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Committee of Deputies
Economic Research Committee

CONCLUSIONS OF ROUND TABLE 120 : "WHAT ROLE FOR THE RAILWAYS IN EASTERN EUROPE?"

(Note by the Secretariat)

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The ECMT held its 120th Round Table, "What role for the railways in Eastern Europe?", in Cambridge (United Kingdom) on 12 and 13 September 2001. The Round Table was chaired by Mr. K. Celinski (PL) and introductory reports were presented by Messrs. M. Brown (UK), M. Ponti (I), J. Siegmann (D) and L. Thompson (World Bank).

The main conclusions of the Round Table are outlined below.

1. STRENGTHS AND WEAKNESSES OF THE RAILWAYS, AN OVERVIEW

1.1 Overview

Governments in Eastern European countries have limited budget resources and many priorities on their social policy agenda, and especially financing pensions. Improving the efficiency of the railways could make more resources available in these countries by stemming the flow of public finances (i.e. tax revenues) used to cover the operating deficits of the rail sector. At the same time, railways have been used to retain surplus work forces to avoid increasing levels of unemployment. The short-term benefits of this expedient are outweighed by the long-term costs. Examples of successful severance packages – financed by the State – were cited in Poland and Romania as well as in Latin America.

The fact that the railways of Western Europe cannot be held up as an example only reinforces pessimism about the rail sector in Central and Eastern European Countries (CEECs). Despite significant public investment in most western networks, no winning strategy has emerged for the future, with the possible exception of high-speed passenger transport. A feeling of "crisis" in the rail sector is shared by practically every country in Europe and this is linked to political uncertainty as to the strategic role in transport for railways over the long term.

At the same time, new challenges have to be met:

– The integration of countries into the global economy is building a network of economic relations critically dependent on "supply chain management" and "extended logistics", i.e. in which economic relations are based on information technologies at European and indeed world level.
– As standards of living rise, private car and air transport will occupy the strong position that they already hold in Western Europe, a foretaste of future trends in Eastern Europe.
– Although there may be good reasons why the CEECs and the Commonwealth of Independent States (CIS) may want to foster the growth of their rail sectors, there will also be a number of social reasons -- such as population ageing -- why they will find it hard to put much money behind these policies. The CEECs and CIS railways may have to develop without much state financial support, except for critically needed social programmes for local transport.
– The types of products and services that are increasingly in demand in the new economies will put a premium on higher quality of transport, which may mean that road haulage shares will grow much faster than rail shares, except in countries or regions where the road network is so rudimentary that no growth in road transport is possible. If economic development is successful, then structural changes -- both economic and social -- will favour flexible and

individual transport modes, further reducing demand for rail transport, especially in the wealthier CEECs. The prospects for rail transport are far from reassuring.

EU accession will also be important for candidate countries in two ways: first, the accession countries are likely to receive a boost in growth and investment from their initial years of membership, and their growth is likely to spread to adjoining countries.

The issue that dominated the discussions was how to ensure that the railways of Eastern Europe play a larger role in meeting demands for transport services than they have over recent decades in Western Europe. The starting point for the discussions was a review of the strengths and weaknesses of the railways in the CEECs and the CIS, *even if important differences exist as to the future of the railways in these countries according to geographic, economic, social and political factors*.

1.2 Weaknesses of Eastern European railways

The Round Table identified several factors which indicated that the current decline in rail traffic in Eastern Europe could well become permanent.

- The decline of heavy industry, such as the steel and coal industries, in Eastern Europe could continue as the international division of labour proceeded. It was likely that the economies of these countries would specialise -- although the underlying trend would be roughly the same as that in the West -- i.e. unfavourable to primary sector industries. At the same time, productivity gains in Eastern European industries would reduce transport intensity per unit of GDP output. It was therefore clear that fewer tonnes would be transported for the same level of GDP, which would have an impact on rail transport in particular.
- Competition in the road transport sector would have a lasting impact, indeed more so in the CEECs than the CIS. It would be a major factor for both passenger and freight transport. In the passenger transport sector, competition from private cars would be merciless. The rate of car ownership per 1 000 inhabitants was rising steadily in the CEECs, and was close to the rate in Western Europe. As the road network was also being developed in these countries, rail would find itself under constant threat. Moreover, the advent of increased competition in the air travel sector will also pose a serious competitive threat for rail in the longer-haul passenger business. In the freight transport sector, the road haulage industry had consistently improved on productivity and service quality since the introduction of Community measures to liberalise road freight transport. This means that, while the level of service has improved, prices have dropped considerably. This trend will continue in the European Union and will be reflected in the CEECs in both domestic and international transport, principally because the privatisation of the road freight haulage industry is almost complete and because the logistics organisations set up in Western Europe will be imported into the CEECs. Inevitably, therefore, the railways of Eastern Europe will no longer be competing with not very efficient road haulage conglomerates but with flexible, high-performance firms like those that exist in the West.
- The productivity gap between rail and road freight transport is so wide that it cannot be bridged simply by internalising the external costs of road transport, if indeed that is a policy CEECs opt for. In other words, environmental protection will only be a positive factor in rail development if the railways make a determined effort to increase their productivity and service quality.
- Rail productivity is generally dependent on labour productivity in Europe. Productivity is unsatisfactory in railways all over Europe and has been aggravated in Eastern Europe by a substantial fall in traffic. Major restructuring will be needed to solve this problem and if governments of some countries resign themselves to the *status quo*, their railways will be

