

## Hiving off Noncore Activities in Railways

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## Foreword

The India Resident Mission (INRM) Policy Brief Series is sponsored by the Asian Development Bank (ADB) and is designed as a forum to disseminate findings from policy research work undertaken on the Indian economy. The series is primarily based on papers prepared under the Technical Assistance (TA) 'Policy Research Networking to Strengthen Policy Reforms in India'. The main purpose of the TA was to provide assistance for developing policy research networking capacity, in order to build support for, and consolidate the reform process. The INRM Policy Briefs provide a nontechnical account of important policy issues confronting India.



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Country Director

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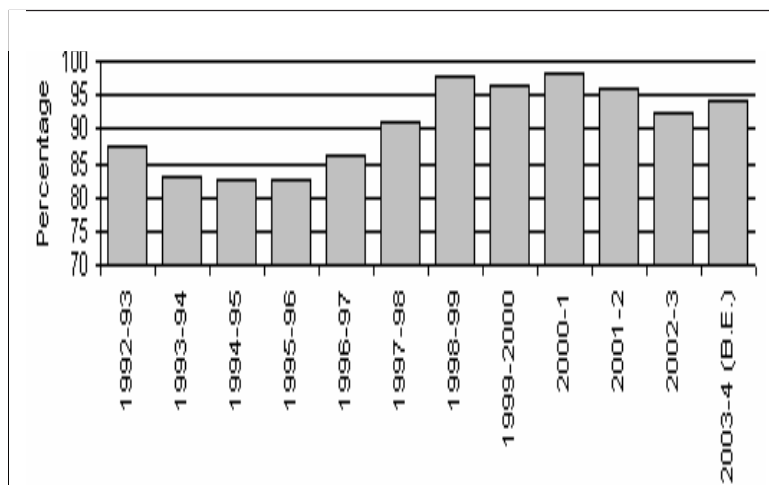
Much of India's development over the last 150 years springs from the development of the railway system. Given their crucial role in the economy, it is vital that the railways are kept in good financial and technological health.

Railway finances, by some yardsticks, are in a crisis. Some of the causes have been the loss of freight market share to road transport; operational rigidity, especially in pricing; high and unrequited costs; a huge pension liability; inadequate internal generation of resources; and skewed investment decisions driven by political or other considerations. The operating ratio (percentage of working expenses to gross earnings) had gradually deteriorated over the last decade (Figure 1) but during 2004-5 significant growth in captive traffic of coal, fertilizers, and iron ore for export has improved matters.

The share of pensions in working expenses has risen from 4.65% in 1980-81 to nearly 14% in 2003-4 and is estimated to rise to 19% in 2004-5. The outgo on staff wages and pensions accounts for an alarming 44% of annual revenues.

The system is badly run down and huge arrears of renewals and replacement have built up, as depreciation had not been adequately provided for (Table 1). The asset failure rate is 7–10 times that of railway systems elsewhere. The network is overstretched in the critical corridors and capacity constraints are being acutely felt.

Renewals, capacity build-up, and upgrading technology would require massive resources. Budgetary support from the central government having



Source: Indian Railways, *Annual Report and Accounts—2003-04 Statistical Summary*.

