

## FIRST PRIVATIZATION OF A FORMER SOVIET RAILWAY: Bringing International Experience and Best Practice to Estonia

Reform and Privatization of Russian Railways Conference  
Moscow, Russia, 17 February 2004

**Henry Posner III, Chairman**  
Railroad Development Corporation  
[www.RRDC.com](http://www.RRDC.com)

---

I would like to clarify the name of this presentation: “First Privatization of a Former Soviet Railway”. I was asked earlier, “Why are you talking about a Former Soviet Railway when you are in Estonia?” It is very important to point out that while Estonia is a European country, Estonian Railways is a railway that goes to Moscow, not to Brussels.

My agenda is to provide some quick background on our company, and then get into the specifics of Estonia; in particular, why Estonia chose to privatize and how Estonia was restructured. This is very interesting because we are not discussing theories but rather discussing one of Russia’s neighboring countries where this was actually done, over two years ago. I will then highlight the differences between Estonia and Russia, including some very fundamental differences; and finally I will presume to make some suggestions for Russia, given the importance of the railways to the Russian economy.

### **Background on RDC — General**

RDC is a railway investment and management company. Everything we do is with Joint Venture partners; as a small company this is our way of making our capital work very hard.

### **Background on RDC — Businesses**

In the **USA** our Flagship is the **Iowa Interstate Railroad** that was part of the bankrupt Rock Island Railroad, which not only went into financial bankruptcy but actually closed. In the late 1970s twenty-five percent of the railway mileage in the USA was in bankruptcy; the railways in the United States were in the process of going out of business. The U.S. government had subsidized highways as a matter of national policy, but basically the railways were told that they had to solve their own problems themselves because there was no government money for them. However, the railways were given the tools of deregulation and as a result many small railways were created from the ashes of what was left of the big railway systems; the Iowa Interstate is one example.

On the Iowa Interstate I am very proud to say that we are the safest railroad of our size in North America because in the year 2003, we had No Personal Injuries.

As I said, the Iowa Interstate is our flagship; we bring people from all over the world to see how 6 million tons can be moved with only 185 employees. RDC now owns 100 percent of the Iowa Interstate as of January 2004. We operate from Chicago and Peoria to Omaha. It is interesting to note that the locomotive shown was built in approximately 1960. So if you think you have old locomotives operating in Russia, come to the USA and see how old the locomotives are on some of our smaller railroad lines.



In **Argentina**, RDC is a minority partner in two of the railway concessions, **ALL-Central** and **ALL-Mesopotámica**; the railways were almost abandoned there in 1991. This was really the first major experimentation with railway privatization and since then it has breathed life into a substantial rail network that had been given up for dead; it was the first international privatization as it's known today. These are much bigger systems than the Iowa Interstate. The two lines are each several thousand kilometers long; one line goes to Brazil, Paraguay and Uruguay and the other line goes to Chile.

In **Guatemala** we have the most extreme example of rail privatization. This national railway system was completely abandoned and shut down in 1996. A portion of it was brought back from the dead in 1999 (operating as **Ferrovías Guatemala**).

The map depicts a black line where Ferrovías Guatemala is operating, but there is also a dotted line which is the half of the system that we have not been able to open because we have found it impossible to finance.

One comment about this railway — by European standards this system is a monopoly. It is the only railway in Guatemala. The problem with this “monopoly” however, is that because the railway was shut down for several years, it was of course impossible to monopolize anyone since we had no customers. With regard to separation of infrastructure from operations, for a railway that runs one train a day and only moves 100 thousand tons per year, imagine the cost of setting up two separate administrations—one for infrastructure and one for operations. I'm sure the cost of administering two separate organizations would be higher than the freight revenue that the company would generate.

In **Peru** we are also partners in the World's Highest Railway, the **Central Andino**. This railway goes to an altitude of 5 thousand meters in the Andes.

In **Malawi and Mozambique**, RDC is a partner in the former Malawi Railways (now operating as **Central East African Railways**) which was privatized in 1999. This railway goes only to

Mozambique and its only connection to the outside world is through the Port of Nacala. Next month we will be taking over the Mozambique side of this railway. This will be the first privatization of a combined port and railway for general cargo. It is very unusual for railways and ports to be integrated, but because these are so dependent on each another, the decision was made to privatize the railway and the port at the same time.

These are very difficult businesses and RDC has gone out of its way to enter into them with local partners for this reason; all of these are Joint Ventures. So I am clearly not trying to brag about how big we are, but rather I am clarifying how small we are and how we nonetheless get things done.

### **Background on RDC — Investment Parameters**

Let us now discuss RDC's investment parameters. In an investment environment RDC looks first and foremost for a **committed government**. If a government is simply going through the motions of appearing to restructure in order to satisfy politicians or The World Bank, we are not interested in being used as a stalking horse to make government agencies look busy.

