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Regulatory Reform of Railways in RUSSIA

2007 UPDATE

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FOREWORD AND ACKNOWLEDGEMENTS

This report on Regulatory Reform of Railways in Russia was prepared for the European Conference of Ministers of Transport (ECMT) and Organisation for Economic Co-operation and Development (OECD) by Louis S. Thompson of Thompson, Galenson and Associates, LLC. It forms part of the OECD's program of cooperation with the Russian Federation.

The report was completed in cooperation with the Ministry of Transport of the Russian Federation and RZD, the Russian railway company. The ECMT and OECD gratefully acknowledge the assistance of the Russian experts, listed in Appendix 2, and Russell Pittman at the United States Department of Justice in preparing this report. Both Russell Pittman and Louis Thompson were members of the ECMT/OECD review team that undertook the full review of Regulatory Reform of Railways in Russia in 2004, available from OECD publications.

GLOSSARY

ECMT	European Conference of Ministers of Transport
FPK	Federal Passenger Company
IAS/IFRS	International Accounting Standards/International Financial Reporting Standards
IPO	Initial Public Offering
JSC	Joint Stock Company
LOB	Line of Business
MEDT	Ministry of Economic Development and Trade
MOT	Ministry of Transport
MPS	Previous Railway Ministry
OECD	Organisation for Economic Co-operation and Development
PC 10-01	Price Courant 10-01
PSO	Public Service Obligation
RZD (OAO)	Russian Railways Joint Stock Company
VIA	Rail Canada
VR	Finnish Railways

REGULATORY REFORM OF RAILWAYS IN RUSSIA: AN UPDATE AS OF APRIL 2007

Introduction

In 2002, the Government of the Russian Federation requested that the OECD, represented by the ECMT, conduct a review of the regulatory approach to rail transport in Russia. The ECMT team conducted the review during 2003 and 2004, culminating in a report issued in 2004 (ECMT, "Regulatory Reform of Railways in Russia," Paris, 2004 – the "2004 Report"). The purpose of this update is to review the progress in railway reform and regulatory change since the issuance of the 2004 Report.

This update is based on the original report cited above as well as summaries of the issues in two meetings (26 October 2004 in Moscow and 15 January 2005 in Paris), and a status report prepared by Russ Pittman, United States Department of Justice (see Annex 2) dated January 13, 2006. The author of this update – Lou Thompson – met with a number of officials in Moscow during the week of 24 April 2006 to hold detailed discussions and review recent materials, and met again in Moscow on 29 and 30 January, 2007, to discuss RZD comments and to incorporate additional data that had become available in the interim. The list of participants in the April and January meetings is included as Appendix 2 to this update. Russian officials were very cooperative in holding meetings and furnishing materials requested. Their involvement and assistance is appreciated, and made a major contribution to the final report.

The update first summarizes the 2004 Report and its recommendations and then analyzes developments since the discussion of the report held with Russian officials in Paris, January 15, 2005. In broad summary, the 2004 Report had five sections: an assessment of the progress in railway reform and regulatory change; a discussion of the "triangle" among railway competitive objectives, system structure and regulation; issues in setting infrastructure access charges and their regulation; issues in freight tariff regulation; and, recommendations for future steps.

Solid Progress up to the 2004 Report

The 2004 Report firmly acknowledged the progress that had been made so far in railway reform:

- The Government adopted an overall approach to railway reform on May 18, 2001. This decision envisioned a stage-by-stage approach to reform organized in three phases.[1] In very broad terms, the reform program called for:

- Dividing the previous railway Ministry (MPS) into two pieces: a railway enterprise, organized as an open joint stock company (OAO RZD, hereafter called RZD); and, a policy and oversight function, to be shared among the Ministry of Transport (MOT), the Ministry of Economic Development and Trade (MEDT) and two Federal Agencies: the Federal Antimonopoly Service and the Federal Service for Tariffs.
- Accounting or institutional separation of infrastructure, freight, long haul passenger, suburban passenger and ancillary social and other commercial activities (eventually to be partially or wholly divested).
- Opening infrastructure for non-discriminatory access by certain types of competitors, but keeping a national freight operator under common ownership with infrastructure in order to provide a degree of integration between operators and infrastructure that was needed given the intensity and importance of Russian rail freight as shown in Table 1.
- Institutional separation for certain specialized freight operations (international transit, intermodal and refrigerated operations) owned by RZD.
- Encouraging development of new, private operators in competition with the RZD freight operator, or with RZD's specialized freight operators.
- Promoting private investment in freight wagons and locomotives, though the infrastructure owner was expected to own most locomotives for the initial period in order to reduce the investment required of new operators.
- Leaving for later decision the possibility for creating competing, vertically integrated freight carriers in European Russia.
- Revising the freight tariff system – a legacy of the planned economy – to reflect the new railway structure and competitive realities as well as to foster the initial entry of new operators and/or carriers.
- Working with Governments at the national and local levels to develop explicit Public Service Obligation (PSO) compensation contracts for support of the social requirements of intercity and suburban passenger transport.
- Upgrading the RZD accounting information to full IAS/IFRS compatibility.

1. See Belova, Anna G. and Louis S. Thompson, "RZD Reform Makes Good Progress," Railway Gazette International, London, October, 2005.

And the phases covered:

- A preparatory phase (2001-2002) to identify and construct the basic legal framework for the reforms. Based on this framework, new laws (6) and governmental decrees (14) were adopted by the State Parliament and Government, the accounts payable of railway transport enterprises and enterprise were restructured, an asset register was completed, the institutional separation was started, and the necessary initial tariff changes were put in place along with the appropriate regulatory system.

- A Second Phase (2003-2005) to implement the institutional separation and complete the legal setup for reform, including creation of the required open joint stock companies (with access to the capital markets) and selling some or all of the shares of the initial set of ancillary activities. In addition, the expectation was that an initial round of private investment by shippers and/or leasing companies would be triggered in freight wagons and, possibly, in competing freight operators. Also, the arrangements for Government PSO support for socially driven passenger services were to be developed.

- A Third Phase (2006-2010) in which the passenger services would be separated and supported by PSO arrangements. Private operators are expected to offer effective competition for the RZD freight operator (and possibly the RZD carrier) under an evolving freight tariff system that is non-discriminatory toward new entrants. The possibility of creating new, integrated freight entrants would be evaluated. Significant private investment in the freight wagon and locomotive fleet would be encouraged, as would access to the private capital markets by RZD.

- The original railway Ministry, MPS, was in fact separated between a railway enterprise (an open joint stock company –RZD-- wholly owned by Government) and the remaining ministerial and regulatory roles of MPS. The new business management structure was established and RZD commenced operations on October 1, 2003.[2]

- The rules for the use of RZD-owned or privately-owned wagons by operators and the proposed rules for access to infrastructure by carriers were established.