deprived of a key element of the strategy for survival and success. In the future, increasing wage levels will cripple the railways if they cannot shed excess labour.

- The position of the railways is something of a vicious circle in which lack of competitiveness leads to lost markets and lost revenues, which in turn leads to under-investment and further erodes competitiveness. The involvement of private investment in the railway system may be one of the ways in which they can break the circle, but private investment will require a change in the mentality of the rail sector, giving priority to options very different to those that have so far prevailed. A change of this kind will always be slow.
- Intermodal transport may be a factor for growth but, because it is complex and road transport prices are low, it is difficult to create conditions in which it can be competitive. In the European Union, it is clear that it is no longer a growth market and could only become so with heavy subsidies, not only for equipment but sometimes for operation, too. Such a policy would come up against the shortage of government resources.
- Choices have to be made as to which services railways should offer. There is no such thing as a homogeneous market for any company, there are only profitable market segments. In other words, the rail sector may have to concentrate on a few priority markets that play to its inherent strengths, and try to make money from them. This would mean turning their back on the temptation to be a universal carrier, a role that road transport is better at. Such a change would exacerbate the problem of overstaffing.
- Railway undertakings will be handicapped so long as government rail policies remain ambivalent. Because of differing rates of progress in European Union countries, and the need to establish consensus on minimum degrees of change, reforms appear tentative. This weakens policy initiatives, when clear direction is needed. This is a problem that applies equally to Eastern and Western Europe.

1.3 Strengths of the railways in Eastern Europe

As well as the weaknesses mentioned above, the Round Table also identified the strengths of rail transport in Eastern Europe.

- Countries that had begun the process of overall reform early enough, may be able to ride out the crisis marked by the very substantial contraction of industrial output. Those that had relied on market mechanisms and private initiative may be seeing the end of recession and this is confirmed by the large increases in GDP growth rates in some countries. This has had a positive impact on rail freight traffic and there have been signs of a real turnaround since 1999-2000. However, the same cannot be said for rail passenger transport. A distinction should also be made between the CEECs and the CIS, where the long distances and underdeveloped road network are structural factors that may maintain or improve rail freight transport's position for many years to come.
- Although rail transport has been declining in the CEECs since the end of the 1980s, this could be regarded as normal since it mirrors the underlying economic changes. Some experts say that the decline may not indicate a "dramatic" weakness in rail transport at this time, just that it needs to adapt better to current trends. Policy can still play a role and build on the positive characteristics of rail in Eastern Europe, i.e. the density and size of its networks although, when considered in terms of costs, this can be viewed as both a strength and a weakness.
- The density and size of rail networks becomes an advantage from the standpoint of territorial development. There is no definite implication as regards land use. Of course, the market is very imperfect since location decisions, particularly by private individuals, do not always take into account the need for optimal access to city centres. In Eastern Europe, where urban sprawl is neither extensive nor irreversible as yet, residential densities are high, which is to

the advantage of mass guided transport, and hence to rail. If governments in Eastern Europe give themselves the means to influence land use -- acknowledging that the opportunity costs of so doing are lower than the opportunity costs of doing nothing -- the role of the railways can be safeguarded to a great extent. One factor which gives hope to the railways in Eastern European countries is that settlement patterns and densities were based, until a few years ago, on criteria dictated by public transport, and specifically so that they could be served by rail. This must be balanced, however, by the fact that the lack of land markets in the former socialist countries created habitation patterns that are to some extent artificial: while the heavy use of mass transport is potentially a positive factor for railways, the development of land markets may shift populations in a way that reduces use of mass transit. Moreover, since urban and suburban transport tends to be unprofitable for railways (because of socially determined rates and services), continuation or even growth in these services implies an even higher participation of governments in support for rail operations.

