, nor waiving its rights to receive an efficient service, nor renouncing [the] ownership of the public assets included [in] the Partnership Contract.[41]

PPPs have also been defined as a contractual agreement between a government agency and a private sector entity that allows for greater private sector participation in the delivery of public infrastructure projects.[42] PPPs can also be defined as the combination of a public need

[40] U.S. Department of Transportation, Report to Congress on Public Private Partnerships. Available at www.fhwa.dot.gov/reports/pppdec2004/pppdec2004.pdf Accessed 14th September 2011

[41] R. 2009 Act No. 29.

[42] Deloitte, "Closing America's Infrastructure Gap – The Role of Public Private Partnerships." (2007) Available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_ps_PPPUS_final%281%29.pdf Accessed 1st September 2011

with private capability and resources to create a market opportunity through which the public need is met and a profit is made.[43]

In Kenya, the Public Procurement and Disposal (Public Private Partnerships) Regulations, 2009 define a public private partnership as

> an agreement between a procuring entity and a private party under which the private party undertakes to perform a public function or provide a service on behalf of the procuring entity, the private party receives a benefit for performing the function...and the private party is generally liable for risks arising from the performance depending on the terms of the agreement.[44]

Recognizing the difficulty with these definitions[45], Peters identifies several characteristics deemed essential to the establishment and success of partnership arrangements: (a) two or more partners, with at least one a public entity, (b) each participant is a principal, able to bargain and decide on its own authority, (c) the arrangement is a continuing relationship, (d) each principal brings genuine value to the partnership, transferring real resources (value) to the partnership, and (e) there is shared responsibility for the outcomes of the partnership's actions.[46]

These definitions carry some common strand and it can be deciphered that the term public-private partnership defines an expansive set of relationships from relatively simple contracts,

[43] Heilman, J. and Johnston, G, *The Politics of Economics of Privatisation, University of Alabama Press*, (Alabama, 1992) p. 197.
[44] The Public Procurement and Disposal (Public Private Partnerships) Regulations, 2009
[45] For further reading on the definitions of PPPs, see, for instance, Linder, S., "Coming to Terms with the Public-Private Partnership: A Grammar of Multiple Meanings," *(*1999) The American Behavioral Scientist, Vol.43, No.1. pp. 35-51.
[46] Guy,P.B,. "With a Little Help From our Friends': Public-Private Partnerships as Institutions and Instruments." In, Jon Pierre, ed. *Partnerships in Urban Governance: European and American Experience.* (New York: St. Martin's Press, 1998) pp. 11–33. See also IRF, *"Public Private Partnerships: Beyond the Financing Aspects"* IRF Discussion Paper, Washington p. 2

to development agreements that can be very complicated and technical. PPPs can include, for instance, private sector-financed development and operation of infrastructure, whereby a private company builds and operates infrastructure and/or provides services in exchange for commuter fees (such as toll revenue) or a significant share of the revenue stream; or, alternatively, a partnership for private sector-financed rehabilitation and operation of a hospital, prison, airport or energy facility, which is then operated by the private entity and "leased" to the appropriate government authority for a negotiated fee.[47]

In the context of this paper, the term public-private-partnership is used for any scenario under which the private sector would be more of a partner than they are under the traditional method of procurement.

PPP initiatives are usually appropriate when: the public sector wishes to maintain a degree of control over certain assets; the public sector must contribute with resources or guarantees to make the project 'bankable'; the implementation and timing of future project investments is uncertain (for instance, due to undetermined commercial prospects); and a publicly owned, commercially-oriented entity wishes to participate in the project for commercial reasons.[48]

It is also important to point out that although the two concepts are closely related, PPPs are not to be confused with **privatisation** which is the process of transferring a public service or facility to the private sector, sometimes together with its ancillary activities, for it to be

[47] McBrady,S,J "Funding America's Infrastructure Needs: Public Private Partnerships May Help Close Infrastructure Gap" Construction Briefings No. 3, 2009.
[48] European Bank for Reconstruction and Development, *Transport Operations Policy*, (London, 1997)

managed in accordance with market forces and within the framework of an exclusive right granted by a ministerial or parliamentary act (or sometimes a licence).[49]

These definitions also reveal that there are a number of participants in a typical PPP arrangement. In the transport sector, a wide variety of stakeholders may be involved in a PPP, based on its mission, its approach to project delivery and financing, and the legal environment in which it takes place. Possible PPP participants who may determine the environment for PPP projects or take part in delivering a specific project may include[50] State legislators, who create the legal environment for PPPs and may play a role in project approval; a public sector executive agency—such as a department of transportation or toll authority—that will act as project sponsor, enter into the PPP contract with one or more private entities, and provide project management and oversight; other public officials who may play a role in project selection or approval, such as governors, mayors, state transportation commissions or boards, metropolitan planning organizations or members of local legislative bodies; equity participants, such as funds and concessionaires; lenders, such as commercial banks, state infrastructure banks or federal credit assistance programmes; private sector companies or public sector employees who provide design, construction, or operations and maintenance services; technical, legal, financial or other advisors to the public or private partners; voters, who in some jurisdictions must approve certain projects; taxpayers, who may provide funding through taxes; and/or users of the facility, who may provide funding through direct user fees or tolls.

[49] *Supra.*,note 35. *See also* E. S. Savas, "A Taxonomy of Privatization Strategies," (1990) Policy Studies Journal 18 (2) pp. 343-55.

[50] Rall, J, et al, *Public-Private Partnerships for Transportation – A Toolkit for Legislators.* (Washington, 2010) p.8

2.2. The Different Types of PPPs

PPP project delivery models can be thought of as being on a continuum of public-private mixes.[51] At one extreme is traditional public project delivery, where the public sector finances, owns and retains control over the project throughout its life cycle. Such projects may outsource certain functions to the private sector, through traditional design-bid-build contracting, for example, but they are not PPPs. At the other extreme is privatization, where projects are privately financed, owned and controlled, subject only to overarching public laws and regulations. These, too, are not PPPs. Between these poles of public and private control lie a range of PPP options, where the public sector retains ultimate responsibility for and ownership of an asset, but the private sector assumes one or more traditionally public roles in and responsibilities for project delivery.[52]

PPPs take many different forms for many different purposes.[53] Some of the most common PPP models are described below.

2.2.1. *Service Contract* - Under a service contract, the government (public authority) hires a private company or entity to carry out one or more specified tasks or services for a period, typically 1–3 years. The public authority remains the primary provider of the infrastructure service and contracts out only portions of its operation to the private partner. The private partner must perform the service at the agreed cost and must typically meet performance standards set by the public sector.[54]

2.2.2. *Management Contracts* - A management contract expands the services to be contracted out to include some or all of the management and operation of the public

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[51] *Ibid.*
[52] *Ibid.*
[53] *Supra.*, note 38
[54] Asia Development Bank, *Public – Private Partnership Handbook* (Manila, 2006) p31

service (i.e., utility, hospital, port authority, etc.). Although ultimate obligation for service provision remains in the public sector, daily management control and authority is assigned to the private partner or contractor. In most cases, the private partner provides working capital but no financing for investment.[55]

2.2.3. *Affermage or Lease Contracts* - Under a lease contract, the private partner is responsible for the service in its entirety and undertakes obligations relating to quality and service standards. Except for new and replacement investments, which remain the responsibility of the public authority, the operator provides the service at his expense and risk. The duration of the leasing contract is typically for 10 years and may be renewed for up to 20 years. Responsibility for service provision is transferred from the public sector to the private sector and the financial risk for operation and maintenance is borne entirely by the private sector operator. In particular, the operator is responsible for losses and for unpaid consumers' debts. Leases do not involve any sale of assets to the private sector.[56]

Under this arrangement, the initial establishment of the system is financed by the public authority and contracted to a private company for operation and maintenance. Part of the tariff is transferred to the public authority to service loans raised to finance extensions of the system.

An affermage is similar, but not identical, to a lease contract. The arrangements in an affermage and a lease are very similar. The difference between them is technical. Unlike a lease where the private sector retains revenue collected from customers and

[55] *Ibid.*
[56] *Ibid.*

makes a specified lease payment to the contracting authority, an affermage allows the private sector to collect revenue from the customers, pays the contracting authority an affermage fee, and retains the remaining revenue. Under a lease, the operator retains revenue collected from customers/users of the facility and makes a specified lease fee payment to the contracting authority. Under an affermage, the operator and the contracting authority share revenue from customers/users.

2.2.4. *Build–Operate–Transfer and Similar Arrangements* - BOT and similar arrangements are a kind of specialized concession in which a private firm or consortium finances and develops a new infrastructure project or a major component according to performance standards set by the government.[57]

2.2.4.1.1. *Build-Transfer (BT)* - Under this model, the government contracts with a private partner to design and build a facility in accordance with the requirements set by the government. Upon completion, the government assumes responsibility for operating and maintaining the facility. This method of procurement is sometimes called Design-Build (DB).[58]

2.2.4.1.2. *Build-Lease-Transfer (BLT)* - This model is similar to Build-Transfer, except that after the facility is completed it is leased to the public sector until the lease is fully paid, at which time the asset is transferred to the public sector at no additional cost. The public sector retains responsibility for operations during the lease period.[59]

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[57] *Ibid.*
[58] *Supra.*,note42
[59] *Ibid.*

2.2.4.1.3. *Build-Transfer-Operate (BTO)* - Under this model, the private sector designs and builds a facility. Once the facility is completed, the title for the new facility is transferred to the public sector, while the private sector operates the facility for a specified period. This procurement model is also known as Design-Build-Operate (DBO).[60]

2.2.4.1.4. *Build-Operate-Transfer (BOT)* - This model combines the responsibilities of Build-Transfer with those of facility operations and maintenance by a private sector partner for a specified period. At the end of the period, the public sector assumes operating responsibility. This method of procurement is also referred to as Design-Build-Operate-Maintain (DBOM).[61]

2.2.4.1.5. *Build-Own-Operate-Transfer (BOOT)* - Here the government grants a private partner a franchise to finance, design, build and operate a facility for a specific period of time. Ownership of the facility goes back to the public sector at the end of that period.[62]

2.2.4.1.6. *Build-Own-Operate (BOO)* - In this model, the government grants a private entity the right to finance, design, build, operate and maintain a project. This entity retains ownership of the project.[63]

2.2.4.1.7. *Design-Build-Finance-Operate/Maintain (DBFO, DBFM or DBFO/M)* - Under this model, the private sector designs, builds, finances, operates and/or maintains a

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[60] *Ibid.*
[61] *Ibid.*
[62] *Ibid.*
[63] *Ibid.*

new facility under a long-term lease. At the end of the lease term, the facility is transferred to the public sector.[64]

2.2.5. *Concessions* - A concession makes the private sector operator (concessionaire) responsible for the full delivery of services in a specified area, including operation, maintenance, collection, management, and construction and rehabilitation of the system. Importantly, the operator is now responsible for all capital investment. Although the private sector operator is responsible for providing the assets, such assets are publicly owned even during the concession period. The public sector is responsible for establishing performance standards and ensuring that the concessionaire meets them. In essence, the public sector's role shifts from being the service provider to regulating the price and quality of service.[65]

The concessionaire collects the tariff directly from the system users. The tariff is typically established by the concession contract, which also includes provisions on how it may be changed over time. In rare cases, the government may choose to provide financing support to help the concessionaire fund its capital expenditures. The concessionaire is responsible for any capital investments required to build, upgrade, or expand the system, and for financing those investments out of its resources and from the tariffs paid by the system users.[66]

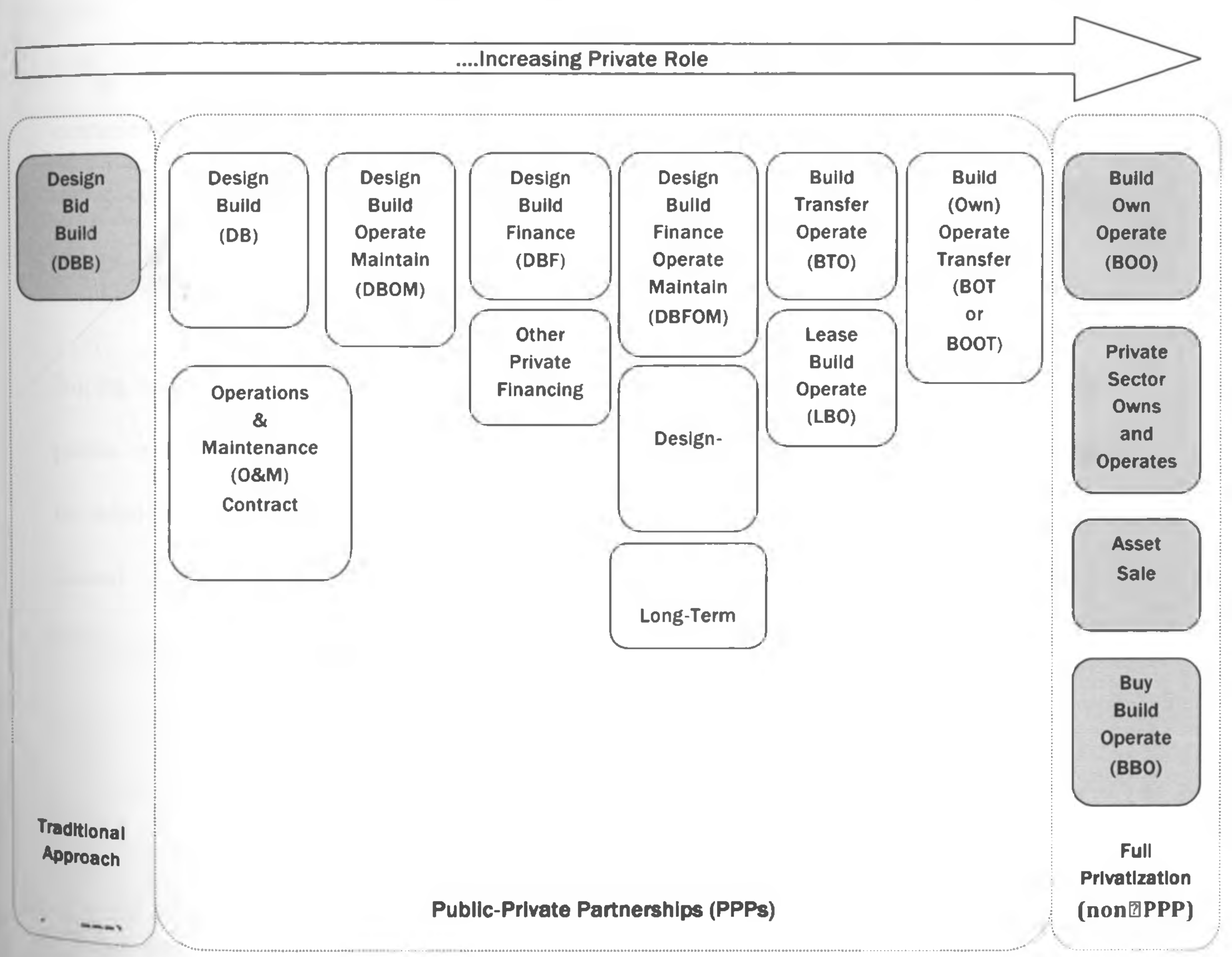
The concessionaire is also responsible for working capital. A concession contract is typically valid for 25–30 years so that the operator has sufficient time to recover the capital invested and earn an appropriate return over the life of the concession. The

[64] *Ibid.*
[65] *Supra.*, note 54
[66] *Ibid.*

public authority may contribute to the capital investment cost if necessary. This can be an investment "subsidy" (viability gap financing) to achieve commercial viability of the concession. Alternatively, the government can be compensated for its contribution by receiving a commensurate part of the tariff collected.[67]

The relationship between these forms of PPPs and privatisation is illustrated in the figure below.[68]

Figure 1 - Project Delivery Models Along a Continuum of Private Sector Involvement



[67] *Ibid.*

[68] Supra., note 50

2.3. Historical Evolution of PPPs

In ancient times, many public works (harbours, public markets) and collective infrastructure (public baths) were conceded.[69] Book 50 of the Digeste[70] is entirely dedicated to public works. It shows clearly the existence of concession law and of a law governing public estate licensees.

This procedure disappeared during the 5th century with the fall of the Roman Empire and reappeared only during the Middle Ages for the construction of new fortified towns and the occupation of new lands in the south western region of France during the 12th and 13th centuries. Occupancy contracts for fortified towns concede whole villages to their occupants under collective emphyteutic contracts which compelled the occupants to improve the village.[71]

During the 16th and 17th centuries, European sovereigns, and particularly in France, conceded public works to their "financial investors" generally called entrepreneurs. Such works included: riverbeds and canal construction, numerous public services such as road paving (actual road concessions), waste collection, public lighting, mail distribution, public transportation, general stores, and even opera houses.[72]

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[69] *Supra.*, note 35

[70] The Digeste, also known as *The Pandects*, is a name given to a compendium or digest of Roman law compiled by order of the Emperor Justinian I in the 6th century (AD 530-533).

[71] *Supra.*, note 35

[72] This system existed in several European countries: e.g. the canal concessions in Britain (Oxford canal concession of 1791) and Spain (the longest concession being to Von Thurn und Taxis which lasted four centuries).

Concessions truly took off in Europe in the 19th century during which public works flourished not only for railroads, but also urban services which expanded rapidly as a consequence.

20th century European wars reversed the trend. The role of the State was increased by wars, both in preparing for them as well as in dealing with their consequences. The disruption of countries, economies and long-term contracts was strongly felt in all European countries. Rare before 1914, inflation and its effect upon contracts became clear by 1918. The notion of state-owned companies was born to avoid the financial vulnerability of traditionally very long-term contracts. This movement grew throughout Europe during the two post-war periods.

