



## RAIL TRANSIT POLICY OF THE EUROPEAN UNION AND ESTONIA: OBJECTIVES AND OUTCOME

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**Abstract.** Currently the only privatised public railway infrastructure in the European Union member states is located in Estonia. The aim of the current article is to determine whether there is a link between the rail transport policies of the EU and Estonia, how it works, and whether the objectives of such policies can be implemented in case of privatised public railways. The findings of the analysis were the following: 1) Estonia's unique opportunity – to manage rail infrastructure on a fully commercial basis through the privatisation of the rail infrastructure – has not been taken advantage of; 2) a relatively wide range of disputable economic decisions of the government can be substantiated by referring to the EU rail transport *acquis*; 3) it is possible that the implementation of the respective regulations does not automatically ensure the achievement of their objectives, if the regional features of the countries remain unconsidered.

**Keywords:** transport policy, privatized infrastructure, open access, infrastructure charging

### 1. Introduction

The common transport policy of the European Union is currently presented in the document “European transport policy for 2010: time to decide” [1]. The action plan consisting of measures for the achievement of the main political goals pays particular attention to the revitalisation of railways, that should be achieved by integrating rail transport into an internal market, making optimum use of infrastructure and modernisation of rail transport services.

In the light of the foregoing considerations, the EU transport policy is focusing on the rail transport [1]. During Estonia's accession to the EU, the Republic of Estonia took the obligation [2] to rely on the EU *Acquis Communautaire* on transport [1] in developing its national transport policy. The principles of the EU transport *acquis* applicable to rail transport are reflected in the Railways Act of the Republic of Estonia that was passed in 2003 [3]. In 2005 the Estonian Ministry of Economic Affairs and Communications [4] completed the preparation of the “Transport development programme for 2006 – 2013”. This document represents the vision of the Estonian Government on the specific goals and stages of development of the Estonian transport sector.

Compared to the other member states of the EU, the rail transport industry of Estonia is in quite a unique position. Similarly to the railway companies in Latvia and Lithuania, the largest railway company in Estonia *Eesti Raudtee AS* (Estonian Railways Ltd., hereinafter EVR) is a subject of the *SMGS* agreement. The organisation of the receipt and delivery of cargo on the Estonian – Russian Federation border is regulated by bilateral agreements. Thus Estonia, as well as the other Baltic countries, must rely on *OSJD/SMGS* regulations in case of freight originating from third countries and *OTIF/COTIF* regulations in case of freight originating from the EU member states [5]. Although there are other railways servicing mostly the transit of Russian origin both through EU-15 (Finland) and EU-10 (Latvia, Lithuania) countries, the only privatised public railway infrastructure in Europe is situated in Estonia. The Republic of Estonia is also the only EU member state that has applied the rules pertinent to the integrated rail transport market of the EU to third countries.

The aim of the present article is to define whether the railway part of the Estonian national transport policy is integrated with the EU rail transport policy and how it has been achieved, considering the situation described above. The main research task is to find possible deviations and quantify them, where possible.

## 2. Literature review, method and data

The documents mentioned in the introductory section define the main bottleneck(s) of the EU rail transport industry as follows [1]:

- Reduction of the share of rail transport on the transport market;
- Insufficient competition;
- Insufficient investments in infrastructure.

The methodological issues of transport policy studies have been analysed the best in the Fifth RTD Framework Programme project TRANS-TALK [6]. This research project lists seven major areas that should be considered in analysing national transport policies. The most substantial ones of them are:

- Market regulation;
- Investment in infrastructure and its funding;
- Access pricing.

The deregulation of the Estonian rail transport industry started in 1996 and has lasted until today. The author finds that this period can be divided into two, characterised by the following events:

- 1996–2000. Establishment of independent business entities on the basis of the assets of state-owned company Estonian Railways: 1) EVR, Ltd, freight transportation and the management of the majority of Estonian public rail infrastructure; 2) South-West Railways, Ltd, hereinafter EER, domestic passenger transportation, as well freight transportation and infrastructure management on the railway section going southwest from Tallinn; 3) Electrified Railway, Ltd, commuter traffic on EVR infrastructure; 4) GoRail, Ltd, international passenger transportation, founded by involving

private capital. Establishment of the Estonian Railway Administration. First rail transport undertakings beside EVR emerge.