– Low salaries, for the time being at least, make Eastern Europe competitive in the transport market and particularly in the rail sector. This may encourage Western European rail companies to form alliances with rail companies in the CEECs or the CIS and pass on rights of access to Western European markets. All of which would strengthen the competitive position of rail transport in the CEECs and the CIS.
– As incomes rise, the need for travel will increase, giving rail an opportunity to capture part of this market which will be in both business and leisure travel. Lower birth rates are synonymous with population ageing and therefore greater dependence on public transport, although at the same time, they indicate a decline in the numbers of young people who will be dependent on public transport until it is supplanted by the private car.

To conclude this review of the strengths and weaknesses of rail transport in Eastern Europe, although there is a demand for transport in these countries, it is not necessarily for rail transport, except in the CIS where rail transport will remain largely dominant given that it will retain a structural role. It is therefore important that rail transport in the CEECs adapts and makes the strategic choices that will allow it to position itself on promising markets. The next section addresses the key issues it will face.

2. KEY ISSUES

Until rail companies offer complete, seamless, end-to-end services to customers, they cannot be competitive with other modes. All reforms must have as the primary goal achieving this focus on meeting the demands of the market and the client. Despite its disadvantages, separating freight operations from infrastructure may help by promoting new entrants to show the way where incumbent national railways have been too slow in innovating.

2.1 Open access as a model

Given the situation outlined above, there is no perfect solution for rail transport in Eastern Europe -- the problems are so complex that no single solution could solve them all – however, the Round Table did produce a series of recommendations.

– The national level was not necessarily the most relevant level for discussing rail transport, particularly freight transport. For the latter, the issues and markets are European. That the only sensible level for discussions was the European was borne out by the fact that more than 50 per cent of the freight revenues of DB and SNCF were from international traffic. However, this was not to say that existing companies should simply merge: the ideal solution would be to see new companies catering for the whole of Europe to come onto the market and compete with existing companies. The rule at this level should therefore be open access.
– As regards local or regional passenger transport -- the levels at which the concept of public service arises -- competition between companies for the market should be the norm. The involvement of private sector companies in the provision of public services, where necessary, ensures that better quality services will be provided at lower cost. For example, virtually all of the railways in the Americas, including suburban passenger services and some major metro networks, are currently operated by the private sector. Governments would have to oversee the services and establish frequency, fares and other aspects such as service arrangements and equipment replacement rates.

2.2 Efficient pricing

The Round Table recommended open access to infrastructure for freight, coupled with basic requirements relating to safety, etc. Separating freight operators from infrastructure management is one approach to providing neutral conditions for access between competing operators and is the model to be followed by EU accession countries. This leads directly to the issue of infrastructure access pricing.

Marginal social costs are the appropriate starting point for charges that promote efficient use of the existing network, as the EU railway package sets out, but it is essential to go beyond this and provide, through charges, incentives for rational development of the network. At the same time, potential rent-seeking by the infrastructure monopoly (by under-investing where capacity is tight and simply increasing charges to ration use) must be prevented through structural or regulatory intervention. Infrastructure access charges should also send the right signals to the infrastructure owner as regards the need for investment on certain heavily trafficked sections, in order to reduce congestion on rail infrastructure.

The pricing mechanism should also promote efficient allocation of train paths among different users. On this point, the Round Table thought that the railways in Eastern Europe should use the latest available technologies to allocate train paths via an auction mechanism in which the bid entered by any company applying for a path is the measure of the importance it attributes to having that path allocated to it. It should be said that, until now, where infrastructure has been separated from operation - notably in the United Kingdom - infrastructure access charges have not been found to provide the right signals and have undergone several major changes Getting the prices right is not a simple task. A secondary market for slot allocation was seen as important in achieving liquidity in any auction system.

2.3 Separate accounting or separate institutions?

Accounting at least should be totally separate and the prevailing view at the Round Table was that institutions too should be totally separate in whatever proved to be the most appropriate way. When there is a balance of users, with no single user predominant, when there is a need for real competition among users on the same line and when the economics of the various services need to be clearly separated, then institutional separation becomes necessary. In this case, institutional separation does indeed seem to be the best arrangement for non-discriminatory open access. The Round Table's emphasis on open access partly reflected a desire to see new rail companies coming onto the rail transport market in preference to the alternative arrangement, which would be the merger of the incumbent public undertakings. It is essential that the process of change should not be left in the hands of the existing rail undertakings, which are not inclined to upset their practices and face competition with profit objectives. To this end, the Round Table thought that measures should be taken to encourage new companies onto the networks, which was quite the reverse of granting "grandfather rights" which favoured existing undertakings. Faced with competition, the latter would be unable to remain set in their ways and this is indeed one of the objectives of the reforms to be implemented. Another point made during the discussions at the Round Table was that there was no fundamental reason why rail freight transport, to give but one example, had to be provided by a public undertaking. There was not a single example of a successful state-run rail service and there is nothing necessarily public about the provision of rail operating services.

