



11

Railway Reform:

Toolkit for Improving Rail Sector
Performance

Chapter 11:

**Creating Commercial Railway
Structures**

11 Creating Commercial Railway Structures

11.1 Introduction

This section discusses what is meant by commercial railway operations, why railways operate commercially, and how commercial railways are organized. Railways are often considered a natural monopoly and in many cases have been owned and operated by government units (or, where privately owned, have been heavily regulated). State-owned and heavily regulated railways tend to pay attention to government units, not to customers—railway management is evaluated on its attention to political concerns. Meanwhile rail services for customers stagnate or decline. In response, many governments have reorganized state-owned railways to operate as commercial entities.

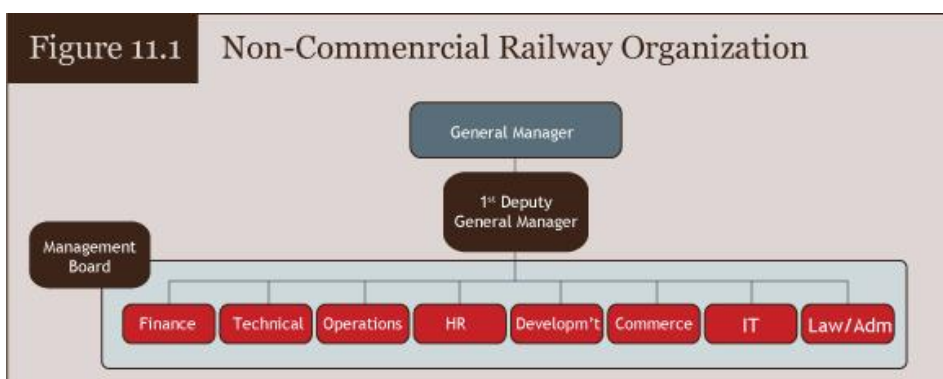
State-owned or private railways that operate commercially compete for customers and revenue with other transport modes and services. Commercial railways enter into mutually beneficial contracts and pursue at least break-even financial performance in their operations. Government may provide some or all of the capital needed to build new railway lines or even renew existing lines, but most commercially oriented railways operate both government-owned and railway provided assets *for profit*. This requires greater focus on customers.

Commercial railways contract with government for services that government wants to provide. Government contracts, sometimes called public service obligations (PSOs) or public service contracts (PSCs) may provide minimum service levels or deeply discounted or low-price passenger services for eligible travelers, such as the disabled, students, or seniors. Public contracts can also be used to provide below-cost freight services for specific commodities such as grain, or fertilizer; or services on light density railway lines that might otherwise be closed. Commercial railways try to price each service to cover its costs and earn a return on asset investments. In the case of PSOs or PSCs, the government is a customer like any other, and pays commercial market rates for contracted services. Hence, commercial railway operations minimize or eliminate the need for railways to cross-subsidize loss-making state services by overcharging for other services, usually freight. (See Section 8: Buying Services from Railways)

This chapter focuses on commercial railway organization, and how it differs from a typical government railway department. An *organizational structure* is designed to focus the attention of management on the principal driving force behind organizational outputs—usually either sources of revenue or of political power.

11.2 Non-Commercial Structures

Most railways organized as government departments focus on politicians, other government departments, or internal functions designed to meet internal needs or the needs of other government units. The figure below shows the organizational structure of a typical government railway department, and often a typical government railway enterprise.



Many government-owned railways have a management board, responsible for company planning and investment programs. This type of management board of directors is internal and usually chaired by the general manager (GM). Usually, the Ministry of Finance or Ministry of Economy supplies the GM with budget allocation information; the Ministry of Transport directs railways policy and development; and another ministry or entity, independent of the railway, regulates prices. In this organizational structure, most staff are in the technical division, which includes engineering, design, (sometimes depots and drivers) and operations, which includes dispatchers, on-board staff, and station staff. Typically, the commerce unit handles waybilling, and some station staff. Only much farther down in the railway structure are major market segments seen. In fact, many organizational units have some role in dealing with each market segment. Customers interface with the railway at passenger or freight stations, or through intermediaries such as freight forwarders.

This typical government-based organization structure has two main features that distinguish it from a commercial operation. First, the organization is designed to respond to government—not customers. Second, below the GM and maybe the management board, no organizational unit is responsible for profit and loss, service versus cost trade-offs, service levels, or revenue.¹³⁸ No department is responsible for investment trade-offs or return on investments.

