

INCREASING THE ROLE OF THE PRIVATE SECTOR IN RAILWAY TRANSPORT

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INTRODUCTION

Explicitly promoting the role of the private sector in railway enterprise reform is a relatively new, but growing element in World Bank lending. Several of the Bank's recent railway projects have contained a component aimed at improving the role of the private sector. The reform of Ferrocarriles Argentinos, for example, is grounded in transferring to private sector operation those rail activities which can be expected to become commercial, and in asking the private sector operator to be prepared to provide for the state's account several activities, primarily intercity passenger services, which the state itself will no longer be in a position to provide directly. A third element of this program calls on the private sector to operate other public services (commuter and Metro services in the Buenos Aires area) under contract to the public sector. In Senegal, a new, semi-private company (SEFICS) was created to handle rail traffic to a new industrial activity: the alternative would have been to expand the service of the existing national railway company.

The World Bank co-sponsored, in conjunction with the U.S. Department of Transportation (Federal Railroad Administration), the UIC, the Association of American Railroads, the American Short Line Railroad Association, the Regional Railroad Association (of the US), the Railway Progress Institute, the Union of African Railways and the Association of Latin American Railways, a World Congress on the Private Sector in Railways. This Congress included speakers and attendees from over 60 countries and all continents discussing the issues of improving the role of the private sector in railway activities. The results of this conference, combined with Bank experience, give us a good base for looking to future initiatives in the field.

The Bank's emerging general policy of encouraging the expansion of the private sector's role in support of state enterprise activities, or of transferring those activities to the private sector, is particularly applicable to railways because many different types of private sector involvement are possible. Experience with state owned railways which have begun to emphasize various private sector links has been substantially positive,^{1/} and not just because of the net revenue contribution to the enterprise budget. An equally important effect has been the recognition by railway staff that they are not necessarily totally divorced from the private sector; they can compete, and they can make a profit, at least on some activities. This realization has been a good morale builder, and changes the way the employees of the enterprise view themselves. The effort is not without some risk, of course, and the ventures have not been uniformly successful. There are also clear risks of corruption (because politicians want to be

^{1/} Japanese National Railways (JNR), British Railways (BR), and Amtrak furnish good examples of this type of activity.

involved in the way state assets are sold or leased) which can be minimized, but not eliminated.

Perhaps the most important point about the term "privatization" is that it should be understood as a spectrum of possibilities, and not a single, either/or decision. The aim, in most cases, is not so much a sale of assets to the private sector as it is to promote contestability in markets the railway serves, or purchases from. A better phrase might instead be "private sector development" (PSD), which is the term now preferred in the Bank. Railways are a rich source of examples (actual or potential) of the various possibilities for PSD. There is no exact set of terms to describe the range of opportunities, but a number of general types of involvement can be listed.

1. PSD OPPORTUNITIES

1.1 "Traditional," or Small Scale Relationships

Many railways, especially in the U.S. and Canada, have long engaged in what are called "pipe and wire" leases. This is a situation where another entity, usually a public utility, would like to place a pipe or wire along or under the railway right-of-way. The railway will typically allow the activity, but will charge an annual fee. This can range from very small, single pipe transactions to quite large ones where a utility wants to run a high voltage electric transmission line for a considerable distance along the railway right-of-way. Other traditional activities can include leasing of station space to a restaurant or news stand operator, or providing low cost leases on railway-owned industrial land in order to promote the growth of business which will ship by rail. There is little risk for the railway in this type of activity, and the only cost is the retention of a small staff to manage the railway's interest (mostly billing, collecting, and periodic revaluation of charges) in a large number of small leases. If the railway has not actively pursued this type of activity in the past, however, a significant effort is required in order to identify properties and set (or bring current) rents and lease fees.

1.2 "Non-traditional" Activities or Joint Ventures

These activities include larger scale station and station area economic development project, such as Washington Union Station in Washington, DC, or many similar projects in Japan and Europe. In general, these are joint ventures between railway and private sector in which the railway contributes its ownership or control of valuable urban real estate and the private developer contributes the development capital, development planning and management expertise. These projects have usually been tied to a railway station where the passenger flow was one of the sources of revenue generation, but some projects have involved surplus rail property which no longer has any rail use or connection. These projects can be highly profitable, but they can obviously also have financial and political risks for the railway. They also absolutely require that expertise be brought into the railway from the outside: very few rail employees know (or should know) anything about real estate investment. They are probably best managed as a completely separate profit center within the railway.