Second, we are looking for **rational competition among bidders**. In Africa our competition is the governments of France and South Africa, through their national railways. When these particular governments are our competition, I will confess to you that RDC has less money than they do and we are not likely to enter into that sort of competition.

Third, we always have **local partners**. It is more important to know the politics, the culture and the macroeconomic business environment than it is to know anything about railways.

Fourth, and only fourth in priority, are **railway skills**. I am not trying to paint an unusually modest picture of what RDC is, but this is the reality of how we invest and we think it is an important consideration as far as investment is concerned.

### **Background on RDC — Businesses**

Now, on to **Estonia**, where since 2001 we have been partners with Rail World (USA), Jarvis (UK), Ganiger (Estonia) and the Estonian Government. **Estonian Railways** is a very interesting business in many respects. First of all, it goes to Russia and most of our customers are Russian customers. It is also the first vertically integrated privatization of a national railway in Europe. And compared with the other businesses RDC is involved in, this is a very big business, with 40 million annual tons of traffic; this would put it in a league with some of the biggest railways in North America. And while this is a relatively small network, it is very strategic because its main business is moving Russian traffic to and from the Baltic ports.

This photo shows the most highly visible accomplishment of Estonian Railways, and that is to take used locomotives from North America, re-gauge them and put them into service. By doing so, these 15 to 20 year old locomotives replaced two-section 2TE116 type locomotives and still have extra hauling capacity. This should be very interesting to those in the rolling stock business in the Russian market. There are many interesting opportunities to take used equipment from one place to another depending on the market and the operating conditions.



### **Why Estonia chose to privatize**

So, why did Estonia privatize? The reasons were not unusual compared with the privatization schemes of other countries. One reason was to eliminate losses, but more importantly it was to improve the competitiveness of what is a major business for Estonia, the transit business. A big piece of Estonia's economy consists of traffic such as oil moving from Russia to export, so between the Estonian Railways and the Estonian ports this is the core business. Another reason was to restructure along business lines. The freight railway was privatized; the passenger business was spun off into several businesses, some publicly held and some privately held. The point was that each type of business was put into its own company so that each management team could focus on its business.

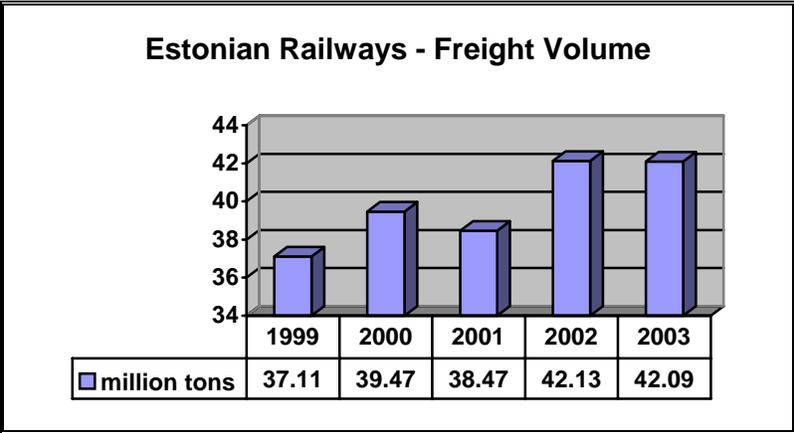
### **How Estonia was restructured**

The prime business of Estonian Railways is freight. The core businesses are the provision of infrastructure and the operation of freight trains. There is provision for Open Access freight operators. And as I said, the passenger business has been moved into several private companies—one receives a subsidy and one does not receive a subsidy. The electrified service around Tallinn remains in public hands.

**Results to date**

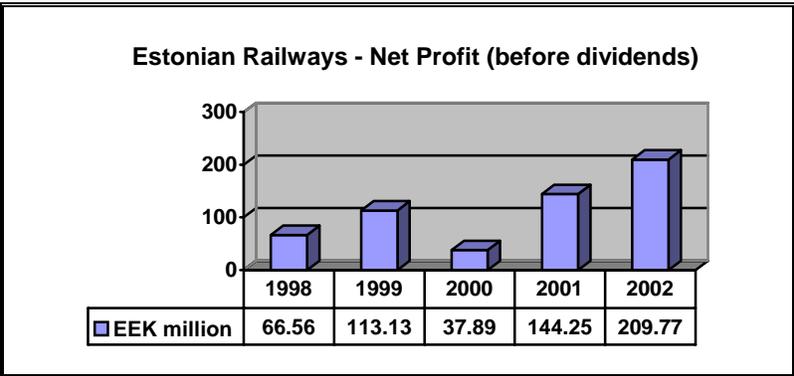
Let's discuss the results to date of the privatization of Estonian Railways. The best measure is traffic and as the graph (Graph A) will show, traffic has increased since privatization. It is also important to note that the railways have worked very closely with the ports in order to make this happen. The Estonian ports are very competitive and Estonian Railways is helping them become even more competitive.