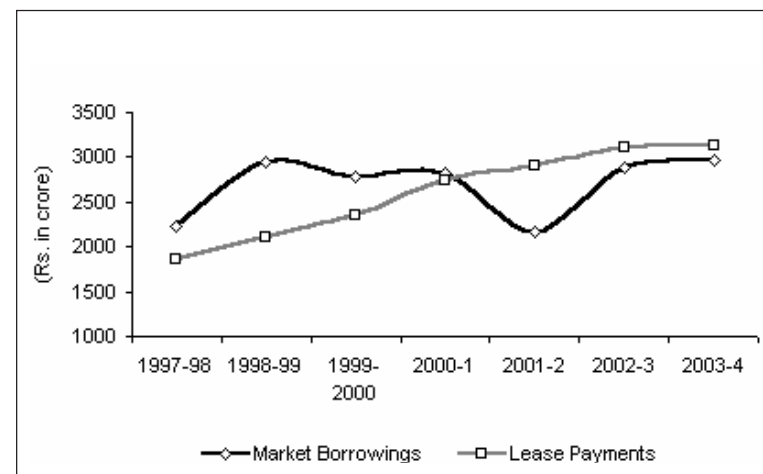
**Figure 1. Railways' operating ratio**

**Table 1. Depreciation Provision as Proportion of Investments**  
(Rupees in crore)

Year	Depreciation Provision	Total Investment*	Col. 2 as % of Col. 3
1	2	3	4
1992-93	2300	28,524	8.06
1993-94	1875	32,212	5.82
1994-95	1885	35,618	5.29
1995-96	2060	39,816	5.17
1996-97	2200	44,627	4.92
1997-98	1904	49,057	3.88
1998-99	1155	53,658	2.15
1999-2000	1670	58,353	2.86
2000-1	2301	63,341	3.63
2001-2	2000	70,117	2.85
2002-3	2401	77,915	3.06
2003-4	2592	87,474	2.96

\* Represents the total value of railway assets whether financed from loan capital, depreciation reserve fund, depreciation fund, or capital fund.

Source: Indian Railways Budget Papers, 1992-93 to 2003-4.



Source: AITD Working Paper, *Finances of Indian Railways—An Uncertain Future*, 2004.

**Figure 2. Market borrowings and lease charges**

gradually declined, the railways have been raising a part of their capital in the open market at high interest. This shift has all but devastated railways' finances; fresh borrowings are used just to service the old debt of lease charges (Figure 2).

There is a high degree of vertical integration in the system, which has gradually diverted attention from the core business of transportation. The railways' in-house activities include catering, manufacturing, designing, running hospitals and schools, and so on. These subsidiary activities need to be hived off.

## Key Issues

Railways everywhere are undergoing a metamorphosis. This has two common features—reversion to core business and introduction of competition as a motive force. Every successful restructuring effort has entailed segmentation of assets and services into 'core' and 'noncore' categories and divestment of the latter to focus on the 'core' business of speedy haulage both of passengers and goods. Improved performance has been witnessed on several fronts—price, quality of service, safety,

market share, investments, and productivity. Now they are competing with other modes of transport on parameters of efficiency, savings in commuting time, and reliability of service.

For Indian Railways, having regard to the ground reality, the prime candidates for hiving off are production units, catering, on-board services, and schools and colleges.

Indian Railways has set up several enterprises under a corporate structure. These are RITES, IRCON International, Indian Railway Finance Corporation (IRFC), Indian Railway Catering and Tourism Corporation (IRCTC), and Container Corporation of India (CONCOR). Government fully owns the first four; in CONCOR Indian Railways holds 63% share. There are also joint ventures like Konkan Railway Corporation (KRC), Mumbai Rail Vikas Corporation (MRVC), Pipavav Rail Corporation Ltd (PRCL), etc. Indian Railways with the Karnataka state government and Infrastructure Development Corporation, Karnataka, has created a special-purpose vehicle (SPV) for gauge conversion of railway links between Hassan and Mangalore. Another SPV, Rail Vikas Nigam Ltd (RVNL), has recently been incorporated under the Companies Act to carry out specific projects using build-operate-and-transfer (BOT) schemes.

The underlying objective in these innovations has been to gain from the freedom and flexibility inherent in a corporate structure. The railways, therefore, are no strangers to the process of corporatization, disinvestment, and setting up of joint ventures with strategic partners.

CONCOR makes an interesting case study. In this case, a segment of the railways' core business—multimodal operations—was transferred to a newly constituted corporate body. It involved transfer of assets, including inland container depots along with plant and machinery, land, buildings, etc. The company was set up with a paid-up share capital of Rs 5 crore, later increased to Rs 65 crore. Initially, the government held all the shares but subsequently divested 37% of the equity in two tranches. The divestment yielded Rs 365 crore. During 2003-4 the company earned a profit of Rs 368 crore and paid out a dividend of Rs 81 crore. Thus while the parent organization is reeling under deficits, the spun-off unit is making sizeable profits. The success of CONCOR has two clear messages. One, that a segment of Indian Railways' activities can be hived off, provided it is well defined. Two, that such spinning off can benefit both the railways and the new organization.