Transportation PPPs were pioneered in Europe and by the 1990s, two types of partnership approaches had evolved. Under the more common "real toll" scenario, private concessionaires arrange financing, construct roadways, maintain them, service their debt, and derive revenue from tolls collected directly from motorists. One of the main benefits of the "real toll" concession approach is that it enables governments to tap into sources of private capital and avoid using public monies to build highways. Real toll PPP precedents established in France and Spain have been replicated in such diverse locations as Iceland, Malaysia, Republic of South Africa, Croatia, Australia, China and Brazil. An equally wide range of countries is now poised to launch ambitious surface transport partnership projects, including Poland, Romania, Lebanon, Egypt, and Austria.[73]

[73] Ongolo, D. *Public Private Partnerships – Practice and Regulatory Policy in Kenya*. (Nairobi, 2006)

2.4. Rationale for Engagement in PPPs

Provision of basic infrastructure has for a long time been considered as the exclusive responsibility of the public sector. But the public sector by itself, for a variety of reasons, has not been able to meet infrastructure requirements arising in Sub-Sahara Africa. The monopoly granted to public entities in charge of providing basic infrastructure often led to under-provision. Frequently, the delivery of infrastructure was rationed to a limited part of the population and associated costs of production were high. Further, the ability to raise capital for financing new projects is constrained in the context of poor credit ratings of African States and macroeconomic stability programmes.[74]

PPPs have shown significant promise in helping governments address infrastructure shortages. To begin with, they provide new sources of capital for public infrastructure projects. Private equity, pension funds and other sources of private financing must still be repaid, but shifting the financing and delivery responsibility to the private partner can help improve infrastructure in settings where public entities are unwilling or unable to shoulder the debt or the associated risk.[75] By providing access to additional capital from private-sector financing sources, PPPs can facilitate the delivery of projects that otherwise might have been delayed or not built at all because of state and local fiscal constraints.

The global consulting firm Deloitte argues that governments choose forms of privatisation for infrastructure and service delivery for four main reasons: the fiscal benefits — from the sale or lease of state-owned enterprises (SOEs) including reduced subsidies to these often loss-making entities, or new investments government cannot afford to provide on its own; the efficiency gains of the private sector, which can lead to lower prices and improved access by

[74] Estache, A et al, "Infrastructure Performance and Reform in Developing and Transition Economies: Evidence from a Survey of Productivity Measures". World Bank Policy Research Working Paper 3514, February 2005.
[75] *Supra., note 42*

more of the population; the development of local financial markets; and increased private sector development (which includes broadening local participation in the economy).[76] In addition, privatization is often an aid conditionality of donor agencies for developing countries.

Additionally, public-private partnerships introduce significant efficiency and reliability, perhaps the most compelling argument for their use. They are also intrinsically transparent. As such, they have earned a strong reputation for the ability to deliver projects on time and without the typical cost overruns that plague many multiyear infrastructure projects—especially when multiple administrations, each with their own priorities, come and go during the lifespan of a project.[77]

In a 2009 study of 114 PPPs, the UK's National Audit Office found that 69 percent were delivered on time and 65 percent came in within budget.[78] In Australia, the financial advantage of PPPs has been well documented. The University of Melbourne conducted a study of 42 traditional procurement projects and 25 PPPs and concluded that PPPs provide far greater cost certainty. The researchers found that once the contract had been signed, PPPs had an average cost escalation of 4 percent, while traditional procurement projects had a much higher average cost escalation of 18 percent.[79]

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[76] SAIIA "Working Together - Assessing Public Private Partnerships in Africa" Nepad Policy Focus Report No. 2, February 2005. See also Timothy Murphy, "The Case for Public Private Partnerships," Canadian Public Administration / Administration Publique Du Canada Volume 51, No. 1 (March/Mars 2008), Pp. 99–126

[77] PriceWaterhouseCoopers LLP, "Public-Private Partnerships: The U.S. Perspective" (2010), Available at http://www.pwc.com/us/infrastructure-ppp Accessed 16th September 2011

[78] National Audit Office (UK), *Performance of PFI Construction*, (London, 2009.)

[79] Infrastructure Australia, "*National PPP Forum: Benchmarking Study, Phase II,*" December 17, 2008.

PPPs that involve up-front payments or revenue-sharing arrangements, it is argued, can be used to extract value from existing transportation assets and raise substantial funds for other public projects and purposes.

Much of the risk inherent in large infrastructure projects can be assigned to private-sector partners in a PPP, including the risks associated with design, construction, integration of various subcontractors, sourcing of funds, and overall operations and maintenance.[80] By spreading risks to the parties best suited to manage them, costly complications are much less likely to crop up later to haunt public officials.

Basic infrastructure such as the provision of water, sewerage and electricity were long seen as typical cases of natural monopolies and public goods. In infrastructure, economies of scale exist due to large initial investments. The cost of every additional connection to the water, sewerage or electricity system is – compared to the initial investment of setting up the network – comparatively low. Economic theory states that the provision of such infrastructure and the services linked to it can be more cost effective when it is done by one single provider that takes advantage of the economies of scale. This situation is referred to as natural monopoly which is frequently used to justify government intervention.[81]

The provision of infrastructure and linked services share another economic characteristic that justifies government intervention: externalities. Improvements in a person's access to water, sewerage and electricity tend not only to improve his or her personal situation and well-being but at the same time increase the overall economic and social outcome in the economy. Further, public goods – such as public health – share the characteristic that private provision

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80 *Supra.*, note 77
81 *Ibid.*

without government intervention leads to a demand that is below the optimum for the economy.

Finally, PPPs enhance public control over, and accountability for, transportation infrastructure. In a PPP, the contract details the many responsibilities and performance expectations the public agency requires of the private entity, including penalties, incentives, and default and termination provisions, as well as limits on tolls, fees or rates of return. Thus, by specifying the desired performance standards in the PPP contract and holding the private entity financially accountable for meeting them, it is argued, the public sector can potentially enhance its control over the project's outcomes.[82]

2.4.1. Shortcomings & Challenges

As beneficial as they appear to be, PPPs have not sailed through without opposition.[83] Whereas some of these concerns are genuine, others are merely based on negative public opinion. In Kenya, for instance, some individuals view public private partnerships with suspicion, particularly when partners from abroad are involved. Others fear foreign control of vital assets and other infrastructure systems. Like some public officials, they suspect that foreign or domestic private companies may end up reaping exorbitant profits and exploiting the government and consumers by charging ever-higher usage fees.

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[82] Gilroy,L "Modernizing and Expanding Pennsylvania's Transportation Infrastructure through Public-Private Partnerships" [Testimony before the Pennsylvania House Republican Policy Committee] (Los Angeles, Calif.: Reason Foundation, 2009), 13–14, Available at http://reason.org/files/testimony_pennsylvania_transportation_public_private_partnerships.pdf Accessed 14th September 2011

[83] These concerns are discussed in substantial detail in Buxbaum, J. N., and Ortiz,I *Protecting the Public Interest: The Role of Long-Term Concession Agreements for Providing Transportation Infrastructure*, Research Paper 07-02. (Cambridge, Massachusetts, 2007, http://www.usc.edu/schools/sppd/keston/pdf/20070618-trans-concession-agreements.pdf. Accessed 14th September 2011

In the development of PPP projects, four main types of constraints are faced:[84]

i. *Political and bureaucratic constraints*, such as fragmented decision making due to the involvement of multiple public agencies, the prevalent emphasis on administrative procedures (rather than on strategies and results) that stem from the traditional, lengthy tendering process (normally split in three or four phases, from planning to final operation).

ii. *Regulatory constraints*, like the presence of fuzzy responsibilities among (independent) regulatory agencies and ministerial units and of unclear regulatory procedures, and the lack of, or deficient, framework for the resolution of disputes.

iii. *Financial constraints*, which largely stem from public budgetary limits and hesitant users' charges policies.

iv. *Methodological constraints*, which stem from the frequent limited knowledge of inter-relationships between variables and which prevent the clear definition of performance indicators or the estimation of values that are key to the economic and risk evaluation of transport projects.

The benefits of PPPs by far outweigh their shortcomings and it does appear obvious that PPPs will continue to grow in importance as approaches or specific tools for conducting various types of state and local economic development programmes.[85] They are politically

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[84] Menendez, A., *Constraints and Opportunities for PPP Transport Projects.* (Washington D.C., 1998) See also note 54

[85] See, for instance Guy,P.B.,. *"With a Little Help From Our Friends: Public-Private Partnerships as Institutions and Instruments."* In, Jon Pierre, ed. *Partnerships in Urban Governance: European and American Experience.* (New York: St. Martin's Press, 1998), pp. 11–33. where it is concluded that "Partnerships are an

popular, and they are generally viewed positively by the business community as a method for contributing talent and capital, as well as assuring their input into important economic development decisions.[86]

2.5. PPPS IN THE TRANSPORT SECTOR – RAILWAY CONCESSIONS

One of the areas where PPPs have been implemented across the globe is in the provision of transport infrastructure. Transport is a service which if under-provided may adversely affect certain sectors of the society and prevent economic development. A recent paper argues that improving transport infrastructure in Africa is an important factor for increasing the continent's trade[87]. It demonstrates that if improvements in infrastructure services could halve transport costs in the region, this would stimulate increases in trade volumes by a factor of five.

The central message from this paper is that most of Africa's poor trade performance can be accounted for by poor infrastructure (road, rail and telecommunications). This in turn means that the manner in which provision of basic infrastructure services is dispensed to meet the demands of the public in general will determine the level of economic activity and, in turn, the overall development of a nation.[88]

Thus, developing infrastructure capacity can deliver major benefits in economic growth, poverty alleviation, and environmental sustainability--but only when it provides services that respond to demand and does so effectively.[89]

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important instrument for government intervention into society. They are neither the answer to all problems of public policy, nor are they a totally symbolic and ineffective mode of action."
86 *Supra.*, note 38
87 Limao, N. and Venables, A.J., "Infrastructure, Geographical Disadvantage and Transport Costs," World Bank Development Research – Policy Research Working Paper 2257
88 UNECA, *Public-Private Partnerships For Service Delivery: Water And Sanitation.* (Addis Ababa, 2005)
89 World Bank, *World Development Report.* (Washington D.C. 1994)

Despite this serious demand for proper transportation infrastructure, the huge capital outlay for the provision of an efficient transportation system is often too heavy for governments alone. The World Bank estimates that in developing countries the annual demand for infrastructure (roads, rail transport, urban transport, ports, water, sanitation, telecommunications, and energy) exceeds US$1 trillion, including about US$250 billion for new and rehabilitation investments.[90] Thus, private participation in infrastructure development through Public-Private Partnerships will help to enhance efficiency, broaden access and improve the quality of public services.

In the design and development of a transport project, three main stakeholders are involved: (a) transport users (who are part of the larger group of the society as a whole and of the taxpayers); (b) the government (i.e., public sector); and (c) private sponsors or providers (to which, other actors, like lenders, are related).[91]

The Government makes possible the provision of a service to the users and receives in exchange the political support of the society and taxes. The Government regulates the actions of the sponsors and may provide capital and guarantees for the development and operation of the transport infrastructure. In exchange, the sponsors comply with the contract and agreed performance and assumed certain risks. And the sponsors provide the infrastructure to the users with a given level of service and for it the users pay tolls or other charges. Finally, the sponsors receive loans from lenders and pay them according to a debt service payment schedule.

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[90] *Supra.*,note 74

[91] *Ibid.*

It is perhaps for these reasons that the UN Economic and Social Commission for Asia and the Pacific reports that in recent years, the need to create better managed, more commercially-responsive and market-led railways has been widely recognized.[92] In consequence, many countries have introduced reforms designed to improve the operational and financial performance of national railways. Such economic reforms, often described as 'railway restructuring', have involved the creation of new organizations; revised accounting methods; liberalization through the introduction of competition; privatization, de-monopolization and regulatory reform.[93]

Railway restructuring has been defined as "the adaptation of railway industry structures, institutions and business processes in response to changing customer needs and technological change."[94] Railway restructuring is almost always done through concessioning.

Concession agreements are said to be the backbone of PPP projects.[95] Dalmon J. puts it thus:

> "The concession agreement allows the grantor to allocate project risk to the project company. The grantor will identify those risks which it is prepared to bear and allocate the remaining risks to the project company. The grantor may also wish to define to some extent the sharing of risk among the project participants through the concession agreement. Therefore, it is not uncommon to find the primary constituent documents defined and described in some detail in the concession agreement."[96]

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[92] UNESCAP, *Restructuring Railways.* (New York, 2003)
[93] *Ibid.*
[94] *Ibid.*
[95] *Ibid.*
[96] *Ibid.*

Long-term concessions are the most predominant form of PPPs in the rail and utility services such as water and electricity supply.[97] The concessions are granted to private companies who are typically consortia linking transnational firms which specialize in the rail sector with banks and local businesses interested in the products carried by the rail.[98] The state will normally retain the ownership of the fixed assets while the private company takes up the responsibility of developing and maintaining the infrastructure and of operating the services and billing for the same.[99]

In Kenya, the law, under section 92 (1) of the Public Procurement and Disposal Act 2005, permits a procuring entity to use concessioning as a procurement procedure. Concessioning may include build-own and operate, build-own-operate and transfer, build-operate and transfer or such similar types of procurement procedures. Concessioning can however only be done with the permission of the Public Procurement Oversight Authority established under section 8 of the said Act.

The rationale for the economic reform of the railways, in many countries, arises from the search for solutions to the myriad of problems faced by them. In essence the reasons that underlie the need for railway restructuring are that governments find railways costly to operate, the institutional arrangements regulating the relationship between owner governments and their railway organizations prohibit the emergence of business reactions among railway managers and, consequently, an improvement in financial performances; railways have been losing market share to their competitors, mainly road transport, and in many instances are patronized by 'captive' customers for whom railway is the only option;

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[97] ITF, *Railway Privatization through Concessions: The Origins and Effects of the Experience in Latin America* (London, 2002)
[98] *Ibid.*
[99] *Ibid.*

and there is an increasing recognition, by many governments, that railways should be retained and developed as an important component of the transport system. Such economic reforms, often described as 'railway restructuring', have involved the creation of new organizations; revised accounting methods; liberalization through the introduction of competition; privatization, de-monopolization and regulatory reform.[100]

2.5.1. The Process of Railway Concessioning

The conventional process for establishing a public-private partnership entails 3 phases. Phase 1 is the preparatory work for establishing the partnership; Phase 2 is the selection of the private partner and the final phase is the establishment and monitoring of partnership operation.[101]

The typical railway concession process starts soon after the state decides to restructure and seek private sector participation. In most cases the government nominates an agency to manage the process (Privatization Agency). It may also seek funding for advisory services and cost of labour downsizing. A consultant is appointed to recommend the most suitable privatization option in the context of the needs and objective of the state. The Ministry of Transport, Railway and Cabinet consider the recommendations and select a particular option for privatization. At this stage consultations with labour unions are also carried out. After the cabinet decision, the consultant is asked to prepare bid documents. The next steps are review of bid documents by the government before issue, receipt of bids, evaluation and approval of government of selection of concessionaire(s). The process manager then negotiates the

[100] *Ibid.*
[101] World Bank, *A Railway Concessioning Toolkit* (Washington D.C., 2003)

contract and the concessionaire then arranges the financial closure of the deal. The last steps are handing over of assets to the concessionaire and the concession becoming operational.[102] These stages are now discussed in detail below.

2.5.1.1. Feasibility studies and definition of goals[103]

Before initiating a concessioning operation, the conceding authorities must first conduct, or arrange for the conduct of, technical, commercial, operational, and financial, and economic studies with a view to determining the feasibility of the concessioning operation and identifying the gains to be expected from it.

2.5.1.2. Risk identification and sharing selection of institutional arrangement[104]

To ensure familiarity with the problems associated with establishing public-private partnerships, the conceding authorities must endeavor to identify the risks they will have to assume in the course of a partnership operation (irresponsible bidders, private operators with poor performance, insolvent private operators, risks of deterioration of public assets, risks of abusing a privileged position), the risks assumed by the private enterprise (country risks associated with legal practices, currency developments, or political instability, project risks associated with performing rehabilitation works, operating conditions), the risks borne by lenders (guarantees of financial commitments backed by assets, by sponsors' own funds, by comfort letters.)

The magnitude and impact of these risks must be analyzed by preparing a reference business plan and several scenarios, which involve financial modeling of the project.

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102 Sondhi, J. and Phipps,L. "The Process of Rail Concessioning in SADC States" http://pdf.usaid.gov/pdf_docs/PNACT634.pdf Accessed 3rd October 2011

103 *Supra.*, note 101

104 *Ibid.*

2.5.1.3. *Preparation of an appropriate legal and agreement framework*[105]

To attain and maximize the chances of success of the partnership operation, it is essential before the call for tenders is launched to assess from the ground up, and to adapt, the institutional and legal framework relating to the privatization process, competition law, the means of using public property, tax and social legislation (in particular when the concessioning operation is multilateral in scope2), mastering the problems of policing and security, etc.

The national public authorities must, to this end, decide whether to follow ordinary law procedures on the privatization of public enterprises, where such procedures exist, or to adopt special procedures. On the basis of the above, they must clearly designate the public entities responsible for the concessioning operation (the respective roles of the finance ministry, transport ministry, privatization agencies, and/or privatization commission or specially-established committees) and stipulate their prerogatives and powers.

2.5.1.4. *Organization of the competitive bidding procedure*[106]

To maximize the chances for success of a concessioning operation and to select the most appropriate bidder, a complete, cohesive, and transparent competitive bidding procedure should be put in place. To this end, the public authority must first designate an entity responsible for designing and initiating the partnership operation, and vest in it broad powers to issue directives and make decisions. It is then desirable, at the very start of the process, to select a consulting firm with experience in providing assistance in privatization operations to work with and provide support to the public agency.