- 2001 – today. EVR and EER (together with the public railway infrastructure in their ownership) are privatised (66 % and 100 % of the share capital respectively). Reorganisation of EER into a group of companies comprising: 1) a parent company possessing freight and passenger transportation activity licenses; 2) affiliates and subsidiaries dealing with infrastructure management, rolling stock management, rolling stock repairs, real estate administration and other activities. The Railway Administration is reorganised into Railway Inspectorate. New rail transport undertakings start operating on EVR infrastructure.

Table presents the comparison of the objectives contained in the EU and Estonian transport policies applicable to rail transport, considering the areas discussed in TRANS-TALK project. While looking at the actual process of Estonian rail transport market deregulation, it becomes apparent that the practical solutions used have not been in compliance with the objectives, means and methods set forth either in the EU or Estonian transport policy.

In recent years national transport policies have been discussed in several surveys commissioned by various international organisations. The regular monitoring of EU rail transport policy is performed by a syndicate headed by NEA (the Netherlands), and IBM *Deutschland* [1, 7]. Unfortunately, both of these companies have not found it necessary to make a direct contact with the companies managing the Estonian public railway infrastructure, and this is the reason why

**Table 1.** Comparison of the objectives of Estonia and the EU in rail transport sector for 1999–2013 [4]

Field of EU policy	1999–2006	2006–2013
Institutional separation	Founding of the Railway Administration. No plans for privatising EVR but privatisation of EER already planned. Vertical separation is not mentioned.	Not mentioned.
Opening of the rail transport market	No direct intention but the existence of other rail transport undertakings was already a reality.	Need for fair competition is declared.
Increasing the share of rail transport in the transportation sector	Reduction in the share of passenger transport by rail is stopped.	Increasing passenger train driving speeds i.e. funding investments needed for that with private capital.
Increasing the level of railway infrastructure investments	Narva and Pechory lines prioritised, government co-funding envisaged.	Priorities: Rail Baltica, Tallinn bypass and Koidula border station – government does not invest into the existing infrastructure.
Fair access fees for the use of railway infrastructure	Stopping the cross-subsidising of passenger transport by freight transportation (actually by infrastructure management – author's remark), replacing it with funds from state budget.	Infrastructure access fees do not increase. Cross-subsidising is not mentioned.

their reports contain some misleading information.

Thus, the author of the present article has worded his thesis question as follows: “Whether the solutions applied in Estonia allow the achievement of the objectives set forth in the EU transport policy, despite the lack of precedent in Europe?”.

In order to answer this question, the author has employed the following method of research:

- Defining the main objectives of Estonian rail transport policy and verifying their compliance with the objectives of the EU, based on the prior research.
- Identifying the main political measure. As indicated before, this has been the privatisation of the public railway infrastructure.
- Choice of measures. Following the objectives presented in the first column of Table, the measures are: number of activity licenses issued, passenger and freight volumes, monetary investments in infrastructure, funds allocated for rail transport from state budget, and the dividend paid by railway companies to state budget.
- Descriptive analysis, summary and conclusions.

The rest of the data used in the analysis has been taken from Estonian national statistics information [3, 4, 8] and the annual reports [9] of railway undertakings. In case of the latter, the author has a reason to believe that their essential parts are correct, as they have been given clean audit opinions.

