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## **Railway Reform:**

Toolkit for Improving Rail Sector  
Performance

## **Chapter 7:**

Overseeing the Railway:  
The State as Owner

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## 7 Overseeing the Railway

### 7.1 Introduction

In many countries, railway transport activities have been organized as part of the state administration. Public transport services to provide for passengers and industries' transport needs (whether state-owned or private) are politically sensitive. This led to establishing state railway departments, and historically, many governments have been deeply involved in managing the daily activities of railway entities.

*Transport markets have changed dramatically. The relationship between the state and the railway must be adapted to reflect a new reality. The best way to do this is by allowing the railway to function as a commercial entity.*

However, in recent decades, transport markets have been transformed by road transport deregulation, urbanization, containerization, and the evolution of new global trading patterns. These have forever changed rail transport entities' role and competitive positions. The relationship between the state and the railway must be adapted to reflect this new reality. Today, allowing a railway to function as a commercial entity is generally accepted as "best practice" for organizing railway activities. As a result, state railway administrations are evolving into state-owned enterprises (SOEs)<sup>76</sup>, private enterprises operating under concession agreements, or partial private/public corporations. This section analyzes options to segregate decision-making and oversight duties between government and state-owned railway enterprises.

State-owned railway performance depends on a complex set of interactions among company management, board of directors, various ownership entities, national government ministries and regulatory bodies, local government bodies, shipper organizations, and other stakeholders. Not surprisingly, accountability for railway entities' performance can be difficult to assign precisely. Because of this, developing a structure that will ensure both efficient decision-making and good corporate governance is challenging.

### 7.2 New Relationships between the State and Railways

#### 7.2.1 Adapting to new market conditions

New market conditions have created a strongly competitive transport environment. This has in many cases reduced railways' significance in the transport marketplace. Since 1950, the efficiency of both road and water transport has grown exponentially, mirrored by changes in ownership and financial structures. Railways are now competing primarily with nimble private companies that can adapt rapidly to market requirements using any combination of trucks, ships, cars, buses, and aircraft. As economies develop, the structure of the economy may change to require less transport. Over the last sixty years, governments have invested heavily

<sup>76</sup> OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015 Edition, p.14) defines an SOE as follows: "...any corporate entity recognised by national law as an enterprise, and in which the state exercises ownership, should be considered as an SOE. This includes joint stock companies, limited liability companies and partnerships limited by shares. Moreover statutory corporations, with their legal personality established through specific legislation, should be considered as SOEs if their purpose and activities, or parts of their activities, are of a largely economic nature."

in developing roads and highways, creating railways' strongest and most successful competitor. In many developing countries, road users pay user charges that do not fully recover the cost of damage to the road infrastructure from heavy vehicles. In some cases, railways pay fuel taxes that are earmarked for road development. All of this puts railways in a difficult competitive position. As a result, rail market share is declining, exerting downward pressure on volume and revenues.

Tough competition and declining market share should trigger changes in railway administration and management—cutting costs, adapting services to customer shipping requirements, and improving service quality. But these responses have historically been rare because railways were managed as government departments, not as business units, and therefore, were managed according to political priorities. This practice has relegated many of the world's railways to a serious state of decline. Common practices in using the railways to accomplish political outcomes that led to this decline include:

- Providing a large-scale source of jobs to help government reduce national unemployment;
- Creating a captive clientele for poor-quality products and services supplied by other government enterprises;
- Providing below-cost transport services as a public good (passenger services) or to subsidize production of other government enterprises;
- Providing high-level jobs for political appointees, who frequently lacked railway experience or business qualifications;
- Garnering political support from trade unions in exchange for railways adopting compensation schedules and conditions unrelated to employee performance, and financially unaffordable for railways; and
- Allowing railway investment decisions to be made at the political level by those motivated by acquiring political capital, rather than railway performance or financial sustainability.

### 7.2.2 *Governance principles for state-owned railways*

Railways are state-owned entities in many countries. As part of state administration they are subject to government decision making and budget processes. The organizational model selected for state-owned railways affects:

- The degree of government decision-making power;
- Railway organizational independence; and
- The distribution of responsibilities between government and the railway entity.