**Graph A**



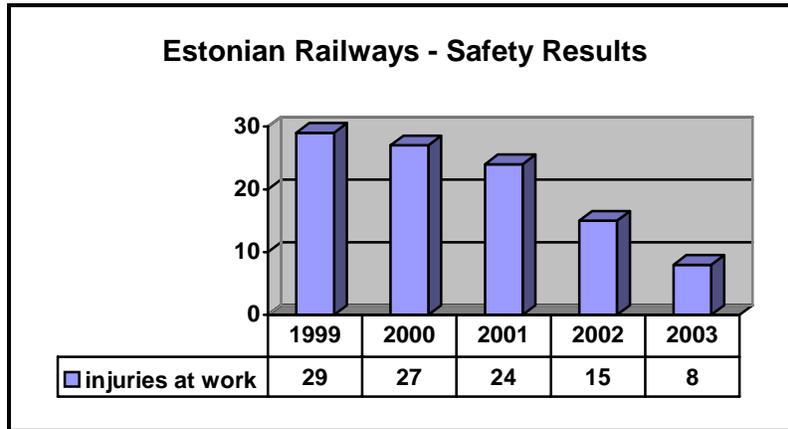
The financial result is one of increasing profits (Graph B). One thing that I should point out since this presentation was put together is that we were able to refinance our debt in the private sector. But the IFC (the International Finance Corporation) was extremely important in getting this off the ground and providing financing when it was privatized.

**Graph B**



My personal, most important measure is Safety. We have had a steadily improving safety performance since privatization (Graph C). These are very good results by North American standards, let alone by Estonian standards. The results speak for themselves.

**Graph C**



**Differences between Former Soviet railways and other continents**

Let me exercise some caution here and point out that there some fundamental differences (Table A) between the Former Soviet railways and even those of other continents. In particular, we've heard a lot at this conference about how Russia compares with Germany and other European countries. But I think it is important to consider that the Russian Railways have more in common with North America than with Europe. The prime business of the Russian Railways is freight, just as in North America; there are long distances in Russia, just like North America; and so there are more similarities between North America and Russia than there are between Europe and Russia.

**Table A**

	North America	Europe	Former Soviet
Distances	Long	Short	Long
Traffic Patterns	Concentrated	Fragmented	Fragmented
Competition	Other Rail	Truck	Other Producers, Pipelines
Capacity Constraints	Line Capacity	Clearances	Line Capacity
Orientation	Freight	Passenger	Freight

**Differences between Estonian Railways and Russian Railways**

And in examining the differences between Estonian Railways and Russian Railways, I think there are some extremely important differences (Table B). For the most part, Russia is full of producers and Estonia is basically a transit corridor for Russian products. Another way of looking at it is: if you have a factory in the middle of Russia, you have one railway to deal with; but in terms of how you get it out of the country, you have many choices—send it to Russian ports, Estonian ports, Latvian ports or Lithuanian ports.

**Table B**

	Estonia	Russia
Traffic Generators	Ports	Producers
Competition	Other Ports	Other Producers
Capacity Constraints	Borders	Line Capacity
Tariff Regulation	NO	YES

So Estonian Railways is in an intensely competitive market and our strategy has been to try to stay ahead of that competition by making the ports more competitive, which we'll discuss next.

**Estonian Railways' market position**

Estonian Railways is heavily dependent on Russian traffic. We are nothing more than the middle link between the Russian producers, the Estonian ports and the ultimate market; and there are many ways for that traffic to go. And we have very little ability to influence the physical capacity of Russian Railways or the tariff policy of Russian Railways. If you look at our tariffs and the percent of the haul that occurs in Estonia, it is a very small piece of the cost of moving the traffic. We have to work very hard, very smart and very fast in order to succeed in this business.

**Estonian Railways' strategy**

Our strategy is very simple — we are working with the Estonian ports to be competitive as an outlet for Russian traffic; we have positioned ourselves as a user-friendly gateway to and from the Russian market; and we are proving, in conjunction with Estonian ports, that we can handle different types of traffic under a variety of conditions. For example, we are handling traffic such as grain, coal and oil, but we need to diversify our traffic base much more and build the customer confidence that this will require.

Most importantly, we have to work very closely with Russian Railways. I took this photo myself at Pechory in September 2003. We have a very good working relationship with the October Railway and we hope to build from there.