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[105] *Ibid.*
[106] *Ibid.*

2.5.1.5. *Conduct of the competitive bidding procedure*[107]

The public authorities must ensure the proper conduct of the competitive bidding procedure by ensuring that bidders receive information in full and in an equitable manner (with the authorities providing the prior studies, maintaining a data room, authorizing local visits, organizing presentation conferences, etc.). The bid evaluation commission responsible for the concessioning must adopt an organizational approach and working method that enable it to best assess bidders' submissions.

2.5.1.6. *Establishment of the partnership*[108]

Once the contract has been signed, the bidder selected must, within a predetermined deadline create the structure that will carry out the project and obtain the requisite administrative authorizations, mobilize the funding required to finance the project, accept the assets subject of the concession when it enters into force, enter into procurement and construction contracts, and then monitor and accept the works.

The public authority must be prepared to provide its support for administrative closing operations by participating actively in the administrative steps taken by the private partner to obtain work permits and building permits, register the structure established to carry out the project, obtain such administrative authorizations as may be required, etc.

Finally, the private partner must ensure the mobilization of financing and be capable, once the decision to award has been made of assembling the pool originally planned and, if necessary, offsetting the nonparticipation of one of the partners in the group, raising all the

[107] *Ibid.*
[108] *Ibid.*

loans planned; and mobilizing the funds necessary for covering any possible overruns related to carrying out the project.

2.5.1.7. *Monitoring of the partnership*[109]

It is important that the private partner be required to provide information such that the public authority is able to verify compliance with the agreement. The major aspects that the public authority in the partnership must be able to monitor relate to the operator's technical and operational performance; and the actual performance of the investment works planned at the time of the railway concessioning operation. A joint monitoring body should be established for purposes of monitoring the partnership agreement during its life.

2.6. ELEMENTS OF A SUCCESSFUL PUBLIC PRIVATE PARTNERSHIP

For PPPs to achieve their desired goals, they must be conducted in a particular way.[110] These include a receptive and supportive public sector to a partnership approach; Clear objective(s), with well-defined, limited, and measurable objectives; Clearly delineated (via fair negotiation) roles, responsibilities, and shared risks; Active and meaningful participation of all partners and Satisfactory accountability and openness with the public.[111]

Ong'olo also posits that for success in PPPs, governments must ensure the existence of a strong legal and regulatory framework that can clarify the legal authority to grant concessions, the procurement process, the contribution from the public authority of assets that can make the project viable and the rebalancing of tariffs which will make the project viable

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[109] *Ibid.*
[110] See, generally, European Commission, "Guidelines for Successful PPPs" available at http://ec.europa.eu/regional_policy/sources/docgener/guides/ppp_en.pdf Accessed 14th September 2011. See also, Urban Land Institute, "Ten Principles for Successful PPPs" Available at http://www.uli.org/ResearchAndPublications/Reports/~/media/Documents/ResearchAndPublications/Reports/TenPrinciples/TP_Partnerships.ashx Accessed 14th September 2011
[111] *Supra.*, note 38

from a financial point of view. In addition, there must be political commitment to give confidence to the partners to make investments. Effective public administration is also important preferably through a dedicated central PPP unit located within government that can oversee the whole PPP process and has cross cutting authority over all Ministries.[112]

The enabling environment refers to the context within which PPPs are to take place in terms of the level of political support, the policy framework, legislation and regulations, institutional capacities and competencies, and PPP processes.[113]

The key elements of an enabling PPP environment can summarily be grouped into three key broad elements. The first is a legal and regulatory framework comprising a framework of enforceable laws and regulations which improves predictability for all parties as regards likely outcomes, thus improving confidence on all sides. The second is strong capable public institutions with responsibility for managing/ facilitating PPP processes and enforcing PPP agreements that minimise confusion and promote efficiency, and thirdly, efficient, effective and coordinated PPP processes, built around the project cycle, that minimise transaction costs.

2.7. THE NEED FOR REGULATION OF RAILWAY CONCESSIONS

The rail industry poses a number of specific problems for transport economists and regulators that are only partially shared with other transport modes. These elements are the multi-product nature of the activity, the particular cost structure of railroad companies, the role of infrastructure and networks, the existence of indivisibilities in inputs and outputs, the organization of rail transport as a public service, and the existence of externalities in the

112 *Supra.* ,note 73
113 http://www.sbp.org.pk/departments/ihfd/days/Day1-05-P4.pdf Accessed 14th September 2011

transport system as a whole.[114] These characteristics define a descriptive framework for this sector, and jointly determine the main factors that should be considered when studying in detail the appropriate economic regulation for the rail industry.[115]

Throughout the world, the rail industry historically has been one of the most extensively regulated of all sectors.[116] Price, entry, exit, financial structure, accounting methods, vertical relations, and operating rules have all been subject to some form of government control. The public utility paradigm of government regulation has been applied on the assumption that the economic characteristics of the rail industry preclude competitive organization or the need for market responsiveness.[117] In the past three decades, however, policymakers and economists have become increasingly critical of traditional regulation of the rail industry. It is generally accepted that in markets where rail carriers seek to meet demand, there is often effective competition, and that government restrictions on the structure and conduct of firms in this industry impose considerable costs on society.

Misguided regulatory policies have been blamed for the misallocation of freight traffic among competing modes of transport, excess capacity, excessive operating costs, and poor investment decisions.[118] Regulatory controls have also shouldered much of the blame for the poor financial condition of railroads, the deterioration of rail plant, the suppression and delay of cost-reducing innovations, and the mediocre quality of rail service. Kessides and Willig suggest principles for restructuring railroad regulation - indeed, for restructuring the

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114 Cantos, P. & Campos, J., *"Recent Changes in the Global Rail Industry: Facing the Challenge of Increased Flexibility."* European Transport \ Trasporti Europei n. 29 (2005): 1-21 Available at http://www.istiee.org/te/papers/N29/03%20%28pg%201-21%29%20cantos%20campos%20I.pdf Accessed 20th September 2011

115 *Ibid.*

116 Ioannis, K. N. and Willig, R. D., "Restructuring Regulation of the Rail Industry for the Public Interest". World Bank Policy Research Working Paper No. 1506. (1995) Available at SSRN: http://ssrn.com/abstract=614994 Accessed 20th September 2011

117 *Ibid.*

118 *Ibid.*

orientation of railroad entities - for the sake of the public interest. Much can be learned, they contend, from applying the principles of industrial organization to analysis of the rail industry. To assess the implications of policies aimed at rate regulation or infrastructure investment, it is essential to understand the nature of technology, costs, and demand in the rail industry. Government's role in relation to market behavior should be based explicitly on the economic and technological realities of the railroad marketplace.[119]

Additionally, there is need for an independent regulator representing the interests of all parties involved (governments, private businesses, consumers) to establish and monitor the exact responsibilities of each player involved.

Several risks are involved in the absence of a regulatory system. Chief among the risks are excessive tariffs, inadequate service level and quality, non-compliance of contractual obligations to users, government or other parties, low efficiency in production and in the provision of goods and services, inadequate level of investment in the sector and frequent discontent between the parties involved.[120]

2.8. PRINCIPLES OF EFFECTIVE REGULATION OF PPPS

Regulation is a key concern of the infrastructure industries, their consumers, citizens and governments alike.

There is a need to regulate a service provider to ensure that services provided reflect the adequate level and meets the desired standard or quality. Regulatory control is also needed to

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[119] *Ibid.*
[120] UNESCAP., *Public-Private Partnerships in Infrastructure Development: An introduction to issues from different perspectives.* (New York, 2007)

ensure sustainable development in a sector.[121] There are three main requirements that any sustainable development must satisfy. First, it must be economically and financially sustainable to ensure that a continuing capability exists to produce and deliver goods and services. Second, it must be environmentally and ecologically sustainable to ensure an overall improvement in the general quality of life, and not merely results in an increase in traded goods and services. Third, it must be socially sustainable so that the goods and services can be equitably shared by all sections of society.

It is important to recognize that regulation is a multidisciplinary activity that embraces law, political science and social administration as well as business and economics. Regulatory processes generally comprise three stages - the enactment of enabling legislation, the creation of regulatory administrations and rules, and the bringing to bear of those rules on individuals or organizations whose behavior is to be influenced or controlled.[122]

A successful PPP also requires an appropriate Legal framework. The core PPP enabling legislation can comprise a single PPP law, together with sector specific legislation, or sometimes a series of other laws and regulations which, taken together, can provide the necessary authorities to enter into PPP contracts. Taken together, however, the legal framework needs to specify private sector investment rights; clear and transparent procurement processes (including approaches to deal with unsolicited proposals); contractual arbitration processes; and remedial actions for bankruptcy/ payment defaults, amongst others. There also needs to be a clear delineation of the capacity for different institutions to enforce contracts. In addition to many of the high level legal issues associated with PPPs which need

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[121] *Ibid.*

[122] UNESCAP, *The Economic Regulation of Transport Infrastructure and Services – Principles and Issues.* (New York, 2001)

addressing, there are also many secondary laws and regulations which need to be in place if transactions are to be undertaken in a timely manner.[123]

Another key element is an ideal Regulatory framework. The economic regulatory framework needs to be developed alongside the legal PPP framework, to reduce regulatory risks and promote private sector confidence. There is often a tension, however, between what investors prefer and what is often seen as being regulatory best practice. For many years and in many countries, the policy aim has been to create independent regulatory bodies – that is, autonomy from government and with considerable discretionary powers.[124]

Yet another element of a successful PPP is strong institutions. The key institutional capabilities required to undertake PPPs successfully might be grouped into the following three broad, but separate, groups of competencies: Policy development, dissemination, monitoring and enforcement, individual project sponsorship, design, preparation, execution and monitoring and Financial management of funded and contingent obligations.[125]

i. *Policy development, dissemination, monitoring and enforcement*

A number of institutions need to feed in to the development of a PPP policy. Whilst this may be typically led by the Ministry of Finance and/ or Ministry of Planning and Development (or equivalent); policy ownership should be broad based, with widespread acceptance.[126]

In practice, however, this may be difficult to achieve, not least because it involves giving up an element of control which many line ministries are typically used to having.

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123 *Ibid.*
124 *Ibid.*
125 *Supra.*, note 102
126 *Supra.*, *note 110*

Without powerful sponsorship, it is unlikely that a PPP programme will succeed. Related to this, but a typically overlooked starting point for PPP policy, is the type of projects which the government wishes to pursue and the types of contractual arrangements it may seek to enter into and any funding or other implications that follow this.

ii. Project sponsorship, design, preparation, execution and monitoring

One of the most common constraints to infrastructure PPPs in developing countries is the inability of the government to originate and develop bankable projects. As a result, they are highly reliant on the private sector to develop projects, which are often provided on an unsolicited basis.

It is not necessary for a line ministry or other contracting authority to be an expert in developing and transacting projects. However, it is important that the processes involved and the implications that flow from particular decisions are well understood. It is usual for and advisable for ministries to hire expert advisors to help them develop and execute transactions – part of this role is to help government clients understand the PPP process better.

iii. Financial management

Whilst the Ministry of Finance (MoF)/ Treasury is responsible for managing a given country's finances, it is not that unusual where there are powerful line ministries for them to agree government commitments with investors and then to expect the MoF to sign up to sometimes highly onerous terms as a fait accompli.[127]

[127] *Ibid.*

A further problem is that although funded commitments are recognised, contingent ones are often either ignored or else totally undervalued. It is essential that the PPP framework and processes provide for the MoF to be involved at all critical stages of the project cycle. In particular, the need for any potential public financial commitments – whether funded or contingent – need to be brought to the attention of the MoF as soon as they become likely and all commitments must be approved.

iv. PPP processes

It is important that the roles and responsibilities of different institutions are clearly defined in PPP processes and that such processes are standardised to limit confusion and improve efficiency. Overlapping roles or cross cutting responsibilities can unnecessarily 'bureaucratize' processes. The starting point for PPP processes is the PPP project cycle. The project cycle requires participation from many different government bodies, individual countries need to develop systems which fit their own particular institutional architectures.[128]

2.9. CONSTRAINTS TO THE DEVELOPMENT OF EFFECTIVE REGULATORY INSTITUTIONS

Even as we study the requirements and procedure for the establishment of a proper and effective legal and regulatory framework for concessioning, we must appreciate that there exist some factors which constrain the development of such a system. Most countries that are trying to create new regulatory systems also will have to deal with one or more constraints or impediments that will hinder the development of a fully functioning, independent regulatory agency. The most commonly observed constraints include[129] an unwillingness or inability to move toward commercialization with cost-reflective prices to small consumers, an inability

128 *Ibid.*
129 ADB. *Developing Best Practices for Promoting Private Sector Investment in Infrastructure: Power.* (Manila, 2000)

or unwillingness to hand over decision-making powers to a non-ministry or nonpolitical agency even if it is formally required by law, weakly functioning or slowly operating law courts that create considerable uncertainty when there is an appeal of a regulatory decision, uncertainty about the nature and strength of regulatory commitments, limited regulatory resources (particularly the lack of money and specialized, experienced staff, such as economists, lawyers, and accountants), popular opposition, especially from consumers, because they believe that their interests are being ignored to provide large profits to private investors (particularly when private foreign investors are significantly involved), macroeconomic crises (or fears of rapid inflation, currency devaluation, and the like) and their aftermath.

It is argued that some of these problems may also affect countries with well-established, non-transitional regulatory systems, but they tend to be much more manageable where institutions are stronger and better established. In those circumstances, these problems typically will not threaten the viability of the regulatory framework. In contrast, the problems tend to be markedly more acute in countries that have transitional regulatory regimes.

2.10 CONCLUSION

This chapter has looked at the theory of Public Private Partnerships with a view to laying a foundation for a study of the Kenya Uganda Railway concession in subsequent chapters. It has become evident that there is no single and universal definition of a PPP, but there are certain common strands. Principally, all definitions agree that PPPs are an arrangement where a public entity works with a private sector entity in the provision of public services.

There are many variants of PPPs, but in the transport sector, concessions are the preferred mode of engaging the private sector. In order to succeed, there are certain key factors that must be addressed by the concession. One of the most important of these is a strong legal and regulatory framework which should cover the criteria for the selection of a concessionaire and provide for a strong oversight institution to oversee the management of the concession. With these factors in mind, this study will now look at how Kenya went about concessioning its railway line with a view to pinpointing the weaknesses in the framework and recommending solutions.

CHAPTER 3

THE KENYA-UGANDA RAILWAY CONCESSION

3. Introduction

In the previous chapter we have discussed the nature of Public Private Partnerships (PPPs) as an option for the government to deliver services to the public. In this chapter we will cover in detail the development of the Kenya Railway concession and the regulatory framework for concessions in Kenya with a few of establishing the relationship between the two.

We have already seen that governments around the world are increasingly looking to public-private partnerships (PPPs) to radically improve infrastructure networks in their countries and enhance service delivery to their people.[130] This is due to the many advantages that come with PPPs, which include the fact that PPPs potentially bring the efficiency of business to public service delivery and avoid the politically contentious aspects of full privatisation.[131] PPPs also allow governments to retain ownership while contracting the private sector to perform a specific function such as building, maintaining and operating infrastructure like roads and ports, or providing basic services like water and electricity. Both sides stand to benefit from the contractual agreement. Government earns revenue by leasing state-owned assets or alternatively pays the private sector for improved infrastructure and better service delivery. Often the private sector can do the job more efficiently, which can lower prices and improve rollout. The private operator gets reimbursed either by government or consumers for doing its work, at a profit.[132]

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130 *Supra.*, note 76
131 Price Waterhouse Coopers LLP, "Delivering the PPP Promise - A Review of PPP Issues and Activity" Available at http://www.pwc.com/gx/en/government-infrastructure/pdf/promisereport.pdf Accessed 4th August 2011
132 *Ibid.*

However, the biggest benefit which African governments seek to enjoy from PPPs is the fact that they provide an alternative source of financing for projects.[133] Due to high poverty levels in Africa, most governments are unable to provide basic services such as water and health, so funding for transport megaprojects are hardly considered. But with PPPs the private sector is able to come in and provide the necessary financing for these projects.

3.1. KENYA'S EXPERIENCE WITH PPPS

In Africa, PPPs began only in the mid- to late-1990s. To date PPPs have been used mainly to make improvements to economic (physical) infrastructure, such as telecommunications, electricity and water. However, in recent years, PPPs have also been used to improve social infrastructure, such as health and education, and other services (garbage collection, agriculture extension services, etc). [134]Traditionally, these services, especially in Africa, have been provided by the public sector. This is mainly because most of them require large capital outlays, and have a long gestation period. Moreover, because of social considerations their pricing tends to be inflexible.[135]

It is reported that since the early 1990s, Sub-Saharan Africa (SSA) Governments have been privatizing state owned and operated infrastructure.[136] In Africa, South Africa has the greatest cumulative experience of public-private partnerships, with over 50 such partnerships in development or implementation at national or provincial level, and 300 projects at municipal level, since 1994.[137]

133 *Supra., note 42*
134 Briceño-Garmendia, F et al (Eds), *Africa's Infrastructure: A Time for Transformation.* (Washington D.C., 2009) pp 1-3
135 *Supra*.,note 73
136 World Bank, *Review of Selected Railway Concessions in Sub-Saharan Africa.* (New York, 2006)
137 *Supra*., note 76

In Kenya, the pressure to reduce expenditure and cut down taxes has forced the government to resort to the private sector.[138] As early as 1992, as part of the framework to implement the privatization Programme a high level policy making committee, the Parastatal Reform Programme Committee (PRPC), assisted by a secretariat, the Executive Secretariat and Technical Unit (ESTU), was established under the chairmanship of the Vice President and Minister for Finance. The functions of the PRPC were to supervise and coordinate the implementation of the Parastatal Reform Programme in general, to prioritise and determine the timing of the sale for each non-strategic public enterprise, to approve the operational guidelines for privatization to be followed by ESTU, including the criteria and procedures to be followed in the divestiture decisions, to give final approval or rejection for the sale of public assets, to monitor and evaluate the progress of implementing the programme; and to provide political impetus for privatization and participate in building public awareness and the national consensus in support of the government programme.[139]

In its draft Sessional Paper No 2 of 2005 on "Privatization of State Corporations and Investments", the NARC Government that took power at the start of 2003 reiterated its role of being a facilitator for private sector led economic growth and investment.[140]

It states that

> Through outright privatisation and various forms of Public Private Partnerships, the Government intends to mobilize resources to rehabilitate, modernize and expand Kenya's productive capacity, and has outlined a number of privatisation initiatives whose implementation is to commence immediately.[141]

With specific reference to infrastructural development the government also stated that,

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138 *Supra.*, note 73

139 Republic of Kenya, *Sessional Paper No 2 of 2005 on Privatization of State Corporations and Investments.* (Nairobi, 2005)

140 *Ibid.*

141 *Ibid.*

In Kenya, private sector investment should be encouraged and facilitated, not only through formal concessioning contracts, but also localized private-public partnership initiatives to contribute towards road construction and repair.[142]

In pursuance of this policy, the Government of Kenya has for some time now considered PPPs to secure funding from the private sector to finance some of its projects. One such project is an arrangement between the City Council of Nairobi and Adopt-A-Light Limited. Under the partnership, the City Council of Nairobi mandated a private entity, Adopt-A-Light Limited to undertake street lighting and advertising on street lighting poles in the city of Nairobi. The private entity was mandated to levy rates on such advertising activities.