### 3. Analysis

#### 3.1. Institutional separation

Directive 2001/12/EC [1] gives the member states the following policy guidelines for the institutional regulation of rail transport:

1. In order to promote efficient management of infrastructure in the public interest, infrastructure managers should be given a status independent of the State;
2. In the case of railway undertakings separate profit and loss accounts, either balance sheets or annual statement of assets and liabilities should be kept and published for business relating to the provision of rail transport services and infrastructure management;
3. The functions determining equitable and non-discriminatory access to infrastructure shall be entrusted to bodies or firms that do not themselves provide any rail transport services;
4. In the case of railway undertakings profit and loss accounts and either balance sheets or annual statement of assets and liabilities shall be kept and published for business relating to the provision of rail freight-transport services.

The previous chapter explained that the requirement to establish a railway infrastructure manager independent of the state was met by Estonia already in 1997 when the former state company EVR was reorganised into a public limited company in private law, and another public limited company in private law i.e. EER was created by separation.

The Railways Act [1] passed in 2003 requires from vertically integrated railway undertakings to keep separate records on revenues and costs for railway infrastructure management and freight transport areas, meaning that separate balance sheets are not required. The Railways Act does not require the publication of railway infrastructure manager’s reports. This publication requirement is applied by the Public Information Act [3] but not followed by the railway companies.

In practice the requirement for separate accounting has been realised in two different ways. EVR has solved it within one business entity by defining business units acting in different areas of business. The reports related to infrastructure management and freight operations are presented to the Ministry of Economic Affairs and Communications on a quarterly basis. EER, on the other hand, has established an affiliate dealing with infrastructure management, whose annual report is available in the commercial register. Meanwhile, the author is not aware of any horizontally integrated parent company reports by passenger and freight transport areas of EER being available.

The Estonian laws do not require the publication of rail freight transport undertakings’ reports. The author finds that such a situation might bring about substantial price distortion, as it gives the rail freight transport undertakings the opportunity to use dumping prices. For example, the annual report of Spacecom, Ltd (a rail freight transport undertaking competing with EVR) for the year 2004 [9] indicates that the company is rendering freight transport service for a price lower than the marginal costs and it is compensated by income earned from the other areas of activity e.g. wagon rental.

As both EVR and EER are vertically integrated railway undertakings, the capacity allocation procedure in Estonia is carried out by the Railway Inspectorate. The real-life situation is that the capacity allocation is turned into a process of redistributing freight volumes, leaving aside the fact that under the *SMGS* agreement it is EVR that is responsible for the rail transport of freight coming from Russia. Estonia does not have a Rail Transport Law, and therefore the obligations of rail freight transport undertakings in freight transport process remain unregulated. From EVR’s perspective this means that although EVR is not hauling the freight itself, it remains fully responsible to state authorities, freight receivers and freight dispatchers.

### 3.2. Opening the rail transportation market

The main guidelines of the EU transport policy [1] provide for opening railways for cabotage operations. The Railways Act of Estonia [3] stipulates that the use of a public railway with regard to base package and additional services ensuring access, the fees, time and other conditions of use shall be ensured without discrimination to all railway undertakings for the provision of rail transport services. Unlike the other member states of the EU, the public authorities of Estonia have extended this provision also to freight originating from third countries. This is something that Finland and Latvia, for example, have never done [1]. This has created for EVR the practical problems related to determining the responsibilities of the operators and the infrastructure manager described in the previous sub-chapter.

Directives 95/18/EC, 2001/13/EC and 2004/49/EC lay down principles and conditions for licensing railway undertakings. These principles have been introduced also in Estonian legislation, which, *inter alia*, provides for issuing activity licenses for railway infrastructure management, rail freight transport and rail passenger transport [3]. Differently from the directives mentioned above, Estonian Railways Act does not require that railway undertakings should own any rolling stock. In practice it means that railway infrastructure capacity can be applied for by companies possessing neither rolling stock nor locomotive drivers.

Fig 1 shows that as of 1 January 2006 there have been issued 19 activity licenses for providing rail freight transport services. Although majority of the rail freight transport undertakings are not operating on the public railway network, the two major operators besides EVR have been able to conquer 30 % of the volume coming from Russia by the end of 2005. In the end of 1999 the situation was broadly similar, although there was only one operator besides EVR working on the public railway. This company has been shut down due to bankruptcy. In 2001–2002 the market share of this company reached 25 % of all the freight hauled on the Estonian railway infrastructure [5].