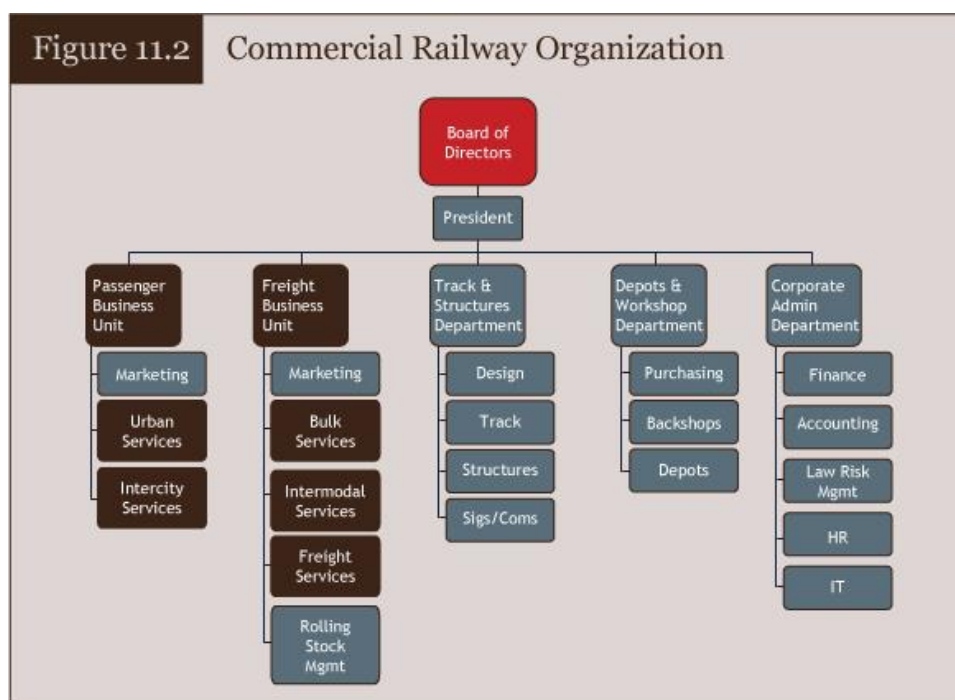
11.3 Commercial Railway Structures

Commercial railway organization requires a structure that focuses most railway activities on markets and customers. To achieve this alignment, many commercial railways use a ‘line-of-business’ structure based on divisions by principal markets. In a line-of-business organization, common railway resources may be managed from a single organizational unit, but the principal focus is on major markets, and sometimes, major customers (Figure 11.2).

11.3.1 Profit centers and cost centers

Key elements of this structure are that the two business units—passenger and freight—are profit centers; each has **revenue and expense** responsibility for services it provides and each is managed on a profit and loss (P&L) basis.

¹³⁸ Arguably, the commerce department is responsible for revenue—but usually it is responsible only for revenue accounting.

Figure 11.2 Commercial Railway Organization

Any segments of the main business lines that can be uniquely segregated (for example, a specific set of customers with similar service needs, specialized or identifiable equipment, or even a particular geography) can be organized as discrete profit centers. In the diagram above, under passenger services, urban and intercity services are discrete business units—each uses separate rolling stock, some different stations, and each has different operating requirements. Similarly, under freight services, bulk and intermodal services could be managed as business segments, each with its own P&L. Each business unit and P&L-based sub-unit is responsible for preparing and justifying its own investment plans related directly to its own primary activities.

Other units, shown above as ‘departments’, are cost centers. The departments have budget responsibility for any costs under their control but are not responsible for generating revenue. Each department may have an investment program; some investments may support several business units or sub-units. For example, investing in track upgrades to increase train speeds may support a passenger business unit strategy *and* provide service improvement benefits for the freight business intermodal services group strategy.

Sometimes transport law will require that other train operating companies be able to provide railway services over the infrastructure. In these cases, the track unit will be formed as a business unit. It will develop a charging scheme for infrastructure access. Infrastructure costs may be subsidized by the government, reducing necessary access charges. Train service companies can compete with railway business units, providing some competitive pressures in the rail transport market. For example, operators for suburban services could be hired in a bidding process by a local government; or a mining company might run its own coal trains to a utility customer. These operators would need to buy or lease equipment, hire qualified employees, receive a license to operate, and contract with the railways infrastructure business unit for access to the infrastructure. Other possible structures and

railway functional arrangements include equipment leasing companies that own and provide rolling stock, or private companies that perform rolling stock maintenance.