- The initial freight and passenger tariff systems were developed and published. These publications (the freight tariff is called Price Courant 10-01[3] and the new passenger tariff is designated as Price Courant No. 10-02-16)

2. RZD, “Materials to the session of the Government of Russian Federation regarding ‘about the progress of the realization of structural reform in rail transport,’” Moscow, November 2005. This will be referred to as RZD 2005 throughout the report.

3. Price Courant 10-01 will be called “PC 10-01” in this report.

were rooted in the existing freight and passenger tariff systems issued by MPS over the years.

- The initial Government oversight and regulatory structure for the rail system was established.

- Non-core activities were identified for potential spin off and/or privatization.

The Triangle of Competitive Objectives, Railway Structure and Regulation

The 2004 Report emphasized the interacting nature of the objectives for rail traffic competition, railway structure, and regulation. Although the Government's 2001 railway reform program identified two approaches to railway competition (competition between or among two or more carriers on the same railway line, as is the policy in the E.U., as compared to competition between integrated railway companies operating between the same end-points, the so-called the American model), the Government had not in fact attempted to define its objectives for competition in the transport sector in any implementable detail. As a result, there was no detailed guidance available as to where each type of competition would be needed, if any. Depending on the competition from other modes such as roads and pipelines, there may be some areas or commodities for which the existing degree of railway competition is adequate especially when, as discussed below, the definition of "competition" is expanded to include competition among operators as well as carriers.

Lacking a specific definition of the competition needed, the structural options could only be developed in a general way. The broad alternatives for the railway – competition on the same line, or between parallel lines – were clear, but there was no indication as to where to apply each. Moreover, as has emerged during the process of reform, the definition of competition on the same line had two meanings: competition between or among **operators** for the provision of rail freight wagons and/or locomotives as compared with competition between or among **carriers** on the same line. As discussed below, operator competition is emerging rapidly, while consideration of widespread carrier competition has been postponed[4] until the Third Phase of reform.

The Russian terminology for carriers, operators and shippers is not familiar to Western railway practice. A "carrier" is a company that owns locomotives and provides crews for running freight (and potentially passenger) trains on the RZD infrastructure.[5] Also, a carrier has the responsibility to offer service to any potential

4. Industrial and smaller regional integrated railways have always been possible, but are not significant competitors to RZD.

5. In principle, a carrier might also contract with RZD for RZD to provide locomotives or crews. The terms under which such contracts can be established are not yet clear, nor has the regulator had an occasion to rule on the terms of such contracts. The actual terms will presumably emerge from experience.

customer (operator or shipper) anywhere on the system in accord with the published tariffs of the carrier, and the carrier must take liability for the cargo if it is lost or damaged. As of the writing of the 2004 Report, there was only one official licensed carrier – RZD – providing service in Russia (though there may have been a few small and unofficial carriers hauling petroleum as well as a few industrial or small, local carriers). An "operator" is an entity that provides its own wagons and/or locomotives (either through ownership or leasing) but uses RZD as its carrier for moving traffic. A "shipper" is an entity that uses an operator or carrier to move its traffic in accord with the published tariffs. As of early 2007, the legal conditions needed to permit establishment of operators have been created, but the legislation needed to establish carriers (other than RZD) had not been adopted (shippers are, of course, fully legal). RZD therefore currently lacks the legal authority to deal with competing carriers. RZD has attempted to foster the growth of the new operators, but the full development of competing carriers awaits adoption of a clear legal framework. See Appendix 1 for a more complete legal description of the carrier and operator terms.

The 2004 Report recommended that the Government assess its competition objectives in a more general way to provide guidance in the later stages of the reform and restructuring process. The 2004 Report emphasized the fact that RZD could not be expected to define the country's competitive needs, partly because RZD did not have the requisite expertise and information, and partly because RZD would have a conflict of interest if it had to create competition for itself. At the same time, the 2004 Report urged the RZD planners to analyze both the on-line competition options and the possibility for parallel line competition, especially in European Russia as discussed in the third phase of the reform program, so that the railway sector would be prepared to fulfill whatever competitive roles that were eventually assigned to it. Finally, of course, as the triangle concept underlines, competition is not necessarily an end in itself; it is, instead, one of the tools available to promote efficiency and responsiveness to customer demands.

The ultimate point made about the triangle is the need for the three parts – competitive objectives for transport, rail system structure and transport regulation -- to be internally consistent. Clearly, where adequate competition exists (in whatever form), regulation should be light. The 2004 report questioned whether it would make sense to opt for on-line competition unless the infrastructure is adequately separated from individual operators or carriers (that is, if the RZD freight carrier and infrastructure are owned by the same holding company, could independent operators or carriers be confident of non-discriminatory access?). Where adequate parallel line competition can exist, infrastructure separation would not be needed, and might not (based on North American experience) even be the best option. If the Government intends on-line competition to be effective, then the freight tariff structure and the infrastructure access tariffs have to make the entry of new carriers and/or operators feasible. In any event, the right mix of competition, structure and regulation will inevitably be specific to Russian policies and conditions, and will clearly not be the same as in the E.U. or North America.

Issues in Setting and Regulating Infrastructure Access Charges

The 2004 Report expressed concern over the way in which infrastructure access charges had been established in the first stage of the Russian reform. The general approach prescribed in the E.U. is that infrastructure access charges are to be rooted in marginal costs directly related to the use of infrastructure, with non-discriminatory markups added if the infrastructure agency has a financial goal to collect some, or all, of the difference between marginal costs and full financial costs. By comparison, the initial Russian approach in effect set freight tariffs in a way that was intended to collect full costs for RZD as a whole, and then offered a discount from this tariff if a shipper, operator or carrier furnishes private wagons (a discount of around 15% from the freight tariff in PC 10-01) and locomotives (an additional discount of around 30% from the freight tariff in PC 10-01).

This top-down approach has the effect of leaving a significant amount of non-infrastructure costs in the access charge. For example, the top-down practice in Russia will yield infrastructure access charges of between 55 and 85% of the freight tariff by comparison with roughly 40% in the E.U. and around 20% in the U.S.[6] The 2004 Report argued that the net result was likely to be to encourage private wagon ownership (and probably private locomotive ownership as well), and thus quite probably to encourage the creation of **operator-based** competition, while limiting the emergence of competing **carriers**. The 2004 Report therefore argued that, **if** the objective of the reforms when they reach Phase III is to create on-line competition between or among **carriers** as a way of restraining freight tariffs, the Russian Government should consider adopting bottom-up access charges, based solely on the infrastructure costs of the specific lines being employed (and possible markups) rather than the top-down, system average approach already in place.

