Railway Restructuring in the Americas –

Implications for the Former Soviet Union

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HENRY POSNER III
Chairman, Railroad Development Corporation

I would like to introduce a different perspective on railway restructuring. My impression is that the Former Soviet Union (FSU) has been looking to Europe for models on what to do with their railways. However the FSU should consider that there are other places than Europe where railways have been restructured and other models to be considered. In particular, a competing model to the European model of Open Access is the Exclusive Franchise model found in North and South America. Key points to be discussed are: (1) that the railway environment varies from continent to continent, especially at the institutional level as opposed to the technical level; (2) that railway restructurings have many origins – some political, some economic; and (3) that railway restructuring is ultimately driven by market forces, not politics.

BACKGROUND ON RDC – GENERAL

Railroad Development Corporation (RDC) is a railway investment and management company based in Pittsburgh, Pennsylvania (USA). In recent years though RDC has been focusing more on corridors and not just railways. In particular, projects involving ports, fiber optics and other businesses that come from railway businesses. RDC is a small company and does nothing on its own—each business is with joint venture partners. RDC is currently the only railway company from the private sector to invest in railways in Africa.

BACKGROUND ON RDC – TRANSACTIONS

Our flagship in the USA is the **Iowa Interstate Railroad** (IAIS). IAIS is one of four railways in the Chicago/Omaha corridor, the most competitive in North America. The fact that it has survived in that market despite the competition from the Class 1s– Union Pacific, Burlington Northern Sante Fe and Canadian National – is a testament to the efficiency of regional railways.

RDC's main business since investing in IAIS has been a pioneering role in railway privatizations overseas. In particular, we got involved in the first railway privatization outside of the USA—Argentina—in 1991. RDC is one of the shareholders in the railway lines that run from the border with Brazil to the border with Chile – **Buenos Aires al Pacifico** and **Ferrocarril Mesopotamico-General Urquiza**. These form the backbone of the

Mercosur common market railway system. The Mercosur common market is Brazil, Argentina, Chile, Uruguay and Paraguay.

RDC is also involved in one of the most challenging projects attempted by the private sector, which is the restoration of service of a completely abandoned national railway. The railway in Guatemala runs from the Atlantic to the Pacific Oceans and from Mexico to El Salvador. It was abandoned in 1996 and **Ferrovias Guatemala** is now operational in the First Phase to the Atlantic Ocean.

In September of 1999, RDC got involved with the highest railway in the world – the railway in Peru now known as **Ferrocarril Central Andino (FCCA)**. FCCA climbs 3 miles in the distance of 50 miles, employing dozens of switchbacks and 4.2% grades.

In December of 1999, RDC participated in the first rail privatization in Africa – **The Central East African Railways (CEAR)** in Malawi. In 2001, in Mozambique, RDC will include the railway to Nacala and the port of Nacala as part of CEAR's railroad system. This is the first example of a private sector integration of general cargo ports with railways. This has some significance for the FSU where ports compete with ports. For example, the railways in Estonia are highly dependent on competitive ports in order to generate traffic. This is one of the reasons that RDC was one of the bidders for the privatization of Estonian Railways.

THE RAILWAY ENVIRONMENT VARIES FROM CONTINENT TO CONTINENT…

	North America	South America	Europe	Southern Africa
Distances	Long	Medium	Short	Medium
Traffic Patterns	Concentrated	Concentrated	Fragmented	Concentrated
Break of Gauge	0	Many	1	0
Capacity Constraints	Line Capacity	Ports	Clearances	Track
Orientation	Freight	Freight	Passenger	Freight

The railway environment varies radically from continent to continent. The characteristics of European railways can be summarized as: short distances; fragmented traffic patterns; breaks of gauge; capacity constraints often driven by physical clearances; and an orientation toward passenger service. This is the exact opposite of the FSU and the USA.

In the FSU and the USA there are long distances, the same gauge throughout the networks, and generous clearances. These are primarily freight railways with passenger service. Thus, if the passenger trains stop running, it will not be nearly as bad for the economy as if the freight trains stop running.

...Especially at the Institutional Level

In Europe, at the institutional level there are many different languages and many different frontiers, which can be as much as barriers to a successful operation of railways as physical problems.

	North America	South America	Europe	Southern Africa
Business Languages	3	2	Many	2
Frontiers	2	Many	Many	Many
Ownership	Private	Private	Public	Public

Railway Restructuring's Origins Range from Economic to Political...