Countries that are reforming the corporate governance of state-owned enterprises agree that this complex undertaking should address two major challenges:

- The state should actively exercise ownership functions, such as nominating and electing the board of directors, but refrain from political interference in company management;

- The state should ensure that markets not only permit, but actively encourage, competition between private sector companies and state-owned enterprises, and ensure that governments do not use their regulatory or supervisory powers to distort a competitive transport market involving both private and public entities.

Problems frequently arise from the practice of converting railways to state-owned companies but failing to deal with essential governance and independence issues. Governance of state-owned railway companies faces all the challenges described above and should address the following three major institutional issues:

- Developing a new state/railway relationship;
- Developing a new railway/shareholder rapport; and
- Building a new commercial culture within the railway organization.

Implementing these changes can be very challenging. Few examples exist of state-owned railways fully compliant with the governance principles described in the most recent *OECD Guidelines on Corporate Governance of SOE's (2015)*. Even fewer state-owned railways are compliant with the more stringent *G20/OECD Principles of Corporate Governance (2015)*, which are intended to be applicable to both private and public enterprises.

Even in developing countries, formerly state-owned railways are now mostly organized as separate, publicly owned corporations. However they are seldom completely at arm's length from politics. As long as public money is involved, the risk of political interference in company management exists. For this reason, the implementation of the role of the state as an owner according to the principles presented in the current chapter requires strong political will. Thus one of the key OECD organizational recommendations is that SOEs shares should be held by an “ownership entity”, which will elect board members as the “owner”.

*Railways should act as transport service providers with the same rights and obligations in the market as any other similar state-owned or private entity.*

## 7.3 Implementing New Governance Principles

### 7.3.1 Segregation of duties

The most important governance principle is to separate the functions of government bodies and railway enterprises. Railways should act as transport service providers, with the same rights and obligations in the market as any other similar state-owned or private entity. Government must continue to play multiple roles as follows, without being involved in daily railway management:

- *Government policymaker* for the transport sector;
- *Regulator* for safety standards, infrastructure access, and sometimes prices;
- *Owner* of some railway assets (permanent way, perhaps rolling stock, stations, freight and passenger facilities); and
- *Client* for contracted social *transport* services.

When the functions of the state and the railways are separate and clearly specified, the following rules should be observed:

- Interaction should occur on a strictly contractual basis, or within a clear regulatory framework.
- The state should exercise ownership rights in terms of setting broad policy, without playing any role in ongoing day-to-day management of the railway business.
- Railway management should maintain independence in railway business decisions, but remain accountable to shareholders for overall business results. The designated holder of state shares may consider a broad range of socio-economic policy concerns in providing guidance, but it is important to maintain a single “policy window”, thus avoiding a structure where multiple representatives of the state “owner” provide conflicting guidance<sup>77</sup>.

### 7.3.2 *Setting up the legal and regulatory framework*

The new legal and regulatory framework must create and protect a market environment, in which state-owned and private railway operators can compete on equal terms, avoiding market distortions. The most recent *OECD Guidelines on Governance of SOEs* define and describe the main pillars and principles of a market environment as follows:<sup>78</sup>

- A. There should be a clear separation between the state’s ownership function and other state functions that may influence the conditions for SOEs, particularly market regulation.
- B. Stakeholders and other interested parties, including creditors and competitors, should have access to efficient mechanisms for dealing with complaints or conflicts, through unbiased arbitration or judicial processes.
- C. Where SOEs combine economic activities and public policy objectives, they should maintain high standards of transparency and disclosure about their cost and revenue structures.
- D. Costs related to public policy objectives should be funded by the state and disclosed.
- E. SOEs undertaking economic activities should not be exempt from the application of general laws, tax codes and regulations simply because they are owned by the state. That is, laws and regulations should be applied equally to SOEs and to their market competitors. For example, a railway that is an SOE should allow creditors to press their claims, including claims to compensation in the event that the railway ceases to provide a service or even to do business.
- F. SOEs’ economic activities should face the same market conditions as private competitors. In particular:
  - SOEs’ relations with both financial institutions and non-financial SOEs’ should be purely commercial;

<sup>77</sup> This, however, should not undermine the independence of the regulator.