The terms “top-down” and “bottom-up” describe alternative approaches to setting infrastructure access charges, and may deserve further explanation. “Top-down” describes the approach in which infrastructure access charges are determined by starting with total costs and subtracting only the costs specific to wagons (and locomotives) with the entire remainder attributed to infrastructure. By comparison, the “bottom-up” approach includes in infrastructure access charges only those costs that are specifically and directly attributable to infrastructure.

The 2004 Report also noted the fact that while rail **infrastructure** is inherently a natural monopoly except where line-versus-line competition is possible, **operators** and **carriers** can still be subjected to competition if policy calls for it. Because infrastructure is a monopoly, infrastructure access charges will clearly call for

6. See article by Aleksandr Sinev, “Tariff System: Current Situation and Development Prospects,” RZD Partner International, June-August 2005, pp. 21-23. To be fair, the E.U. and Russian infrastructure costs include the cost of maintaining electrification facilities that do not exist in the U.S. It can also be argued that the harsh climate in Russia will inevitably make infrastructure more costly. With both points acknowledged, it is also clear that the Russian infrastructure costs include activities that are not included in either the E.U, or in U.S. infrastructure charges.

continuing regulation and oversight. This will be especially true if, as is the case under PC 10-01, access charges are partly determined by commodity tariffs. On the other hand, if the access charges to the infrastructure are purely based on infrastructure costs, regulation of the infrastructure part will be simpler and more easily separated from regulation (if any) of freight tariffs.[7]

Issues in Setting and Regulating Freight Tariffs

The 2004 Report acknowledged that the initial set of freight tariffs published in PC 10-01 were necessarily based on past practices because there had not been enough time for a competitive market in freight transport to develop. Moreover, the information available to the developers of the tariff system did not contain detailed information that met IAS/IFRS standards. From this perspective, PC 10-01 was a useful place to get the reforms started, with full recognition that further development would be needed.

The 2004 Report also emphasized, however, that PC 10-01 has a number of shortcomings that will cause problems as competition emerges in the Russian freight transport sector. First, PC 10-01 takes the entire set of many thousands of freight commodities handled by the railway and reduces it to three overall tariff grades: Grade I, Grade II and Grade III.[8] Freight of tariff Grade I consists of basic commodities (e.g. coal, sand and gravel, basic metals) that amounted in 2006 to about 62% of RZD's tonnage, 58% of ton-Km, and 37% of revenue (see Tables 2, 3 and 4). These commodities travel at very low rates, especially at longer distances. They were described by RZD (Table 4) as being "low profitable," though some railway staff argue they are actually loss-making on the long distance movements. Tariff Grade II commodities are higher-valued (e.g. petroleum) and face somewhat higher rates. These commodities made up about 22% of RZD's tonnage, 23% of ton-Km, and 32% of revenue, and are described as "medium profitable" by RZD. Tariff Grade III commodities (e.g. finished goods such as rolled steel or automobiles) travel at higher tariffs and are considered "highly profitable" by RZD: these account for about 15% of RZD's tonnage, 19% of ton-Km, and 31% of revenues. The ECMT team argued that having only three Grades (even with sub-categories within the grades and with the old Grade III split into two new Grades) is too simple and rigid: competitors (rail or otherwise) will be able to exploit any mis-classifications that might have been created.

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7. There is debate in Russia about the need for bottom-up infrastructure access charges. See, e.g., Sinev article in RZD Partner International, June-August 2005, p. 23, "This fee should not depend on the demand elasticity and will be determined on the basis of the load per axle (cargo and package weight) and the transportation distance." "Thus it will be the **carriers** and the market laws that determine the general tariffs rate." p. 23 [emphasis added].

8. There are sub-categories within the broad grades that have the effect of increasing the effective number of commodity tariffs, but they still operate within the Three-grade boundaries. As of January, 2006, Grade III was broken into two new grades, effectively yielding four Grades.

Second, PC 10-01 does not permit contract tariffs based on guaranteed annual volumes, shipper investment, service quality guarantees, or other demand determinants. With other modes able to offer more flexible tariffs and services, rail's position will be unduly and unnecessarily restricted.

Third, the three-Grade approach almost certainly creates cross-subsidies within the freight tariff structure.[9] The possibility for cross-subsidies appears most likely for extremely long-distance movements such as Siberian coal where there is already in place a policy of using freight tariffs to enhance regional connectivity with the rest of Russia. Cross-subsidies within the freight tariff structure force certain tariffs to be higher than necessary and weaken the railway's competitive position for the commodities affected. The result on the one hand is that RZD is forced to carry traffic that loses money and drains the ability of RZD to finance maintenance and reinvestment while, on the other hand, causing RZD to lose profitable traffic to competitors thereby generating a net increase in the total cost of transport to the economy.

The 2004 Report's Recommendations for Future Steps

Thus far, the reform program has met the objectives set by Government, and the key recommendation of the team was to "keep going." In essence, the reform program was judged to be well founded: the major danger was that the reform process might stall in the face of inertia and the resistance of a number of interest groups. The team recommended that the Government consider a number of suggestions as the process proceeds:

- Develop a Government position on the degree, location and type of competition needed in the rail sector. Use this decision to refine the desired structure of the railway, with particular reference to on-line versus parallel line competition and to the question of whether competition at the operator level will be adequate or whether competition among carriers will be required.

- Continue to up.rade the internal accounting of RZD, aiming at full compatibility with IAS standards and yielding good accounting separation of the various activities (infrastructure, freight, intercity passengers, the various suburban passenger systems, non-core, etc). This was also emphasized by Standard and Poor's in their credit rating for RZD.

- Separate the passenger transport activities rapidly from the rest of the system, at least on an accounting basis, and establish the agreements with the Federal Government and with the local governments to support direct subsidy payments.

9. The location and degree of cross subsidies will become clearer as the transition to International Accounting Standards (IAS) proceeds and the improved information is available to support better cost analysis of the RZD traffic by commodity and by shipment.

- If the Government does want effective on-line competition between carriers, then the infrastructure access charges should be revised to become bottom-up rather then the top-down approach initially instituted.

- Revise the tariff structure in PC 10-01 to permit many more tariff Grades. Permit the competing carriers much more flexibility in setting tariffs, including contract tariffs. In any event, make the authority of the regulators clearer and more transparent (also a recommendation in the Standard and Poor's rating).

Developments in 2005, 2006 and Early 2007

As in any reform program, there have been problems and unanticipated questions. Fortunately, the primary danger – allowing the process to stall – has not happened yet. All of the officials interviewed believed that real challenges remain ahead and some were impatient with the speed of change so far, but all argued that progress has been made.

At the railway level:

Since the formation and corporatization of RZD, the new company has brought stability to the rail sector and has furnished a solid platform for reform.