Another example of a joint venture with rapidly growing importance to the Bank's railways is the use of railway right-of-way for fiber optic cables. Several of these types of projects have already been completed in the U.S., Europe and Japan as joint ventures between the railway and a telecommunications company: many others are

well along in planning. Railways are fortunate in having rights-of-way which furnish continuous links between urban centers without the need for expensive and environmentally sensitive acquisitions by the telecommunications company. There is a natural deal: the railway contributes the use of its right-of-way, the telecommunications entity installs the cable and operates it. The railway gets much better communications services, a fee for the installation of the cable, and a share of the revenues (or profits) of the communications traffic; the communications company gets a cheap and readily available right-of-way and an enormous increment in capacity. Both benefit. Here again, managerial and investment expertise is required which is not typically part of a railway staff.

1.3 Using Railway Assets for Non-Rail Businesses

There are a number of examples of this type of activity which, in effect, constitutes a private sector, non-rail venture by the railway. Nigeria Railways Corp (NRC) has used its railway printing plant to do contract printing jobs for a wide range of non-rail customers (activity which was probably not profitable). Zambia Railways produced and sold office furniture from its locomotive workshop in Kabwe, Zambia. Tanzania Railways Corp (TRC) uses its railway catering facilities in Dar es salaam to sell food to local restaurants and to the public. A major telecommunications company (US Sprint) was founded as a way to sell to the public the excess capacity which the Southern Pacific Railroad had in its corporate microwave system. Several railways, including Amtrak, use railway shops to assemble or repair non-railway equipment such as heavy diesel engines.

In the abstract, this is an appealing idea as it appears to be a "free" use of surplus capacity. In practice this is generally not true. State-owned railways are not usually commercially sophisticated enough to get their prices right, and, more important, they often get their costs wrong. They also may attempt to compete in activities where their assets (and expertise) are not truly competitive: at the same time, they may use their access to cheap public investment capital to gain an unfair advantage over potential, private competitors. There are positive opportunities, but they are not without considerable risk. In many cases, it is probably better for the railway to divest truly surplus capacity rather than attempt to use it to compete in fields unrelated to railway operations.

1.4 Contracting With the Private Sector for Services

This field has already received a great deal of attention, but has some unusual aspects in the railway area. There are, of course, the well known functions such as janitorial services and food catering. Many railways have contracted out these activities, even in the developing countries. The primary difficulty is employee (labor union) resistance: this issue has, for example, initially impeded the development of contract locomotive maintenance in the U.S. Another manifestation is contracting with hospitals or physicians groups to provide medical services in place of the railway medical department: this is also reasonably well known. Less prevalent in railways is contract maintenance of the right-of-way, both because of labor union resistance and because there are legitimate issues of safety and coordination of operations and maintenance activity between railway and contractor which do not arise with the same severity in most other modes. The right-of-way for the Shinkansen (the JNR Bullet

Train line) is entirely maintained under contract with the private sector, and is done much more efficiently than maintenance on the JNR conventional lines. Another possibility is contracting with the private sector for maintenance of wagons and locomotives. Interestingly, this idea arose in the U.S. where there is no particular problem with in-house locomotive maintenance (U.S. locomotive availabilities are among the highest in the world). The impetus in the U.S. was economic (as was the decision no longer to make locomotives in-house when diesel locomotives became important): locomotives have become extremely expensive and specialized pieces of equipment which must be effectively utilized, and it is simply less costly to hire someone to do the job than to try to do it in-house.

An extreme example is a management contract to operate the entire enterprise. In 1980, the Government of Nigeria signed a contract with RITES (the consulting arm of Indian Railways) under which RITES agreed to take over the management of NRC completely.^{2/} There are several companies in the U.S. which will manage short line railways for their owners (usually industrial companies or local governments) for a fee, and Amtrak provides commuter services in Boston, Massachusetts under a contract with the Massachusetts Bay Transportation Authority and in Los Angeles, California, (Amtrak operates only intercity trains, and is forbidden by law to provide commuter rail services unless it is under a contract which provides for full cost reimbursement plus profit). The government of Argentina is now receiving offers for contracts to manage and operate the Buenos Aires Metro (Subte) and the suburban services of FA.

As the NRC experience illustrates, the success of contracting is primarily determined by the ability of the parties to define their objectives clearly, and not by any inherent technical difficulty. Almost every activity has already been successfully contracted by a railway: the challenge is in recognizing the opportunity, in overcoming internal resistance (usually labor, but also often defense of managerial turf), in finding and maintaining competition, and in developing good contracts which have the right incentives.