The authority supervising competition on the Estonian rail transport market is the Estonian Competition Board. Currently the Competition Board is proceeding complaints dealing with the freight tariffs of EVR and the pricing of certain additional freight services [5]. Defining relevant freight market is the key issue in all of these cases, as the railways of the Baltic countries are competing among themselves for the transit freight coming from Russia. This means that railway viewed as an essential monopoly can suddenly be in a different position, as the freight owners have the ability to choose between alternative transportation channels throughout the Baltics.

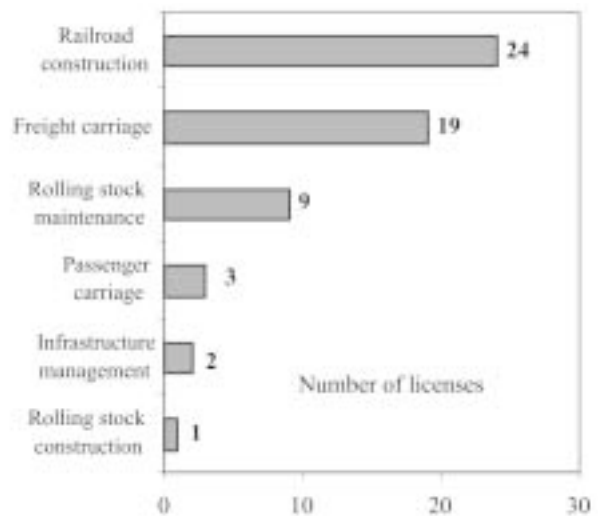


Fig 1. Activity licenses issued to railway undertakings as of 1<sup>st</sup> January 2006 [3]

### 3.3. Increasing the share of rail transport

The White Paper of EU transport policy from 2001 [1] sets the target to increase the market share of rail passenger traffic to 10 % and rail goods traffic to 15 % of the total volume of all modes of transport.

Estonian official transport statistics [8] do not contain any information about the passenger turnover of private road vehicles. Even the structure of domestic passenger traffic prepared without using this data indicates that the share of rail passenger transport has reduced considerably more than the share of other modes of public transport. The reason for that is the amount of local rail passenger traffic commissioned by the state, which was reduced drastically in 2001 for ostensible reasons. Looking at the existing lines we see that rail transport is competing with buses, mostly due to the line permits' policy of the Ministry of Economic Affairs and Communications. At the same time Valga–Pechory railway section is not used for rail passenger traffic at all, although there exists no alternative in the form of bus transport. The author finds that there is a serious conflict between the transport and regional policies of Estonia.

A major reduction in the share of rail transport for the benefit of roads has also occurred in domestic freight traffic. The main commodity hauled domestically has due to both geographical and historical reasons, been oil shale. The consumption of oil shale is constantly decreasing, as the technology used by Estonian national energy company is becoming more efficient.

The share of rail transport in international passenger traffic has become marginal (see Fig 2). Currently there is only Tallinn–Narva–Moscow passenger train being operated. After the reorganisation of the railway sector the traffic has been stopped on Tallinn–Tartu–

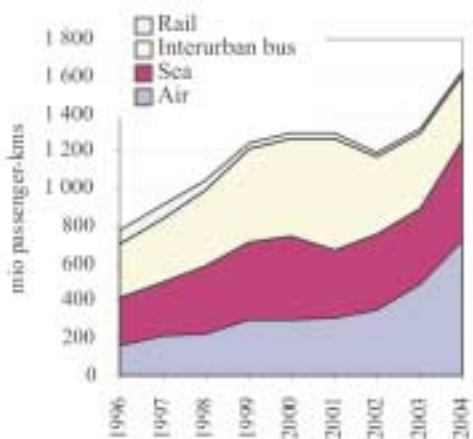


Fig 2. International passenger traffic dynamics and structure [8]

Moscow and Tallinn–St. Petersburg lines, and the planned Tallinn–Minsk line was opened only temporarily.

