

EUROPEAN CONFERENCE OF MINISTERS OF TRANSPORT



**Regulatory
Reform of
Railways
in**

RUSSIA

REVIEW OF REGULATORY REFORM OF RAILWAYS IN RUSSIA

UPDATED SUMMARY AND CONCLUSIONS

1 FEBRUARY 2005

OECD REGULATORY REFORM REVIEW OF THE RUSSIAN FEDERATION:

ECMT/OECD REVIEW OF RAILWAYS

UPDATED CONCLUSIONS

**FOLLOWING THE SEMINAR HELD AT THE CENTRE FOR STRATEGIC RESEARCH MOSCOW ON
26 OCTOBER 2004**

RAILWAY REVIEW TEAM:

Mr Fabio Croccolo (Railway Review Team Leader)

Deputy Director of European Programme, Ministry of Infrastructure and Transport, Italy

Mr Lou Thompson

Thompson, Galenson and Associates, Senior Railways Advisor, World Bank until June 2003

Mr Jean Arnold Vinois

Head of Rail Transport and Interoperability, Directorate for Transport and Energy, European Commission

Mr Russell Pittman

Director of Economic Research and Director of International Technical Assistance, Economic Analysis Group, Antitrust Division, United States Department of Justice

Mr Ralf Schweinsberg

Vice Chairman of the Federal German Railway Regulatory Agency

Mr Jeremy Drew

Consultant, formerly with the United Kingdom Office of the Railway Regulator

Mr Ben Eijbergen

Russia Transport Task Manager, World Bank

Ms Elene Shatberashvili

Secretariat, European Conference of Ministers of Transport

Mr Stephen Perkins

Secretariat, European Conference of Ministers of Transport

SUMMARY AND CONCLUSIONS

1. The Russian railway system is in the process of rapid legal, organisational and regulatory reform. This paper is based on a series of discussions with the Government on the reforms and the progress in implementing reform. The conclusions are not intended to be interpreted as requirements or instructions on the next steps in the process. They instead aim to raise questions where, from observing difficult reform issues in other countries, the team believes further refinement might help the Russian regulatory reforms progress more effectively and in some cases avoid costly mistakes made in other countries. With these suggestions in mind, only the Russian authorities are in a position to judge what the best course of action will be in making the right trade-offs between valid, but competing, objectives.

PROGRESS

2. **Good progress** has been made in developing a comprehensive program of reform for the Russian railways. Incorporation of the Russian Railways as RZD OAO¹ on 1 October 2003 marked the first milestone in the implementation of the program and in October 2004 RZD was assessed by Standard and Poor's and issued with a BB+ credit rating, sufficient to enable it to issue bonds. The Laws adopted set out a firm direction for reform whilst acknowledging the need to retain flexibility in the structural changes to be made as the market develops and responds to reform. The programme has been designed to avoid economic shocks to this key section of the economy. Progress is favourable compared with the planning and speed of reform in most railways world-wide. Some results are already evident, with significant investment in rolling stock by private operators following creation of the necessary legal framework and modifications to rail tariffs.

3. The team believes it is critical that the momentum for change developed so far be continued and strengthened. Firstly, to implement policy decisions already taken, gaps in the legal and regulatory frameworks must be filled as quickly as possible. And secondly, more emphasis now needs to be placed on clarifying the stated objective of enhancing **competition** (both intra-rail and intermodal) and its relation to **regulation**, both of infrastructure access charges and of end-user rail tariffs, and the **structure** of the rail industry in Russia. The objectives, and the linkages between them, must be developed in a coherent way, or they will conflict with each other and defeat the overall goals of reform.

4. Major spurs for reform, clearly identified by the Government, are severe under-investment in infrastructure and rolling stock since 1990 that, coupled with the cost of supporting passenger services, may begin to limit the railway's ability to meet transport demand and threaten the financial performance of the railway. These issues have begun to be successfully addressed but the rapid pace of change in the structure of Russia's economy and in the markets the railways serve, and growing competition from road transport to carry higher value freight, make it essential that the agreed reform plan (set out in decree 384 of May 2001) is completed and does not become stalled at an intermediate phase. The team also foresees that competition from road haulage will increasingly limit the ability of the railways to contribute to the Government's regional and national economic development policies.

1. RZD Russian Railways is a joint stock company owned 100% by the Government and formed to own and operate rail infrastructure, freight and, at least temporarily, passenger services. Prior to October 2003, the Russian railway system was managed and operated by the Ministry of the Means of Communication (MPS).