1.5 The Private Sector as a Source of Funding

Market based economies make considerable use of the private sector as a source of funding which the enterprise would otherwise be required to generate itself or obtain from the government. This is done either through direct borrowing, or through leasing. For example, almost all U.S. railway wagons or locomotives are actually mortgaged to non-railway lenders; virtually no railway wagons (or commercial aircraft) are bought for cash by railways or airlines. Leasing is a parallel method of funding whereby a private company, often specialized in leasing, buys a piece of equipment and then leases it to the railway for a fee (direct or implicit). Many railway locomotives are also

^{2/} Although RITES succeeded in significantly and immediately improving the technical performance of NRC, the contract was not a success. The reasons are not completely clear, but are mostly related to the lack of clarity and conflicting provisions in the contract. Had each party known better how to formulate the objectives and responsibilities in the contract, it might have met with much more success.

leased; in fact, a recent leasing program has arisen for locomotives^{3/} in which the lessor also provides maintenance and the railway pays by usage unit (per megawatt-hour of tractive effort, or per locomotive-km). Indian Railways has recently inaugurated a subsidiary, Indian Railways Finance Corporation (IRFC), which will issue bonds to private individuals and entities, buy equipment, and lease it to IR.

The opportunity for leasing is especially favorable for specialized, or limited use equipment. U.S. railways do not own any tank wagons -- they are all owned by private lessors or users. In most cases, unit train wagons used for the transport of coal to electric utilities are owned by the utilities because the utility's cost of capital is less than the railway's, because the utility wants total control over the use of the wagon, and because the railway has no other use for the equipment. In some cases, the railway maintains the wagons (for a fee); in others, the utility maintains them. The detailed arrangement is reflected in the total rate for the coal hauled.

An interesting variant on leasing is the reverse transaction, i.e. leasing of state owned assets to the private sector in order to promote the process of growth of the private sector. This has already emerged in Hungary and Poland where there may be a need to lease state-owned trucks to potential entrepreneurs who would otherwise lack the capital to get started in the trucking business. Exactly the same issue would arise if a railway wanted to promote private sector contract locomotive maintenance; the cost of a locomotive shop is so large, and the risk so high, that leasing the shop to an entrepreneurial venture (possibly with railway equity participation) could be the only feasible way of getting the process started.

1.6 Operating Concessions and Franchises and Outright Sale of Public Assets or Activities to the Private Sector

Operating concessions by a private sector, non-rail entity are often viewed as a relatively new innovation, but they are not. Wagon Lits Cooks began in Europe as a concession operator of sleeping and dining coaches on railways which eventually became state owned. The Pullman company provided sleeping car services for railways in the U.S. on much the same basis. Several railways (India and Pakistan, for example) have operated smaller stations on a concession basis under which an individual receives a concession to manage the station, sell tickets and provide customer services, in return for which the concessionaire receives a share of revenues from tickets and sales of food or other items in the station.

Interesting examples of the use of franchising on a larger scale are emerging in developing countries. In Thailand, the State Railways of Thailand (SRT), has franchised the marketing and operation of several passenger trains to a private operator. This activity, although on a small scale as yet, appears to be succeeding.^{4/} On a much grander scale, Argentina is franchising operating authority on major segments of the state owned freight network to private operators. These franchises are only now being implemented, but apparent successful bidders for two of the franchises have been

^{3/} The Burlington Northern and Santa Fe railroads.

^{4/} Unfortunately, because of labor opposition, the existing franchises have not been renewed.

announced, and one franchise has actually been transferred and is operating successfully. The right-of-way will remain in state ownership, and the government (through FA) will receive a 15 to 20 percent share in the equity of the new franchise.

Another version of "concessioneering" is found in Amtrak, VIA and the Japan Freight Railway Company. These are, in fact, concessions to operate a particular type of service over the tracks of another entity in return for the payment of a fee to the franchisor. The cases of SEFICS (Senegal) and COMILOG (Gabon and Congo) also illustrate operation for a fee of a specialized rail carrier over the right of way of another railway. An alternative version of the same approach is the case of SJ in Sweden where the operating function has been separated from track ownership and maintenance and, in principle, public and private operators could provide service over the same track. The EC order to require European railways to separate their railway operating and right-of-way functions, and permit any EC railway to operate over the tracks of another for a fee, could well lead to the same position, especially for freight which is now suffering from the way in which many European railways emphasize passengers and down-play freight.

In fact, the separation of railway between right-of-way and operations could create an opportunity for broader use of competitive operations on common track. This could range from a mere separation of track from operations (with both in public hands), to competitive public operators on public track (a logical development of the SJ or EC proposals), to private operations on publicly owned track (Argentina), to multiple operations on privately owned, common track (as occurs in joint terminal companies in the U.S.). Although limited versions of this approach have been employed for years, its use on a broad scale is unproven. The potential advantages, especially the opportunity for competition and the ability to privatize some services (freight) while keeping other services (commuter) in the public sector, are promising: the problems, in particular the issue of conflicting track access and coordination of track maintenance with operations, are also well known. There are many instances in Bank lending where the idea deserves further exploration.^{5/}

Even outright privatization of a railway is subject to degrees. Conrail in the U.S. is an example of total transfer from public to private sector. In a parallel case, the U.S. Federal government sold the Alaska Railroad to the State of Alaska because both governments felt this would better serve the interests of the state.