REASONS		North America	South America	Europe	Southern Africa
Economic	▪ Bankruptcies	X			
	▪ Lack of Investment	X	X		X
	▪ Operating Losses		X	X	X
Political	▪ Privatization Thrust		X		X
	▪ De-Monopolization			X	

There is a wide range of reasons as to why railways have been restructured. In North America, the reason has primarily been economics, and in particular, bankruptcies. In 1980, approximately one-third of the railway mileage in the USA was in bankruptcy and there was very little investment taking place. The Iowa Interstate branch to Peoria, Illinois – now at the speed of 25 miles per hour for freight trains – had at the time of the Rock Island bankruptcy a top speed for passenger trains of 10 miles per hour. (I know…I first rode the Peoria line in 1976 as a passenger and since 1991 have done so as Chairman of Iowa Interstate.) This is how far North America has come.

In contrast, the reasons that railways have been restructured in Europe are as much about politics as economics. Railways are beginning to be restructured for financial reasons, because railways generate losses; but the main thrust is one of de-monopolization—meaning dismantling institutions, not restructuring them.

...Producing a Wide Range of Strategies...

	North America	South America	Europe	Southern Africa
PRIMARY	Deregulation	Privatization	De-Monopolization	Increased Trade
SECONDARY	Labor Reform	Labor Reform	Privatization	Privatization

Various strategies have evolved within different environments. The primary strategy that has driven railway restructuring in North America has been, once again, economics – in particular, deregulation. Deregulation means railways compete with railways or more importantly, railways compete with trucks. Deregulation was implemented to create value for railway customers because competition creates lower transportation costs through efficiency.

In South America the strategy was to privatize. The goal was first to get people back to using the railways and only second to dismantle institutions. In contrast, the prime thrust of Europe is de-monopolization and only secondarily is privatization the goal.

…BUT, RESULTS TO DATE HAVE CONSISTENTLY BEEN DRIVEN BY MARKET FORCES

Ultimately it is the marketplace and not politics that drives the results. And where the intent may be political, the marketplace still has a way of figuring out how to achieve an economic result. In particular, I would argue that the financial markets have rewarded the investment in equipment and infrastructure based on demand for transportation in both North and South America.

	EXCLUSIVE FRANCHISES	OPEN ACCESS
FINANCIAL MARKETS	Customer-specific investment in equipment and infrastructure (USA, Latin America)	Customer-specific investment in equipment (UK)
	Consolidation of Brazilian and Argentine franchises; USA rail mergers	Consolidation of UK trainload freight businesses
	High valuation of Mexican businesses; Conrail	Low valuation of UK trainload freight businesses (even after consolidation)

And in Europe, there has been customer-specific investment in equipment; for example, in the United Kingdom, special cars for containers, cement, etc. But the investment in infrastructure has largely been driven by politics in terms of where the money is being spent. One of the big constraints on the ability to expand the freight business in the UK is that the infrastructure provider—Railtrack—is not disciplined to be responsive to the needs of the freight operator who is trying to be responsive to the needs of the freight customer.

In the UK, three separate trainload freight companies were carved out of British Rail to compete with each other, and the marketplace figured that out as well. The same company – EWS – bought all three freight operators and put them back together again. So it was politics that broke up the rail freight business into three companies in the UK and the private sector put them back together again. This is what is also driving the merger trend in North America and, in fact, consolidation of RDC's businesses in Argentina with those of our neighbors in Brazil.

In terms of the value of these businesses – in other words, what an investor should be willing to pay – Open Access has diminished the value substantially of the freight business.

In particular, the price that was paid for the freight business in the UK was roughly 20% of what that business would have gone for in the USA, if there were no Open Access. Based on performance to date, even though that price was low, it still may have not been low enough because of their inability to grow the business because of the capacity constraints imposed by Railtrack, as well as an underestimation of fundamental thrust of Open Access – the taking of value from the operator to the customer to the point that the business may not have any value at all.

In addition to the financial markets, it is also important to consider the transportation markets. What is happening in the transportation marketplace in the Open Access environment, as opposed to the Exclusive Franchise environment that we have in North and South America, is that European traffic continues to decline, whereas in Latin America traffic is increasing. In fact, in Europe barges are increasing their market share for the transportation of containers at the expense of rail. By contrast, in places like Africa traffic is returning because the railways are integrating themselves or, as described earlier, they are at least cooperating. Capacity constraints have reduced the ability to grow the freight business in the UK, whereas in Latin America, concession agreements have been restructured to promote additional investment.

	EXCLUSIVE FRANCHISES	OPEN ACCESS
TRANSPORTATION MARKETS	Increase in Latin American traffic	Decline in European traffic
	Return of Southern Africa's international flows	Growth in European river transportation (containers)
	Renegotiation of franchise terms (Latin America)	Capacity constraints on freight growth (UK)
	Penetration of eastern coal markets by western coal (USA)	Cannibalization of EWS coal flows by Freightliner (UK)

A prime example of why Open Access is not such a good thing for freight railways, is what has been going on in the UK in the last year. The UK's Modern Railways magazine recently devoted an entire page to nothing but various descriptions of traffic that had been cannibalized from EWS, the largest freight operator, by other Open Access operators. One article described how a coal movement had been lost by EWS to Freightliner. There was another example of how a movement of ballast had been lost by EWS to GB Railways. This is not taking trucks off the highways – this is taking existing railway business and hauling with someone else's locomotives. Again, it's about transferring value from the railway operator to the customer. One must consider that if most of the value goes to the customer and there is very little left for the railway operator, why invest in railways?

