PARTNERS IN PROGRESS?

Estonia's role in the export of oil by rail

TRANSPORT INFRASTRUCTURE FOR OIL AND GAS IN RUSSIA & CIS • MOSCOW • 10 NOVEMBER 2005

Railroad Development Corporation
www.RRDC.com
Henry Posner III, Chairman

My agenda will be as follows: a brief background on Railroad Development Corporation (RDC); and then spend most of the time discussing Estonia and how the railway was privatized; the results of the privatization; and its particular market in the oil transit trade, which is the focus of this conference.

Background on RDC

RDC is a small private company based in the USA. We describe our business as focusing on *Emerging Corridors in Emerging Markets*, meaning that RDC does not just focus on railways, but in some cases railways and ports, railways and electricity distribution, railways and fiber optics, etc. Another significant point is that RDC does nothing on its own. In each of our businesses we have partners and it has been a very successful formula in every country in which we operate. RDC has investments in railways in the USA, Latin America, Africa and Europe.

Table A is a brief summary with statistics about the various railways in which we are involved. I would like to point out that in some cases we own 100% of the railway, for example the Iowa Interstate in the U.S., but in other cases RDC owns a very small percentage like in Estonia. So please do not be misled that these are all companies that RDC owns and controls. Also, please note that these railways vary widely in size. For example, our railroad in the USA handles 8.5 million tons in contrast to Guatemala which handles 160,000 tons.

Table A

Country	Entity	Length (km)	Employees	Tons Y. 2004 (in millions)
USA	Iowa Interstate	1,000	181	8.5
Argentina	ALL Central	5,350	1,012	3.4
Argentina	ALL Mesopotamica	2,740	313	1.4
Guatemala	Ferrovias Guatemala	322	115	0.16
Peru	Ferrocarril Central Andino	591	94	1.7
Malawi	Central East African Railways	797	487	0.24
Estonia	Eesti Raudtee	693	2,536	42.8
Mozambique	Nacala Corridor	872	227 Rail 125 Port	0.3

In addition, ***Table B*** contains some very interesting descriptors of the various railways that we are invested in. Just to highlight a few, our railroad in the U.S. the Iowa Interstate was actually abandoned in the era of regulation and put back together as a through railway after sitting abandoned for four years. And now it is handling more annual tonnage than, I believe, the national railways of Portugal or Moldova just to give you an idea of the density of traffic and the demand for freight transportation in the USA.

In contrast, the railway in Guatemala, which I previously mentioned, is experiencing low tonnage, and was in fact a completely abandoned national railway. The entire national railway system was shut down and we put it back into operation after three years of abandonment.

In Peru, until last month I could tell you that we had the World's Highest Railway. The Central Andino goes to an altitude of 4,818 meters (15,800 feet) crossing the Andes. We lost this title last month to the Chinese with their new Golmud-Lhasa line to Tibet.

An interesting aspect of the railway in Mozambique is that it is integrated with a port system. RDC participates in the port and railway concession in Northern Mozambique which we believe is the first private sector integration of general-cargo ports and railways.

Table B

Country	Anecdote
USA:	Abandoned as through route from 1980 to 1984
Argentina:	First country to "privatize" railways
Guatemala:	First example of 100% abandoned national railway restored by private sector
Peru:	World's highest railway
Malawi:	First private sector rail investment in Africa
Estonia:	Only vertically-integrated privatization of a national railway in Europe
Mozambique:	First private sector integration of ports and railways

But the accomplishment that RDC is most proud of is our safety record. In 2004 our railroad in the USA, the Iowa Interstate, won the Gold Harriman Award, which is the first prize for rail safety. For railways of our size, we had no personal injuries for the entire year of 2003 with a workforce of 185 people. We are very proud of this accomplishment and we believe that bringing that safety culture to the other railways that we are involved with is not only important but also good business.

Photo 1

In Peru, we have pioneered the use of natural gas to power locomotives. ***Photo 1*** shows the new locomotive at 4,783 meters (15,693 feet) at Galera. By the way, this is the same type of locomotive that we use in Estonia. In both cases, these are used locomotives from the USA that were rebuilt and shipped to Peru and Estonia. There is nothing in the way of technical modification that was required except in the case of Estonia, a slight adjustment to the gauge.