Some railways are dominated by passenger traffic, others by freight traffic, and the infrastructure unit is sometimes consolidated into the dominant business unit forming what is called a vertically integrated business unit. This is most typical in mining railways that may provide some incidental passenger services. In such cases, other railway operating units and private operators would pay an infrastructure access fee to use the tracks. Access rights are normally set by the railway law; access prices are set by railway management under a regulatory process established under the railway law. (see Chapter 9).

Governments and railways have developed many different commercial structures and organizational forms for railways. CN (Canada), Conrail (US), QR (Australia), NZR (New Zealand) are among the many railways that were privatized after a great deal of thought and planning on the part of their respective governments. In the UK, the British Government tried a number of organizational reforms for British Rail (BR), including a complex sector management structure.¹³⁹ The sector management structure presaged in many ways the eventual equally complex strategy used by the UK government in the breakup and privatization of BR.

The EU has required open access to EU member networks and while the implementation has been slow in some ways, the reforms have had a significant impact on the management structures of the formerly vertically and horizontally integrated railways. Over the last 15 years the EU rail sector has been undergoing reforms with many new private operators (of both freight and passenger services) flowing into the market. The result has been a significant increase in private investment in the sector, especially in rolling stock.

Reforms in Russia have been different but have also resulted in a flood of new private investment into the rail sector. In Russia, the Russian Railway (RZD) has been restructured from a cabinet level Ministry to a state-owned enterprise. Over time, RZD has relinquished customer contacts and most direct marketing services to “operators” who are like freight forwarders with rolling stock. RZD provides infrastructure, dispatching, drivers, locomotives, and even shunting services while the operators take over customer relationships, freight car ownership, loading and unloading duties, and car management activities. Private owners are responsible for freight car maintenances and use RZD maintenance depots and a newly privatized network of RZD depots to obtain those services. RZD has moved its freight car fleet into two new enterprises (Freight One and Freight Two), the largest operators on the network. However, over the past eight years of this reform process, private owners have replaced about 40% of the freight car fleet (many of these acquisitions financed by IFC and other development banks specializing in private sector financing). In addition to growth in private operators, there are now a number of equipment leasing companies active in the Russian market. Passenger services have been similarly restructured with the “operators” in

¹³⁹ Louis S. Thompson, *Privatizing British Railways: Are There Lessons for the World Bank and Its Borrowers?* (World Bank, 2004). <http://sitere-sources.worldbank.org/INTTRANSPORT/214578-1099319223335/20273748/Final%20Version%20for%20Publication.pdf>

these cases being local transport authorities, often in joint ventures with RZD's passenger business unit.

Each country develops an individual style of private sector participation that is suited to its legal structures and political abilities. In each case, the major focuses of reform efforts have been to increase the commercial sensitivity of rail enterprises to customer needs (both passenger and freight) and to structure the sector to attract private investment. In these areas, the more “radical” restructuring done in the UK, Russia, Canada, and Australia have resulted in significant inflows of private capital into the rail sector.

11.3.2 Purpose of commercial management structures

Commercial management structures introduce *accountability* for revenue, expenses, and investments to discrete railway business units or cost centers. They also distribute performance accountability downward in the organization and much closer to customers. P&L results, rather than production or output, can be used to evaluate railway business unit managers. Commercial orientation fundamentally changes how management performance is measured, because costs and revenues can be attributed directly to discrete business lines, thus permitting managers to recalibrate P&L components. Commercial organization structures also facilitate the introduction of incentive systems to reward improved financial performance.

By contrast, in a traditional government departmental organization, performance is harder to measure—loss-making services are mixed with profitable services, making it difficult to isolate actions that will improve financial results. Often, financial results are the responsibility of the finance department, and results are reported months after transport services are delivered.

A commercial structure can boost business unit performance by providing incentives for managers to reduce or reform loss-making services, and focusing management attention on improving customer services, increasing revenue, and reducing costs.

A commercial management organization must have an accurate and detailed management cost accounting system that can prepare monthly P&L statements for each business unit.

A commercial railway structure will be led by a non-executive board of directors. The board's primary objective is to represent shareholder interest, therefore, the board should include no more than one member of the railway executive. Typically, this would be the general director, president, or the chief executive officer. The board must maintain independent oversight on railway management; therefore, no other railway officers should be voting members of the board. However, other management team members may attend board meetings, to provide specialized advice, for example, the chief legal counsel or company secretary. Railway law or government ownership regulations may determine board member eligibility for ministry representatives from Transport or Finance. If possible, the board should include representatives from other commercial entities such as local business leaders. Many private commercial railways have at least one member who is a railway shipper or customer. Railway governance structures are discussed more fully in Chapter 10.