CONCLUSIONS

Under Open Access, the primary focus has been political, and in particular, the de-monopolization thrust. The secondary focus has been about the customer. Operational control is in the hands of a third party – the Regulator. And the company that actually provides the service to the customer, who we are trying to convince to use rail instead of trucks, has no control over the infrastructure.

	Open Access	Exclusive Franchise
Primary Focus	POLITICAL	CUSTOMER
Secondary Focus	CUSTOMER	INVESTOR
Operational Control	REGULATOR	OWNER
Investment in Infrastructure	NO	YES

In contrast, with the Exclusive Franchise model (which in European terms would be considered a "monopoly"), the primary focus is on the customer. The secondary focus is on the investor. In order to have a successful business there has to be capital and so there is an accommodation for the needs of the investor to earn a reasonable return.

"Because of its lack of focus on the Investor, and its secondary focus on the Customer, the financial and transportation marketplaces have repudiated (meaning rejected) Open Access."

The Iowa Interstate may be the weakest of the four railways between Chicago and Omaha, but it is in control of its fate and can decide whether to put money into the track or into the equipment to expand capacity or increase the speed. Control of the infrastructure means that the customers' needs translate directly to the type and configuration of infrastructure provided.

The railways in the Former Soviet Union have half of the world's railway traffic and a very high market share (estimated at above 80%) for the freight business. Thus, when the FSU considers options to restructure its railways, its countries should consider the various models and look at what is happening around the world. The FSU can benefit from some of the very expensive mistakes that other countries and other continents have made when figuring out what is best for their environment.

RDC takes pride in its cultural adaptability – essential when doing business overseas, taking inspiration from diverse sources. A good example of this is our frequent use of a slogan of Samora Machel, the first President of Mozambique after independence, "A luta continua!" which translates as "The struggle continues!"

In the case of Guatemala, the most appropriate inspiration is a quote from Che Guevara, “The only struggle which is lost is that which is abandoned.” Surely Guatemala’s abandoned railway, now restored to commercial operation to the Atlantic *(see Guatemala Case Study following the speech text)*, is an example of this and proof that RDC is willing to go anyplace in the world and take on these transactions IF we are able to harvest the fruits of our labors, and IF we can develop the types of franchises where, if we are successful, we get to keep our business as opposed to having our own customers turn against us.

[END]

CASE STUDY: GUATEMALA

In 1996, the railway was abandoned, and in fact, the only service in Guatemala was this private sector light rail service, which actually helped preserve the infrastructure as there was a problem with rails being stolen from the mainline.

This is how the mainline looked when the railway was abandoned. Squatters had to be relocated from the right-of-way.

In the three years that the railway stood abandoned, there was no maintenance done. As a result, when it rained, many of the bridges were washed away.

In 1998, rehabilitation was underway on the railway. This is not a TGV. This is a low technology labor-intensive solution based on the railway's ability to survive. We are very proud to say that we provided hundreds of manual labor jobs putting this railway back into operation. Please note that there are no concrete ties nor electrification.

This bridge was rebuilt using 50 manual laborers and the highest technology was a cement mixer. The cost of the entire project – 200 miles of a national railway system, track, rolling stock, etc. – under US$10 million. Why? Well, a railway with no revenue cannot justify an investment much higher than that.

In the middle of rehabilitation Hurricane Mitch struck in 1998. This is one of the mainline bridges after Hurricane Mitch.

Nonetheless, in 1999, despite more storms that severed our mainline again…

…after some creative engineering that included dragging the bridge (pictured above on its side) back into position using a bulldozer and a front-end loader (Truly a low technology approach!)…

…the railway was opened for commercial traffic.

Since the year 2000, we are moving containers, steel and other products.

"This railway project in Guatemala is a project that I take great personal satisfaction from being associated with because it is a combination of both economics and values.

"I would like to say that there is a message here…for these types of deals, it has to be more than a business – it has to be a cause – a cause that must be committed to with sufficient resources to see it through. In the case of Guatemala we did not renegotiate the concession. We rebuilt this railroad as we promised the government. It was late because Hurricane Mitch was not in the business plan. But we did it, not only because it is a good business, but also because we are committed to the business."

— **Henry Posner III**, Chairman of Ferrovias Guatemala