2.4 Privatisation should not be a dogma

This said, there were historical, contradictory sociological and institutional realities that made calls for "privatisation of state-owned railways" meaningless. There is no basis for dogma regarding the role of the private sector and, as far as infrastructure is concerned, the experts at the Round Table took the view that privatisation could only be contemplated where there was no vertical separation between infrastructure and operations in a company (as was the case in the United States). Above all, companies should be encouraged to change by responding to competition and by adopting the internal operating rules of the private sector. With this in mind, one point that the Round Table emphasized was the need for cost accounting by activity centre for rail companies, so that their competitiveness, not the policy objectives imposed on them, will dictate the markets they can position themselves on. Monolithic rail companies in a market economy would guarantee failure and accounting procedures based on private sector standards would be a first major step towards avoiding this.

2.5 Non-core activities

Under a planned economy it was argued that really large entities, such as railways, could efficiently be independent of the rest of the economy because their needs were large enough to justify self provision. This would not be sustainable under market conditions because equipment, supplies and services can be purchased at lower costs and higher quality from sources outside the railways. It should also be noted that the process of spinning off these non-core activities has already begun in many countries and in the normal course of events should be brought to completion as reform proceeds.

However, it is not sure that selling railway properties situated in town centres is a useful initiative, inasmuch as by keeping a stake in these properties and in their development, the railways may gain a share in activities with a high transport utilisation. A shortage of sites for freight terminals in cities is a handicap for developing rail markets in many Western European countries.

3. STRATEGIES

3.1 Measures for railways

First, accounting systems based on cost transparency

The first priority is to put in place a line-of-business cost accounting system for operations, based on cost transparency principles. Cost transparency is essential for taking informed decisions: the aim is not necessarily railway growth in absolute terms, but to concentrate on profitable markets and market segments, like any competing company. On the contrary, this could mean a reduction in size.

It is therefore essential to base the structure around markets so that revenues and costs can be related to each market. Line-of-business management will require agreement on public service obligation payments from governments to operators for the provision of unprofitable passenger services that governments wish to preserve.

Second, introduce the same practices as any commercial company

The railways must help themselves by adopting the same strategies and practices as any commercial company. The adoption of a commercial paradigm implies a major change in management process. It is essential that senior management is committed to such change. An independent senior management team must be empowered to structure the organisation and to appoint and dismiss staff. This will also mean that new practices have to be shared by all staff. Clearly, therefore, an innovative strategy is needed, based on staff motivation and a management style that is geared to the railways, but inherited from private enterprise.

Third, the railways should position themselves on profitable markets, such as complete logistics services

The railways in Western Europe and the CEECs are basically geared to providing passenger services, with freight a minor concern. Markets are not homogeneous and they have various potentially profitable segments. The railways must aim to increase their penetration into these market segments and consider developing a logistics approach for freight transport. In other words, they must position themselves on promising markets.

Fourth, encourage investment in new technology

A key factor in the development of the railways depends on their ability to capitalise on the inherent features of rail, including its ease of automation. Contrary to what has been the experience to date, rail is inherently a technology-intensive, not labour-intensive industry. On this point, the Round Table considered it vital for the railways to get involved in new technologies, including automation technologies. The problem of overstaffing that this would inevitably expose should be resolved in collaboration with governments. In addition, they should invest in the acquisition and operation of the equipment necessary to calculate infrastructure costs and manage track capacity in a non-discriminatory way. This managerial software is critical to all of the transformations needed to support market-based management and no railway should undertake reform without it.

3.2 Measures for governments

The Round Table set out a series of initiatives that governments should take to resolve the problems posed by the railways in Eastern Europe.

First, open up access to the infrastructure as required by EU practice

For many experts, Western Europe had failed to implement the provisions of the Treaty of Rome with regard to the liberalisation of transport in the rail sector. A certain economic philosophy and special interest groups had caused some countries to shield state enterprises, especially railways, from market forces. Eastern Europe, then, should learn from the mistakes made in the West where past policy on rail transport cannot be used as a model. Attempts to co-ordinate the activity of different modes in the West had been very costly, since railway subsidies in the West per passenger carried are 15 to 20 times higher than in the East of Europe but had still failed to halt the decline in rail's market. What could be considered the key recommendation to emerge from the Round Table was that there must be open access to rail infrastructure for freight operators, i.e. open to new operators and open to the rewards of the free competition model. Competition is a major factor in efficiency and in responsiveness to the demands of the market.

