

Reform of the Railway Sector in Russia: Achievements and Challenges

Alexander Kolik*

The Russian railway system has been in the process of reform for 15 years. The introduction of the unique railway market model had solved some problems but numerous challenges still exist.

Reform background and preconditions

The Russian railway system is one of the world's largest. Russell Pittman (2013) calls it "...one of the economic wonders of the 19th, 20th, and 21st century world". Railways account for more than 85% of freight tonne-kilometers (excluding pipelines) and 27% of passenger-kilometers (Rosstat 2016). Railway transport is the backbone of the entire Russian economy. Many basic national industries (mining, metallurgy, etc.) have no alternative transport mode. It is not a surprise that for decades "railways" and "transport" were actually synonyms in everyday Russian language.

For nearly a decade the industry was not affected by the dramatic socio-economic reforms that started in Russia in 1992. The Railway Ministry (MPS – Ministerstvo Putei Soobschenija) combined the roles of service provider, policy maker, and regulator. It remained a monolithic non-transparent state monopolist amidst the developing market economy.

The declared reason was that the risk of damaging the highly integrated railway system could, in turn, harm not only Russia, but other post-soviet states for which railways had been the essential connecting link.

But in the beginning of the 2000s the enormous investment needs of the industry could not be funded at the expense of operations any more. Loss-making passenger services needed growing internal cross-subsidies. The situation demanded changes. The government recognized that competition, if introduced, could attract private capital, drive cost reduction and improve service level.

Railway reform program and initial steps

The railway reform in Russia started in 2001 after adopting the "Program for Structural Reform in Railway

Transport" (Russian Federation Government 2001).

The declared goals of the reform were to introduce competition and facilitate private investment in the industry, improve the service quality, sustainability and safety, and reduce the economic costs of transportation. The program envisaged three phases.

The first phase (2001-2003) was aimed to separate the policy-making and regulatory functions from business management and operations.

To achieve this, a 100% state-owned joint-stock company "Russian Railways" (Rossiiskye Zheleznye Dorogi - RZD) was established. The "policy-making" segment of MPS was integrated into the Ministry of Transport. RZD inherited all the basic assets of MPS, while numerous non-core structures such as hospitals, schools, etc. were divested. Significant staff reduction took place. At the same time, a considerable number of new legal acts were adopted in order to prepare the transition from state-owned railway monopoly to competitive railway industry.

The second phase of the reform (2003-2005) was aimed at RZD corporate restructuring and further market-oriented legal base improvement.

During this period certain business lines and activities within the company were institutionally and legally separated. More than 40 subsidiaries were established in the segments of container transportation, reefer services, new auto transportation, rolling stock repair, etc. Phasing out of internal cross-subsidizing of passenger operations of the expense of freight started.

In the legal sphere the principle of non-discriminatory access to railway infrastructure was declared, although RZD was still the only railway carrier. New legal acts and modified tariffs encouraged private investment in freight rail-

* Professor, Higher School of Economics, Moscow, Russia, akolik@hse.ru

cars. During this period the segment of so called “wagon operators” was rapidly growing up to eventually become one of the principal components of the Russian railway market model.

The third phase of the reform (2006-2010) was planned to be a period of intensive attraction of private capital to the industry. Some of the RZD subsidiaries were to be privatized. It was planned to create a competitive market for freight transport services and, probably, long haul passenger transportation.

At the same time, within ten years of reform, after all the initial and preparatory steps described above, the model of the future railway market was not clear at all.

Reform model debates

The discussion on the railway reform model had actually begun much earlier than the 2001 Program was adopted. This discussion was far from being academic since it was a time of deep socio-economic transformations that dramatically changed the life of the whole country.

Some of the old-school experts came along with the slogan “Hands off the railways!” They argued that the MPS system, so integral and solid, was capable of surviving through hard times – probably, with a little help from the government. But any serious intervention, they said, will lead to industry collapse and economic disaster.

But the majority agreed on the necessity and inevitability of the reform and discussed the appropriate model to be chosen. The main criteria were “Not to cause economic shocks”, “Not to make irreversible steps”, “Not to destroy the integrity of the system”. It sounded reasonable considering the dominating role of railways in freight transportation.

As is known, international practice provides two main models of competitive railway market: a) competition between vertically-integrated companies (North America) or b) separating the infrastructure management from operations to establish a platform for competition of carriers “on rails” (introduced by the EU “railway” directives).

In the course of discussion only a few voices called for straightforward choice of one of these models. Most of the experts and decision-makers agreed that some special approach was necessary - adequate to historic development of railways and the current economic situation in Russia. In this case the “American” approach of creating several independent, integrated companies to compete with each other was unanimously rejected because it led to immediate “loss of system integrity” (although some

international experts admitted the possibility of horizontal separation in the European part of Russia: see, for example (ECMT 2004)). The “European” model was seen as the possible option, but its implementation was meant to be very careful and gradual.