<sup>78</sup> OECD, *Guidelines on Corporate Governance of State-Owned Enterprises*, 2015 Edition

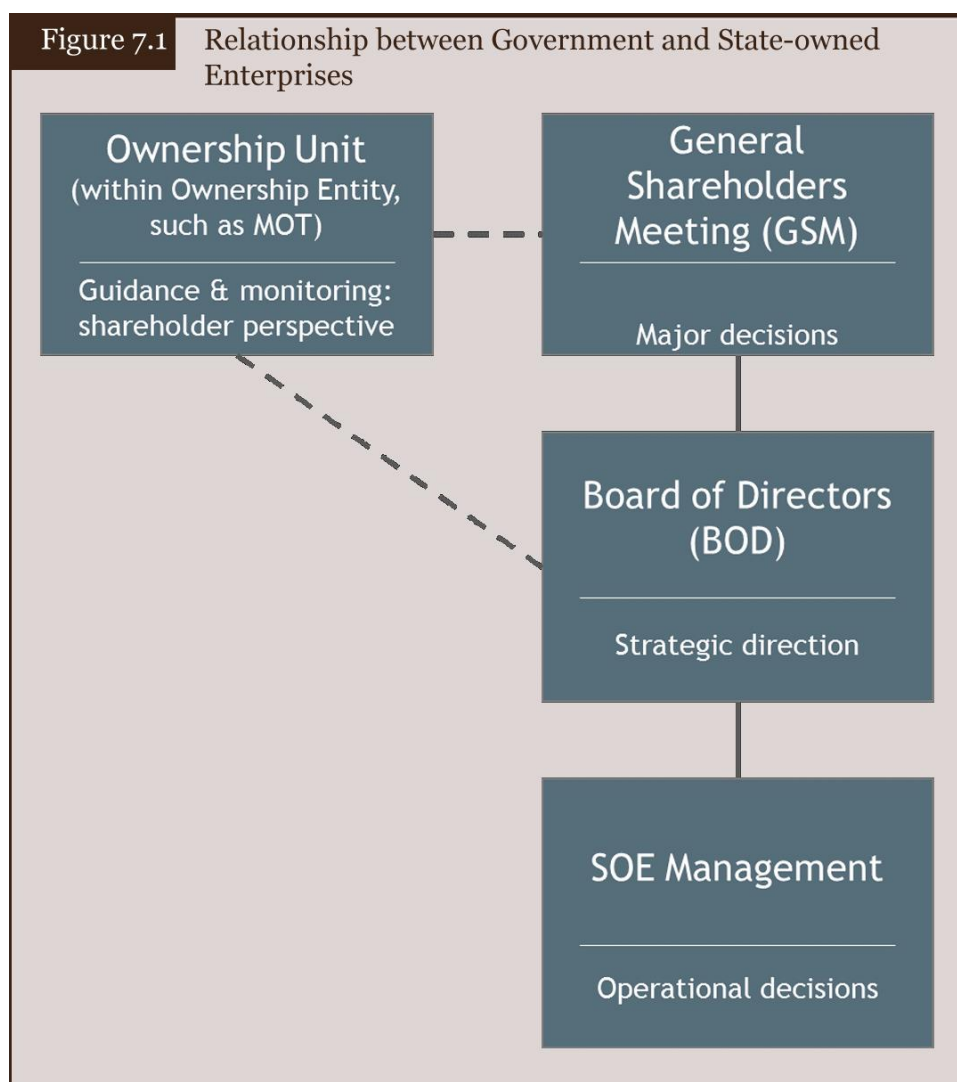
- SOEs' economic activities should not benefit from any indirect financial support that might give the SOEs an advantage over their private competitors, such as preferential financing, tax arrears or preferential trade credits from other SOEs. SOEs' economic activities should not receive inputs (such as energy, water, or land) at prices or conditions more favorable than those available to private competitors.
- G. When SOEs engage in public procurement, whether as bidder or procurer, the procedures involved should be competitive, non-discriminatory and transparent.