Meanwhile, there has been an increase in the number of charter trains that Estonian regulations treat as single railway capacities intended for specific purposes [5]. The position of the Ministry of Economic Affairs and Communications is that the fees charged for the use of such capacities cannot contain any infrastructure access fee. Therefore, a situation has been created where rail transport undertakings that have been allocated regular capacity subsidise the companies receiving single railway capacities intended for specific purposes.

The share of rail transport in international freight traffic has been constantly increasing (see Fig 3). Considering that the freight volume has increased from 39,4 mio tonnes in 2000 to 42,8 mio tonnes in 2004 [5] i.e. 8,6 % then the increase in freight turnover of 35,1 % over the same period refers to longer average haul distances. The latter would mean that there has occurred a growth in volume in the case of Tallinn–Tartu–Pechory,

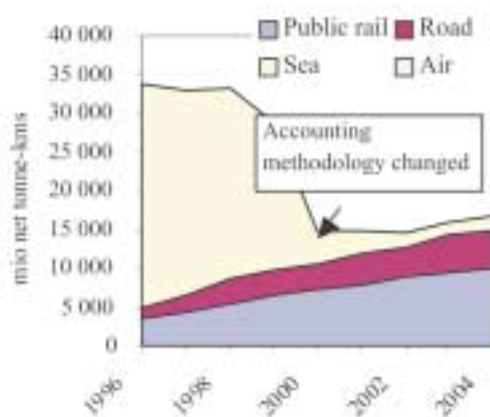


Fig 3. International freight traffic dynamics and structure [8]

and that the role of Paldiski port has become more significant in servicing transit freight.

While analysing the tendencies described above, it appears that opening rail transport market for competition has not brought the expected additional volumes and there has been no competition created in case of either domestic or intra-Community rail transport.

### 3.4. Increasing the volume of investments

Directive 91/440/EC [1] notes that the member states should be responsible for the development of railway infrastructure. The White Paper on European transport policy sees the involvement of additional sources of financing, including private capital and funds paid as infrastructure access fee, as a measure for increasing the volume of investments for railway infrastructure.

Fig 4 showed that in 1995–1999 the state allocated altogether 17,7 million euros for the renovation of the infrastructure belonging to EVR, plus additional 8,6 million euros of PHARE program facility. After this period the Government of Estonia has not found it necessary to support any investment in the largest railway infrastructure of the country.

Unlike CER, the European Commission has also taken the position that the use of the EU or member states' funds for infrastructure investments is not appropriate if the infrastructure is in private ownership. This has allowed the Government of Estonia to require from EVR, for example, the construction of buildings and structures needed for border and customs procedures using its own funds [5].

State subsidies for passenger transport have continued to decrease since 2001 (see Fig 5), despite the fact that the number of rail passenger transport users

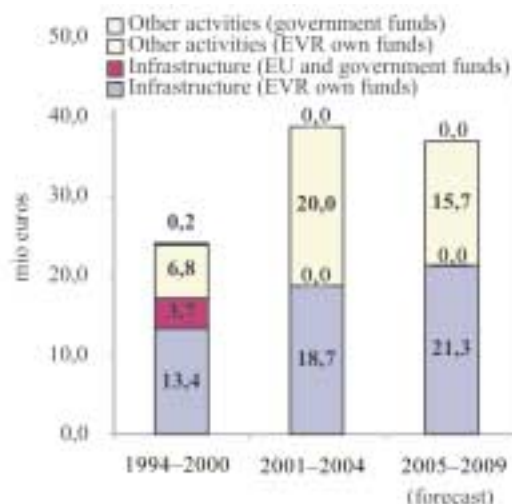


Fig 4. Annual average investments made by EVR and their sources of financing [5]

that had gone down due to the setbacks caused by the erroneous decisions at the time of privatisation has started to grow again.