As I mentioned earlier, in Mozambique we operate a port (***Photo 2***) as well as a railway under the integration of the concession. The railway in Mozambique connects with the railway in Malawi so this is in fact a transit corridor between Malawi and the Indian Ocean totaling two railways–one in Malawi and one in Mozambique–and a port in Mozambique.

Photo 2

Estonia

What is unique about Estonia is that it is first of all the only vertically integrated privatization of a national railway in Europe. There was only one other rail privatization in Europe and that was the notorious and disastrous privatization in the UK, which as far as I'm concerned gave capitalism a bad name because it was driven more by politics than economics. In contrast, Estonia has been a very successful privatization at least as it was originally structured. The main business of Estonian Railways (EVR) is to transport transit traffic from Russia for export; approximately 90% of EVR's business is the Russian transit trade, by which we live or die.

Our partners include another American railroad operator–*Rail World Inc*; an institutional investor–*Mid Europa Partners* (UK); and an Estonian investor group–*Ganiger Invest*. By U.S. standards this is a big, big railway, handling 46 million tons annually, which would put it in the category of a Class 1 railroad, which is as big as they come in North America.

The plan in Estonia was quite simple. We replaced the entire locomotive fleet over a period of one year with a standard type of used locomotive from the USA, the GE C30 series. As part of the privatization, we also accepted a limited Open Access regime. (Apparently the European consultants got to Estonia before the privatization program was fully formed.) The limited Open Access was agreed to and that was reflected in the price that we paid for the majority share of Estonian Railways. However, and more details will follow later, two years after we bought the company the landscape was changed dramatically with some extremely punitive, retroactive legislation that had had quite a negative effect on both the company's finances and its ability to promote the transit trade.

Why Estonia Chose to Privatize

There were really four objectives as to why Estonia decided to privatize its railway:

1. **To eliminate losses**, which the State had to fund.
2. **To generate cash** from selling the business to the private sector.
3. **To get more focused on specific markets**. For example, in Russia there is an acknowledgement that the passenger business is much different than the freight business and within the passenger

business, suburban trains are much different than intercity trains. So there was a very conventional segmentation of the business and what we focused on was the freight business.

4. **To promote the transit trade** because Estonia does not have a lot of industry. Estonia's main business is the ports and we are really nothing more than a very large port railway that connects to the source of traffic, which is Russia.

Estonian Railways is succeeding in diversifying its traffic base. There is a new coal terminal that opened in early 2005 that is expected to generate approximately 5 million annual tons of coal traffic.

How Estonia was Restructured

Here is an overview of how Estonia was restructured:

- The core business is freight; therefore we bought the infrastructure and the freight operation. There was provision for a limited number of Open Access paths on our main line which was accepted as part of the privatization deal and factored into the purchase price.

- The intercity passenger service was privatized to a different company that receives a subsidy.

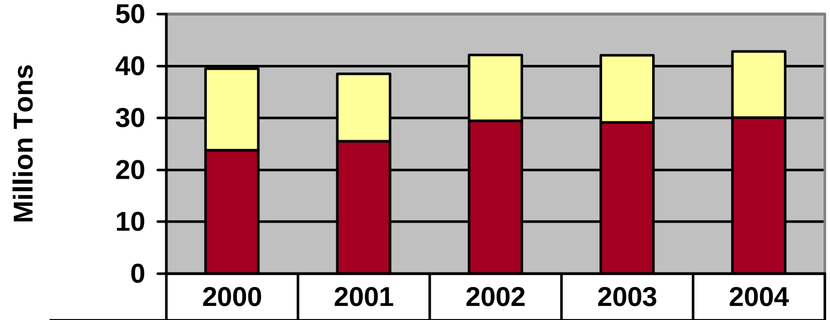
- The international passenger service, which I rode last night from Tallinn to Moscow, is operated by the private sector without subsidies. It is quite interesting because if you go to the USA, the folks at Amtrak (USA's national passenger service operator) will tell you that nobody in the world makes money on passenger service. Well, don't tell that to the Estonians, because they have been running this train for years without a subsidy.