Broad accomplishments:

- Reform efforts so far have been wholly financed by RZD, and RZD is one of Russia's largest taxpayers (approximately 180 billion RUR paid in 2006).

- RZD has so far been able to meet the demands imposed by the growth in the Russian economy (freight traffic grew by 17% from 2003 to 2006 and passenger traffic grew by 14%).

- Freight tariffs grew by less than inflation, reducing the share of freight costs in the end price of products and promoting Russian competitiveness.

- Service quality and reliability for critical products such as coke, ores and machinery have improved, as has operational safety and security. Rolling stock utilization reached a 15 year high in 2006.

- As Table 5 shows, despite freight tariff increases that were below the rate of inflation, RZD's profit more than doubled between 2003 and 2006 because of increased efficiency and lower costs. As a result, RZD is the first Russian company with three international investment-grade ratings assigned by major international rating agencies (Baa3 by Moody with "positive" forecast; BBB+ by Fitch, and BBB- by Standard & Poor's with "stable" forecast). These ratings are partly based on improved earnings and partly based on the increasing degree of financial transparency that RZD is implementing.

- Passenger traffic has grown steadily (Table 5), by 14% between 2003 and 2006. Equally important, losses on passenger services have been reduced by higher efficiency, by a more flexible pricing policy and by replacement of in-kind benefits with cash. Beginning in 2005, the train fare for passengers eligible for federal benefits when traveling on suburban trains, is being paid on a contractual basis by the Federal Agency for Healthcare and Social Development.

- In addition to its own investments, the reform program has also fostered private investment into freight wagons, relieving RZD of this part of the investment burden. As a result, the share of the total freight wagon fleet belonging to independent carriers, operating companies and other private owners has grown from 25.9% in 2004 to 32.4% in 2006 – a positive trend that appears set to continue.

Accomplishments and issues in the passenger sector:

Separation of intercity passenger services from freight and infrastructure has proceeded, though not as rapidly as hoped. RZD created an intercity rail passenger Branch[10] that commenced operations as of the end of May 2006. Until the Federal PSO funding is in place, the Branch will be debited with average-cost infrastructure access charges. The Branch was created in a way that would permit it to be split into up into 5-7 regionally based companies competing in major markets. The Branch will have its own income statement and balance sheet (on an accounting separation basis). The Branch will own its coaches, shops, and (eventually) the smaller stations: it will not own locomotives or larger stations, and commuter related rolling stock will remain with RZD for eventual transfer to the individual suburban companies.

For the time being, keeping the intercity passenger services as a Branch will have a number of advantages:

- Integrated operational control of freight and passenger services will reduce potential access conflicts between the passenger and freight services and will ensure priority for passenger services in the event of an emergency.

- The deeper financial capabilities of RZD will protect the passenger operations against short term funding shortfalls that might result from delays in public funding or in limitations on the tariff increases needed to match inflation.

10. The Russian term for “Branch” can also be translated as “Division,” “Directorate,” or, ultimately “Subsidiary.” This update uses the term Branch to indicate that passenger operations will initially be under the control of an internal line of business that will be separated only in accounting terms while remaining fully integrated operationally. RZD plans eventually to set up the intercity passenger company (FPK) as a wholly-owned subsidiary in order to clarify the cost and revenue separations, but does not currently intend to spin it off as an entirely independent enterprise.

- RZD will be a more secure source of equipment financing and can enforce common technical standards for all rolling stock to ensure efficiency and safety.

- There will be no need for separate laws and regulations governing the passenger operators.

- Better coordination between the infrastructure needs of freight and of intercity passenger services will be promoted.

RZD planners, MEDT and MOT also recognize the potential disadvantages of the Branch approach:

- Accounting separations are always contestable, making the justification of Federal funding harder to support.

- Retaining passenger services as a Branch, financed by RZD, reduces the priority for finding PSO funding. Since passenger losses currently consume nearly half of freight profits, RZD's self-financing ability can be seriously compromised if the definition and payment of adequate PSO support is delayed. As the freight markets become more competitive, especially if new rail entries attack the more profitable commodities, RZD's ability both to provide needed freight investment and to provide cross-subsidy for passenger services will be diminished.

- As the Russian passenger and freight transport markets become ever more sophisticated, it will become more difficult for a single management to serve increasingly divergent needs. This will be especially true if one market is perceived as "profitable" and the other is seen as a financial drain. The need for separate managements was one of the basic rationales for the creation of Amtrak and VIA in North America.

During the third stage of reforms, intercity passenger services should be further separated in institutional and legal terms by means of creating a Federal Passenger Company (FPK). This separation is conditioned on full compensation of losses from the federal budget.

Despite the advantages to RZD of operating intercity services as a Branch or subsidiary, the MEDT and MOT may eventually prefer a completely independent passenger company or companies not owned by RZD because their services have such an important social value that direct public control may be needed. The Federal Government agreed in principle (August 2005) to compensate the railway for revenue losses due to socially based ticket privileges extended to various groups (war veterans, children, students, etc). Going further, the Federal Government has agreed in principle to support the losses of the intercity passenger companies, with the support to be phased in beginning in the 2009 budget year through a Public Service

Obligation (PSO) agreement.[11] In 2007 40% of anticipated RZD loss of income (10.9 billion rubles) will be compensated; in 2008 - 60% (16.4 billion rubles); in 2009 - 100% (22.6 billion rubles). The suburban passenger companies will be supported at least partly by Federal funding and partly by local funding on a continuing basis: the exact shares are not yet determined. RZD still faces a dilemma in the final step of the reform: according to Government authorities, the final arrangements for a PSO agreement cannot be reached until FPK is legally established and FPK cannot be legally established until the PSO agreement is in place.[12] It is not clear how this will be resolved.

The process of establishing distinct companies for managing suburban and regional passenger entities is fully underway. Thus far, ten of the suburban and regional passenger companies (Moscow and Moscow Region; St. Petersburg; Altai, Primorye, and Krasnoyarsk territories; and Sverdlovsk, Volgograd, Novosibirsk, Omsk and Kemerovo regions) have been established. On March 15, 2006, the Federal Government established procedures for licensing these companies to operate services, and for licenses the above ten companies have been granted. Agreement has been reached on at least partial local support in a few areas (Moscow), but has not been reached in most areas because of a lack of funding at the local level. The Federal Government has supported the devolution of these services and does not intend to provide complete support indefinitely, though it will continue to support the losses associated with privileged travel that is mandated at the national level.

A separate company is being created to own and manage the large stations (Vokzals) such as the Leningrad or Belarus stations in Moscow. One reason for doing this is to ensure that the intercity and suburban passenger operators have non-discriminatory access to the stations they use jointly. Another reason is to control the real estate development potential of the major urban stations.