## Policy Options for Hiving off

### Production Units

In the early years after independence, in order to meet the twin objectives of developing indigenous capabilities and conserving scarce foreign exchange Indian Railways set up its own production facilities as the private sector was not able to venture into this field. Five production units were set up during 1950–59: Chittaranjan Locomotive Works (CLW); Integral Coach Factory, Perambur (ICF); Diesel Locomotive Works, Varanasi (DLW); Wheel & Axle Plant, Bangalore; and Rail Coach Factory, Kapurthala (RCF). These units are managed as departmental undertakings of the Ministry of Railways unlike public sector undertakings which, though owned by the government, are autonomous corporate entities. The Railway Board sets down policies for them for procurement of materials, plant, and machinery. It also decides the nature and quantity of their annual output. The manufactured products are supplied to the railways at a 'transfer price', worked out on actual cost basis but not including the cost of capital, the profit element, and share of administrative charges. The Ministry of Railways provides the funds through the railway budget and the Comptroller and Auditor General of India audits the accounts.

These production units suffer from several constraints, some of them inherent in the railways' vertically integrated structure. The railways have not been able to make even essential investments in plant and machinery. A result is that 49% of the ICF's plant and machinery have outlived their economic life; 16% of the machinery is over forty years old. Over-age and obsolete equipment require frequent maintenance and additional staff. Not surprisingly, ICF deploys 2631 maintenance staff as against 476 in RCF. Similarly, at the Wheel & Axle Plant most machines have outlived their economic life, causing heavy downtime and low-quality output. All production units have remained roughly at their initial levels of technology. They are also overmanned and productivity is low. For example, DLW uses 33 man-years of direct labor to produce a locomotive; CLW is no better. In comparison, China uses 12–15 man-years and the developed countries about 6 man-years only.

Over the years, the production units have developed their own vertical integration. They continue to produce components that could easily be outsourced at competitive rates. Efficiency matters little to

them as the transfer price takes care of the costs. Capital is available without a price tag. The Ministry of Railways pays out over Rs 900 crore to the production units as annual wage bill and dividend on the capital advanced as manufacturing suspense. In addition, their market is sheltered. By and large, they have continued with the technology and designs initially procured, with some incremental improvements. Upgrading technology is also delayed in government procedures. It has taken twenty years to start the process of technology transfer for the new generation of diesel locomotives and a similar timeframe for upgrading coach design.

The world over, major industries have been structurally changing, largely driven by technology, capital, and competitive pressure. The technological complexity of the products and the need for a large enough market to support research and development strengthens the process. All national railways have hived off their production units into independent enterprises. Indian industrial base has acquired the capability for producing high-quality equipment. The ancillary industry has developed significantly to produce quality products at competitive prices. The private sector is willing to invest in capital-intensive industries.

The production units' combined staff strength is around 48,000. Their age profile makes it relatively easy to offer a combination of incentives in a 'cafeteria approach', wherein alternative menus are available: join the corporatized unit, continue with the railways, or retire with attractive severance payments. Indian Railways, with a total workforce of around 1.5 million, has the capacity to adjust the transferred labor.

Corporatization of production units would be an interim phase. The follow-up phase would be disinvestment and adoption of some suitable model for restructuring. Several models have been adopted in different countries, such as management contract; concessioning; public offering of stock; and joint venture with a strategic partner. Any chosen model should be able to infuse capital, induct cutting-edge technology, and resource managerial skills. A management contract will not infuse private capital. In concessioning, the concessionaires take care of the investment and risks but government retention of ownership dissuades private investors. Public offering of stock may bring in capital but does not improve competitiveness. Joint venture with a strategic partner would possibly be the best option.

Consolidation through mergers and acquisitions the world over has resulted in a few large companies dominating the world market and also introducing new technologies in their products. Indian Railways will necessarily have to depend on such organizations for technological inputs. It would, therefore, be prudent to look for a strategic partner amongst global enterprises. This will not only provide Indian Railways with modern rolling stock but also encourage the restructured production units to develop the potential for exports.

There are two units each for manufacture of locomotives and coaches. Hiving off will induct healthy competition between them.

The transition from a departmental unit to a corporatized entity would entail both regulatory and financial restructuring. Financial restructuring will typically involve deciding on the treatment of state-guaranteed obligations, setting up of financial systems, and preparing financial statements in accordance with the generally accepted accounting principles.