5. The response of the government to financial weakness has been a determination to improve cost effectiveness by separating government from railway enterprise roles, separating non-core activities from the railway, contracting for public service requirements and creating legal and tariff frameworks for shippers and industrial customers of the railways to invest in private wagons. This has been the focus of stage one of the three-part reform plan. The later stages foresee the creation of competition in rail freight transport. Stage two provides for the creation of conditions for new general freight carriers to develop to compete with the existing, state-owned freight carrier, paying fees to RZD for the use of infrastructure. Stage three evokes the possibility of splitting out businesses from RZD as vertically integrated units (managing both infrastructure and train operations) that would be able to compete with each other to serve the main markets. A decision on whether to introduce this kind of competition will be taken at some point in the future.

6. In the meantime, further measures will be required to promote the competition foreseen for stage two of the reform plan. The team believes that the proposed implementation of enhanced competition should now occupy a more central place in the Government's priorities for reform of the sector. The initial phase of private investment in rolling stock may be reaching its end and further scope for private investment needs to be created if investment is to continue on this scale. More fundamentally, experience in other countries shows that monopolies rarely maximise efficiency and are slow to innovate and provide the service that customers require. It is also significant that the Standard and Poor's rating analysis generally accepted the reform program but focused on the need for improved implementation, especially transparency in financial reporting and in tariff regulation.

FUNDAMENTAL POINTS BASED ON OECD EXPERIENCE WITH RAIL REFORM

7. The regulatory framework adopted for the railways will be critical in determining the performance of the system both financially and in terms of quality of service. **Tariff regulation** that continues to limit the scope for both adapting to market pressures (responding to competition from road haulage especially) and pricing services according to the ability of customers to pay will damage the railways. And although geographically uniform tariffs may appear to promote regional development objectives, they place the railways at a severe disadvantage in competition with other freight carriers, such as trucks, that have the flexibility to charge tariffs specific to each commodity and local market.

8. Similarly, unless the **prices charged by RZD to other carriers**² for using state owned infrastructure are regulated in a way that maximises the control that these licensed carriers have over their costs, the competition envisaged in stage two of the reforms will not develop fully.

9. An effective mechanism for rapidly resolving cases where discrimination is alleged in the provision of access to infrastructure is also essential for this kind of competition. Capacity is not generally constrained on the network so RZD is likely to have a general incentive to sell infrastructure services to other train operators. Nevertheless, maximising income for RZD will not always be consistent with promoting the development of new train operators especially when they compete with RZD for higher value cargoes. The Federal Antimonopoly Service will need additional resources to cope with an increase in its already heavy case load to address the issues that are likely to arise. Alternatively, it might be more effective to establish a **specific regulatory agency for rail competition** to manage the increasingly complicated regulatory issues that are likely to arise. Markets where competition fails to develop are likely to see quality of service decline and traffic lost.

2. The 2003 Federal Law on Railway Transport provides for the licensing of "carriers" to compete for business with RZD across the board as well as undertaking transport for their own account. The law also provides for the approval of "operators" that provide their own wagons for RZD to carry their goods in and thereby secure certainty in the availability of rolling stock and train paths for their shipments.

10. Around 30 independent carriers now³ successfully carry freight in niche markets for own-account transport. These are in relatively high value bulk markets, especially oil products. RZD is losing this potentially profitable business as it is not able to offer negotiated contract tariffs. At the same time the independent carriers are not able to offer transport services to other companies as the regulations to enable RZD to sell infrastructure services are not yet in place. Moreover there is no appropriate regulatory framework for licensing or setting charges for the use of infrastructure or leasing locomotives from RZD. In these circumstances, although RZD is losing income, shippers do not benefit from the reduction in tariffs that would be expected from effective competition (only own-account carriers gain, through better access to and control of wagons). Thus until the licensing and regulatory framework for competition under stage two of the reform plan is completed, the income of RZD will be undermined without delivering the benefits to the economy of competition. At the same time as completing the framework for competition, freight tariffs in the potentially competitive markets need to be liberalised; that is, end user tariff regulation should end or at least become more flexible, so that RZD can compete with own-account carriers and with trucks.

11. The burden of regulation on the Government, in terms of financial resources, expertise and institutional capacity, varies greatly with the type of regulatory framework adopted. Regulatory systems have been most successful when they both reduce the scope of prescriptive regulation and reduce the need for intervention by regulatory authorities, through the design of the industry structure. Such systems rely on **competition in place of regulation**. The more complicated, more prescriptive frameworks, where competition depends primarily on operational regulation rather than the competitive structure of the industry, have been adopted where government-financed passenger services dominate the rail system or where external constraints limit the freedom to choose industry structure, as for example in the case of regulation to promote the development of a single market in rail services in the European Union. The limited public resources available in Russia strongly argue for adopting a structure for the rail industry that reduces the need for regulatory intervention and minimises the burden on Government. This would argue for restructuring the rail system to create competition between vertically integrated freight rail companies where feasible.