Freight accomplishments and issues

RZD has continued to assess the practicability and feasibility of total institutional separation between freight and infrastructural services. In doing so, RZD has explored measures short of total separation that might achieve some of the competitive objectives discussed above without the same threat of irreversible change and disruption that full separation along the lines of the EU model might cause. Within this context, preparations are being made for creating an RZD subsidiary **operator** (current called the Freight Company) with subsequent examination of a possibility to transform the operator into a railroad freight carrier.

11. RZD 2005, p. 17. See also “Fradkov Shelves Railway Reform for a Year,” Kommersant, 11 November 2005, and RZD Partner, “Duma Energy, Transport and Communications Committee Discus Rail Financing and reform,” October 23, 2006.

12. RZD 2005, p. 11.

The basic concept of the Freight Company is that it would be a wholly owned subsidiary of RZD. It would, when incorporated, receive title to a major part of the existing wagon fleet of RZD. RZD proposed that the entire 530,000 freight wagon fleet be transferred to Freight Company ownership, leaving in RZD hands only the specialized wagons needed to equip its specialized operators (containers and refrigerated transport). RZD would then lease back from the Freight Company the wagons needed to carry out its common carrier responsibilities, mostly in the lower tariff grades where competitive entry by other operators appears unlikely. The Freight Company would be a fully competitive, and unregulated, operator, using its own wagons, for transport services in the higher-graded commodities.

The Government's response has been cautious. Current discussions would require RZD to retain ownership of about half of the wagons, with the other half going to the Freight Company. Government willingness to fully deregulate the Freight Company's wagon charges is also not clear. RZD argues that the Freight Company's tariffs, as an operator, should not be regulated because there are already at least 100 competing operators in Russia at the moment, and the number is clearly increasing.

As a fully independent, hopefully unregulated company with a strong traffic base, the Freight Company would have access to private markets for expanding its fleet. In addition, the financing ability of the Freight Company should be enhanced through a planned IPO in 2009/2010 of at least a significant percentage of the shares. This would, in turn, encourage the Freight Company to conduct business according to market principles, aiming at increasing business value, profitability and capital investment return.

RZD expects that the Freight Company will readily find outside investment in wagon debt (as is the case in North America), and that it will thus be able to finance modern equipment with much improved service quality. In addition, about one-third (rapidly growing) of the freight wagon fleet is now separately owned (either by private operators or by leasing companies), and these **operators** are generating an increasing share of Russian traffic: 33.8% of tons in 2005 versus 27.2% of tons in 2003 (See Table 2). MOT staff estimate that about RUR 80 billion have been invested in freight wagons so far by external investors, and believe that more than half of the wagon fleet will be privately owned within the next few years.[13] Ton-Km shares are showing a similar trend (Tables 2, 3 and 4). RZD has encouraged the creation of the new wagon owners because there is a shortage of good wagons (about 40% of RZD-owned wagons are reported to be in bad repair and many other wagons are life-expired, or soon will be so) and thus private investment is welcome. RZD has also accelerated the development of the rules and regulations needed to ensure that the new wagons can be assured of non-discriminatory access to the system.

13. Igor Levitin, "On the progress of the realization of structural reform in the rail transport," Moscow, 2005, p. 15. This will be called Levitin 2005 elsewhere in this update.

The incentives in PC 10-01, which have strongly encouraged the private wagon ownership trend, will now be made more explicit for locomotive ownership as well, which should also lead to investment in locomotives. RZD has implemented a model form for rental of locomotives and has established the rates to be used when locomotives are used by operators to run train services.

Creation of the Freight Company is consistent with the goals and objectives of the Railway Structural Reform Program. Equal market conditions will be provided for the Freight Company and other freight wagon operators, and there will be full competition at the wagon supply (and possibly locomotive supply) level. The Freight Company activities will allow it to intensify procurement of freight wagons at its own expense, to reduce wagon fleet deterioration, and avoid wagon shortages.

RZD will have to continue to provide carrier services on the basis of public contract. This means that RZD must comply with the requirements concerning service prices and other contractual conditions equally for all customers who use its services. Thus, RZD will have to maintain assured access to a part of its rolling stock fleet as stipulated in the Federal Law "On Railway Transportation in the Russian Federation", whether owned or leased. The Freight Company at the time of its opening will have a wagon fleet sufficient for satisfying its service demand, and it plans to actively update this fleet. The remaining part will remain with RZD, at least on an interim basis until the final structure of wagon ownership is decided.

In the future, as the client base of the Freight Company grows, the ratio of the wagons operated by the Freight Company independently from the wagons owned or leased by RZD will shift toward the Freight Company. This will satisfy the Railway Structural Reform Program's requirement to increase the privately owned share of the wagon fleet (the goal of the structural reform is to achieve a share of at least 50% privately owned wagon fleet).

The proposal to create the Freight Company has been discussed in detail with all major market players, including shippers and the largest operators, appropriate committees of the two Federal Assembly Chambers, and heads of the federal executive authorities.

The RZD Board at its meeting on September 22, 2006, concluded that creating an RZD subsidiary – the Freight Company – will be practicable. The Board viewed creation of the Freight Company as a system measure ensuring development of market-based relations in the area of rolling stock operation.

Creation and or disposal of subsidiaries

During the completion of the second structural reform stage and the beginning of the third structural reform stage the process of creating subsidiaries has intensified, with the goal of building an efficient holding company by the end of the third stage in 2010 that will acquire a strong foothold on the market under the conditions of the global transportation market.

During the 2004-2006 period, the RZD Board of Directors completed decisions on establishing 27 subsidiaries in a number of different areas of activity: 9 for production and repair of track equipment; one for signaling and telecommunications; two subsidiaries for capital repair, design and management work (consolidating 22 design institutes and 19 construction and assembly activities); 3 freight wagon repair shops; two scientific research institutes; one freight container operation; one refrigerated freight company; six suburban passenger services; an intermodal transportation company (JV Russian Troika jointly with the Far Eastern Steamship Company) and one security company.

Ten subsidiaries received state registration certificates in 2006 for various types of activity, including: two for capital repair, design and management work; three for maintenance of freight wagons and production of spare parts; two for specialized freight services; and, three for scientific research, design and development. In September, 2006, the RZD Board of Directors approved establishment of a Joint Venture with Finnish Railways (VR) for high-speed rail service between Helsinki and St Petersburg. Over 40 more subsidiaries and joint ventures with Russian and international partners are projected for 2007.[14] RZD plans to sell at least part of the shares in most of these companies, but Government restrictions continue to limit RZD's ability to conduct negotiations, even though the sale of the shares is included in the governmental program of structural reform in order to reduce RZD's monopoly position in the sectors involved.