Another such partnership is the agreement for the management of motor vehicle parking and car park revenue collection services between the Municipal Council of Mombasa and Kenya Airports Parking Services Limited (KAPS).

However, the most discussed PPP in Kenya is the Kenya Railways Concession.

3.2. THE KENYA-UGANDA RAILWAY CONCESSION

The Public-Private Infrastructure Advisory Facility reports that by 2006 the use of traditional, long-term concession contracts to substantially shift the financial risk of investment in rail infrastructure to the private sector had all but disappeared in Sub-Saharan Africa.[143] Nevertheless, against all odds in December 2006, one of the largest, most ambitious rail concessions in African history was closed in East Africa – the Kenya Uganda Railway Concession.

[142] Republic of Kenya Consultative Group on Donors, *Joint Statements of Development Partners for the Kenya Consultative Group Meeting Roads.* (Nairobi, 2005)
[143] *Supra.*, note 5

The Kenya–Uganda rail line, linking Kenya's seaport of Mombasa and Uganda's capital city Kampala, is the oldest and most important rail link in East Africa. Constructed a century ago, the line was nicknamed the Lunatic Express by the British Colonialist who built it, because its construction was plagued by tribal raids, man-eating lions, outbreaks of malaria affecting the construction workers, and uncertainty over the business case for the colossal initial investment.

The backbone of the rail network in East Africa was what was at first known as the Uganda Railway, opened in 1902 from Mombasa to Kisumu on Lake Victoria, with steamer connections from there, initially to Entebbe but subsequently extended to several ports on the lake, including some in Tanzania (then German East Africa). At the time, there was very limited development in Kenya (Nairobi did not exist prior to the railway arriving) and the railway was constructed in large part for political purposes. Branches and, in Uganda, feeders to ports on Lake Victoria, were progressively added, one of the more important being the Magadi line serving the soda-ash deposits, and a direct rail route to Kampala was completed via Jinja in 1931. At the time, the 2,350 km rail line played a key role in the early development of East Africa by serving for decades as the most important means for moving goods and people back and forth between inland population centers and the seaport of Mombasa.[144]

Development of the network continued after the into the 1950's, with the last major line being the Western and Northern Uganda lines, to Kasese in 1956 and Pakwach on the Albert

[144] *Ibid.*

Nile in 1964. Many of these lines only generated limited traffic and have since been closed.[145]

The line continued to be important through the 1970s. By 1983 the annual amount of cargo shipped via the link peaked at 4.3 million tons—70% of all east-west shipping at the time. Immediately thereafter the rail business began a steady decade-long slide into insolvency as maintenance and investment lagged, revenues dropped, but the workforce continued to expand.[146]

By 1992 the Kenyan government, responsible for most of this stretch of rail infrastructure, employed 22,000 workers to look after it, probably at least 15,000 more than necessary. In the 2004-05 fiscal year, the annual cargo tonnage had slipped to 1.9 million, less than 20% of total east-west shipping. By June 2004 Kenya Rail had accumulated $277 million in debt. The monthly cash deficit was around $3.2 million, with annual losses running at about $39 million. The Kenyan government admitted that their rail operation was technically insolvent.[147]

indeed the World Bank reported that most of the railways that have been presented for concessioning in Africa are badly run-down, requiring substantial rehabilitation of both infrastructure and rollingstock. They generally carry volumes that are very low by world standards, about what a self-respecting branch-line would carry in many countries. A few railways have substantial mineral traffic but most are carrying semi-bulk freight between the

145 Bullock, R., *Results of Railway Privatization in Africa.* World Bank Transport Papers, TP-8 (Washington D.C., 2005)
146 *Ibid.*
147 *Ibid.*

interior and the ports and vice versa; only in a few cases are there significant internal flows.[148]

The need to do something about the rail line was recognized in the late 1990s at about the same time in both countries. The Kenyan Finance Minister, Musalia Mudavadi, announced in June 1998 that Kenya Rail would be concessioned. International consultants were hired, but they advised that a concession was not practical unless the Uganda side of the line was brought into the deal. In August 1999 Uganda asked the Public-Private Infrastructure Advisory Facility (PPIAF) for funding to survey opportunities for expanding private participation in the country's infrastructure services. The resulting Country Framework Report put rail concessioning high on the list of quick-win possibilities. Uganda confirmed this via a second PPIAF-funded study in July 2000, which looked specifically at the rail sector. The study recommended a joint rail concession with the Kenyan government.

In June 2002 the Kenyan government also requested PPIAF funding to assess the kind of regulatory framework needed for transport in general, and a rail concession in particular. Shortly after the initiation of that study the government hired the IFC advisory team to begin work on a transaction structure and tender documents. The PPIAF research on the regulatory framework, completed in April 2003, was closely coordinated with the IFC advisory work. Later in 2003 the Kenyan President Mwai Kibaki and Ugandan President Yoweri Museveni announced at a meeting hosted in Kampala that a joint concession would be prepared.

In late October 2005 after two years of deal structuring and procurement, a consortium led by Sheltam Rail (Pty) Ltd (Sheltam) was named the preferred bidder for what had become a 25-

[148] *Ibid.*

year concession. Sheltam was an affiliate of the Sheltam Grindrod Group, which included Comazar (Pty) Ltd, the biggest private railway operator in Africa, which in turn had links to South Africa's largest transport and logistics enterprise, Transnet. Comazar had already been active in Burkina Faso, Cameroon and Madagascar. Through its local consortium, Rift Valley Railways-Kenya (RVR-Kenya), Sheltam edged out the Magadi Soda Consortium, led by Rail India Technical and Economic Services Ltd (Rites). The two groups reportedly spent as much as $1.5 million each on their bids.

The joint concession is structured legally as two separate 25-year concession contracts signed by each government with the subsidiary company in each country of the Rift Valley Railways Investments (Pty) Ltd (RVR), which acts as the overall concession holding company. While for regulatory and political hurdles in each country the concessions were signed by the RVR subsidiaries with each government, it was always the intention of the procuring agencies that RVR should run the railway as a seamless operation. The legal and corporate structures therefore required by the two governments, in addition to the interface agreement between the two governments and the concessionaires, were aimed at 'bringing it all together' as one business. A large amount of freight traffic was expected to be cross-border, and the success of each operation was expected to depend heavily on the joint coordination of operations on the total network.

Key details of the contracts include the following:

i. *Conceded Assets*:[149] All railway assets, consisting of the railway infrastructure, locomotives and rolling stock, railway and marine equipment, and maintenance facilities, were conceded by the governments to the concession companies. But these

[149] Government of Kenya, Agreement providing for the Concession of Kenya Railways Freight and Passenger Services. Section C

are assets conceded for use, meaning that ownership of the infrastructure still rests fully with the respective governments.

ii. *Operational Responsibilities*:[150] The concession covers the provision of freight services over the entire rail network and passenger services at a specified frequency in particular sections of the network in Kenya alone (passenger service in Uganda had already been discontinued). The freight concession was supposed to last 25 years and the passenger concession for five years in the case of Kenya.

iii. *Maintenance & Rehabilitation*:[151] The concession companies were also to be responsible for the rehabilitation and maintenance of all assets to specified standards and for the achievement of minimum investment levels and traffic growth targets stipulated in the concession contracts.

iv. *Payments to Governments*:[152] The concession companies were to make payments to the respective governments of concession fees for use of the conceded assets—a minimum once-off entry fee of $3 million to Kenya and $2 million to Uganda. In addition, an annual variable fee was to be paid, amounting to 11.1% of each concession company's gross freight revenues. In the case of the passenger business in Kenya, the concessionaire agreed to pay the Government of Kenya a flat, annual fee of $1 million.

v. *Expected Investments & Business Growth*:[153] The concessionaires were expected to make a minimum, annual investment over the first five years of $5 million in Kenya and $1 million in Uganda. The investments were to focus on upgrading and rehabilitating the main rail line and rolling stock, growing the business volume by 75% by year five, and maintaining it at 60% of GDP growth thereafter.

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150 *Ibid*., Section B
151 *Ibid*., Clause F
152 *Ibid*., Section E
153 *Ibid*., Section G

vi. *Tariff Setting*: In return for taking on these responsibilities, the concession companies were to be allowed unilaterally to set freight rates in both countries. The only limit was to be on increases in third-class passenger fare in Kenya: these increases were not to exceed increases in the annual consumer price index.

The transaction structured by PricewaterhouseCoopers, RVR's financial advisor and arranger, had a debt component of $64 million; equity of $24 million and internal cash generation of $33 million pledged towards the five-year investment requirements of the business. The project equity was over-subscribed at the time of closing and the project ended up taking in US$28 million of equity. The advisors created a "Standby Capital Reserve Fund" with the $4 million over-subscription set aside as a "rainy day fund" to strengthen the project. The debt financing was to be provided by IFC and KfW ($32 million each) for a total amount of $64 million.[154]

The projected total capital expenditure required over the lifetime of the project was approximately $450 million, and was to be provided via equity, debt financing and internal cash flows generated by project operations. The project was structured and funded as a non-recourse financing, although concessions were no longer typically structured this way. The base case financial projections showed that if RVR met its targets, it might never need to access the bank market for future capital investments after the initial five-year funding. Such investments could then be financed entirely by internal cash generation.[155]

[154] *Supra.*, note 5
[155] *Ibid.*

The financial structure of the project assigned the projects' risks, such as commercial risks associated with the concessions (including the operations, investment, and most importantly, traffic risks) to the concession companies and their lenders.[156]

The financing tenures of the project were the longest ever negotiated in the region; 15 years with a five-year moratorium on repayment of principal during the investment period. This was the first time such a term structure had been used in Sub-Saharan Africa, outside of South Africa.[157]

By 2005 Kenya Railways was spending more on salaries and wages than it was on maintenance and equipment—about 40% of total revenue. The company employed 9,500 workers, down from a high of 22,000 in 1992, but still 4,000 to 5,000 too many for even a reasonably efficient operation. In Uganda the labor force at 1,500 seemed three times more than what was needed. An IDA credit for $44 million was made available to the Government of Kenya to cover retrenchment benefits determined by the projected number of layoffs by RVR. In Uganda, the Divestiture Unit retrenched all staff with termination benefits. The concessionaire was free to rehire the Ugandan staff for the operation of the concession, while in Kenya only staff that was not retained by RVR was retrenched.[158]

3.3. CHALLENGES FACED BY THE RAILWAY CONCESSION

Railway concessions face a myriad of problems – many cut across the board while some were specific to the Kenyan case. On the whole, Richard Bullock, an independent consultant with a wide experience in infrastructure development in Africa opines that Concessions have not

[156] *Ibid.*
[157] *Ibid.*
[158] *Ibid.*

been without their problems.[159] In some cases, there were very few bidders, with limited financial resources; governments have had to guarantee investments; and mobilizing finance has been slow. Concessionaires have generally been unenthusiastic about running passenger services, which generate less revenue than freight, and tie-up scarce traction-power. Further, there have been disputes about the payment of Public Service Obligation (PSO) compensation by governments for non-profitable services, and problems have arisen about the level of concession fees, the length of concessions, and staff redundancy payments.

At the time it was signed, the Kenyan railway concession heralded a new beginning to the transport sector in the region and it even won the Euromoney Project Finance Magazine's Africa Deal of the Year, in recognition of the complexity of the deal and the many innovative efforts to overcome the challenges associated with the project. Experts predicted that within three years, the rail line would be able to carry five million tons of cargo, sharply increasing revenues for the private operators. Economic benefits to both countries were expected to include a reduction in the costs of carrying goods within the economies by an estimated $42 million a year. The governments also expected millions of dollars each year in new corporate tax revenues, and equally large savings in road maintenance and fuel costs.[160]

However, the going has not been as rosy. The Kenya Railway Concession has faced numerous challenges, some which started even before the agreement was signed.

[159] Bullock, R., "African Railway Concessions, a Step Forward but not the Whole Answer." Private Sector and Development, No. 9 March 2011 Available at http://www.proparco.fr/webdav/site/proparco/shared/PORTAILS/Secteur_prive_developpement/PDF/SPD%209 Proparco%20SP%26D%20-%20What%20role%20for%20the%20private%20sector%20in%20African%20railways%20development.pdf Accessed 20th September 2011

[160] *Supra.*, note 5

In spite of seven years of preparation, and ground-breaking efforts to manage key political and government risks, the deal came perilously close to collapse on October 30, 2006, just a day before RVR was scheduled to take over the railway. A key member of Sheltham's consortium pulled out, meaning that the equity was no longer in place and the financial closing with lenders (KfW and IFC) scheduled for later that day, had to be called off. Collapse of the deal with RVR would have meant starting the procurement process over; Sheltam would have lost millions in project preparation costs as well as over $3 million in operating costs already incurred.[161]

Sheltam was given 45 days by the two governments to rebuild its consortium with a new set of credible investment partners and source the $24 million equity required by the lenders as a precondition to financial close of the debt facility. The lenders insisted that this be provided as proof of the consortium's ability to raise money from its own sources to run the railway. In a whirlwind series of meetings and negotiations, three new shareholders were recruited. Instead of Sheltam selling its stake in the company, new shares were created and offered to the new shareholders with the proceeds going into the business. The new partners included Trans-Century, a strong Kenyan institutional investor (20%), global infrastructure company Babcock & Brown (10%), and the Industrial and Commercial Development Corporation Investment Company, another Kenyan investment company listed on the Nairobi Stock Exchange (10%). Significant involvement by a Ugandan investor was still missing, but the shareholders pledged to cede up to 15% to such an investor in the future. On December 14, 2006, at 4:29p.m., the respective governments were paid their one-time entry fees ($2 million

[161] *Ibid.*

for Uganda and $3 million for Kenya), and the deal was finally closed with a few hours to spare.[162]

One of the other challenges is that RVR proved not to have sufficient expertise in actually running a railway operation to begin improving the system's revenues. Lead shareholder Sheltam Ltd took on operational responsibility, but without bringing in outside technical expertise to manage the operation as the government had expected.[163]

Second, because revenues were not improving, RVR was not making required initial investments and was eventually unable to make fee payments to the government owners. The operator reported a loss in 2008 of Sh1.8 billion ($24 million) on revenues of Sh3.7 billion. This was three times the reported loss the year before. The dire financial problems of the operator caused lenders to withhold loans needed for more capital-intensive improvements. The business continued to suffer.

Third, in early 2009 government officials in both countries began talking about canceling the concession,[164] and the RVR consortium was prompted to take action. The smaller shareholders had begun to view Sheltam's deteriorating relationship with the governments and lenders as a principal obstacle blocking new investment finance. These shareholders proposed a change in the concession agreement requiring that the consortium have a lead investor with at least a 35% shareholding. Their idea was to dilute Sheltam's shareholding to 10% from 35%, with the difference taken up by Trans-Century, the Kenyan equity firm that

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162 *Ibid.*

163 *Ibid.*

164 *Struggling Concessions Under Review.* Railway Gazette International 4th September 2009 Available at http://www.railwaygazette.com/nc/news/single-view/view/struggling-concessions-under-review.html Accessed 24th September 2011. Here it is also stated that "A report by Kenya's Auditor General Prisca Komora presented to parliament in July found that KRC 'is technically insolvent', relying on 'financial support from the government and its creditors'. This was attributed in part to a failure by RVR to meet its committed payments for use of state-owned railway assets. KRC had reported a loss of KSh1bn for the year to June 30 2007, covering the start of the concession on November 1 2006, and a loss of KSh1·9bn was projected for 2008-09."

had stepped in at the last minute to save the deal in December 2006. At the same time, RVR acknowledged its operational weaknesses and announced its intention to engage the services of America Latina Logistica of Brazil as a technical partner to strengthen operational management.[165]

Fourth, Sheltam responded to Trans-Century's proposal by selling 49% of its company to Ambience Ventures Ltd, a subsidiary of Egyptian private equity firm, Citadel Capital. This gave Ambience half of Sheltam's share in RVR, or 17.5% of total shareholding in the rail company. Saying that it invests only in companies over which it has shareholder control, Ambience indicated that it was eager to become the largest shareholder in RVR.