Finally, the following formulation concerning the reform model was included in the text of the Program: “...in the course of the structural reform conditions can be created to make possible the complete organizational separation of infrastructure and operations. The appropriate decision can be taken in the light of international experience”. At the same time, it was stipulated that necessary is “...to preserve the integration of infrastructure with a portion of freight operations, at least during the first years of the reform” (Russian Federation Government 2001).

As for the new competing carriers, the Program said the following: “on the basis of industrial railway transport (on-site railway operators - AK) and certain new-built local railway lines vertically integrated railway companies can be created. On the licensing basis these companies can be given the right to access the public infrastructure to carry out cargo transportation” (Russian Federation Government 2001).

Anyway, the Program was adopted, while there was no clear vision of the market model to be reached at the end. But the practical development of the reform had identified the basic principle of the new railway industry: wagon operators as the main competing market players.

Wagon operators

The first wagon operators arrived on the stage in early 2000s against a background of an acute shortage of railcars. In 1998 the railways had purchased 6680 freight wagons while in 2001 only 104 (Farid Husainov 2012). The MPS, admitting the incapability of investment in the rolling stock, suggested that big shippers should buy railcars for their cargoes in exchange for a tariff discount.

This mechanism was implemented and a growing amount of freight was transported in shippers-owned rolling stock. Soon enough the number of private wagons had exceeded the demand in many industries and the fleet owners started outsourcing their railcar companies.

The wagon operating business turned out to be very profitable due to free tariffs. Besides, wagon operators had no service obligations (unlike public railway that had to serve each registered customer) and they could choose the most attractive commodities and trade lanes. As a result, enormous investments in the wagon operating segment were made not only by shippers but also by independent finan-

cial structures as well.

The government was satisfied by the fact that private business was rapidly entering the railway transport. Some observers equated the growing competition between wagon operators to the intramodal competition declared among the reform priorities.

RZD decided to participate in this process. In 2007 the First Cargo Company was established – the RZD-daughter wagon operator with 200 thousand ex-RZD wagons. In 2010 it was followed by the Second Cargo Company (currently - Federal Cargo Company) with 175 thousand freight cars. RZD preserved a small fleet for its internal operating and maintenance needs only.

After all was finished, the freight railway market had acquired the following structure unparalleled worldwide:

- RZD as a single state-owned monopolistic railway carrier, the owner of infrastructure and the long haul locomotives. No wagons in operation. RZD manages and executes transportation, issues waybills and follows a state-regulated tariff. The tariff has commodity classes, is weight and distance based and includes the “infrastructure”, the “locomotive” and the “wagon” components;
- More than 1400 wagon operators with the fleet of 1,6 million railcars offer capacity to customers together with a set of additional services (forwarding, documentation, mediation in relations with RZD, etc.). The wagon operator subcontracts the wagon component and charges the shipper adding the payment for his additional services.

Passenger transportation

Reforms had affected the passenger transportation as well, and their results vary greatly in different segments of this business.

The reform in the long-distance passenger segment was, probably, the most consistent one. The Federal Passenger Company (FPC) was established in 2009 as a subsidiary of the RZD. FPC owns the passenger wagon fleet (traction and infrastructure services are bought from RZD) and is legally acting as a carrier. At the same time, several independent private carriers occupy a small share of the market (about 5%), competing with FPC on the most popular routes (Moscow - St. Petersburg, Moscow - Nizhny Novgorod, Moscow - Ekaterinburg, etc.).

The economy-class services of FPC are directly government subsidized since the tariffs are regulated. This scheme

had replaced the internal freight-to-passenger cross-subsidies within RZD. At the same time, the tariffs for high-class passenger services are deregulated.

The largest share in the structure of the rail passenger traffic (about 90% of passenger-kilometers) belongs to suburban (commuter) segment. It was planned to outsource this activity from RZD and to establish Regional Suburban Companies (RSC) holding the depots, rolling stock, etc. RSCs were to be owned - partly or entirely - by regional authorities. The latter were recommended by the government either to subsidize their RSCs or to set their rates at the “economic level” (Julia Panova, et al. 2014).

But in practice most of the regions could not follow these recommendations. Subsidies would have been an unbearable burden for their budgets while economic levelled suburban tariffs covering the costs would have meant the social shock for millions of passengers.

In most of the regions RSCs act as the formally established administrative structures that are just selling tickets. The assets belong to RZD which is the operator as well. But RZD can't run this business in full scale since it is formally overtaken by the regions, and the federal subsidies are terminated. Cancelling of suburban trains is common practice now; in certain regions this activity is completely frozen.

In the end of 2012 the new concept of the local passenger railway services was drafted which was aimed to tackle the mentioned problems, first of all, by passing corresponding legislation, but it is not adopted yet. In fact, the reform in suburban segment has effectively failed because of poor economic substantiation and the absence of an adequate legal base.

