



**OECD REGULATORY REFORM REVIEW OF THE RUSSIAN FEDERATION:
ECMT/OECD REVIEW OF RAILWAYS**

SUMMARY AND CONCLUSIONS

3 FEBRUARY 2004

REVIEW TEAM:

Mr Fabio Croccolo (Review Team Leader), Deputy Director of European Programme, Ministry of Infrastructure and Transport, Italy;

Mr Lou Thompson, Thompson, Galenson and Associates and Senior Railways Advisor at the 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 system¹ 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 reform plans 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 RZhD OAO on 1 October 2003 marked the first milestone in the implementation of the program. 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 many western railways. 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. More emphasis should, however, 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 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 may begin to limit the railway's ability to meet transport demand and threatens the financial performance of the railway, together with the cost of supporting passenger services. The team foresees that the rapid pace of change in the structure of Russia's economy and in the markets the railways serve, and the growing competition from road transport to carry higher value freight, will compromise the ability of the railways to contribute to the Government's regional and national economic development policies.

5. The response of the government to financial weakness has been a determination to improve cost effectiveness by separating non core activities from the railway, contracting for public service requirements and creating legal and tariff frameworks for shippers and industrial customers to invest in private wagons and locomotives. In addition, the reform plan provides for the creation of new general freight carriers to compete with the existing, state-owned freight carrier. Further measures will be required to promote this and other kinds of competition and the team believes that enhanced competition

¹ In the past, the Russian railway system has been called the Ministry of the Means of Communication (MPS). The system was separated in 2003 into a number of components, of which a Ministerial component along with a railway operating component (Russian Railways or RZhD OAO) are the most important. In this paper, MPS is used to refer to the rail system that existed prior to the split. RZhD refers to the new company established on 1 October 2003 to own and operate rail infrastructure, freight and, at least temporarily, passenger services in Russia.

should occupy a more central place in the priorities of the reform program. Experience in other countries shows that monopolies rarely maximise efficiency and are slow to innovate and provide the service that customers require.

FUNDAMENTAL POINTS BASED ON OECD EXPERIENCE WITH RAIL REFORM

6. 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.

7. Similarly, unless the **prices charged by RZhD to other carriers**² for using state owned infrastructure are regulated in a way that maximises the control that these licensed train operators have over their costs, the competition envisaged in stage one of the reforms may not develop fully. 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. The Antimonopoly Ministry may need additional resources to cope with an increase in its already heavy case-load, or a specific regulatory agency may need to be created to manage the increasingly complicated regulatory issue that are likely to arise. Markets where competition fails to develop are likely to see quality of service decline and traffic lost.

8. 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, through the design of the industry structure, they both reduce the scope of prescriptive regulation and reduce the need for intervention by regulatory authorities. 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.

9. The potential weakness of such a system would be in directing adequate investment to infrastructure to sustain the largely government funded operation of passenger trains. Particular regulatory attention would also need to be directed at ensuring sufficient priority in the dispatching of passenger trains to maintain 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) and the application of European style public service obligations to a North American style system of competing integrated railways.

² The 2003 Federal Law on Railway Transport provides for the licensing of “carriers” to compete for business with RZhD across the board in addition to the approval of “operators” that transport freight on an own-account basis.

10. 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.

11. A **regulator** will be required to protect the public interest from an economic and commercial viewpoint. This body should be independent in its organisation, funding decisions, legal structure and decision-making from the infrastructure manager or any carrier. It should be an independent agency of the government, free of potential conflicts of interest that might arise were it to also have responsibilities for regulating prices that are themselves affected by rail charges (such as coal) or have a large impact on rail costs (such as electricity). The principle role of this regulator, under the proposed structure, will be to ensure that infrastructure access is fair and charges appropriate. This is a complex task, given the conflicting objectives encompassed in government policy.

12. 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.

13. **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 a vital next step in Russia, this is a universal lesson from reform in other countries.

14. 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 Touche³ on the losses associated with social services and the need for more transparent and IAS compliant accounting for MPS, and encourages MPS and RZhD to continue the effort to develop line of business based, IAS compliant reporting. RZhD's intention to begin publishing such accounts in 2004 is very welcome. 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.

15. It is important to prepare **public expectations** as to the results of the reforms. The public should not be promised unrealistic improvements as this will surely lead to dissatisfaction with the eventual results. The inevitable trade-offs between different goals have to be explained and discussed at throughout the process of reform. Making good and detailed data available to the public will also improve the quality of public understanding of the reform process.

³ 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.

KEY DECISIONS TO BE MADE NOW

16. **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.

17. 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.

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 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.

NEXT STEPS IN REFORM

19. For the next steps in reform it is essential to clarify and define 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 to introduce competition and provide for non-discriminatory access to infrastructure by the Antimonopoly Ministry. With the incorporation of RZhD stronger leadership from government will be required – no for-profit company has the incentive to create competition for its own services. Government responsibilities for the development of rail competition policy and law⁴ 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?

⁴ As opposed to exercising powers under existing laws.

- Rail versus rail – if so where?
 - a. among integrated freight/infrastructure companies on parallel lines;
 - b. among integrated freight/infrastructure companies competing to serve customers at commonly served points (often called “source” competition), or
 - c. among 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. 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.

20. 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.

21. One potential inconsistency arises in the current formulation of charges for the use of RZhD infrastructure and other services. Charges are derived by formulae from the regulated tariffs for shipping goods. This means in effect that infrastructure charges are determined by subtracting from the end user tariff elements for wagons and locomotives when a shipper provides its own rolling stock. Some other services, such as loading, insurance or marketing, can be subtracted when these are also provided by the shipper or by an independent carrier. The result appears to be a charge for the use of infrastructure that is higher than would result by following the approach typical elsewhere, which establishes **track access charges** on the basis of costs from the bottom up. By deriving charges through subtraction from a commodity based end-user tariff, Russian access charges are themselves based on commodity class. This may well increase the ability of the infrastructure company to cover its total costs, but there is a risk 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 RZhD, and it could severely limit the ability of all rail freight carriers to engage in flexible, tariff and service-based competition with trucking companies.

22. In Russia the Law on Natural Monopolies identifies sectors of the economy where tariffs are to be 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 carry more freight than RZhD 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 RZhD’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.

23. 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 RZhD freight carrier on infrastructure owned by RZhD. 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. Before embarking on the major task of establishing a regulatory system that promotes competition between carriers with the structure proposed, 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 of infrastructure management from train operations 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.

CONCLUSION

24. The urgent need is to **continue the reforms**. The profound transformation of the railways over the last two years has been achieved in a remarkably short time and positive results in terms of investment, productivity and traffic are already apparent. Stalling reforms now would, however, arrest the recovery. The risks of delay are 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. How quickly should the new tariff schedule (10-01) be reviewed and from what points of view? Does it encourage, or limit, the entry of new common carriers that will compete with RZhD across the full spectrum of general freight? Will it permit adequate pricing flexibility for rail freight carriers 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?
- d. What is the future significance, if any, of the 17 traditional regional railways? Should they be recombined into a smaller number? Should the borders be redrawn to facilitate competition and reduce costs?

Though RZhD 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. The priority for RZhD will be in adapting its methods of analysing costs⁵ to a market environment. Following the separation of RZhD from MPS in September 2003, the respective roles of the Federal Government Railway Commission (chaired by Vice Prime Minister Khristenko), the Ministry of Railways, the Ministry for Economic Development and Trade, the Antimonopoly Ministry and the Ministry of Transport would benefit from clarification, particularly in relation to leading reforms aimed at promoting competition in rail markets.

⁵ Data on approximate marginal costs will be most relevant.