By December 2007, Kenya Railways, the Government of Kenya and the business community noticed performance of railway deteriorating. Freight volume decreased by roughly 10% pa and service quality became unreliable.[166] Between December 2007 and April 2008, RVR's business was adversely affected by political events linked to the disputed 2007 Presidential polls. This culminated in RVR defaulting on the payment of quarterly concession fees. In June 2008, KRC commenced issuing default notices on fees, freight as they became due.[167]

By August 2008, RVR admitted having financial, technical and corporate governance challenges and proposed restructuring & amendment of the Concession Agreement. The

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165 *Ibid.*

166 Muli,N., "Development of Modern Rail Infrastructure & Managing Concession Contracts." Paper presented during the KSC Workshop On International Best Practice in Transport & Logistics at Whitesands Hotel, Mombasa. 17th-18thFebruary, 2011. *See also* Patrick Kagenda, "*Kenya, Uganda governments stuck with bad concession over legal complications,*" The Independent (Uganda) 28th January 2009

167 *Ibid.*

Government of Kenya, Uganda Government, Kenya Railways, Uganda Railways and RVR concluded negotiations and signed Deeds of Amendment on August 25, 2010.[168]

Under the amendments, Sheltam Ltd was replaced by KURH Ltd, a Special Purpose Vehicle, as the Lead Investor. The shareholding was also restructured such that Citadel Capital of Egypt (Ambience Rail & Ventures) held 51%, TransCentury from Kenya (Safari Rail) held 34% while Bomi Holdings from Uganda held 15%. KURH was also required to inject additional minimum equity capital of USD 40million within 24 months.

A look at the genesis of these amendments to the concession agreement reveals the fierce battle between the shareholders for the control of the concession. The Business Daily reported in 2010 that[169]

> Citadel made the controversial entry into RVR's board after it acquired a 49 per cent stake in concession leader Sheltam - beating a local private equity group TransCentury that was eyeing the same stake.
>
> TransCentury, Kenya's best known investment group with powerful political backing, has been waging an epic battle for the stake even after its partners in the 25-year concession declared Citadel's entry a done deal.

3.4. THE GENESIS OF THESE CHALLENGES – REGULATORY GAPS

As serious as they appear, the challenges discussed above are only a manifestation of the real problem that faced the Kenya-Uganda Railway Concession – regulatory gaps.

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168 *Ibid.*

169 *RVR Consortium Strikes New Ownership Deal.* Business Daily 24th January 2010. Accessed at http://www.businessdailyafrica.com/Corporate+News/-/539550/848590/-/view/printVersion/-/72oi4hz/-/index.html on 12th August 2011

At the time the concession was negotiated and entered into, there was no legal framework to cover the concessioning. A proper legal framework would have helped by outlining the process of concessioning, the requiring for bidding and the selection criteria for the best bidder. Such a framework was not in existence at the time the Kenya Uganda Railway was concessioned.

The concession was also done without full appreciation of the fact that lack of regulation of infrastructure operations results to exposure to inherent risks as a result of its complexity, the temptation to use it for political objectives, the limited capacity of regulators, the need to balance discretion vis-à-vis flexibility in regulatory framework and the need for efficiency in performance and marshalling of investment - since these activities generally face shortages of capital investment or maintenance.

Privatization of infrastructure also risks the introduction of private sector monopolies that will exploit their economic power, leading to supernormal profits (high "producer surplus") and reduced consumer welfare (a lower "consumer surplus"). Consumers may suffer from no – or a limited choice of – goods and services and face monopoly prices. A key requirement for privatization success then becomes the effectiveness of the regulatory regime in promoting competition or in controlling the anti-competitive behaviour of dominant firms.[170]

However, merely having legal structures and institutions in place without an enforcement incentive and orientation leads to opportunism and exploitation in the short run and a tendency to treat such issues as mere "window-dressing" in later concessions.[171] It has been

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[170] Kirkpatrick,C. et al, "Foreign Direct Investment in Infrastructure in Developing Countries: Does Regulation Make A Difference?" Available at http://www.unctad.org/en/docs/iteiit20061a6_en.pdf Accessed 12th August 2011

[171] Strong, J.S. et al, "Managing Risks of Infrastructure Investment in Latin America: Lessons, Issues, and Prescriptions." Inter-American Development Bank Working Paper (Washington) Accessed at

proved that the probability of renegotiation decreases with the level and effectiveness of enforcement measures.[172]

In a study on the risks of privatisation in Latin America, it was found that in many cases, the regulatory institutions and procedures were not in place at the time of contract award.[173] The study found that due to these gaps in regulation, most of the concession contracts had to be renegotiated after they were signed. In 72% of the cases studied, contracts were renegotiated as actual regulatory behavior diverged from the conceptual framework in the agreement.[174] The study found that in cases where the concessions were entered with a regulatory framework in place, only 19% of the contracts were renegotiated.[175]

The study also found that the stronger the legal grounding (constitution, law, decree, administrative rule) was, the lower the probability of renegotiation. Thus, when the regulatory system is imbedded in the general law, less of these challenges will be experienced. In general, the key seems to be the ease of which either party can unilaterally amend the regulatory system, either through decree or administrative discretion.

Such a legal framework must be backed by strong enforcement. The regulation debate has moved from mere development of legal and regulatory institutions, but ones that are seen as credible as well. In settings in which concessions are new, the importance and visibility of the first enforcement decision can hardly be understated. The reputation effect is critical in driving behavior and incentives of operators of subsequent concessions.[176]

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http://www.ppp.mg.gov.br/biblioteca/downloads/Managing%2520Risks%2520of%2520Infrastructure%2520Investment%2520in%2520Latin%2520America%2520Lessons%2520Issues%2520and%2520Prescriptions.pdf on 12th August 2011

172 Laffont,J. *"Enforcement, Regulation, and Development,"* Mimeo, June 12, 2001.

173 *Ibid.*

174 *Ibid.*

175 *Ibid.*

176 *Ibid.*

Due to lack of stringent enforcement, it is widely reported that in practice, many concessions ignore many or all of their reporting obligations under the concession agreements. In some cases, this situation obtains because of operator intransigence, in others because of a lack of expertise or initiative. Not surprisingly, both politicians and bureaucracies are often ill informed about the problems facing a concessionaire and the remedies being attempted. The Kenyan concession agreement, like many others, has a long list of requirements for the concessionaire to meet, and allowing reporting to be ignored inevitably creates plenty of scope for later disputes. Regulatory bodies must strengthen their capacity and impose annual independent financial and operational audits as part of concession contracts. One solution for funding the regulatory bodies is to use the concession fees, but funding from a land transport fund, if one can be established, may be preferable.[177]

Perhaps if Kenya had in place a proper legal and regulatory framework for concessioning at the time the concession was negotiated and entered into, we would not have experienced some of the problems we have seen to date.

3.5. THE LEGAL, REGULATORY AND INSTITUTIONAL FRAMEWORK FOR THE KENYA UGANDA RAILWAY CONCESSION

The process of negotiating the Kenya-Uganda Railways concession took around 7 years during which time there was no specific legal framework for PPPs in the country.

The two key Acts of Parliament that variously spells out the legal framework for PPPs in Kenya are the Privatization Act[178] which after some delay was given Presidential Assent on

[177] *Supra.*, note 134
[178] No. 2 of 2005

13th October 2005, and the Public Procurement and Disposal Act,[179] assented on 26th October 2005. This is therefore one of those areas where the law plays catch-up with advancements in government policy and practice.

The Privatization Act

This is an Act of Parliament which was passed to provide the framework for the government to offload its stake-holding in previously public-held enterprises. The Privatisation Act 2005 was enacted after nearly a decade of botched privatisations in which the public lost billions of shillings through asset-stripping and undervaluation by politically-connected businessmen. The Privatisation Act states that public assets can only be transferred to the private sector through public offering of shares, concessions, leases, management contracts and other forms of public-private partnerships or negotiated sales resulting from the exercise of pre-emptive rights and the

sale of assets, including liquidation. The law also gives leeway for any other mode authorised by the cabinet in the approval of a specific privatisation proposal.

In the Act, privatization is defined to include all transactions that result in the transfer to a private entity the assets, operational control and operations of all public assets.[180] It includes PPPs as one of the methods of privatization which in turn includes concessions.[181]

The Act also establishes the Privatisation Commission as a body corporate with functions to formulate, manage and implement the privatization programme, the institutional structure for implementing PPPs as part of the privatization programme is clearly established.[182]

179 No 3 of 2005
180 Privatization Act, Section 2
181 *Ibid*, Section 25 (b)
182 *Ibid*, Section 3

Public Procurement and Disposals Act, 2005

The Act was passed in 2005 and came into force in January, 2007. The purpose of the Act is to establish procedures for procurement and the disposal of unserviceable, obsolete or surplus stores and equipment by public entities.

With specific regard to PPPs, this is recognised by the Act under Sec. 92 (1), which states that

> "A procuring entity may use a procurement procedure specially permitted by the Authority which may include concessioning and design competition. For the purpose of this section... "concessioning" means a procurement that encourages the mobilization of private sector resources for the purpose of public financing, construction, operation and maintenance of development projects and may include build-own and operate, build-own-operate and transfer, build-operate and transfer or similar types of procurement procedures."

Pursuant to the passage of this Act, the Minister for Finance made the Public Procurement and Disposal (Public Private Partnerships) Regulations, 2009. These regulations define a PPP as[183]

> an agreement between a procuring entity and a private party under which
>
> a. the private party undertakes to perform a public function or provide a service on behalf of the procuring entity;
> b. the private party receives a benefit for performing the function, either by way of-
>   i. compensation from a public fund;

[183] Public Procurement and Disposal (Public Private Partnerships) Regulations, 2009, Regulation 2

ii. charges or fees collected by the private party from users or customers of a service provided to them; or

iii. combination of such compensation and such charges or fees.

c. the private party is generally liable for risks arising from the performance depending on the terms of the agreement.

At Regulation 3, the Regulations detail the various number of ways in which government entities can enter into parterships with the private sector. It provides that a public entity may enter into

(c) a concession for a period not exceeding thirty years whereby the private party maintains, rehabilitates, upgrades and enhances the facility in question.[184]

The Regulations also established a Public Private Partnership Steering Committee which shall consist of the Permanent Secretary to the Treasury who is the Chairman, the Attorney General or his representative, the Permanent Secretary, Office of the Prime Minister, Permanent Secretary for the Ministry responsible for Planning, National Development and Vision 2030 and three other members not being public servants appointed by the Minister from a list of nominees from private sector bodies approved by the Cabinet.

According to the Regulations, the Steering Committee is responsible, among others, for spearheading the public private partnership process and promote understanding and awareness of PPP's among key stakeholder groups, reviewing challenges constraining participation or realization of full benefits expected from PPP's and formulating time bound solutions to address the challenges and to create an enabling environment, establishing public

[184] *Ibid.*, Regulation 3 (1) (c)

private partnership standards, guidelines and procedures including development of standard procedures for conceptualisation, identification, prioritisation, development, assessment of PPP projects and development of standardised bid documents, reviewing direct and indirect liabilities and assessing contingent liability risk exposure of the Government and advise on the acceptable levels of direct and indirect liabilities, ensuring that all proposed public private partnership projects are consistent with the country's national priorities outlined in various policy documents, coordinating with the Public Procurement Oversight Authority established under the Act to ensure that all tender phase activities of PPP projects conform to procurement best practices, and approving public private partnership projects submitted to the Committee.[185]

The committee is to be supported by a PPP Secretariat which is to operate out of the Ministry of Finance.[186] The Regulations also provide for considerations when determining the duration of a PPP[187] as well as performance indicators for assessing the performance of PPPs.[188]

There are several problems with this legal framework as far as concessions are concerned. First, it came into place after the Kenya Uganda Railway was concessioned. This means that the concession was conducted in a lacuna which created room for the selection of an unqualified concessionaire, and gave birth to many of the problems that have bedeviled the concession. Secondly, although the Privatization Act and the PPDA were an attempt at sealing the lacunae in the legal framework, they have not been quite effective in this endeavor. The law has not provided an adequate framework for bid processing, contractor selection and contract management when it comes to concessions. It also lacks a strong

185 *Ibid.*, Regulation 5
186 *Ibid.*, Regulation 7
187 *Ibid.*, Regulation 12
188 *Ibid.*, Regulation 14

regulatory institution for oversight purposes, an institution which has enough power to ensure all parties to the concession perform their obligations.

This can explain the fact that the passage of the Privatisation Act, the PPDA and the PPP Regulations do not seem to have ameliorated the situation, since some of the squabbles at RVR persisted way after these laws came into place.

Perhaps in recognition of the weaknesses in these laws, the government is now considering a Public Private Partnerships Bill to revamp the legal framework for the regulation of PPPs.[189] The Public Procurement and Disposal (Public Private Partnership) Bill 2011 will put in place procurement and management structures to promote public-private partnership (PPP).

3.6 CONCLUSION

Kenya joined the concessioning bandwagon in the late 1990's hoping to reap some of the benefits that other countries have enjoyed by concessioning their infrastructure. There was a lot of hope that the concessioning of the railway line would invite huge investments from the private sector, and result in more superior quality service provision. It was anticipated that the cost and time spent in the movement of goods and people around the country would reduce significantly, while government revenues would increase through improved tax collection. However, this was never to materialize.

The concession has persistently been faced by numerous problems with no significant improvement in service delivery. One of the reasons for this sorry state of affairs is the lack of a proper legal framework for concessioning at the time the railway was concessioned.

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189 *Law On Way for Public and Private Partnership*, Daily Nation 11th September 2011

With no legal framework, there were no proper criteria for selecting a concessionaire, and no proper institutions to regulate the concession. The experience Kenya has had should awaken it to the need to pass concession-specific legislation, especially now that there are other proposals to grant concessions for some of the major highways like Mombasa Road.

CHAPTER 4

RAILWAY RESTRUCTURING AND REGULATORY REFORM

THE BRAZILIAN CASE STUDY

4.0. INTRODUCTION

In the previous chapter of this study we have looked at the Kenya Railway concession and the existing regulatory framework for concessioning Kenya. We identified several weaknesses and loopholes in the regulatory framework which led to numerous challenges experienced by the concession. In this chapter we will look at railway concessioning and the accompanying regulatory reform in other jurisdictions with a view to identifying some best practices which Kenya can emulate. Given the considerable success that concessioning has had in Latin America, we will look at Brazil as a good example of a country where a proper legal framework resulted in a successful concession.

4.1. RAILWAY CONCESSIONS IN LATIN AMERICA

The World Bank reports that the 1990s witnessed a spectacular wave of private sector participation in infrastructure around the world. Considering the four infrastructure sectors, transport, water, energy and telecommunications, US$754 billion was invested between 1990 and 2001 in around 2,500 projects with private sector participation in developing countries.[190] Of this, 48% was directed to Latin America and the Caribbean (LAC),[191] where these

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190 Harris, C.,"Private Participation in Infrastructure in Developing Countries. Trends, Impacts, and Policy Lessons." World Bank Working Paper No.5, (Washington D.C., 2003)

191 Sharp, R., "Results of Railway Privatization in Latin America," World Bank Transport Papers, TP-6, September 2005. Where it is reported that "About four dozen State railway properties in Latin America, principally freight railways, but also including urban/suburban passenger lines, have been placed under concession, over three dozen of those being predominantly or exclusively intercity freight carriers. In contrast, less than a dozen State rail properties in Africa have been concessioned, mostly very low volume carriers, and rail concessions elsewhere have been quite scattered."

investments were in their majority related to the sale or concessioning of existing assets. Within LAC, these flows were predominantly channeled to the telecommunications and electricity sectors, and, moreover, heavily concentrated in a handful of the larger economies: Brazil, Argentina, Mexico, and Chile.[192]

Interestingly, developing countries have not been alone in taking the privatisation route. Japan, New Zealand and the United Kingdom are among OECD countries to have introduced private ownership and management into their railway in one form or another. In the European Union, the trend is likely to accelerate as the terms of the European Commission's Directive 91-440 take increasing effect, because they require national networks to be structurally separated between infrastructure, freight and passenger services and opened up to cross-border participation.[193]

LAC's ability to attract such an inordinate share of infrastructure investment flows can be explained by the region's early opening of its infrastructure sector to private sector participation, the existence of substantial levels of unmet demands in practically all infrastructure sectors, and perspectives of macroeconomic stability and reasonably high growth.[194] In addition, to a much greater extent than in other regions, LAC went ahead with major divestitures of public enterprises. Thus, it is estimated around 60 percent of these capital flows were captured by the state as fiscal revenues associated with asset sales, while the remaining 40 percent were invested directly within the infrastructure sectors.[195] Many

[192] Sirtaine, S. et al "How Profitable Are Infrastructure Concessions in Latin America? Empirical Evidence and Regulatory Implications," Trends and Policy Options, (PPIF, No. 2, January 2005)
[193] Martin, B., *Railway Privatisation Through Concessions: The Origins and Effects of the Experience in Latin America*. Public World, 2002
[194] *Supra.*, note 5
[195] *Ibid.*

Latin American governments have gained experience in concessioning through private participation in electricity, telecommunications, and water and sanitation.

In the case of railways, at the end of the 1980s the industry was characterized in most LAC countries by a steady decline in market share started after the World War II. This was caused both by the failure to respond to the intermodal competition arising from road (freight) and air (passengers) transport and by the rigid market structure, often dominated by government-owned monopolies with a dire financial situation and very low efficiency records. Despite the long distances and the growing demand for transport, these national companies could only survive on public subsidies and the quality of their services and infrastructures were rapidly deteriorating due to lack of investment.[196]

By the mid-1980s many countries in the region were aware of these problems and realized that, due to their financial weakness, the only long-term viable solution required private sector participation. The rail industry embraced the reform with more or less forced enthusiasm. In most cases, however, even the constitutions or the sectoral laws limited the participation of private sector, not only in the ownership but also in the operation of services, which were attributed to the exclusive responsibility of the existing national monopolies.