### 7.3.3 *Contractual relationships between government and railways*

Relations among state entities (Government owner, Ministry of Transport, Ministry of Finance, etc.) and the railway corporation must be governed by publicly available written documents to ensure long-term business sustainability. A railway law should establish these relationships and long-term agreements, to shield the railway from day-to-day political changes that would undermine its inherent need for long-term planning. Typically, other legal agreements between state and railway enterprises relating to railway infrastructure administration and railway enterprise social responsibilities are multi-annual contracts. These include both financing of infrastructure maintenance and public service contracts to establish terms and conditions for managing these obligations. All written agreements should follow standard business practices.

The structure presented in Figure 7.1 below provides an example of a governance structure that clearly separates the policy role of Government, represented by the Ministry of Transport (MOT) for the railway, from day-to-day management and decision-making. This structure is designed to assist SOEs in the transition from a Government entity with a broad range of often-conflicting goals to a commercially-oriented SOE that must meet broad goals set by Government while operating as an independent commercially-oriented entity.

The legal bodies that provide governance to state enterprises are, typically, the General Shareholders Meeting (GSM), the Board of Directors, and the company management. The ownership entity, for example, the Ministry of Transport or Ministry of Finance (or similar) depending on the country's SOE ownership structure, would be represented in its role as a shareholder (initially as the sole shareholder) by a unit located within the ownership entity.



The GSM is responsible for making major decisions such as appointment of directors and approval of their plan (the Statement of Corporate Intent) and approval of major transactions.

The Board of Directors is responsible for providing strategic direction to the enterprise (Administrative Plan or Statement of Corporate Intent) and ensuring effective management of the enterprise. It appoints the SOE management and approves their plan (Management Plan or Business Plan).

The SOE Management provides day-to-day guidance to the enterprise and takes operational decisions.

The unit established within the owner Ministry to represent the owner acts on behalf of the Ministry as the shareholder of the SOE. As such, it provides general guidelines for the SOE on performance indicators, remuneration, conflict of interest, dividends and disclosure. It works through the GSM and SOE boards to ensure compliance with relevant corporate governance codes and principles. The ownership unit monitors both compliance and overall performance of the SOE. The ownership unit reports to the public on the performance of the SOE portfolio.

## 7.4 The State as Owner

### 7.4.1 *The ownership role*

As owner, the state should:

- (i) Ensure that state-owned railway governance is transparent and accountable;
- (ii) Establish a clear and consistent ownership policy;
- (iii) Act as an informed and active owner; and
- (iv) Clarify and prioritize the railway's objectives.

State ownership policy and overall objectives should remain broad, clear, and consistent over the longer term, providing the railway, the market, and the public with predictability and a clear understanding of railways' long-term commitments. Objectives should be developed through public consultation. The ownership policy and objectives should be described in publicly available documents, widely circulated among relevant ministries, agencies, railway boards, management, and parliament. As an owner, the state should decide what is required from the state-owned railway and how the company should be administered to best meet those goals.

The state should not be involved in daily management. Instead, it should allow the railway full operational autonomy to achieve agreed business objectives. Similarly, the state should respect the board of directors' independence, except for exercising the state roles as owner, regulator, and contractor for services provided to citizens and customers. All objectives, policies, regulations, and contracts should be fully disclosed in publicly available documents.

The state generally exercises its power as owner in the shareholders' meeting, where a board is elected to be legally and financially responsible for the railway company. "Management independence" does not mean that managers of state-owned railway can set objectives that contradict the objectives of the state as owner, nor can management define the limits of public services. If serious differences arise, the state as owner retains the right to replace board members, including the chairman when necessary, to align overall railway business objectives with those set by the government for the railway.

This organizational model is based on typical powers of the state as railway owner and typical uses of ownership powers and responsibilities. The state as owner is responsible for making this model work, but the model will fail if government allows politics to influence decisions that should be made by the railway company. Another risk to the effectiveness of this model is political interference in recruitment, which can undermine the process of hiring competent and professional railway management. Therefore, governance structures for the state and the railway enterprise must be comprehensive, precise, and clear to all participants and to the public.