Owing to the dividend policy of EVR, there exists a new possible source for financing passenger transport investments – the dividends paid by the company to the state budget. As it can be seen from Fig 5, in the year 2002, for example, the dividend paid equalled to approximately 30 % of all the subsidies allocated for passenger transport.

### 3.5. Fair charging and financial sustainability of railway undertakings

Directive 2001/14/EC [1] that deals also with access charging, outlined the following main objectives of access charging:

1. Investment in railway infrastructure should be desirable;
2. Fair value of railway infrastructure, and thereby the actual costs of keeping it operating, should be defined;
3. Costs of the infrastructure manager should be covered.

Since the end of 2000 there have been three different railway infrastructure charging methodologies applicable in Estonia. Although there have been some differences in details, the basic principle has always been the same – the charging mechanism should be full cost based i.e. fee for the services ensuring access must cover both the variable and fixed costs of the infrastructure management, including the cost of investments. Fig 6 indicates that infrastructure access charge includes also the return on invested capital, which in the current version of the access charging methodology [3] has been defined as the product of the residual value of fixed assets and weighed average cost of capital.

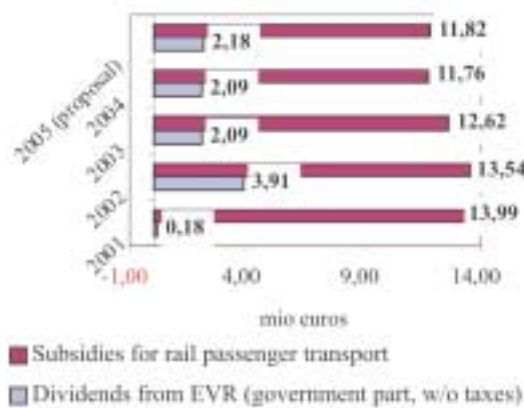


Fig 5. EVR's net dividend paid to the state budget and subsidies for rail passenger transport undertakings: based on public information [9, 10]

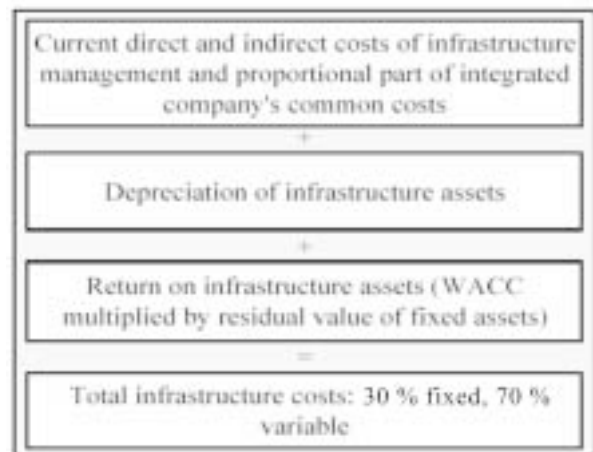


Fig 6. The general method of calculating railway infrastructure charges in Estonia

In the opinion of the author, the methodology described above is in principle appropriate for the infrastructure manager in private ownership, leaving aside the fact that the return component of the investments does not cover the investments made in working capital. Unfortunately, there has occurred an irreconcilable conflict between EVR and the government authorities regarding the implementation of the methodology. The true value of the infrastructure owned by EVR and the reasoning behind the more advantageous treatment of passenger transport have become the key issues of the dispute.

The previous subparagraph explained that in case of EVR the funding of infrastructure investments has been left to be an internal concern of the company. The real value of infrastructure assets used for calculating depreciation is of crucial importance in such situation. In 2004 EVR carried out the revaluation of its fixed assets, employing the method of depreciated replacement value. After the revaluation it appeared that the residual book value of EVR's fixed infrastructure assets was approximately three times lower than their replacement value [9]. Depreciation calculated using the fair value would cover the annual average investment needed for infrastructure, reaching 21 million euros in the medium term perspective (see also Fig 4).