12. The coexistence of profitable freight services with unprofitable passenger services creates incentives that make it difficult for the infrastructure provider to direct adequate infrastructure investments to sustain the largely government funded passenger train operations. Instead it will tend to direct resources to support revenue-generating freight services. Particular regulatory attention will need to be given to investment incentives and also to ensuring sufficient priority in the dispatching of passenger trains, to meet the levels of service required and ensure value for money for the public support provided for passenger train operations. Innovation, rather than adoption of any one existing model among OECD countries, would be required in terms of the ownership of integrated railways (with perhaps a mix of public and private ownership, including leasing concessions rather than ceding ownership of infrastructure to the private sector) and the application of European style public service obligations to a North American style system of competing integrated railways.

13. Whatever approach is adopted, the key regulatory task is to encourage both investment and efficient operation of the railways, in line with the government's prime objective of reducing costs. To this end it will be important that the regulators have both adequate information and economic expertise to make judgements on issues such as tariff structures and access charges that are fundamental to efficiency. The **regulatory authorities should be making economic assessments**, not simply overseeing application of the letter of the law.

3. In October 2004 about 2300 companies owned rolling stock, 50 with over 1000 wagons each, and of these 29 had been licensed as carriers.

14. The rail competition regulator, in whichever institution it is housed, should be charged with protecting the public interest from an economic and commercial viewpoint. This body should be independent in its organisation, funding, legal structure and decision-making from the infrastructure manager or any carrier. Experience in OECD countries suggests it will be most effective if it is an independent agency of the government, and it should be free of potential conflicts of interest that might arise were it to also have responsibilities for regulating prices that have a large impact on rail costs, such as electricity. The principle role of this regulator would be to ensure that infrastructure access is fair and charges for the use of infrastructure appropriate. This is a complex task, given the conflicting objectives encompassed in government policy.

15. The results of Government decisions, discussions and negotiations can only be as good as the **quality of the information** on which they are based. Whatever the objectives of reform for the Russian railways, it is vital that more accurate information be produced and made readily accessible to all railways, to their customers and to the public at large. The last few years have seen remarkable progress in the publication of accounting data but some rail traffic and operating information that would be public in most OECD countries remains restricted in Russia: restriction of information severely reduces the quality of analysis and debate on crucial issues. The need to increase the transparency of regulation, which will reduce risks for potential investors, and improve the quality and availability of data was underlined by Standard and Poor's assessment of RZD, and is a condition for achieving improved credit ratings. Making good and detailed data available to the public will also improve the quality of public understanding of the reform process and make the inevitable trade-offs between different goals that will have to be made throughout the process of reform more readily accepted.

16. **Transparent accounts** of costs and revenues presented according to International Accounting Standard methodology by line of business are required, identifying in particular losses and subsidies. This is essential if the economic impact of reforms is to be understood. It will also be needed to monitor the successes of reforms, and present them to the Duma, the press and the public, especially when criticisms and problems arise. As well as vital in Russia, this is a universal lesson from reform in other countries.

17. Such transparent accounts are also essential to prepare the way for **replacing cross-subsidies** with direct financing for loss making passenger services. The team recognizes the work done for MPS by Deloitte and Touche⁴ on the losses associated with social services and the need for more transparent and IAS compliant accounting for MPS, and encourages RZD to continue and accelerate the effort to develop line of business based, fully IAS compliant reporting. The accounts published by RZD on its first year of business are a major step in this direction. More detailed IAS based reporting of information is needed both for better management and for improved access to capital markets, as the Standard and Poor's assessment makes clear. More generally, the government will need to develop standard sets of data that it requires all carriers to submit in order to enable it to regulate the industry effectively.

NEXT STEPS IN REFORM

18. The trade-offs to be made in achieving the objectives of reform need to be more clearly identified for all of the government bodies involved in reform. There is an important trade-off between a) improving the economic performance of the railway system itself (the stated goal of the reform process) and b) using the railway to promote **social policies and regional development** policies (a stated goal in the methodology of development of the freight tariff schedule). International experience suggests that social and regional development goals should be addressed by direct government support and not through

4. Deloitte and Touche, and Scott Wilson Consultants, "Report of the Consortium of the Advisers on Analysis of government spending in the railways transport of Russia," Moscow, 2002.

manipulation of the tariff schedule by creating favoured commodities and regions at the expense of other commodities and regions. The economic costs of social and regional development goals need to be identified accurately and transparently. There is a major risk of damaging the railway when these goals are hidden rather than addressed by direct financial support and other government measures.