A more relevant example might be found in the rapid growth in the U.S. of what are called "short line" railroads. These are railroads which are formed when a larger railroad decides that a branch line, or system of branch lines, is no longer profitable for the larger railroad because of rigid labor work rules, difficulties of operation of a light density railway, or other localized factors. Several larger U.S. railways have developed aggressive programs of finding entrepreneurs who will acquire the line and operate it on a low volume, low cost basis. In some cases, the larger railway will help in financing the transfer, or a local government will acquire the line and lease it to an operator. Many of these lines fail because of overoptimism on the part of the investor. Others succeed quite well when: the short line operator reduces

^{5/} See Neil Moyer and Louis S. Thompson, Options for Reshaping the Railway, The World Bank, to be issued in Spring of 1992, for a thorough discussion of these issues.

labor costs (e.g. by personally driving the train and by generally abolishing all labor craft distinctions); does a better job of marketing at the local level than the larger railway could ever hope to do; and has major shippers which are also investors and furnish a stable base of traffic.

2. ISSUES OF PRIVATIZATION

Although they have been well discussed in many other sources, it will be useful to summarize several issues as they bear on increasing the role of the private sector in railways.

2.1 Skills

Very few railways possess the skills needed to identify, analyze and manage business ventures, especially outside the field of railway activity. It is absolutely vital that skills from outside the railway be acquired and brought to bear to analyze business opportunities and to protect the railway's interests vis a vis its private sector partners.

2.2 "Commercialization" Before Privatization

Many governments are impatient to "privatize" and insist on selling assets or ventures "as is". In the railway area (as elsewhere) this is almost always difficult or, at the least, often a mistake. Most railway operations are currently inefficient and poorly marketed, and are thus essentially worthless in their present state. Much more value is realized when the obvious inefficiencies are eliminated and the activity operated on an effectively commercial basis for a period before involving the private sector, either as purchaser or partner.

2.3 Process Integrity

Sale or other transfer of public assets to the control of the private sector has always been a contentious process. At one level, this touches the obvious and very real concern for corruption, which arises in every country. At a second level, this involves whether a "fair" price is received -- a point on which endless debate is possible. The same problem can arise when a public entity makes non-competitive contracts for services with a private sector entity. The issues must be as fully resolved as possible, which means that the railway must proceed in a fully transparent and professional way.

2.4 Regulation

In many cases, privatization can mean the transformation of a public monopoly into a private monopoly. In these cases, the issue of the need for regulation (if any) must be addressed. The regulation needed can cover economic issues as well as safety or "fitness" questions. On another level, the railway may have labored for years under a regulatory system which was intended to impose cross subsidies on the railway: this must change if the enterprise is to be operated in private hands.

2.5 Level Playing Field

The way in which a railway privatizes its activities, or engages in competition with the private sector can give rise to a number of important competitive issues. For example, use of the railway workshop to do maintenance for outside customers can easily represent unfair competition with a nascent private sector outside the railway because the competitor did not get its facility free and does not have access to public capital. Rules are needed to ensure that the railway activity allocates its costs properly, and fairly includes a capital charge to its non-rail ventures. The same issue could arise if a railway facility is sold or leased to the private sector: a "sweetheart" deal on either price or lease or financing terms with a purchaser, especially if the purchaser is a joint venture partner, can give the new venture an unfair competitive advantage over others in the sector.

2.6 Payment for Social Services

Under competition, private sector companies cannot absorb the deficits of socially imposed activities. While it is entirely possible, even desirable, to contract with the private sector to provide services for the public sector for a fee, payments must be clear and adequate. Activities cannot successfully be privatized with the hope that the new operator will be willing or able to continue to operate losing services, or operate in an inefficient way, just like its public railway predecessor.

SUMMARY

PSD is not a panacea. Experience has shown that, although very significant benefits can be realized through PSD, the process of promoting PSD is complex and replete with opportunities for costly mistakes. In this, as in much else, the best approach starts with formulation of clear and agreed policies, and then proceeds based on adequate planning and use of all necessary managerial resources in a transparent and defensible way.

At the same time, experience is also showing more and more clearly that the old-style railway monolith, rooted in history when railways had a monopoly of surface transport, just does not work well when markets are important and when competition arises. There are better ways of operating -- and PSD is a key tool in realizing them.