Apprehensions that hiving off the production units could betray the railways' social objectives are misplaced. They never had any social role to play. Greater efficiency would itself be a better social contribution.

### ***On-board Services***

Indian Railways also needs to shed on-board passenger services. Bangladesh Railways leased out commercial activities of 44 passenger trains to the private sector, boosting their revenue earnings by 57%. Likewise, cleaning and refurbishing of rolling stock has been outsourced to the private sector. The State Railway of Thailand has also turned around loss-making on-board services by leasing these activities.

### ***Catering Services***

The corporation for managing catering activities is a wholly owned subsidiary of the Ministry of Railways. It is hoped that it will soon have the infusion of private capital and managerial talent.

### ***Schools/Colleges***

The schools and colleges run for the benefit of the wards of railway employees could perhaps be brought under the umbrella of Kendriya Vidyalayas, with financial assistance extended to the latter for management.

## Extending the Net

### ***Uneconomic Branch Lines***

The Uneconomic Branch Lines Committee, 1969, designated all narrow gauge lines and such of the broad gauge and meter gauge lines that join the main line network at one end only as branch lines. A review during 2001-2 indicated that 116 (46 BG, 46 MG, and 24 NG) branch lines were uneconomical and the railways lost about Rs 449 crore excluding dividend, on their account. The quantum of this loss has increased over the years.

Several high-level committees have unanimously recommended that all such uneconomic branch lines, where alternative modes of transport exist or can be developed, should be closed down. State governments are, however, reluctant to close down such lines. The Railways Reforms Committee in Part XI of its report on 'Economies' (October 1983) had recommended closing down (i) 40 such lines where adequate alternative road infrastructure is available, and (ii) 17 such lines in Gujarat where alternative road infrastructure could be developed; state governments not agreeing to closure should equally share the losses with the railways.

The railways have since issued instructions for closure/dismantling of 21 uneconomic branch lines (15 out of 40 and 4 out of 17 referred to above plus 2 others) and have offered financial assistance to the state governments for closure of the remaining 38 lines.

Concessioning can be a useful mechanism of controlling losses. The government retains ownership but transfers to a private concessionaire an operation or a function for an agreed period. The operator covers investment costs and carries commercial risks. Normally, any new assets revert to the government at the end of the concession period.

Concessionaires may be asked to bid on the basis of a minimum subsidy rather than a minimum profit share. Where revenues accrue to the operators they carry both cost and revenue risk. Where revenues accrue to the government, concessionaires carry only the cost risk. Experience with transport concessions elsewhere suggests that the latter type of concessions attract more bids and yield a more competitive contract price.

Different countries have addressed their problems differently, providing different insights into what can be achieved through

concessions. But some common trends may be discerned. Restructuring and substantial government investment in the design of a concession does pay off. Concessionaires can do exactly what is expected—increase traffic, improve service, and enhance labor and asset efficiency. Concessions work because government interference is ended and commercial management techniques are introduced and allowed to operate.

### ***Suburban Railway System***

With low passenger tariff, suburban railways are a losing proposition. Railways charge only 13 paise per passenger kilometer while bus services in urban areas charge upward of 48 paise. The problem of suburban losses can be resolved only by hiving off this business as a separate corporation.

As mentioned earlier, a joint venture between the Government of Maharashtra and Government of India (MRVC) has been set up for commercial exploitation of railway land and airspace and to augment the rail structure by raising funds through loans that will be paid back by levying a surcharge on passenger tariff. Similar ventures would be necessary to shed suburban business at other metropolitan cities.

## Glimmer of Hope

Many committees and expert groups have made numerous suggestions for reform of the railways. Lack of a clear political mandate, noncommercial organizational ethos, and short tenures at the policymaking levels have been responsible for maintaining the status quo.

In an international seminar organized by the Asian Institute of Transport Development in New Delhi in 1995, eminent speakers from various academic institutions and from European, African, and Indian railways presented various policy options for restructuring railways. More recently, the World Bank and an Expert Group on Indian Railways, set up by the Government of India, have made detailed recommendations. Both reports have recommended hiving off noncore activities. Regrettably, precious little has happened in this direction. There is, however, a glimmer of hope with the Planning Commission pressing for implementation of this specific recommendation of the Tenth Plan document.