Three basic forms of SOE ownership exist: centralized ownership, where one government entity owns all SOEs in the country; decentralized ownership, where different SOEs are owned by different government entities; and dual ownership, where certain ownership functions are performed by one government entity (such as the Ministry of Finance) for all SOEs while other ownership functions are performed by other government entities (such as Ministry of Transport for state-owned railways). While there is a trend toward centralized ownership, there remain debates on the advantages/disadvantages of different ownership models.

Regardless of which ownership structure is selected, the ownership must be established under law and the ownership entity should act in accordance with a publicly disclosed ownership policy. State ownership functions should be strictly separated from both regulatory functions in the railway sector and the setting of transport policy<sup>79</sup>.

The state as owner acts through the ownership entity, in a manner similar to any major shareholder, to protect and optimize its ownership interests. As defined by the *OECD Principles of Corporate Governance*, basic shareholder rights include:

- (i) Participation and voting in shareholder meetings;
- (ii) Obtaining adequate information on the corporation on a timely and regular basis;
- (iii) Electing and removing members of the board; and
- (iv) Approving extraordinary transactions.

When an SOE's shareholding structure changes from single state owner to multiple shareholders, it becomes essential to protect fully the rights of minority shareholders. That is, the state needs to understand that the rights it has over the SOE through shareholding are in general no greater than the rights of other shareholders, except for cases where special rights are clearly defined in the enabling statutes. OECD therefore recommends that from the beginning even SOEs wholly owned by Government should follow all applicable elements of the more general OECD guidance on corporate governance, to minimize potential difficulties later in the transition process when shareholding is broadened.

### *Ownership unit responsibilities related to government and parliament*

The ownership unit, within the ownership entity, fulfills the following obligations on behalf of the ownership entity of the railways:

- Elaborating and defining ownership policy, owner objectives, and long-term state commitments;
- Conducting consultations on policy issues with the public, ministries, agencies, the railway board of directors, and parliament;
- Maintaining accountability to government and parliament for implementing ownership policy;

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<sup>79</sup> This is most effectively accomplished by appointing different state entities to address ownership, policy and regulation.

- Maintaining defined relationship and continuous dialogue with external auditors and state control organs within limits of existing legal framework; support state audit institution tasks and take measures to respond to audit findings;
- Publicly disclosing reliable quantitative performance reports on exercising state ownership, and achieving state objectives in the interests of the owners through administering state-owned railways (ad-hoc or permanent commissions could maintain dialogue with Parliament)<sup>80</sup>.

### *Ownership unit tasks relative to state-owned railways*

The ownership entity, through the ownership unit, will exercise state ownership rights in overseeing the railway according to legal and institutional frameworks. In many countries, Ministry of Transport has the authority over the country's railway and has the legal responsibilities, including:

- Coordinating oversight of the SOE;
- Exercising the functions of the shareholder on behalf of the state; and
- Coordinating the exercise of shareholder functions.

The specific responsibilities are to:

- Appointing the representatives of the state to the board;
- Proposing candidates for the management board and supervisory board in compliance with requirements of the relevant corporate governance ordinance on SOEs;
- Monitoring the management board directly for autonomy and through the GSM for commercial companies to ensure that the SOE is operating under principles of efficiency and financial sustainability; and
- Ensuring the transparency of the state in its oversight.

The ownership unit within MOT is responsible for carrying out the responsibilities of MOT as the owner for the transport SOEs. Based on the legal requirements and good practice examples, MOT should assign the following seven responsibilities to its ownership unit.

- Overseeing the board member selection process;
- Establishing and monitoring performance objectives;
- Monitoring the implementation of the remuneration guidelines;
- Monitoring conflicts of interest and approval of related party transactions;
- Monitoring other corporate governance practices in the SOEs;
- Developing a general dividend guideline; and
- Ensuring transparency with respect to the state's governance of SOEs.