### **Suggestions for Russia**

At this point let me be highly presumptuous and come up with some suggestions for Russia, given that you are in a critical stage as far as the future of the railways. The most important thing to remember is that Russia's environment is much different from that of North America and Europe. For this reason and more, restructuring should be undertaken very carefully. Most of the countries in which RDC does business privatized their railways because they had nothing to lose, the classic example being Argentina; there, the railways did not have a major role in the economy, so if we screwed up it would not be a big problem. But given the heavy dependence of Russia's economy on the railways, this is not something that should be done lightly, and this is not something that should be done for political reasons to get done before the next election, as was done in the United Kingdom. Another reason is that in North America we have a highly developed road system, which is one of the reasons we only handle 30 percent of the traffic; if the railways failed in North America, it would not be as bad as if the railways failed in Russia.

At this point in the year 2004, there are many countries that have gone down this road—many countries that have privatized, many countries that have restructured—and there are lots of models from which to pick and choose. There are probably more failures than successes, but that is what Russia gets to benefit from—that others have made mistakes and paid for them.

My other advice is to focus on the Customer, which is how the North American railways have evolved. What is left of the North American railway system is a vigorous and privately financed system that exists to do nothing other than serve our Customers.

Finally, I would like to extend a personal invitation to come to Estonia and see for yourself how a Former Soviet Railway has been restructured, and you can do so by taking the overnight private sector passenger train from Moscow to Tallinn. We are very proud of what we have accomplished and we want to have a closer relationship with Russia.

These are very exciting times for railways. As somebody who in my younger days admired the Russian Railway system for being the world's biggest—handling at that time half of the world's rail traffic—Russia still has 25% of the world's railway traffic. I'm personally proud to be

associated with a little railway that is a gateway for Russia to the outside world, just as it represents an opportunity to introduce new technology into this environment.

Thank you.

### Question-and-Answer Session

**[Q] How will the future of Estonia as a transit country be impacted by not only the increasing number of port facilities in Russia but also the tariff policy of Russian Railways?**

**[A]** My response is that it is very much as I stated in my presentation. We do not control Russia's tariff policy; and we are in an extremely competitive business. Estonian Railways has to work very hard to stay ahead of the game, working with the Estonian ports to make Estonia as competitive as possible given that there is a big piece of the pie that we do not control. What we hope to do in Estonia is to convince customers that they are best served by routing their traffic through Estonian ports because we have the capacity and the user-friendliness available right now to meet their needs. We hope this will result in increased utilization of Estonian Railways and ports as well as increased investment in Estonian Railways and ports. In other words, we are making the best case we can to have as much of that traffic and that investment working through Estonia given that we compete with Russian ports, Latvian ports, Lithuanian ports, etc.

**[Q] What aspects of the privatization process in Estonia would you have done differently? And, will you be taking on Russian partners given your stated dependence on Russia?**

**[A]** I would like to respond to both questions. First of all, in terms of mistakes that were made, I can't really say that there was anything we would have done differently. I think we would have preferred that during the privatization process that the original much higher bid by a competing consortium, which turned out to be bogus, was not accepted by the government; it basically delayed the privatization of the railway for about 6 months and caused a lot of embarrassment and lost opportunity for everybody. But in general I think it has worked out quite well by every measure—traffic, profitability, safety, etc.

With regard to bringing Russian partners into the business, for the time being it is difficult to say how things will evolve, but it would be very early to be selling off our interest or diluting our interest; we have made a commitment to the government of Estonia that we are who we are, and to sell off our interest for a short-term profit would send the wrong messages. Fundamentally, the fact that almost all of our customers are Russian would be an indication that we want to have a close relationship with Russia in terms of both

traffic and investment, and it is just a question of what form that takes and what the timetable is. For example, another possibility is Estonian investment in Russian Railways. So, this is another interesting possibility and who knows where that might lead. I would just like to put that on the table as a possible alternative scenario in the future as well.

**[Q] Do you agree with the earlier presentation that it is “not possible to make money on passengers”?**

**[A]** I could not help but think about the question as to where suburban railways make money. There is one example and that is Japan. The reasons are because there is such a high population density and the people are so wealthy. When you put the two of them together, it makes for a very viable business. But the third piece of that is that many of the suburban railways in Japan are also in other businesses. For example, one would own a department store or a baseball stadium into which the suburban railway operates and that is an additional generator of traffic. Japanese railways are a very interesting model of how to run a profitable passenger service.

**[Q] In Russia it is very difficult to justify purchase of wagons by customers when our tariffs do not provide much of an economic incentive to do so. Could you comment on this?**

**[A]** This is another example of how countries can learn from what has happened elsewhere. This type of discussion is not unusual in North America where we have customers who tell the railways that they would be happy to invest in equipment if only they would get a lower rate. Usually those discussions result in some sort of negotiation and as long as it is a benefit to both parties, quite often the rate will be adjusted and the customer will have the economic justification to invest in equipment. It is very much a back-and-forth process and I can tell you that 20 years after deregulation we're still feeling our own way and handling these one-on-one types of discussions, as opposed to relying on centralized regulatory dictates from Washington.

[END]