Under these circumstances, the outright privatization of services and infrastructures was always a difficult policy choice. Important legal changes were needed to sell state-owned enterprises: Argentina and Chile had to change their entire legal systems, Brazil passed a new constitution in 1988; Mexicans had to reform theirs in 1995. Therefore, restructuring mechanisms without full privatization – particularly those involving concession of rail

[196] Campos, J. and Cantos, P., "Rail Transport Regulation", in G. de Rus and A. Estache (Eds.) *Privatization and Regulation of Transport Infrastructures: Guidelines for Policymakers and Regulators.* (Washington, D.C., 2000) p.21

services while keeping the ownership of the assets – were preferred in most countries. The most relevant concessioning experiences in the region – in terms of the size of the rail industry, the amount of investment involved and the comparability with other countries – were those of in Argentina, Brazil and Mexico.

Latin America's private sector participation in infrastructure programmes was generally part of a broader set of policy reforms. The reforms were expected to improve much needed sector performance, increase levels of service coverage, and attract private sector financing for long-delayed investments in infrastructure expansion and upgrading, thereby enabling scarce public funds to be used for investment in the social sectors and for the creation of fiscal benefits by creating sale revenues and reducing ongoing subsidies.[197] Moreover, a principal objective of Latin American railway concessioning was to relieve the large public debt burden that over-staffed and under-performing public railways were imposing on governments.[198]

4.2. RAILWAY CONCESSIONING IN BRAZIL

4.2.1. Development of the Railway in Brazil

In common with other Latin American countries, Brazil's railway developed in the context of exploitation of natural resources for export in the late 19th and early 20th century. Having established its political independence from Portugal, during the 19th century, Brazil easily fitted into the world economic order dominated by Britain.[199]

197 See *Supra.*, PPIF note 139

198 Guasch, Laffont and Straub, "Infrastructure Concessions in Latin America : Government-led Renegotiations", World Bank Policy Research Working Paper 3749. 2005

199 *The Brazilian Economy: Growth and Development*, Werner Baer, Praeger, 1989

Brazil became, in fact, a typical example of such a country in that its economy was dependent on one major primary export product (coffee) and a few others (sugar, cotton and cocoa), whilst being open to foreign (mainly British) manufactured products and foreign (mainly British) capital. That capital flowed into the country and was designed to build a financial, commercial and transport infrastructure that would link the country more efficiently into the nineteenth century world economic order'.[200]

However, the idea (promoted in some World Bank literature) that concessions rather than public ownership represent the natural and best order of things is undermined by the difficulties arising from the concession approach when railways were first developed. The first railway of Brazil was opened in 1854. The railway covered a distance of 14.5 km.[201] After this first railway, several other railways where build. The rail projects from mining areas to ports since the mid 1980s account for the bulk of the railroads.[202]

In Brazil, there were several concessions, most of which were awarded to British firms, and some of which went to French companies. It was a lucrative business: concession firms were paid subsidies by the state and they were also guaranteed rates of return.

Consequently, there was considerable patronage involved in the choice of concessionaires. The results of developing railways in this way included many problems. According to one account, different lines were constructed with different gauges, they linked plantations to the port, and there was a tendency for many lines to meander instead of linking the interior with

200 *Ibid.*, See also Shapiro, H, *Engines of Growth. The State and Transnational Auto Companies in Brazil* (Cambridge, 1994)

201 Williams, G., "Railways in Brazil." (2006). Retrieved 29th September 2011, from World Railways: http://sinfin.net/railways/world/brazil.html

202 Mongabay.. "Brazil Railroads." (1997) Retrieved 29th September 2011, from http://www.mongabay.com/history/brazil/brazil-railroads.html

the port in the most efficient way. The resulting transportation system did not link the country into a more unified market.[203]

These and other deficiencies, together with the financial burden of guaranteeing rates of return to their foreign owners, became increasingly onerous for the Brazilian state. It was felt that borrowing money abroad in order to buy a number of railroads would ultimately be less burdensome on the economy. Thus, in 1901 the Brazilian government contracted a large loan in order to nationalise some of the railroads. This process continued over the years. By 1929 close to half of the railroad network was in government hands, and by the 1950s this had grown to 94 per cent.[204]

4.2.2. The Concessioning in Brazil

Brazil faced similar fiscal restraints than Argentina, although the greater dispersion of the rail network forced a more extensive and difficult geographical restructuring. In fact, the first rail line in Brazil was completed in 1854 by private foreign capital. During most of the following 100 years, private operators dominated the industry, but with an increasing participation of the public sector. In 1957, culminating nationalization policies of previous years, Federal Law 3115/1957 was enacted, incorporating under the jurisdiction of the Ministry of Transport the government-owned Federal Rail Network Corporation (RFFSA or Rede Ferroviária Federal, Sociedade Anônima). Twenty years later, a second operator in the form of a state-owned corporation, Ferrovias Paulistas, Sociedade Anônima (FEPASA), was created by State Law 10410/1974, which also established rules for the state of Sao Paulo financing of uneconomic rail services, absorbing the contributions to the workers pension fund, and other liabilities of the existing operators within that State.

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203 *Supra.*, note.7
204 *Ibid.*

These two operators provided rail transport services to about 95% of the country's freight shippers, whereas the third important operator (and the largest in terms of output at the beginning of the 1990s) was the Companhia Vale de Rio Doce (CVRD), a huge government-owned industrial holding that exploited two specialized rail lines, EFVM (Estrada de Ferro Vitória a Minas) and EFC (Estrada de Ferro Carajás), from their mining sites to the ports in the north and center of the country. This company only served its own traffic, which mostly consisted of large volumes of iron ore for export.[205]

By 1996, several restructuring procedures had been already tried to tackle the most urgent needs of the industry while maintaining it within the public sector. These policies, however, were not enough and the government started to look at the Argentina experience. Encouraged by this example, Decree 473/1992 included RFFSA in the Brazilian National Privatization Programme in a political movement that represented the first major privatization of public infrastructure services. At this moment, in view of the geographic characteristics of the country, the size and state of conservation of the railway network, as well as the significant cross-regional differences in traffic, it was decided that the restructuring process could be more easily implemented if based upon RFFSA's existing regional structure.[206]

RFFSA's network was separated into six vertically integrated monopolies (called malhas) whose rail services would be concessioned out by the Ministry of Transport, and whose rolling stocks and existing infrastructures would be simultaneously leased by RFFSA to the private operator. The reason for this double concession-leasing method was that, according to the 1988 Constitution, the federal government had to remain the titular to the right of

[205] Thompson, L., "Liberalization and Commercialization of the World's Railways: Progress and Key Regulatory Issues," Paper Presented At The OECD International Transport Forum In Paris, 2009
[206] *Ibid.*

providing rail transport services in the country and, in addition, retain under its ownership the assets involved in those services.[207]

Six concessions – Nordeste, Centro-Leste, Sudeste, Sul, Teresa Cristina and Oeste – were awarded between 1996 and 1997. Four of these railroads connected ports along the coast with their respective hinterlands, approximately 400 kms inland. On December 23, 1997, FEPASA was transferred to the federal government and in May 1998 the Malha Paulista, as it was also known, was immediately included in the privatization programme. Its sale took place in November 1998 and concluded the privatization process of former government-owned rail operators.[208]

Finally, when CVRD was privatized in June 1997 its two railroads (EFVM and EFC) were sold with it as part of the industrial holding; they were not concessioned in the same way as the RFFSA network. Since they had been originally designed to connect the company's mines and mills with one another and with the exporting ports of Vitória, Tubarao and Sao Luis, the railroads were kept with the company under control of the new owners. The two railroads essentially now operate as internal departments of CVRD, specialized in iron ore traffics, although they are obligated to carry traffic for other shippers as well.[209]

Except in the case of CVRD, the concessioning was implemented through public competitive bidding for the operation and maintenance of each of the malhas for a period of 30 years

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207 Castro, N., "Privatization Of The Transportation Sector in Brazil," Available at http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_en/Galerias/Download/studies/ensa10-7.pdf Accessed 1st October 2011

208 *ibid.*

209 Campos, J and Jimenez, J., "Evaluating rail reform in Latin America: Competition and investment effects" Paper Presented during the Conference on Railroad Industry Structure, Competition and Investment. Toulouse 7-8 November 2003. Available at http://idei.fr/doc/conf/rai/papers_2003/campos.pdf Accessed 1st September 2011

(renewable for another 30 years at most) with the simultaneous leasing of operational assets by RFFSA and the sale of some small non-operational assets. There were no prequalification requirements for candidates and the only limit established to avoid excessive concentration of ownership was that the share of each economic group participating into a concession should be limited to a maximum of 20% of total stock. However, no restrictions were imposed for cross-participation in different concessions or about the participation of major rail users, clients or suppliers as shareholders in privately operated concessions.[210]

Each auction was won by the highest bid consortium, whose bid had to be above a minimum stipulated by the government. The amounts paid by each concessionaire – a down payment of between 10-30% of the minimum price and quarterly installments for the rest – were shared by the Federal Treasury (5%, corresponding to the concession of rail services) and RFFSA (95%, corresponding to the lease of assets). Five of the seven RFFSA concessions sold for more than the minimum bids. This success was due in part to the fact that the government reduced the workforce by approximately half in advance of the concessioning, and also in part due to the relatively stable macroeconomic environment during these years. The government had to receive a total of about R$1,700 million (US$950 million) for the seven concessions, although only about R$400 million was paid in the first installments with the rest due (after a 1-3 year grace period, depending on the concession) in 108-112 quarterly payments over the remaining life of the concessions.[211]

4.2.3. Legal and Regulatory Framework of the Railway Concession in Brazil

Brazil's national privatization programme was instituted by Law 8,031, of April 12, 1990 (replaced by Law 9.491, of September 9, 1997 and subsequent amendments thereof) and is

[210] Pinheiro, A., "Regulatory Reform In Brazilian Infrastructure: Where Do We Stand?" Texto Para Discussão Nº 964

[211] *Ibid.*

regulated by Decree 2,594, of May 15, 1998 (as amended). The statute applies to the sale of certain assets owned and/or companies controlled by the Federal Government. The concession of public services to private entities was also defined by Law 9.491 as one type of privatization. The privatization programme has been extended not only concessions for public services controlled by the Federal Government but those of States and Municipalities as well.[212]

The overall regulatory system with respect to concessions in Brazil is based on the Federal Constitution, the Auctions and Public Contracts Law[213], the Concessions Law[214], and the Public Partnership Law.[215] The latter two are the most significant to this study and are discussed in detail below.

The Federal **Constitution** (1988) establishes that the private sector can only provide public services through concessions and permissions, always preceded by public auctions.

In order to implement the privatisation plan in the early nineties, the **Auctions and Public Contracts Law** and the Concessions Law were approved by the Congress.[216] In summary, what these two laws established that infrastructure services privatisation could only be done through concessions, and that a private partner could only be contracted through public auction, as determined by the Constitution. This is the rule for all concessions to Federal Government, States and Municipalities in all infrastructure sectors. Exemptions are only

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212 World Bank, "The Regulatory Framework of FDI in Brazil," Available at http://www.fdi.net/documents/WorldBank/databases/brazil/fdilaw_brazil.pdf

213 No. 8666/93

214 No. 8987/95

215 No. 11079/04

216 Although both laws apply for every infrastructure sector, each sector has also a legal framework that establishes the sector regulatory agency and that establish some particularities of the concession awarding process. Some of these laws are Law 9472/97 for telecommunications; Law 10233/01for roads, railways, surface and water and transportation and Law 9427/96 for electricity.

accepted in emergency cases, when services are interrupted and for a short and limited period of time.[217]

4.3. The Concession Law

Law 8987/95, in its 47 articles and several subsections, deals with several different issues, the most important of them being that a concession is the operation of public facilities and services, for a determined period, at the concessionaire's risk; it can involve exclusively the rendering of a service or the rendering of a service coupled with the construction of public works or facilities; the concessionaire must recoup its investment exclusively from the revenues collected from the users, within the term of the concession.

The law also provides that concessions will be awarded only through a public bidding process[218]; the criteria for award in such bid processes can be economic (lower rates to be charged from the users, higher payment to the state in consideration for the right to exploit the concession), technical (best technical solutions) or a mix of both. Additionally, prior to the bidding process, the government sphere responsible for that public service or facility must justify, through a written report, why the development of the service through a concession is convenient for the public interest.[219]

The concessionaire is also bound by the law to abide by minimum service levels that should be established in the Concession Agreement. There is also the possibility of the unilateral amendment of the Concession Agreement by the government, for protection of the public

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217 Submission by Brazil during the OECD Global Forum on Competition - Roundtable On Concessions Available at http://www.oecd.org/dataoecd/40/39/36017795.pdf Accessed 3rd October 2011

218 Art. 4. A public service concession, whether or not preceded by public works, shall be executed by contract complying with the provisions of this Law, applicable rules and a public bid procedure.

219 Art. 5. Prior to the public bid procedure the concession authority shall publish an act justifying the convenience of granting a concession or permit and specifying the purpose, area and term.

interest, but also the right of the concessionaire to have the Concession Agreement changed in its favor, so that the initial economic balance of the agreement is always preserved.[220]

Moreover, the bid procedure must allow for an objective comparison between all proposals, and must contain all the rules that will be relevant for the concession; the draft Concession Agreement will be a part of the bid documents, and is an adhesion agreement, it may not be changed through negotiations with the government.

It is also stated that the concession may not be transferred without the previous express consent of the government, directly or indirectly; in each case the new concessionaire must meet the same criteria that was applicable to the previous one.[221] However, the concessionaire may give rights, assets and future revenues related to the concession as warranties in financing agreements, with the exception of assets considered to be essential for the rendering of the relevant public services; the lenders have step in rights in case of the concessionaire's default, in order to restructure the concessionaire[222]

The government is given the responsibility to permanently oversee the rendering of the services, and may apply penalties to the concessionaire in case of non-compliance with service rules and the Concession Agreement; such penalties, however, may only be applied after the concessionaire has made use of its rights of ample defense and due process; the penalties must be progressive; reiterated non-compliance may cause the unilateral revocation of the concession, for cause. The government also has power to intervene in the concession

[220] Art. 9. The tariffs for public services rendered under a concession shall be set by the winning bid in the tender and according to the rules for revision set forth in this Law, the invitation to bid and the concession contract.

[221] Art. 27. The transfer of a concession or of corporate control of the concessionaire without the prior consent of the conceding authority shall imply forfeiture of the concession.

[222] Art. 28. In the financing contracts, the concessionaires may offer the rights emerging from the concession in guarantee, up to a limit that does not impair the operation and continuity of the service.

and take over its operation if the services are not being rendered satisfactorily.[223] The government may also revoke the concession without cause, in the public interest, but only through the enactment of a specific parliamentary act in that regard, and after full indemnification is paid to the concessionaire.[224]

Another key provision is that all assets and rights related to the concession will revert to the government after the concession ends; in case there are investments made by the concessionaire which have not been fully amortized the government will indemnify the Concessionaire.

The concessionaire also has powers to terminate the agreement. In case the government is not performing on its obligations pursuant to the Concession Agreement, the concessionaire may seek to terminate the Concession Agreement, but this must be done through the filing of a lawsuit before the relevant courts.

One major weakness of this concession law is that it did not allow the government to complement the funding provided by private investors, or to assume some of the risks taken up by the concessionaire. To remedy this situation and make concessions more attractive, Brazil passed a new law, the Federal Public-Private Partnerships Law.[225]

4.4. The Federal Public-Private Partnerships Law

This statute modified and complemented the provisions of the Concessions Law. It created two new kinds of concessions, apart from the "at its own risk" concession of Law 8987/95.

[223] Art. 32. The concession authority may intervene in the concession in order to ensure adequate service-rendering and full compliance with the applicable provisions of law, regulations and the contract.
[224] Art. 37. Expropriation is the recovery of the service by the concession authority during the concession term for reasons of public consequence and necessity, by specific authorizing law and after prior payment of indemnity, pursuant to the preceding article.
[225] Law 11.079/04

These are (i) the Sponsored Concession ("*Concessão Patrocinada*"), which is basically a concession in the fashion of Law 8987/95 in which the state is allowed to complement the concessionaire's revenues and/or share and mitigate risk with the concessionaire, and (ii) The Administrative Concession ("*Concessão Administrativa*"), which is not really a concession at all, but a modality of provision of long term services to the state (and not to the end users) coupled with the private construction of the necessary facilities for the rendering of the services.

The main provisions in the Federal PPP Law are:

i. The statute's rules are applicable to all federal PPPs; it provides also general rules to be applicable to the States' and Municipalities' PPPs.[226]

ii. The minimum value for a PPP is R$ 20,000,000.00 (twenty million reais), the minimum term is 5 (five) years and the maximum term is 35 (thirty five years).[227]

iii. The lenders have step-in rights, and the state is authorized to pay the consideration arising from the PPP Agreement directly to the lenders, if the relevant financing agreements so establish.

iv. The state's consideration may be paid to the concessionaire in cash, in the form of non-tax credits, in the form of other rights in face of the state, use of government real estate, and other lawful means provided for in the relevant Concession Agreement.

v. The state is authorized to establish a performance based remuneration to the benefit of the concessionaire.

[226] Art. 1. This Law establishes the general rules for tenders and contracting of public-private partnerships under the ambit of the branches of the Union, States, Federal District and Municipalities.

[227] A public-private partnership may not be entered into when the contractual value is less than R$ 20,000,000.00 (twenty million reais), when the term of the service is less than 5 (five) years; or when the subject matter is only the supply of labor, the supply and installation of equipment or the execution of a public work.

vi. The state may only make any payments to the concessionaire after the services are made available; partial payments for partial availability of services is allowed.

vii. The state may provide warranties to its payment obligations, in the form of segregation of revenues, use of special funds, hiring of performance bonds with independent insurers, warranties posted by multilateral institutions or independent banks, warranties provided by special funds or companies created with this aim by the state.

viii. The federal government will establish a fund to provide warranties to its obligations pursuant to PPP Concession Agreements.