19. For the next steps in reform it is essential to clarify the goals of introducing **competition**. To date the railway itself has led many aspects of the reforms and developed the concepts for the introduction of competition in the sector – albeit directed by the former Antimonopoly Ministry to introduce competition and provide for non-discriminatory access to infrastructure. With the incorporation of RZD, stronger leadership from government will be required because no for-profit company has the incentive to create competition for its own services. Government responsibilities for the development of rail competition policy and law⁵ now need to be clarified. The laws already adopted stress the importance of competition, but competition can take different forms and serve different purposes. What kind of competition is to be encouraged:

- Rail versus truck and barges?
- Rail versus rail – if so where?
 - a. among vertically integrated freight/infrastructure companies on parallel lines;
 - b. among vertically integrated freight/infrastructure companies competing to serve customers at commonly served points (often called “source” competition), or
 - c. among vertically separated competing carriers running trains on the same line?

It will also be important to clarify the priority of the competition objective relative to other objectives. If competition is critical, the structure of the industry and the formulation of access charges have to be set first and foremost in ways that enable competition.

20. In markets where a significant degree of competition is achieved, either intermodally or between rail companies, then the need for, and the approach to, regulation can and should change accordingly. For example, it is not appropriate to regulate end-user rail tariffs in parts of the market where there is strong competition from road haulage. Also the need to regulate access charges will be reduced if there is competition between vertically integrated operators.

21. As the goals for competition become more clearly defined, it will be essential to review the compatibility of the tariff system with those goals. The plans for structural reforms will also have to be reviewed to ensure all three components: competition, regulation and structural changes are mutually supportive, not conflicting. The next steps in reform should focus on the coherence between these three parts of the reform program to make sure that each supports the other.

22. Potential inconsistencies arise in the current formulation of charges where a shipper or operator wishes to provide both wagons and locomotives and pay RZD only for the use of the infrastructure. No tariff schedule for the sale of infrastructure services alone has been published. Procedurally, it is possible to derive charges for infrastructure usage alone from the commodity based end-user tariffs. Ancillary services, such as loading, insurance or marketing can be subtracted when these are also provided by the shipper or independent carrier. But the net result is a charge for the use of infrastructure that is higher than would result by following the approach typical in the European Union that establishes **track access charges on the basis of infrastructure costs** from the bottom up. Instead of being based on infrastructure costs, Russian infrastructure access charges are based on commodity class and other demand factors. This may well increase the ability of the infrastructure company to cover its total costs, but there is a strong risk

5. As opposed to exercising powers under existing laws.

that an infrastructure charge that is higher than the economic costs directly attributable to infrastructure use will act to limit the ability of new carriers to enter and compete with the freight carrier operation of RZD, and it could severely limit the ability of all rail freight carriers to engage in flexible, tariff and service-based competition with trucking companies.

23. Russian law identifies monopoly sectors of industry where tariffs are regulated. The railways fall under this category. Nevertheless, strong competition already exists in some markets. Competition from road haulage for higher value freight is developing rapidly in European Russia; particularly over distances below 400 km. Niche rail operators owning their own wagons carry more freight than RZD in some markets. For example own-account transport companies carry 60% of the oil carried on the national rail network rail. In markets demonstrating competition, rail end-user tariffs ought to be free of regulation. If tariffs remain regulated in markets where rail faces competition from other modes, the railways risk long-term insolvency in the same way that US railways came close to bankruptcy in the 1970s. If tariffs are not freed in markets where rail-on-rail competition develops, some of the benefits of competition will be foregone, and prices to shippers will be higher than they need be. Niche carriers, which are free to negotiate shipping rates, currently charge shippers substantially more than RZD's regulated tariffs (in return for better assurance or rolling stock availability). **Freeing tariffs** in these markets would of course make the current approach to setting access charges redundant, as it is based on deducting the costs of wagons and locomotives from the regulated tariff (which would cease to exist). It would require a new approach to setting access charges based more directly on costs.

24. The current approach to introducing **competition** in the railways is to create the legal framework for the emergence of new carriers to compete with the RZD freight carrier on infrastructure owned by RZD. Fostering the emergence of general freight carriers that compete with vertically integrated Russian Railways will be demanding on the regulators if it is to result in more than the development of specialised niche operators. Establishing a regulatory system that promotes competition between carriers with this rail industry structure will require a major effort from the Government. The team considers that further thought should be given to **reducing the regulatory burden** by either creating a vertically separated structure with full organisational separation and without dominance by a single train operator or by separating the railways horizontally and establishing vertically integrated companies that would compete with one another.