- The commuter service around Tallinn has been moved to a public sector company called Elektriraudtee.

Results to Date – TRAFFIC

Let's talk about the results at Estonian Railways since it was privatized. The most important factor after safety is what we have done to promote the transit trade. This is a very easy statistic to measure because all you have to do is look at the tonnage (***Graph A***) and note that it has increased since privatization. Also, please note that Graph A starts at a base of zero which gives a more accurate picture of how, despite the transit trade being intently competitive, we have continued to grow the business thus benefiting the ports and the national economy. Most of our business is oil, but we are working to diversify because we cannot depend on any one commodity. For example, Estonian Railways is currently developing the coal business, but in the meantime the bulk of business is oil.

Graph A
Eesti Raudtee – Freight Volume

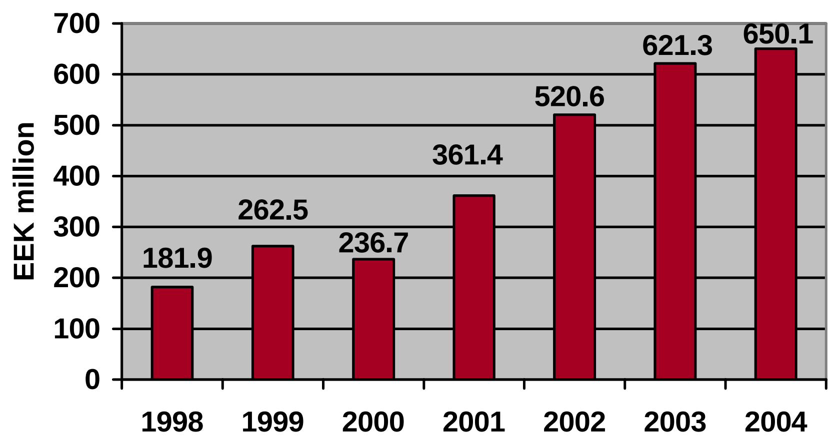


	2000	2001	2002	2003	2004
Other	15.68	12.97	12.67	12.92	12.77
Oil	23.79	25.5	29.46	29.17	30.06

Results to Date – PROFIT

Next, let's discuss the results to date in terms of profit (***Graph B***). It's important to note that profit is a good thing for two reasons, even from the State's perspective: (1) the State owns 1/3 of the company; and (2) a railway company that makes a profit can fund infrastructure. Estonian Railways has been expanding its capacity by rebuilding additional tracks and stations, and new track connections to expedite movements, etc.

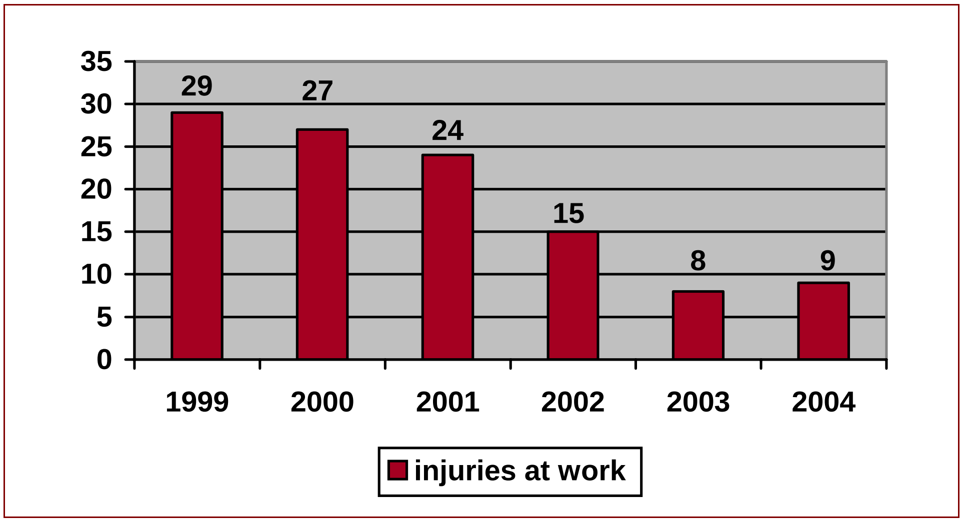
Graph B
Eesti Raudtee – EBITDA



Results to Date – SAFETY

Graph C shows our safety performance, which I am most proud of, measured in number of injuries. Every year, with the exception of the most recent year, Estonian Railways has been able to dramatically reduce the number of injuries. We are now to the point where it may not be possible to do much better in a business where employees are working 24 hours and outdoors. I doubt if we'll ever get to zero, but this is a very good safety performance by North American and world standards.