Competitive developments and issues

RZD has argued that **competition at the operator level already exists and is having a beneficial effect**. RZD argues in addition that the regulatory and technical preconditions for multiple carrier competition do not yet exist: that is, the laws still have not been changed to make competing carrier access to the infrastructure legal. Most important, RZD observes that the current law mandates that a "carrier" must be a common and universal carrier, able and willing to offer all services to all shippers over the entire network. This is a test that only RZD's freight carrier can currently meet, and is one that few potential new entrants will want to meet. RZD argues, therefore, that the necessary conditions for multiple carrier condition will need to be created based on a clearer understanding of competitive and market realities. These conditions will need to provide a level playing field for all parties, and should be based on a thorough review of costs and tariffs in order to expose and remove (or, at least, reduce) the degree of cross-subsidization in the existing PC 10-01.

Despite the initial lack of commitment to on-rail competition through infrastructure separation, the official position of RZD has evolved somewhat. Shortly before his departure in June 2005, the former President of RZD, Gennady Fadeyev, had stated emphatically about infrastructure separation "[d]on't cherish these illusions – we'll never have such conditions [to permit total separation]. But if we separate them

14. Igor Levitin, "Report at the Russian Federation Government Meeting on November 2, 2006."

anyway and ruin the company, quite a few in the West will applaud us…"[15] Later in 2005, the new RZD President, Vladimir Yakunin, stated "[I]t is quite clear today that to provide financial stability the company must participate in the transportation business" [i.e., RZD would have to remain as a freight carrier]. At the same time, he acknowledged that "[g]uaranteed providing of non-discriminatory competition conditions [i.e. access to infrastructure] to all cargo transportation market players is one of the key issues of the reform."[16]

Current Russian law requires line of business (LOB) accounting separation in order to promote financial transparency and accountability.[17] RZD began reporting revenues and some calculations of profits and losses by very broad activity lines in their 2004 Annual Report, and has continued to elaborate on their LOB reporting. Unfortunately for the outside observer, the publicly available reports are over 500 pages long and appear to be filled with considerable detail unrelated to LOB performance. In addition, the costing breakdown in these reports makes more detailed analysis difficult.[18] RZD should consider preparation and publication of a less complex annual LOB report that shows individual LOB statistics (revenues by source and costs by cost categories -- around one page each for income statement and balance sheet) along with a similar overall report for the corporation.

Developments at the Government Level

From the outset, railway reform has been is carried out with the support of, and under supervision of, Russia's President and Government. The progress of the reform program is regularly examined at the Russian Federation Government's meetings (for example, January 23, 2003; November 27, 2003; September 9, 2004; November 10, 2005; and on November 2, 2006), as well as at the meetings of appropriate State Duma Committees and of the Federation Council of the Russian Federation Federal Assembly Commission.

The results achieved during the first two stages were very positively evaluated at the Russian Federation Government's meeting in November 2005 where it was emphasized that the reform work has proceeded in accordance with the objectives enumerated in Railway Structural Reform Program approved by the Russian Federation Government; e.g. increased stability of railway operation; accessibility and security of railway transportation; strengthening of integrated social and economic conditions based on reliable and efficient transport communications; and, provision of infrastructure to support economic development of the country and enhanced personal mobility.

15. RZD Partner International, September-November 2005, p. 51.

16. RZD Partner International, September-November 2005, p. 53.

17. Decision of the Government of the Russian Federation dated 29 December 2004, No. 8.

18. To be fair, although E.U. law requires all of its railways to adopt and publish LOB reports that at least distinguish the infrastructure, freight and passenger businesses, very few of the E.U. railways actually comply with the requirement.

The Russian Federation Government Direction # 1094-r dated August 10, 2006, approved the Working Plan for relocating the ministerial roles of the old MPS, folding them into the MOT as a railway advisory agency (The Federal Railway Transport Agency) and the Federal Transport Control Service, thus implementing the separation between the governmental and enterprise functions of the old MPS. The new Agency "has not been playing any noticeable role yet," but has inherited all of the administrative powers of the old MPS.[19]

MOT and MEDT do not believe that competition limited to the operator level will necessarily be sufficient for Russia. They agree that a critical issue is the current legal definition of carrier status and they agree that the law will need changing if competing carriers are to emerge. As of now, MOT explicitly wants to change the law and provide for competing carriers, but they are not considering the creation of parallel line competition. MEDT and MOT stated a concern that the RZD wagon operator may not produce fully effective competition because of its linkage with the other RZD subsidiaries.

At the meeting on November 2, 2006, dedicated to reviewing the railway reform, the Russian Federation Government examined and approved the results of railway reforms implemented in 2006. The Government focused particularly on: the necessity to improve legal and regulatory framework for continuing railway reform; corporate restructuring and establishing RZD subsidiaries and subordinate companies; improvement of governmental tariff regulation; attracting more investment; developing the domestic railway engineering industry; and, issues of RZD global competitiveness.

At the meeting on July 5, 2006, dedicated to the Third Stage of the railway structural reform, the State Duma Committee on Energy, Transportation and Communications emphasized the need for a balanced and evolutionary approach to reform and emphasized the priority of minimizing risks and precluding irreversible consequences resulting from the reform implementation.

At the meeting on October 24, 2006, the Federation Council Commission on Natural Monopolies confirmed that planning and implementation of the Third Stage of the railway reform has proceeded according to the Railway Structural Reform Program approved by the Russian Federation Government. The Commission concluded that the reform results have a positive impact on the country's social and economic development.

In summary, RZD development has proceeded in full compliance with the reform's goals and objectives. The reform of Russian railways has been based on experience accumulated by major world railway systems. Development and implementation of reforms has been accompanied by careful study and analysis of analogous reforms abroad, including benefits and risks.

19. See interview notes of MOT Minister Igor Levitin, Vedomosti, April 5, 2006, No. 59 (1586).

MOT has created a working group on developing a target model for railway transportation services by the year 2010. The task of the group will be to analyze the state of competition in the transport sector in Russia and to identify the markets in which rail intramodal competition will be needed. This will be used to decide where on-rail competition among carriers is needed (if any) and where (if anywhere) competition at the operator level will suffice. The working group is slated to complete its work in the first quarter of 2007. Issues to be addressed are:

- Improvement of governmental regulation in the sphere of railway transportation.
- Implementation of a mechanism for governmental subsidy to passenger service within the Federal and regional budgets that will resolve the problem of remozing the passenger cross-subsidies from RZD's financial responsibility.
- Creation of market mechanisms for railway development, including continued establishment of RZD subsidiaries.
- Improvement of transportation tariffs regulation to permit elimination of distorted tariffs and enhanced competition.

MOT believes that the process of spin off of non-core businesses should be intensified, as this will at least create competition in some parts of the rail sector, such as wagon or locomotive maintenance.