4.5. Management of Concessions

The Concession Law provides a clear separation of functions between ministries, regulatory agencies and the competition authority. The role of planning and deciding if some service shall be privatized is executed by sectoral ministry (for example, Ministry of Transportation or Ministry of Telecommunications). The role of designing and overseeing the allocation and operation of concessions is conducted by the sector regulatory agency,[228] whereas competition and antitrust policy is taken care of by a separate competition authority.[229]

The three levels of government may award concessions in Brazil, i.e. the federal government, state governments and municipalities. The general rule, based on the Federal Constitution, is that one level of government may only award concessions for the public services which it is responsible for. Following this rule, federal government is responsible for: electricity generation and transmission, telecommunications, railways and federal roads. States are

[228] OECD: Joint Concessioning of the Kenya Railways and Uganda Railways (May, 2005) Session 5 Investment for Africa Development: Making it Happen, Entebbe, Uganda

[229] Gustavo, M et al, "Competition Law in Brazil" Available at http://www.wcl.american.edu/blr/04/1pinto.pdf?rd=1 Accessed 11th September 2011

responsible for gas, electricity distribution (although the regulatory agency is federal) and state roads. Municipalities are responsible for water and sewage and local roads.[230]

Disputes between government and concessionaire first must be solved administratively by sector regulatory agency. If both parts do not arrive to reasonable solution they may go to the Judiciary. In 2005 the possibility of arbitration was introduced in the Law of Concessions in order to allow faster solutions for both parts.[231]

The new rail regulation (Decree no. 1832), issued in March 1996, defines multiple key factors: operators are allowed to freely set their prices for services if they face effective competition, including tariff differentiation to account for the needs of individual shippers; operators are required to enter into reciprocal switching or, when this is not possible, they must quote unbundled rates and provide connecting service for joint hauls; the regulators must allow operators to set prices that are responsive to differences in demand and in marginal costs, and to enter into voluntary shipper contracts with individualized terms and conditions; and the prices which a railway sets for captive shippers over whom the railway has monopoly power are constrained using to a revenue ceiling defined by the stand-alone cost of providing service.[232] The regulation also obliges concessionaires to seek permission from the federal government before closing rail lines.

The concession contracts also address the relationship between concessionaires and shippers and define the maximum prices to be charged for transport services. Ceilings vary according to the length of the haul, type of product, and the geographic region served. These maximum

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[230] *Ibid.*
[231] *Ibid.*
[232] Estache, A. et al,, "*Privatization and Regulatory Reform in Brazil: The Case of Freight Railways.*" (2001) Available at www.seae.fazenda.gov.br/central_documentos/...1/doctrab09.pdf Accessed 12th August 2011

prices are to be revised periodically to correct for inflation. There also exists a vague notion regarding the concessionaire's obligation to maintain its financial and economic equilibrium: the concession contract stipulates that tariffs should be above the railroad's long run variable cost (although no methodology is provided for the calculation of those costs).[233]

Finally, the provisions of the concession contracts regarding captive shippers and joint traffic are worded in very broad terms. In general, the interested parties are expected to reach an agreement on these issues. If they do not, the government, through the Ministry of Transport (MoT), has the power to review the problem and set rates for captive shippers. As noted above, railroads are obligated either to carry joint traffic or to allow connecting railroads access to the tracks necessary to complete the movement. The two railroads are to negotiate the tariffs for joint traffic, but again the government can step in to set the rates or order access if the negotiations fail.

The institutional setting for the monitoring and enforcement of regulation has been evolving over time. It started with a fairly straightforward enforcement of the contractual commitment by the residual RFFSA. This responsibility was then moved to the Rail Transport Federal Commission (COFER) in the MoT.

4.6. CONCLUSION

Looking at the details of the legal and regulatory framework for railway concessioning in Brazil, it is not difficult to understand why it is a global leader when it comes to concessioning, and why it provides a good example for developing countries who want to pursue railway concessioning. The success that has been registered by Brazil is largely

[233] *Ibid.*

because of the vibrant legal and regulatory framework which existed before the concessioning, as well as the periodic adjustments that have been done to the law to meet the changing demands.

Kenya too can learn from the Brazil experience in modeling and improving its concession laws, so that in the end the users of the railway, the government and the concessionaires are satisfied with both the process and the outcome of the concession.

In the next chapter we will draw conclusions from the theory already covered and the experience of Brazil and make recommendations on how Kenya can move its concession law forward.

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.0. INTRODUCTION

In the previous chapters we have discussed the nature of Public-Private Partnerships, the Kenya-Uganda Railway concession and the legal and regulatory framework of railway concessioning in Brazil. This chapter is a summary of what has already been covered, done with a view to drawing conclusions and pointing out what aspects of international best practices in the regulation of concessions that Kenya can adopt in improving its own regime for concessions. We have seen that many of the challenges faced by the concession in Kenya were due to the lack of a proper regulatory framework, and conversely, that the successes of the concessions in Brazil resulted from its strong regulatory framework. So what lessons can Kenya learn from Brazil? Ultimately we want to improve the legal and regulatory environment for concessions in Kenya, and the chapter will make some salient proposals which, if adopted, will lead to a more robust regulatory system for concessions.

We have seen how transport is important for the development process in general and for the promotion of national, regional and international trade in particular, which significantly contributes to the eradication of poverty.[234] Weak infrastructure and inappropriate policy environments lead to inefficient transport services that result in high transport costs, which are a major impediment to trade expansion, competitiveness, and hence sustainable development in developing countries. The development of a coherent, national, regional and international transport network, combined with efficient transport services, are essential for

[234] Asian Development Bank and The World Bank Group, *Best Practices for Private Sector Investment in Railways*, (Manila, 2006)

stimulating economic activity, opening up productive areas and linking them to national, regional and international markets.[235]

The most common structure for the rail sector, over the last fifty years, in most countries was that of a single state-owned firm, entrusted with the unified management of both the infrastructure and the rail services.[236] State enterprises are not necessarily technically inefficient, for as long as they have recourse to deficit financing to maintain supply, railways have little incentive to be cost-effective or to respond flexibly to changes in user demand. Interference, from the government on matters relating to railway day-to-day operations, has often led to the railway enterprises having poorly defined goals and relatively passive management unlikely to respond to changing market conditions.[237]

Due to this ownership structure, railways in many countries around the world (including Kenya) have experienced a variety of interrelated problems including chronic financial deficits, growing operating subsidies, archaic pricing systems where charges are not related to cost, lack of an equitable fare structure and excessive fares, costs have been excessively high, low operating efficiency, poor management and technical efficiency, low labour productivity, severely congested services, low service quality, services have failed to respond to need, deficiencies in the physical infrastructure, poor asset maintenance, inadequate funds to invest in transport infrastructure and/or services, widespread state ownership and operation of transport infrastructure and services and low private sector participation in the transport sector.[238]

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[235] *Ibid.*
[236] Supra., note 92
[237] *Ibid.*
[238] *Ibid.*

For these reasons governments accord high priority to the transport sector by formulating and strengthening their policies to attract investment in infrastructure and related services. In this context, private sector participation has an important role in improving the quality of transport services. One of these policies is the involvement of the private sector through Public-Private Partnerships. Governments worldwide have increasingly turned to the private sector for additional resources, increased efficiency, and sustainable development in many fields, including transport infrastructure and services.[239]

One of the areas in which PPPs have been employed is in the financing of railway operations through concessioning. These arrangements avail additional funding for transport infrastructure which would otherwise not be raised but for the participation of the private sector. They are also touted as leading to more efficiency in the provision of services.

A typical PPP is an arrangement involving three parties – the government, the private sector and the public. The government has the primary responsibility to provide these services to the public, but contracts out the work to a private sector player who enters the arrangement for profit making purposes. The public will be interested in efficient services while the investor is interested in profits. But for all parties to realize their objectives, a proper framework for contracting and contract management must be in place.[240]

Against this backdrop, this paper set out to investigate the ideal regulatory framework for railway concessioning which Kenya can adopt for herself. However, it must be cautioned at the outset that no two railway systems are alike. Railway operations and services vary from country to country depending on the demand for services as well as the stage of development

[239] *Ibid.*
[240] *Supra.*, note 234

in other transport modes. For example, railway services range from one percent passenger traffic (in the U.S.) to over 90 percent passenger traffic (in several Asian countries, including Japan, Philippines, Indonesia, and Sri Lanka). Further, railway passenger transport services range from having insignificant suburban service (as in PRC) to as much as 90 percent (as in the Philippines). Because of the widely varying demands for railway services and the divergence in operations, the need for typical and specific solutions is obvious. [241]

There are many varieties and degrees of private sector participation in railway infrastructure investment and operations. And the conditions and approach used in each country is unique, reflecting local circumstances.[242]

5.1 WHAT MAKES A SUCCESSFUL CONCESSION?

Experience suggests that if PPPs are to succeed, governments must: enact adequate legal reforms to allow the private sector to operate efficiently and effectively; develop and enforce regulations that are clear and transparent to private investors; remove unnecessary restrictions on the ability of private enterprises to compete in the market; allow for liquidation or dissolution of existing state enterprises that cannot be commercialized or privatized; expand opportunities for local private enterprises to develop management capabilities; create incentives and assurances to protect current state employees after the private operator takes over service provision; and redefine the role of government from producing and delivering services directly to facilitating and regulating private sector service provision.

From its extensive experience with PPP, the United Nations Development Programme (UNDP) concludes that strong public sector leadership and political commitment are essential

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[241] *Ibid.*
[242] *Ibid.*

to the success of PPP projects.[243] PPP projects work best and are sustainable if they are mutually beneficial to both public and private sector partners and if each can overcome adversarial posturing to build mutual trust. It is important to develop a win-win situation for both the public and private partners.

With special focus to the transportation sector, it is necessary to deepen reforms in each sub-sector, resolving conflicts of interest and overlapping responsibilities (as in ports) and extending the network operated by private investors (as in the case of highways); strengthen the recently established regulatory agencies, guaranteeing close interagency coordination; and strengthen the policy, planning and coordination roles of the Ministry of Transportation, so as to foster intra- and inter-mode cooperation and help to identify and make viable investments with significant network externalities.

Moreover, in the railway sector the break up of state owned enterprises (SOEs) and the restrictions imposed on cross-ownership seem to have led to an excessively fragmented industrial structure, while downstream vertical integration has fostered anti-competitive conducts and discouraged investment in expanding output capacity. Although the law provides instruments for improving this situation, a strong regulatory presence will be necessary to make that happen.

[243] See http://pppue.undp.2margraf.com/en/01_2.htm where it is said that "In addition to the regulatory climate, a bad political climate caused by the pressure of election cycles, the potential instability of new democracies, the personal agendas of government officials and the special status of some services (particularly in terms of access to water, for example), can create barriers to starting or maintaining public-private collaborations. Governments must provide assurances whenever possible to private sector partners that such political factors will not disrupt the contractual partnership."

5.2. THE IMPORTANCE OF REGULATION

There are a number of reasons why it is sensible to retain a degree of public control of the right to supply railway services. It may be that the duplication of rail operators on a given route is wasteful or impractical. The existence of indivisibilities in capacity provision could lead to the emergence of a 'natural monopoly' with its associated adverse consequences. It may also be that unregulated competition could lead to undesirable practices such as frequent timetable changes; carriage overloading; and, volatile fares, and direct competition could lead to the loss of particular services, which perhaps benefit poorer communities, for the reason that they are not viable without cross-subsidization or government grants. In such circumstances, it may be desirable to create competition for the right to provide subsidized services, at least cost.[244] Such imperfections give rise to the need for control but do not necessarily justify continued state operations or the granting of monopoly franchises. Indeed the scope for private sector management in railways is considerable.

Effective economic regulation covers also deterrence of anti-competitive practices.[245] Most of the developing countries lack laws or agencies for dealing with anti-competitive practices. Economic activity continues to be concentrated in large conglomerates.

The lack of established legal and regulatory procedures applies to contract law as well.[246] In the Kenyan PPP framework, the means for enforcement of contracts and the resolution of disputes are not adequately provided for. Political interference in the award of contracts has also been a problem. PSP without a well-developed legal and regulatory framework increases the level of risk to investors. It also encourages investors to rely on special situations and political relationships rather than their merits as a means for securing and implementing

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244 *Supra.*, note 92
245 *Supra.*, note 129
246 *Ibid.*

contracts. The transfer of infrastructure services to the private sector should not lead to privileged deals or profits secured by government guarantees. They should be businesses with regulated income streams which derive their profits from increased efficiency and the attraction of additional demand. These income streams should be capable of securing substantial private sector funding, both because their semi-regulated nature makes them much like a government bond, and because the essential and often monopoly nature of the service lowers demand risk. Such assets are also long-lived and thus attractive to pension and similar long-term funds.[247]

Clearly, then, regulation that provides a credible commitment to safeguarding the interests of both investors and customers—particularly when economic shocks create political pressure to shift the balance of power among competing interest groups—is crucial to attracting the long-term private capital needed to secure an adequate, reliable supply of infrastructure services.[248] Successful reform requires regulation that clarifies property rights, allocates them sensibly, and assures private investors that their sunk investments will not be subject to regulatory opportunism.[249]

Credible, stable regulation is required to achieve the benefits of privatizing and liberalizing infrastructure. The past two decades show the importance of planning such regulation before privatization, including its economic content and institutional architecture.[250] Kenya must therefore design an appropriate concession law, as well as a regulatory institution.

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[247] *Ibid.*

[248] Kessides,*Supra.*, note 30. *See also* Kessides, I., *Infrastructure Regulation Promises, Perils and Principles. AEI-Brookings Joint Centre for Regulatory Studies.* (Washington D.C., 2003)

[249] *Ibid.*

[250] Willig, R., "Economic Principles to Guide Post-Privatization Governance." In F. Besanes, E. M. Uribe, and R. Willig, eds., *Can Privatization Deliver Infrastructure for Latin America?* (Washington, D.C., 1999) pp. 99-102

5.3. DESIGNING AN EFFECTIVE CONCESSION LAW

The effectiveness of concessions has suffered from the lack of adequate regulatory structures to control both technical and economic performance. Regulation of tariffs and other economic factors is particularly undeveloped. The basic objectives of autonomy, accountability, transparency and predictability have been difficult to achieve. More importantly, the mechanism for consultation between the public and private sector and for dispute resolution between the providers and users of the network has not been fully developed. A further problem has been the failure to separate regulation from administration in order to avoid conflicts of interest. Most countries have been slow to establish autonomous regulatory agencies with independent funding and professional staff.[251]

We have seen from our discussions that one of the weaknesses of the Kenyan concession regime is that it lacks a law to cover the concessioning process. Throughout the negotiations and signing of the Kenya Uganda Railway concession, there was no law for PPPs nor concessions in Kenya. Parliament sought to remedy this by passing the Public Procurement and Disposals Act[252] which made some provisions for Public-Private Partnerships. The provisions for concessions in the Regulations published by the Minister under the powers granted by the Act are inadequate in providing a proper regime for the negotiation and management of concessions.

Kenya must therefore establish a concession law, not under regulations under a procurement statute, but as a self-standing statute, complete with institutions for oversight. Concessions law plays a vital part in the implementation of many types of PPPs.[253] However, it is not

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251 *Supra.*, note 129
252 No. 1 of 2005
253 European Bank for Reconstruction and Development, *Law in Transition: Public-Private Partnerships Legal Reform in Russia.* (London, 2007)

sufficient merely to have a concession law – the law must be effective in achieving its intended purposes. In 2004-05, the European Bank for Reconstruction and Development (EBRD) undertook an assessment of concessions laws in transition countries.[254]

These assessments involved a detailed analysis of concessions laws in selected core areas: the general policy framework, the general concession legal framework, definitions and scope of the concessions law, selection of the concessionaire, the project agreement, availability of security instruments and state support, and settlement of disputes[255] and applicable law. It is along these lines that this paper will make recommendations on how to improve Kenya's legal framework for concessions.

The challenge posed by concession legislation is to develop a legal regime that will encourage private investment in these sectors. Privatisation of public monopolies is an objective, but the outright sale to third parties of "public" activities is not a viable alternative given the resulting lack of competition. Accordingly, the development of a legal regime which permits the grant of concessions or specific contractual or licensing rights to private sector entities, while retaining other public rights and ownership over specific assets, is a primary policy objective.[256]

In developing this legal regime, Kenya will need to provide an environment which will attract foreign equity investment from international companies with experience in the railway industry. To the extent that the general legal regime minimizes legal uncertainty in connection with the award and implementation of concessions, allows the concession

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[254] For more information, see: http://www.ebrd.com/country/sector/law/index.htm

[255] For an analysis of dispute settlement for PPPs in Kenya, see Madialo,L., "Public-Private Partnerships and the Development of Sustainable Infrastructure in Kenya: Best Practices in the Resolution of Disputes." Unpublished LL.M. Thesis, University of Nairobi School of Law.

[256] *Supra.*, note 253

granting authority, concessionaires and lenders to contractually allocate risks among themselves and takes into account the interests of lenders to ensure effective security over a project, such regimes can enhance the bankability, and thus the viability, of concession projects.[257] The recommendations that are suggested in this paper are drawn mainly from two statutes in Brazil, namely, the Concession Law and the Federal Public-Private Partnership Law, which have been discussed in greater detail in Chapter 4.