Graph C
Eesti Raudtee – Safety



EVR's Market Position

Let's review Estonian Railways' market position. It is quite simple. EVR is heavily dependent on being competitive in the Baltic Corridor, meaning traffic originating in Russia that could go to Estonia, but it could also go to Russian ports, Latvian ports or Lithuanian ports. Further, we are the tail end of the movement and our ability to compete is heavily dependent on Russian tariff policy. Thus EVR works very hard with Estonian ports, Estonian customs, etc. to make sure that we are the most user-friendly and competitive gateway to Russia. Now let's talk about recent developments.

Recent Developments – Railways Act of 2003

In the year of 2003, two years after we bought EVR, there was a Railways Act that was passed which basically took both operational control and commercial control away from EVR. Capacity on EVR's main line is now controlled by a new government entity called the Railway Inspectorate. And even though when we bought the company it was agreed that 20% of our slots would be opened to open access operators, that was changed with the stroke of a pen to 100%. Further, the tariff that open access operators pay EVR is controlled by the government.

To put it another way, suppose you build a factory and after you built the factory the government came and told you how many hours a day you were allowed to use your production line, and that they would let you know later what the people who would start using your production line in competition with you were going to pay. This is Estonian Railways' position.

To put it in an overview, both EVR's revenue and cost structures are now controlled by the government. This has been done under the guise of EU regulations, but there is no country in the European Union with regulations like these.

Let's look at it another way. ***Graph D*** shows three different columns highlighting the fundamental differences between Estonian Railways and Russian Railways. The most important highlight is the column on the left and the column in the middle. Note that before the Railways Act the competition was other ports. Like I said earlier, EVR's job is to advocate for Estonian ports in competition with Latvian, Lithuanian and Russian ports. Now the competition is not only other ports, but also other railway operators using our assets.

The other important thing is – what is the constraint on capacity? I would make the case that before the Railways Act, the major constraint was borders and how quickly traffic could be cleared through customs and onward to the port. Now it is not only the borders but also the Railway Inspectorate because EVR has to get permission from the government to solicit traffic to move on our railway thanks to the regulatory regime regarding capacity.

Graph D

	ESTONIA Pre-Railways Act	ESTONIA Post-Railways Act	RUSSIA
Traffic Generators	Ports	Ports	Producers
Competition	Other Ports	Other Ports, Other Operators	Other Producers
Capacity Constraints	Borders	Borders, Railway Inspectorate	Line Capacity
Tariff Regulation	NO	YES	YES

EVR's Strategy

Part of the strategy remains the same strategy that we put in the day we bought the company. We will work with the Estonian ports to pull traffic from Russia; we will act with the customers to be a user-friendly gateway to Russia; and we're going to prove that the ports