Reform results and remaining challenges

When the ten-year period of the 2001 Program had elapsed, the government prolonged the reform. “The Target Model of the railway freight market until 2015” was the document defining the further actions for five years. It expired on December 2015 bringing no fundamental changes to the industry. In the absence of any other governmental orders the reform can be formally considered complete.

So what are the main results achieved during these 15 years? No matter how disappointed can many observers feel with the speed and character of the reforms, it should be admitted that Russian railways had changed dramatically.

Among the positive results it should be mentioned, primarily, that the private capital had entered the industry.

About 50 billion USD in comparable prices were attracted (EBRD 2014), which solved the rolling stock shortage problem and gave good incentives to wagon-building.

The first competitive segment in the industry – wagon operating – is successfully developing. Many private wagon operators are ready and eager to develop as full-scale railway carriers. A reasonable degree of success has been achieved in the long-haul passenger segment where the carrier company is outsourced and independent operators exist.

The policy and regulatory framework was separated from railway operations. A number of legal acts had been developed in order to adapt the industry to market conditions. Particular new institutions (like independent freight carriers) are now envisaged legally, although do not exist in practice. The first timid steps were taken to deregulate both freight and passenger tariffs. The last but not the least to be mentioned here is that serious shocks were avoided. Railways were functioning sustainably enough.

But the list of unsolved problems is even longer. There is still no competition in the freight transportation sector. RZD, being the monopolist here, has no incentives to improve services and decrease costs.

Freight tariffs – even in their regulated part – are growing faster than the main shippers' prices (indexes 2014 to 2002 are 349% and 320% correspondingly) and faster than the trucking freight rates (indexes 2014 to 2002 are 349% and 270% correspondingly). All the evaluations are related to 2014 to eliminate the influence of the economic crisis of 2015. Data: Rosstat 2016). It means that one of the main declared goals – to reduce the economic costs of transportation – is not reached.

The service quality is not improving. Cargo delivery speed is low (2002 – 290 km/day, 2013 – 223 km/day. Data: RZD 2016). Freight railway services are not available for many potential “unprofitable” shippers who are simply ignored by wagon operators.

As a result, railways are losing freight in favor of road transport. The freight turnover index 2014 to 2007 is 10% for railways and 19% for trucking (Rosstat 2016). The reform in the socially sensitive suburban segment should be recognized as a complete failure. Obviously, there are still many challenges to be tackled. It appears that three main lessons should be learned to move forward.

1. The scale and economic importance of Russian railway system probably justify the careful and slow conversion. But, if so, the more important is the definite action plan. Unfortunately, the reform program

had set out clear enough goals but did not contain a clear enough roadmap. Many steps in the course of the reform were done as a response to current market situation rather than according to the long-term strategy.

2. The best results were achieved in wagon operation – the segment that was fully open to market forces. It does not mean that total privatizing is the best decision but indicates the main vector of the reform strategy: steadily opening the industry to competition.

3. Some experts argue that the current crisis situation is not the best time for changes. The Institute of Natural Monopolies Research (IPEM) – the Russian research center that develops recommendations often reflecting the opinion of the “reform headquarters” – confirms that the renewed reform strategy is necessary. But “... at the same time, in the current crisis conditions, it is appropriate that this document should be aimed at «restoring order» and current problems solution, rather than at fundamental transformation” (IPEM 2016).

This mistake should not be committed. The reforms should not be frozen under any circumstances.

References

1. EBRD (European Bank for Reconstruction and Development) (2014), Russian Railway Reform Programme. Working Paper (London: EBRD)
2. ECMT (European Conference of Ministers of Transport), 2004. Regulatory Reform of Railways in Russia (Paris: ECMT).
3. Husainov, Farid. (2012), *Economicheskie Reformi na Zheleznodorozhnom Transporte* (The Economic Reforms on the Railway Transport) (Moscow: Nauka Publishers)
4. IPEM (The Institute of Natural Monopolies Research) (2016), Analytic Report ‘On the 15-th anniversary of the structural reform of the railway transport in Russian Federation’ (Moscow: IPEM)
5. Panova J., Korovyakovskiy E., and Volkova E. (2014), ‘Development of commuter and long-distance passenger traffic in Russia’, *Russian Journal of Logistics and Transport Management*, Vol.1, No.1: 3-14.
6. Pittman, R. (2013), ‘Blame the Switchman? Russian Railways Restructuring After Ten Years’ in M.Alexeev, S.Weber, *The Oxford handbook of Russian Economy* (Oxford: Oxford University Press), 490-527.
7. Rosstat – Russian Federal State Statistics Service (2016). <http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/en/main/>, accessed 31 May 2016
8. Russian Federation Government (2001), ‘Resolution of 18.05.2001 No. 384 “On the program for structural reform of the railway transport”’, <http://www.consultant.ru/document/cons_doc_LAW_31692/>, accessed 3 June 2016
9. RZD Russian Railways. Official site of the company (2016). <http://eng.rzd.ru/statice/public/en?STRUCTURE_ID=23>, accessed 8 June 2016.