Secondly, create a competitive framework for the transport market

In order to do this, the first lesson to bear in mind is the need to provide a framework for the transport market and give companies total autonomy. The responsibilities and freedom of every actor in the transport market must be harmonized in order to build a "level playing field". This is easy to say but more difficult to do, as the liberalisation of the transport market will mean establishing regulations on safety, the environment, market access, social conditions, charging, taxation, etc. However, there are numerous ways in which these principles can be introduced and each country can find a suitable way to do so.

Another objective of this kind of change is to put an end to the railways' hold on regulatory power, which is the result of the close relationship between the rail companies and governments.

Third, encourage new entrants

All national policies should have a common aim to encourage new entrants to the rail transport market as a matter of urgency, thereby preventing the existing companies invoking grandfather rights. Access rights are essential and must not discriminate in favour of established companies. Effective access rights can be provided by competition *for* the market as well as competition *in* the market. That is, competition for an exclusive suburban rail concession, with public subsidy under contract, can be a fully acceptable way of opening up the competitive use of infrastructure. In other words, the open access objective needs to be taken together with the enhanced competition objective if the best approach is to be found.

Fourth, give decisionmaking back to companies

This kind of model can only work if companies are given a free hand in strategic decisionmaking in their operations. After the public needs for infrastructure capacity are decided, and social needs for operating services (primarily regional and suburban/urban passengers) are identified, governments must therefore hand the decisionmaking powers they still exercise back to rail company management. The managerial freedom of the companies is essential and can only be based on transparency of costs and revenues, as well as a direct relationship between market demands and enterprise performance. A point made several times in the course of the Round Table was the need for rail companies to have a standardized accounting system, i.e. a system that allows them to see the return on operations in each of their markets, in line with a cost accounting model. In addition, government oversight of rail performance is greatly enhanced if the rail accounts are relevant, accurate and comprehensible.

Fifth, grant public service franchises

For transport markets in which the open access concept is not realistic, such as local and suburban transport, governments may grant franchises to operators that submit the least costly bids. As governments subsidise these services, they will retain decisionmaking powers on frequency, fares, services operated, etc., but here too, new entrants will be encouraged to enter the market through invitations to tender.

Sixth, resolve problems at border crossing points

Problems at border crossing points are a determining factor for freight transport in that, as the Round Table stated, it makes little sense these days to talk about national issues for freight transport when the international dimension is so large. Governments should therefore promote cross-border competition and joint ventures between incumbent railways to the extent that this does not create barriers to new entrance.

Seventh, set up a regulatory body

Governments should institute a national regulatory authority in each country with powers to prevent anti-competitive practices and enforce compliance with the applicable laws. Independence of the regulatory bodies is important to give new entrants confidence to enter the market.

Eighth, do not overlook environmental concerns

An increasingly important influence on European transport policy is concern for the environment, which may materialise as incentives designed to promote rail traffic. Typically, they will include reduced or short-run marginal cost access charge regimes for rail freight and subsidies for urban or regional passenger transport. The danger that such practices diminish resources available to the infrastructure operator has to be overcome. But such incentives should only be valid for services with a demonstrable and quantified environmental benefit. The CEECs and the CIS have tended not to share the same environmental concerns as in the European Union, but will increasingly do so, even if it is particularly difficult for them to correct the environmental misbehaviour of their state enterprises.

Ninth, adopt a state-financed plan for overstaffing

Lastly, one of the most difficult aspects of the changes to be made relates to the overstaffing of established railway companies. This problem cannot be left in the hands of the rail companies alone. It is vital that it be resolved, even if the unit cost of labour in the CEECs is low at present. Savings in the region of 4 to 5 billion Euros per year could be made in the CEECs overall, in other words, enough to finance large-scale investments over five years. In order to find a satisfactory solution to this problem, governments must help to design and fund programmes for early retirement, training and redundancy compensation, etc., while at the same time taking care to retain and recruit high-calibre managers with the skills required for the business environment to be created in the railway sector. Examples from Latin America were cited during the Round Table: staff were generally reduced by fifty per cent, while taking care to attract quality personnel in new domains. Salaries must reflect individual merit. It helps to define and obtain general acceptance of planned redundancy payments first and then allow the enterprise to decide which personnel to keep. The agreed redundancy programme is then applied to employees who have not been offered a new job.