Photo 3

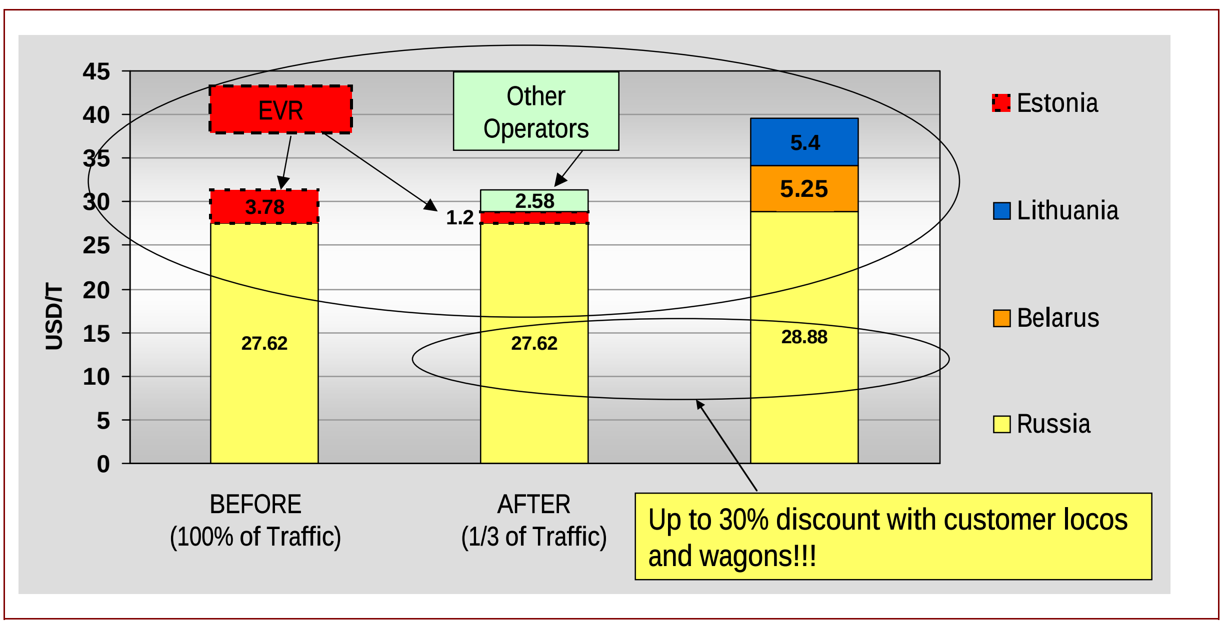
and railways in Estonia can work together as a team to compete for the transit business. And most importantly, we have a very good and close working relationship with Russian Railways. ***Photo 3*** shows six of our GE locomotives in Russia which I personally took in September 2003.

Since the Railways Act, EVR has had to adopt additional strategies, increase its management team and also compartmentalize it so we can do several things at once. First, EVR is going to operate a safe and efficient railroad. The day-to-day business of Estonian Railways has not changed – operate safely, operate efficiently. The commercial objective of EVR has not changed – we will promote the transit trade through Estonia just like we signed up to do when we made our investment. However, we will fight the government and contest the Railways Act through arbitration and the court system.

To put this into perspective, how important was it to the overall scheme of the transit trade that other operators could start using EVR's track? ***Graph E*** shows three columns; the two on the left are prices through the port of Tallinn including the Russian tariff. In other words, starting in Krotovka and going to Tallinn, how much is the Russian tariff? How much is the Estonian tariff? Please note that the Estonian part is a very small piece of the through-movement compared with operating through Klaipeda. It is still cheaper than operating through Klaipeda. So the whole impact of the Railways Act was to shave a small piece off of the Estonian component, but at the same time the Russian tariff can vary as much as 30% depending on whether the customer supplies locomotives or equipment. This graph is to put it all into perspective as to how much an impact this has had on the overall transit trade.

Graph E

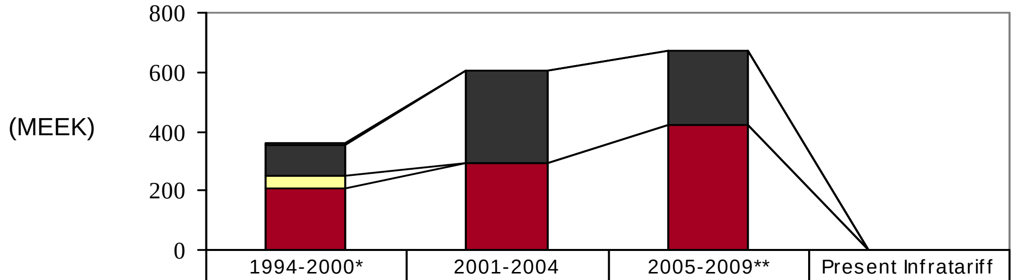
Short-Term: Minor impact of lower Estonian infrastructure tariffs
(Oil, Krotovka-Tallinn vs. Klaipeda)



What is more of a problem is the ability to finance infrastructure. Based on the new infrastructure tariffs that have been imposed on EVR, our ability to fund infrastructure has been compromised. ***Graph F*** is probably too busy to get into much detail, but it is worthy of attention like Graph E regarding the tariffs.