The regulatory agency (the Federal Service for Tariffs) acknowledges that the inherent cross-subsidies in the freight area (from Grade III to Grade I) are a significant barrier to reform. Making the tariff grades more complex would almost certainly expose more cross- subsidies (especially for long haul coal from Siberia) that would require increases in tariffs for the basic commodities. They recognize that on-rail competition is certain to aggravate the problem, because new competitors will aim first at the high value commodities ("cream skimming") and leave RZD to carry the low value commodities. They plan to attack this by gradually making the access component of tariffs the same for all grades. In the longer-range future, they hope to replace hidden cross-subsidies in freight with more explicit support from Government.

Overall Assessment by the Government

The Russian Federation Government, the State Duma, the Federation Council of the Russian Federation Federal Assembly, and a number of Russian transportation experts have analyzed the course and results of the railway structural reform, and reached the following conclusions:

- The reform has been implemented effectively so far, roughly in accord with the original schedules.

- The quality of rail transportation services has improved.
- Competitive market segments have expanded and competitive market conditions are being established in some areas of railway operation.
- The stability of railway operation has been maintained and the security of railway carriage has improved.
- The flow of investment into railway development, especially freight wagons and potentially locomotives is increasing despite holding freight tariffs below the rate of inflation.
- Social stability among railway employees has been maintained.
- Cross-subsidies from freight to passenger services still exist, and are a financial burden on RZD.
- Railway operational efficiency has improved.
- As the international bond rating agencies have recognized, the financial transparency of railway operations is growing.
- Opportunities for attracting private investment into railway development are expanding.
- The legal and regulatory framework is improving, though much remains to be done.

Overall, the Government believes that reform results so far have been relatively successful and effective, providing a positive contribution to the overall social and economic development of the Russian Federation.

Recommendations and Conclusions from ECMT to RZD, MEDT and the FTS

Although the financial separation of passenger carriers from the rest of the railway has taken longer than hoped, the current efforts are headed in the right direction. **This effort should be continued on a priority basis, with particular attention to inclusion of the PSO funding requirements in the Federal budget and to the issue of defining adequate sources of local finance to the suburban and regional JSCs.**

If adequate and stable Federal PSO support could be obtained for the intercity passenger services (a large assumption if experience in the E.U, and North America is any guide), it is less clear whether RZD should continue to operate the intercity passenger services as a Branch rather than an institutionally separated company. Experience with Amtrak and VIA in North America has shown that the fundamental objective of full separation – getting the financial burden of passenger services off the back of the freight railways – has been successful. From RZD's point of view, with nearly half of its freight profits being absorbed by passenger losses (the same ratio as in the U.S. before creation of Amtrak), separation could be a critical step to ensuring continuing financial viability for rail freight. At the same time, the fully separated approach for Amtrak and VIA has led to exactly the kinds of problems of inadequate financing, difficulty in track capacity management, poor on-time performance and unending political interference that RZD has highlighted as disadvantages of separation for the passenger railway. **RZD's plans for developing a separated company or companies should take these problems into account and, at least in the near term, it may well make sense to establish the passenger company as an RZD subsidiary.**

Intercity rail passenger service is much more important in Russia than in North America, so Russia's tradeoff will be more difficult. **In the short run, the current emphasis by RZD and Government on clear accounting separation and a strong push for adequate financial support from the Federal Government is the right approach.** At the same time, if the stated intention to create separated intercity passenger company(ies) is still firm, then MOT may want to intensify its analysis of the need for competition in the intercity rail passenger markets in Russia and refine its definition of the social aspects of rail passenger services, as well as the added institutional costs of separate companies to operate passenger services.

All parties agree that the spin off of the non-core RZD businesses, especially wagon and locomotive maintenance, will be important in buttressing competition throughout the rail sector. It will also generate funding that can be profitably invested in RZD's rail activities. RZD is currently developing further plans for spin-offs. **A clarification of the issue, and a speed up in granting clearances should be a matter of priority. In addition, it would be helpful if RZD could provide more information about their strategic plans to form the markets for the various ancillary railway support services, including repair of locomotives and wagons.**

The formation of MOT's working group on competition is a very positive step. As discussed in the 2004 Report, the results of this working group's efforts will be a crucial step in shaping the structural development of the rail sector, both in resolving how much competition is needed, and where it is needed, but also in deciding what kind of structural approach will be acceptable. **The efforts of this group should receive a high priority in expertise and resources.**

The method, or methods, to be used for developing competition will be critical. In principle, four methods are available: intermodal competition among rail, highway, water and pipeline modes; intramodal competition between parallel railway lines with integrated operators (as was identified as a possibility in the 2001 reform program[20] – called the "American" approach); intramodal on-line competition among competing railway carriers paying access charges for infrastructure use (called the "European"

20. See MPS, "Railway Sector Restructuring Priorities," Moscow, 2001.

approach); and, intramodal competition at the rail operator rather than rail carrier level (the “Russian” approach).

All parties interviewed stated that the option of creating competition between parallel lines with integrated carriers in European Russia poses serious challenges.[21] The ECMT review team discussed this option at some length (see pp. 48 and 49 of the 2004 Report) because of the potential it could have to reduce the regulatory burden. **As the work of the competition working group progresses, the possibility of creating at least some parallel line competition in European Russia may deserve reconsideration.[22]**

Probably the most important outstanding question in the entire complex reform process is the issue of the degree of on-line competition between or among railway **carriers** that is needed. In reviewing the original reform plans from MPS, it appears that MPS may have focused on promoting competition at the **operator** level and not at the **carrier** level. While the provisions in PC 10-01 that were intended to encourage private wagon ownership and the growth of operators appear to have been quite successful (one-third of the fleet is already privately owned and there are more than 100 operators), carrier versus carrier competition remains extremely limited and of questionable legality. Indeed, RZD emphasizes that conditions for carrier versus carrier competition have not been established: the legal regime is not adequate, the tariff system would need thorough reform, and a number of expensive physical and technical problems would need to be addressed. Moreover, the legal requirement that any carrier must be a common carrier offering service to all shippers over the entire system clearly has limited the possibility of the emergence of competition at the carrier level.

MEDT, MOT and the Federal Service for Tariffs have all stated their belief that competition limited to the operator level, while undoubtedly a positive force in reducing a part of the system costs (around 15% of the system costs are for wagons, slightly above the 12% level in the U.S.), would not expose the remaining 85% of the system costs to competition, though it may offer a way to improve services to the shippers.[23] The creation of specialized RZD operators for refrigerated commodities or automobiles may well improve service to some shippers, but would not create competition for other commodities or other parts of the network. Creation of the

21. See, op cit, Figure 1, p. 11.

22. In this regard, it is interesting to note that the possibility of on-rail competition may not be entirely dead. See Levitin 2005, p. 15, where he mentions “the estimation of the possibility of designing of several competing vertically integrated railroad companies.” He also explicitly includes “the estimation of the expediency of complete organizational separation of infrastructure from the transport activity (if the necessary conditions for separation achieved in this stage).”