KEY ACTIONS TO BE TAKEN NOW

25. **Completing the licensing and regulatory framework for competition** through access to RZD infrastructure for independent common carriers and freeing RZD from end user tariff regulation in markets where there is competition from these carriers or from road haulage is urgent. Inflexible tariffs hinder competition and expose RZD to losing potentially profitable business to own account carriers and to trucks. Making tariffs more flexible was one of the central recommendations of the Standard and Poor's report to enhance the credit rating of RZD.

26. RZD has made proposals for the structure and level of **future charges for the use of infrastructure**. These need to be reviewed by government and a decision taken in conjunction with the liberalisation of tariffs in the potentially competitive markets.

27. As envisaged in the reform plan, **passenger rail transport** should be separated rapidly from the rest of the system. At the beginning, this separation might commence with a financial separation through separate accounts for the various passenger functions (including payment for infrastructure access and use): this can progress to institutional separation, with separate companies for the various intercity and suburban services. The assets that should go to the passenger companies should be established and the cross-subsidies from freight to passenger services ended. For loss making suburban services, **contracted public service obligations** should be developed, as practiced in the European Union. Direct government

funding might be introduced, as with Amtrak in the USA and Via in Canada, for the long haul, intercity passenger companies, though it is possible that with pricing flexibility and direct central or local government support for the various privileged passengers required for social purposes, the intercity passenger services may require little or no additional support. Moreover, everywhere it has been tried, **involving local governments** in planning and funding local services improves the planning and selection of which social rail services to maintain and by how much to support them. Even channelling only a small part of the finance needed through the local authorities has a big impact in making their demands for public services more realistic and improving the efficiency of the services organised.

28. The procedure for **spinning-off subsidiaries** from RZD was designed to handle businesses that are destined to remain in public ownership such as intercity and suburban passenger train operations; RZD forms a subsidiary company and this is then passed to the Government to determine its ownership. For commercial activities destined to be sold into private ownership this process is unnecessarily long. Authorising RZD to handle the sale of these businesses through direct creation and sale of subsidiaries could greatly speed up this essential part of the reform process.

29. In order to be able to make a decision on whether and how to introduce the kind of **competition** envisaged in the third stage of the reform programme, between vertically integrated railway companies, the necessary data collection and analysis needs to begin now. It will require detailed information on freight flows, from origin to destination, to be collected by the government and modelling to assess where competition would be possible. Making this information available also to other researchers would enhance the quality of analysis and at the same time address the demands for more information on the regulatory environment made in the Standard and Poor's report.

CONCLUSION

30. The urgent need is to **continue the reforms**. The profound transformation of the railways over the last three years has been achieved in a remarkably short time and positive results in terms of investment, productivity and traffic are already apparent. The risks of delay are probably greater than the risks of pushing through the reforms. Given the rapid pace of economic development in Russia, allowing the railway reforms to lag behind could be very damaging both to the rail system and to the national economy. Planning and analysis for the next stages of reform should commence as soon as possible. Questions that need immediate attention include:

- a. In which areas of Russia, and for what commodities, is rail versus rail (as opposed to truck versus rail) competition needed?
- b. The current tariff schedule (10-01) needs to be reviewed to determine if it encourages or discourages the entry of new common carriers and the development of licensed own-account carriers into businesses that will compete with RZD across the full spectrum of general freight. It is also important to determine whether the tariff schedule permits adequate pricing flexibility for rail freight carriers, including RZD, to compete with trucking companies for high value freight?
- c. Will there be line versus line competition in Western Russia? If so, how should the railway be divided and restructured? What data are required to design a system of competing railways that minimises the need for detailed regulatory intervention? Will the competition be on parallel track, at commonly served points, or both?

31. Though RZD will need to prepare for the next stages of reform with analysis of the potential options, it cannot be expected to lead the process of introducing competition. This can only be done by the Government and its regulatory agencies. It would help to identify a lead ministry or agency in this regard.

The priority for RZD will be in adapting its methods of analysing costs⁶ to a market environment. The respective roles of the Ministry of Transport and the Ministry for Economic Development and Trade would benefit from clarification, together with the role in the rail sector of the Federal Antimonopoly Service and the Federal Tariff Service, particularly in relation to leading reforms aimed at promoting competition in rail markets.

6. Data on approximate marginal costs will be most relevant.