Following the instructions given by the Ministry of Economic Affairs and Communications, the Railway Inspectorate has taken the position that although EVR has the obligation to reflect its assets with their fair value under international accounting standards (IAS, IFRS), the company is not allowed to use the result achieved for calculating infrastructure access fee. The Inspectorate has also expressed a particularly peculiar view, stating that the growth in the value of assets constitutes an unjustified expense [3, 5].

After a temporary decline in 2002 the total

infrastructure management costs of EVR have been at the level of 70–90 million euros a year [5]. While setting the infrastructure access fee for the 2005–2006 timetable period, the Railway Inspectorate used the cost base of less than 50 million euros [3]. Thus the author has asessed that the annual loss of EVR's infrastructure management activities will reach ca 20 million euros during this period, jeopardizing the financial sustainability of the company.

Another peculiarity of the Estonian way of calculating railway infrastructure access charges is its approach to rail passenger transport undertakings. As Fig 6 explains, the methodology has divided the infrastructure management costs into two, assuming that 30 % of them are fixed and 70 % variable. In case of an infrastructure, which is predominantly not designated for the provision of rail passenger transport services, the rail passenger transport companies are exempt from paying the infrastructure access fee component that is based on fixed costs [3].

Fig 7 shows that the railway infrastructure access fee paid by rail passenger transport undertakings has covered only up to 25 % of the respective costs. Until the 2005/2006 timetable period the rest of the costs were covered by EVR as an infrastructure manager. The railway infrastructure access fee calculation methodology that is effective starting from the 2005/2006 timetable period [3] stipulates that this obligation is imposed on all rail freight transport undertakings collectively.

The Estonian railway infrastructure access fee calculation methodology applicable since the timetable period of 2005/2006 [3] interprets that direct costs mean short-term variable costs. Charges based on such costs are required to be used in case of the sale of electricity, access to telecommunication network,

technical inspection of rolling stock, allocation of single capacities intended for specific purposes and some other services.

#### 4. Results and conclusions

The aim of the present article was to identify how the Estonian national transport policy has taken into account the fact that the railway infrastructure of the country has been privatised. The analysis of five main areas defined by the author lead to the following conclusions:

1. Although the Estonian solutions are generally in compliance with the EU regulations and sometimes even more liberal, the methods employed by the Estonian public authorities do not allow ensuring sustainability of the infrastructure managers.

2. This is the reason for giving a negative answer to the question whether the key measure of Estonia's informal transport policy – privatisation of railway infrastructure (the privatisation of EVR was not foreseen in the official transport policy) – has produced the expected results. The author finds that the unique opportunity of Estonia – to manage the railway infrastructure on a commercial basis – has not been taken a full advantage of. In the short-term perspective this could lead to the preferential development of rail transit operations on the account of state's tax revenue.

3. Although the EU transport policy and *acquis* welcome all private sector initiatives in the area of rail transport, they cannot be fully implemented due to their generality and negligence in considering the regional features of the countries.

The author is of the opinion that the experience of Estonia described above is also relevant for other SMGS agreement parties who have started (or are currently envisaging) reorganisation of railway companies.

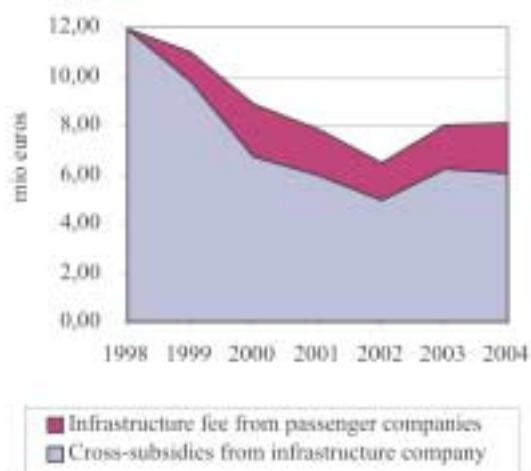


Fig 7. EVR infrastructure costs for passenger transport and their sources of financing [5]

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