23. Milkhail Kozlovsky, in RZD Partner International, March-May 2005, concludes that “the whole operator business consists in the difference between the payment according to the Tariff Regulation No 10-01 for cargo transportation in a carriage in common use and their own carriage including the empty mileage of the latter (return trip)”, p. 72.

proposed RZD Freight Company subsidiary would promote system wide competition for freight wagon supply and utilization.

The E.U. has opted for on-line competition as a vital tool in improving rail freight service and reducing costs in its 25 member States. The "American" model, though predominantly based on parallel line competition, also includes a significant element of on-line competition through imposed (or negotiated) trackage access rights. In both cases, rail versus rail competition is considered a necessary part of overall transport sector strategy, even though intermodal competition is far stronger in the E.U. and North America than in Russia. Neither the E.U. nor the U.S. or Canada would consider competition limited to wagon or locomotive supply to be adequate in limiting the exercise of market power. The legal, regulatory and technical regimes in the E.U., U.S. and Canada are designed to foster such competition whereas, as RZD experts point out, current conditions in Russia limit such competition.

As the competition/structure/regulation triangle highlights, the three elements must be consistent. If the MOT working group identifies a need for effective on-line competition in Russia, then the emergence of competing carriers will need to be encouraged if competition is to restrain market power. If competition at the carrier level is needed, it is also unlikely that the current structure of PC 10-01 will yield an efficient rail transport sector. If the need for competition requires carriers as well as operators, **then the planned structure of the railway will need thorough revision, as will the tariff structure in PC 10-01**. In addition, of course, if carrier versus carrier competition is desirable, then **the top-down approach to infrastructure access charges will need to be replaced with a cost-based, bottom-up approach, and should be accompanied by public funding of PSO obligations.**

As the results of the working group on competition are developed, RZD and **the relevant Ministries need to give high priority attention to resolving the issue of the role to be played by carriers as opposed to operators**.[24] One possibility that deserves strong consideration (as indicated by MEDT) is to revise the legal definition of carriers to permit private carriage (a private carrier only moves commodities for selected shippers at unregulated rates and does not hold itself out for carriage for others). Another possibility would be to permit creation of carriers that are regionally focused in order to remove the burden of having to operate throughout the system: this might also include ability to focus on a limited number of commodities or shippers. Though this kind of competition could well benefit regional shippers or shippers of specific commodities, it would also clearly threaten RZD's net income and would attack the cross subsidies buried within PC 10-01. A related option (as mentioned by MOT) is to permit voluntary contract tariffs among operators, carriers and shippers; such tariffs would be unregulated. Finally, if more competition at the carrier level is created, then the need to regulate competition at the operator level will

24. It is interesting that the Government's long range policy statement, "Russian Federation Transport Strategy until 2020" implies that both carriers and operators were contemplated: "[a]llow a guaranteed nondiscriminatory access to railway infrastructure by **independent carriers** and **rolling stock operators**." [emphasis added].

be correspondingly reduced. As with intercity passenger service separation, the impetus for creation of added competition in freight services, either by more operators or carriers (on-line or parallel line) will need to come from MOT and MEDT.

All parties realize that the initial tariff structure in PC 10-01 will limit the rail sector's ability to compete effectively with other modes. The inherent cross-subsidies in the freight tariffs and the compression of tens of thousands of commodities into three grades will distort rail traffic patterns and shift at least some rail traffic to other modes and, as competing rail operators and carriers arise, will encourage "cream skimming" by the new competitors.[25] **The Government's efforts to review PC 10-01 should be intensified, both by MOT and the Federal Service for Tariffs in line with decisions about the development of rail sector freight competition.**

Overall, hard work by RZD and by the Government of the Russian Federation has avoided the greatest danger to the reform process – stalling as a result of day to day challenges or simple inertia. Structural reform is never easy and, as this review has discussed, the next steps in the process will be at least as challenging as those that have already been accomplished. **Continued focus on a few broad issues will be important:**

- **Consistent policy decisions on the desired competitive and structural model for the railway and transport sector.**
- **Revision of the regulatory regime in consonance with the competitive and structural model.**
- **As competition develops in the future, maintaining the right balance between regulation and competition.**
- **Definition of, and compensation for, PSO requirements.**
- **Ensuring that rehabilitation and capacity up.rading needs in the rail sector fully met, either by railway earnings or by appropriate public support.**

25. RZD 2005, p. 39.

APPENDIX 1.

LEGAL DEFINITION OF "CARRIER" AND "OPERATOR"

Mikhail Kozlovsky, in his article in RZD Partners International, March-May 2005 on "Development of Private Carriers on the Russian Railways: Trends, Problems, Perspectives" included a definition and discussion of the terms "carrier" and "operator" at pg 68. This discussion is quoted below in its entirety.

"A **carrier** is a legal entity or a private entrepreneur having undertaken according to a railway transport in common use transportation contract the obligation to deliver (…) the consignment entrusted to it by the consigner from the point or shipment to the point of destination, as well as to hand the consignment (…) to the person authorized to receive it." Thus, a carrier concludes with the consigner a transportation contract and issues a transportation document (railway bill of loading) and is fully accountable for the cargo delivery and integrity according to the law. To carry out its functions "a carrier is to dispose of rolling stock to ensure transportation, on the basis of ownership or some other basis, conclude contracts for locomotive traction services, if the carrier has no locomotives, conclude corresponding contracts for the infrastructure use services (with the exception of cases when the carrier accomplishes transportation within its own infrastructure), the significant conditions for which are the carriage flows organization, carriages and locomotives turnover regulation, setting the order of the railway rolling stock maintenance and exploitation, the parties' accountability for the obligations arising from railway transportation" and, naturally, to have corresponding licenses.

"An **operator** of railway rolling stock is a legal entity or private entrepreneur having carriages, containers on the basis of ownership or on some other basis, participating on the basis of a contract with the carrier in the transportation process with the use of the indicated carriages, containers." Thus, the law allows an operator only to participate in the process of transportation accomplished by the carrier on the basis of a contract with the latter. The forms of this participation, the essence of the contract between an operator and a carrier, its main conditions are to be determined by the Government, but this has not been done so far and there is no legal basis for such contracts between the carrier and operators. Therefore an operator has now to work as a consigner and accomplish at that certain carrying operations of the transportation process without the specified contract and to submit itself to the fact that some of the operations accomplished by it have been paid for to the carrier as part of the transportation price (tariff).

APPENDIX 2.

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APPENDIX 3.

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