Graph F

Long-Term Effect of lower infrastructure tariffs
Infrastructure Investments 1994–2009



	1994-2000*	2001-2004	2005-2009**	Present Infratariff
Other (state support)	3	0	0	0
Other (EVR)	107	313	246	0
Infrastructure (state support)	39	0	0	0
Infrastructure (EVR)	210	292	424	0

(*) 1994 - 2000 without PHARE aid (total 78 MEEK)
(**) Assumed by agreed new Business Plan based on asked infratariff

Conclusions

Let's draw some conclusions and I'll provide the big-picture result. In the short-term, the customers will benefit because they basically get to use EVR's railway for almost free. In the long-term, the ability to fund the infrastructure to support those operations has now disappeared.

In conclusion, we're going to do our jobs; we're going to operate safely and efficiently; and at the same time, for the benefit of the transit trade and our customers, we're going to contest the Railways Act and try to get it changed. In the meantime, EVR will obey the law!

Question-and-Answer Session

[Q] Can you explain how you got involved with Estonian Railways?

[A] RDC has been one of the pioneers of rail privatization from its early days beginning in Argentina in the early 1990s. So when the opportunity came along to own a piece of the Former Soviet Railways, which in their prime handled 75% of the world's railway traffic, we jumped at the opportunity. I've always been an admirer and a student of the Soviet Railways and this was my opportunity to become part of the world's greatest railway system.

[Q] What was the process by which RDC got involved in Estonia?

[A] What happened was there was a private sector consortium which was formed to bid for a 66% share of Estonian Railways; the State retained 34%. So RDC became part of this consortium because they needed a rail operator and RDC was happy to sign up.

[Q] Do you lease or own the infrastructure?

[A] No, actually we own the infrastructure–the tracks, the rolling stock, the stations. The only thing we don't own is the land underneath the infrastructure and that is on a very long-term lease, so we effectively have control of it.

[Q] So this law effectively exercises over your track?

[A] Correct. The law was constructed under the guise of EU guidelines for de-monopolization. But those guidelines were constructed to deal with the passenger-oriented state railways of Europe, not a freight-oriented private railway in the Former Soviet Union. In our case, there really is no need for regulation because it is so competitive that our tariffs are constrained by what Latvia, Lithuania and Russia do. So there is no such thing as a railroad monopoly in the Baltics.

[Q] I sympathize with your position. Was there any protection given to you in relation to the privatization about whether you would be discriminated against or bringing about a regulatory change? I am speaking tomorrow morning about Project Finance and one of the problems is the competence and stability in the regulatory regime. So I am interested to know on what basis you bought in and indeed the consequence on your experience and your advice to others who may be lulled into privately financing…

[A] You've asked a legal question and I'm not a lawyer. So I shouldn't answer you; however, I will give you my interpretation as a career railway person who has seen a lot of railways and a lot of regulatory environments.

There is protection in that there is a privatization agreement and this will ultimately lead to arbitration which years from now will probably reward us in terms of what's going to happen with our investment. In the meantime, we are now invested in a country that has decided retroactively that they wished things had gone a different way. It is quite an uncomfortable position to be in; however, we believe that we are right and what we are doing is in the best interest of the country. So we are sticking to our guns and trying to focus on running the railway while seeking arbitration and other legal remedies that are available to us. The problem with pursuing the legal route is that it is distracting and there is the time value of money. Some people don't have the stomach for it; but we do. I hope that answers your question.

> If you wanted advice, then my advice to any country considering a privatization or investment scheme is to decide up front what you really want. In some cases, it may not be possible to control the agenda of the next political party; when you invest internationally, you always run the risk that when a political party changes, the first thing they do is look at the previous party's economic program and try to prove how bad it was for the country. I'm not sure that you can control it, but I think that it is something you have to consider as an international investor. It does raise the cost of projects because you are introducing a political risk premium. One interesting aspect is that RDC has invested in Africa and Latin America, but Estonia is the riskiest investment we've made because of the politics. Go figure; this is Europe!

Thank you.

[END]