The concession law needs to provide for a **fair procedure for the award of concessions**.[258] In considering whether to finance a concession, lenders are particularly concerned with the process by which a concession was awarded. If a concession is awarded to a private investor in a manner which suggests that the concessionaire obtained such rights through influence, corruption or on the basis of having access to non-public information, lenders face a number of risks. First, the credit risk for the lenders is increased because it may be easier for the award of the concession to be challenged, either legally or politically. A new government may decide that an awarded concession is unfair and actively seek ways of either terminating the concession or inhibiting the ability of the concessionaire to exercise rights. Second, most lenders are wary of risks to their reputation associated with financing a project where there are, or may be, rumours of corruption or unfairness in the award of the concession. For these reasons, a perception of lack of fairness in the award of concessions may turn away potential good investors who have both the resources and experience necessary to run the concession.

The concession law should also **clarify the power of granting authorities**.[259] Lenders are obviously concerned that any concession agreement to be financed has been properly entered into by the relevant governmental parties. In addition, it is important that the government's

[257] *Ibid.*
[258] *Ibid.*
[259] *Ibid.*

authority to enter into a concession agreement will not be subject to challenge. Accordingly, it is essential that either the general concessions law or the sector-specific concessions laws, if any, identify the authority/ authorities that are empowered to enter into concession agreements, and specify the scope of their authority to modify the terms of a tendered concession agreement.

The concession law should also **clarify tax and licensing regimes**.[260] An important component of lender due diligence in a concession project is to ensure that the concessionaire has (or will obtain) all licences necessary for the construction and operation of a project. In addition to licensing issues, the financial viability of a project often hinges on whether tax or customs duties exemptions granted contractually in a concession will be respected by the relevant authorities. Unfortunately, in many jurisdictions inconsistencies among various laws and the terms of a concession agreement raise uncertainty regarding the tax and licensing regime applicable to a project. In assessing the efficacy and clarity of the legal regime applicable to a concession, lenders would look at the existence of a general regime that regulates the tax and licensing issues relating to the grant of concessions in a number of different sectors. It is often preferable to have such overriding legislation that defines in broad terms the tax and licensing regime applicable to different sectors, thus giving lenders some assurance of the stability of the legal system.

The law must also **provide lenders with effective security**. A legal regime which seeks to establish a framework for concession financing should allow and encourage structures which provide for protection of the rights of lenders under their relevant security documents, and in the event of the termination of a concession. Of fundamental interest to any lender

[260] *Ibid.*

considering project finance of a concessionaire is whether the lender will have effective security over the assets of the concessionaire.

As a form of additional security, the concession law should **permit government undertakings to lenders.**[261] Lenders invariably require some form of direct agreement or consent to assignment with the government authority granting the concession the granting authority. The legal regime should allow for the granting authority to make such undertakings.

On top of these, the concession law should **permit concessions to be governed by investor-friendly choice of law rules and dispute resolution mechanisms.** Lenders are more comfortable with the legal risks associated with financing concession contracts when such contracts are governed by a set of legal rules that are well known, generally acceptable internationally, and rooted in a system with effective enforcement. Moreover, lenders are not comfortable in relying on enforcing any rights they may have under a concession agreement exclusively in the courts of the granting authority.[262] In most cases, they require that such disputes be resolved in accordance with an international arbitration regime outside of the relevant country, in order to avoid any perceived (or real) bias in the local courts which may not have a track record in adjudicating against the government.

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[261] *Ibid.*

[262] If it is the courts that are going to be adjudicating on regulatory decisions then several questions come to the fore: - How efficient are the court systems in a country? How much delay can they cause? How familiar are the judges with the new legislation and associated regulations? Would the absence of case history delay matters further? Are there jurisdictional problems between regulatory agencies?

5.4. DESIGNING AN EFFECTIVE REGULATORY INSTITUTION FOR CONCESSIONS[263]

The organization of the infrastructure sectors (i.e., ministries, regulatory agencies, and utilities) has remained largely unchanged with the introduction of PSP. With financial transactions being the primary mechanism for transferring infrastructure services to the private sector, insufficient attention has been given to the broader issue of institutional reforms. It has been implicitly assumed that the introduction of private management into the ownership or operation of specific assets would obviate the need for such reforms. Instead, the weaknesses of existing institutional structures have limited the effectiveness of the private sector initiatives. In most countries, the piecemeal transfer of infrastructure components has proceeded slowly and the controlling bureaucracies that add overhead costs and often limit improvements in infrastructure performance, have remained relatively unaffected.[264]

Perhaps before making recommendations on how Kenya can structure its regulatory institutions for concessions, we need to caution, and it needs to be borne in mind that there is no unique design of regulatory institutions that can be transplanted from one country/sector to another. Each country/sector has to take into account the level of development already attained and the targets/paths that they would like to achieve. There is also no perfect design that would ensure that no regulatory failure takes place. With time, developmental goals, market structures and policies would all change. The Regulatory institution would need to constantly adapt to this changing environment and must constantly evaluate their own effectiveness of methods and decisions.

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[263] For a detailed discussion, *See*, Brown, A. et al., *Handbook for Evaluating Infrastructure Regulatory Systems.* (Washington D.C., 2006)

[264] *Supra.*, note 253

Be that as it may, when addressing the issue of institutional design the foremost questions that come to mind are: Are the objectives/functions of the new institution clearly defined? Does the institution have the financial and operational powers to meet these objectives? Does it have the wherewithal to operate and exercise its powers effectively? Does it have the flexibility to adapt?[265]

From our study of the historical evolution of concessions, it has become apparent that the 1980s and 1990s saw a dramatic global reassessment of the state's role in infrastructure and of the view that such industries were mainly natural monopolies. As developing and transition economies began restructuring and privatizing their infrastructure, they looked to the countries that had first taken this approach: Canada, New Zealand, the United Kingdom, and the United States. But these advanced industrial countries have long traditions of market capitalism supported by strong legal institutions. They also have well-developed education programmes that teach how to regulate private monopolies, facilitate entry by new service providers, and promote competition. Lacking these features, developing and transition economies have faced a huge challenge in developing effective regulation for infrastructure.[266]

Under pressure from international agencies, investment banks, and financial advisers, many developing countries have hastily adopted regulatory templates from industrial countries, especially the United Kingdom and the United States. But these models have rarely been adapted to the political and institutional features common to poorer countries, including lack

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[265] Srivastava, L., "Issues in Institutional Design of Regulatory Agencies." Paper presented in SAFIR Core Training Course on Infrastructure Regulation and Reform Organized by the World Bank and Tata Energy Research Institute, New Delhi, December 4-15, 2000.

[266] Gray, P., "Utility Regulators: Supporting Nascent Institutions in the Developing World." Public Policy for the Private Sector Note 153. 1998. *See also* Noll, R. 2000. *"Telecommunications Reform in Romania."* in Kessides, I., ed., *Romania: Regulatory and Structural Assessment in the Network Utilities.* (Washington, D.C.: 2000) p.46

of checks and balances, low credibility, widespread corruption and regulatory capture, limited technical expertise, and weak auditing, accounting, and tax systems.[267] As a result such efforts have had limited success—or been outright failures. To avoid such pitfalls, this paper has attempted to draw from the experience of such developing countries as Brazil and Argentina which pursued privatisation of infrastructure with relative success, and the rest of this paper now brings out the lessons Kenya can learn from these experiences.

Starting timidly in the late 1980s but accelerating markedly after 1994, Brazil engaged in one of the world's largest privatisation programmes. At first privatisation was concentrated in the steel and petrochemicals sectors, later embracing such state firms as the airplane manufacturer Embraer. From 1994 on the privatisation programme expanded rapidly, as it now included public utilities, such as telecommunications, electricity distribution, railroads, ports and some of the major high-ways. At first foreign participation was limited. After a number of constitutional amendments which allowed foreign firms to participate in public utilities, the involvement of foreign capital in the privatisation process increased dramatically.[268]

One notable feature of Brazil's privatisation has been the fact that public utility privatisation has been carried out through the granting of concessions rather than a permanent transfer of assets.[269] The winner of the concession contract would be running a facility for a limited period of time (usually 20-25 years) at the end of which the assets would revert to the state unless a new concession would be granted either to the old firm or a newcomer after an

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267 Laffont, J., "Creating Competition through Interconnection: Theory and Practice." (1996) Journal of Regulatory Economics Vol. 10 (3) pp. 227–56.,

268 Amann, E. and Baer, W., "From The Developmental to the Regulatory State: The Transformation of the Government's Impact on the Brazilian Economy." Available at http://www.direitogv.com.br/subportais/publica%C3%A7%C3%B5e/RDGV_ESP01_p267_282.pdf Accessed 4th October 2011

269 *Ibid.*

appropriate auction. During the concession period, the concession contract would be in force. It would include provisions for rate or tariff readjustments, investment obligations for both maintenance and upgrading the relevant facilities etc. For instance in the telecommunications sector, strict targets have been set for increasing provision of fixed and cellular lines, while service quality is also monitored and enforced. The administration of the concession contract would be in the hands of special regulatory institutions and in some cases government ministries. As one commentator noted the introduction of these agencies established "an array of sectoral regulatory-normative federal agencies that...have changed not only the procedures but indeed the culture of Brazilian public sector management primarily in the area of infrastructure. Previously line ministries or public enterprises under their jurisdiction have carried out not only policy-making functions but also economic alterations..."[270]

One of the key lessons from Brazil is that in an ideal regulatory system where the role of the state is confined to avoiding instability of the markets, curbing abusive profits, and ensuring a reliable supply of services to the population, each regulatory agency should provide the legal-institutional framework for the particular sector concerned, grant concession contracts to the actual economic operators, and issue such norms as are required for the smooth operation of the sector, aiming at the public welfare.[271] To this effect, the regulatory bodies should have technical competence and specialization; independence from political pressures; interdependence with other agencies; ability to settle disputes; constant participation of users and consumers; and administrative and judicial control of their activities.[272]

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[270] Landau, G., "The regulatory-normative framework in Brazil," Policy Papers on the Americas, Vol. XIII, Study 2 April 2002 p.2
[271] *Ibid.*
[272] *Ibid.*

Kenya must also appreciate that the performance of the railway sector, and every other industry where concessions are entered, will improve if regulatory discretion is limited, regulatory personnel are not subject to short-term political pressures, the regulator can require detailed information from operators, the regulatory process is open to public scrutiny and regulatory decisions are subject to appeal by the judiciary. Furthermore, and to enhance the credibility of reform initiatives, it is important that an independent judiciary can solve disputes between operators or between the government and service providers, the regulator is isolated from political discretion, and agency officials' terms are not tied to other political office terms.

Another key lesson regards the **independence**[273] **of the regulator**. It is generally accepted that regulators should be independent with a reasonable amount of discretionary power; be autonomous and expert; and, appropriately accountable. Independence requires regulators to be at arm's length from both political pressures, in particular ministries, and from the regulated enterprises themselves. It is generally not sensible to have regulators under the control or influence of politically appointed ministers or the utilities that provide services since both have direct or indirect effects on customers or users. On the one hand, ministers establish the policies within which operators compete and where applicable any capital or operating subsidies, on the other hand, the operators themselves directly provide services to intermediate and final consumers. Independence also requires that regulators, both board members and executives, are appointed and replaced on the basis of professional and not political criteria, preferably for a fixed period.

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[273] According to regulatory theorist William H. Melody: "The term independence . . . does not imply independence from government policy, or the power to make policy, but rather independence to implement policy without undue interference from politicians or industry lobbyists." International Telecommunication Union, Trends In Telecommunication Reform 2002: Effective Regulation 17 (2002) at 29.

Independence requires that the regulator is not restricted to an advisory role but is able to make effective decisions on the basis of rules. In practice, it will be necessary to secure a balance between the regulator having too little and too much discretion without political intervention.

Kenya needs to appreciate the fact that any new institution that is being established is being set in an existing environment and has to operate within the constraints placed by existing systems. In the words of Jacobs, "new institutions function within a general governing environment – itself shaped by long-standing values, attitudes and traditions of behavior that is more resistant to change than are individual institutions and that produces pressures, influences and constraints that are beyond the control of institutional designers".[274]

The regulator needs credibility which has been said to be the alpha-omega of regulation.[275] The credibility of a regulatory agency is established in two ways – either through the design of the institution itself which indicates the extent of discretionary power that the regulator might enjoy and the independence with which they will be allowed to operate. The credibility of the agency will also be enhanced if it is able to demonstrate expertise and independence of both the members as well as its staff. Credibility is also created through the manner in which the regulatory agency would go about its business. In most countries, it is apparent that the Government that is setting up these new regulatory institutions is itself wary of the extent of independence that must be provided. As such, the onus is on the regulatory agencies to

[274] Jacobs, S, "Building Regulatory Institutions in Central and Eastern Europe," Proceedings of the OECD/World Bank Conference on Competition and Regulation in Network Infrastructure Industries, Budapest, 28 June 1 July 1994, p. 301-317.

[275] Albuoy Y., "Regulation for Infrastructure Sectors: How to adapt it to Country institutions. Energy Markets and Reform," Proceedings of the Annual Meetings of the African Development Bank, May 1999.

establish their credibility not only with the regulatory entities and consumers but also with the Government.[276]

The regulator also needs to be fair in its decision making processes. It is said that without a reputation for fairness, a regulatory agency is indelibly tainted, its credibility is compromised, and its effectiveness is reduced. An ineffective regulatory agency, in turn, then comes under political pressure from the government, thereby irrevocably altering the nature of its independence. Transparency and fairness, then, are the foundations of regulatory accountability and underpin the very legitimacy of the regulatory agencies.[277] Transparency promotes the legitimacy of a regulatory agency and helps it avoid regulatory capture.[278]

Given the watch-dog effect of public scrutiny, an agency whose actions are transparent is more likely to be accountable, efficient, fair, objective, independent, and can more easily adhere to its legislative mandate.

In summary, it cannot be gainsaid that the government of Kenya needs to be aware that the sound design of the regulatory framework and the regulatory institutions requires a number of issues to be fully accounted for.[279] The first of these is *the degree of independence of the regulatory agency*. It is generally accepted that the regulator will perform most effectively when independent of the various stakeholders, namely government, passengers, corporate rail users, train operators, and infrastructure providers. Secondly, the government must also

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[276] *Ibid.*

[277] International Telecommunication Union, "Trends in Telecommunication Reform," (2002) Effective Regulation 17

[278] "Regulatory capture" refers to an agency that becomes too dependent on the industry it regulates. This phenomenon can happen, for example, when the regulators rely too much on information from a particular company. Regulatory capture also occurs if there is too much personal contact between regulators and company executives.

[279] *Supra.*, note 120

consider *the relationship of the regulator with the government.* The reporting requirements need to be defined and arrangements for auditing created. The third consideration is *the scope and jurisdiction of the regulator.* When establishing a new regulatory function, decisions have to be made about whether it will be a single sector operation or part of a wider multi-sector agency. Even with a single sector agency it will be necessary to determine the boundary of responsibilities between agencies such as health and safety bodies and competition authorities. Finally, the government should consider *the number of regulators and their appointment procedure.* It will be necessary to determine whether regulatory powers will be vested in a single executive, for example, a Director General, or in a board, commission or other corporate body.

5.5. FINAL REMARKS

From this study, it can be concluded that transport is pivotal to economic development. On the one hand, the achievement of economic growth and poverty reduction requires good physical access to resources and markets while on the other, quality of life is generally dependent on the quality of physical access to employment, health services, homes, education and other amenities. Conversely, in many developing countries the inadequacy of transport infrastructure and the inefficiency of transport services are recognized as being among the main bottlenecks to socio-economic development and social integration.

In an attempt to improve efficiency many governments have implemented economic reforms in recent years that have increased the role of the private sector in the provision of transport infrastructure facilities and services. Concessions have been more common than other types of private participation, with most countries turning to the private sector to improve the management of loss-making railways and rehabilitate deteriorating infrastructure. Private participation in the railway sector has increased significantly since the 1990s, and this pattern looks set to continue.

In the 1990s, the Latin America and Caribbean (LAC) region embarked on the so-called first generation of reforms in the infrastructure sector, which involved privatization, deregulation, and restructuring of service provisions. As a result, remarkable changes occurred in the role of the state with respect to the provision of infrastructure services. Following privatization several independent regulatory bodies were created all over the region and the view was that an appropriate regulatory environment would naturally emerge.[280] Improvements in performance in most of the projects in Latin America have encouraged governments in Sub-Saharan Africa and the Middle East and North Africa to consider concessions for railway management, operation, and rehabilitation.

For many developing economies, the experience in Latin America highlights some lessons. For example, the renegotiation of freight concessions in Argentina has revealed the importance of establishing flexible contracts and setting clear renegotiation or other adjustment mechanisms in advance. The only means of ensuring this is through the establishment of a proper concession law and an effective concession regulator.

This need in the transport industry is due to the existence of natural monopolies, the limitations of competition for the market, the existence of assymetric information between transport operators and regulators, the need for private investment in infrastructure facilities, and the need to assign risks between operators and government.

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[280] World Bank, *Regulatory Governance in Infrastructure Industries Assessment and Measurement of Brazilian Regulators.* (Washington, 2006)

Regulation is a key concern of the infrastructure industries, their consumers, citizens and governments alike. It is important to recognize that regulation is a multidisciplinary activity that embraces law, political science and social administration as well as business and economics. Regulatory processes generally comprise three stages: the enactment of enabling legislation, the creation of regulatory administrations and rules, and the bringing to bear of those rules on individuals or organizations whose behaviour is to be influenced or controlled.

It should be emphasized that investor risk assessments will be based on a number of factors, including the nature, stability and credibility of macroeconomic policy, corporate governance, tax policy, labour market policy, and other non-policy risks. Risks can be mitigated however, through increasing stability in the government's policy approach. Reform through systemic regulatory, legal and related institutional reforms should be transparent, stable and predictable. It is essential to protect the independence of the regulator and ensure that it operates in a transparent manner, within a clear framework for accountability.

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