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<sup>80</sup> Accountability requirements for the ownership entity should not restrict its autonomy in fulfilling responsibilities. Cases in which the ownership entity needs to obtain ex-ante parliamentary approval should be limited to significant changes in overall ownership policy, the size of the state sector, or major transactions.

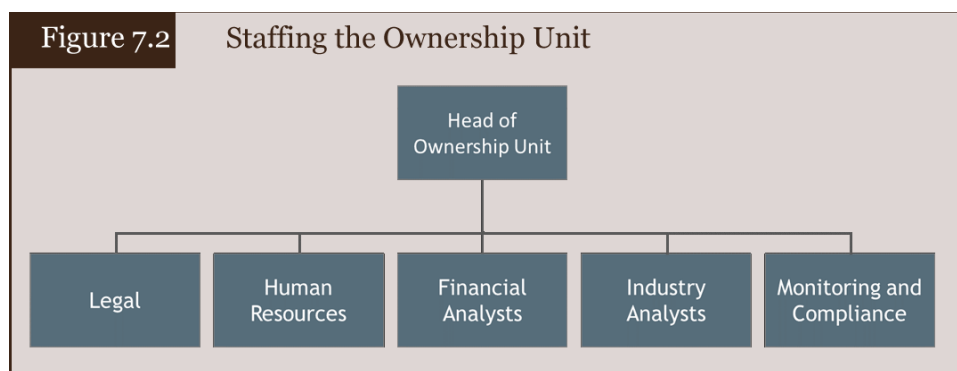
*The ownership entity should have skilled staffed professionals with legal, financial, economic and management expertise that are experienced in carrying out fiduciary responsibilities.*

### 7.4.2 Staffing the SOE ownership unit

The ownership unit, which is to exercise the responsibilities of the ownership entity, needs professionals skilled in law, finance, economics, and business management. These professionals should provide experience in strategic thinking and in carrying out fiduciary responsibilities. They must also have a good overall understanding of entrepreneurship and their roles and responsibilities as civil servants with respect to state-owned railways. However, detailed knowledge of railway operations is not required in this unit.

The ownership unit requires a degree of budgetary autonomy. It must be able to contract for external advice from independent specialists and to carry out evaluations or monitor railways results in specific domains. Thus, it must have sufficient flexibility in staff recruitment, remuneration, and retention, including from the private sector.

The ownership unit should be staffed with people having the skills needed to properly execute its assigned functions. A schematic structure for an ownership unit, which illustrates basic functions, is shown in Figure 7.2.



- **Head of the ownership unit.** The head of the ownership unit should have a broad knowledge of corporate governance principles and their application, and be able to apply them to the work of the ownership entity. S/he is responsible for creating and leading an effective team to manage the implementation of better governance practices within the SOE.
- **Legal.** The position should have a strong grounding in the country's corporate law and strong knowledge of corporate governance principles and their application. S/he contributes knowledge of law and regulation and will be responsible for compliance aspects of the ownership unit's oversight of board activities, including identifying and dealing with conflicts of interest and transactions with related parties
- **Human Resources.** The position should have experience with corporate recruiting and compensation. S/he contributes to the oversight of board member recruitment, and compensation including the establishment of broad limits on board member and executive compensation.
- **Financial Analysis.** The position requires experience conducting financial analysis of commercial companies. S/he will be responsible for financial monitoring of the portfolio. Together with the industry analyst, s/he monitors the

SOE performance and risk, including the development of the basic dividend guidelines.

- **Industry Analysis.** The position requires experience with investment analysis of transport stocks. S/he will be evaluating and commenting on the SOE's strategy and performance objectives set by ministers, the board and management in the context of the annual planning process.
- **Monitoring and Compliance.** The position requires strong information management and organization skills. S/he will be responsible for monitoring that the SOE boards are implementing the ownership unit's guidance on governance practices according to the currently accepted national practice.

In practice, a number of the desired functions can be combined in a single individual. All members of the team need to have a basic understanding of good governance practices. They should be comfortable working in a team environment and have the capacity to communicate and interact well with high-level individuals within government, in boards and within the SOE. The team needs to have the capacity to act proactively and be an effective advocate for better governance practices.