

Economic Risks

Economic risks involve the redistribution of cash flows generated by JSC "RZD" to local carriers without any corresponding creation of industry added value as a result of their entry into more profitable segments of the market.

The Holding Company is now also facing a number of other serious threats to its operations, such as:

- ▶ cutbacks in government spending to support the development and operation of rail transport resulting in reduced infrastructure capacity in the context of high wear and tear and numerous bottlenecks;
- ▶ growing competition from potentially profitable traditional and emerging segments of domestic and foreign transport markets;
- ▶ decline in national freight traffic due to structural changes in the economy;
- ▶ disintegration of technological relations due to the sale of controlling (blocking) stakes of JSC "RZD" subsidiaries and affiliates.
- ▶ tougher regulatory environment, tariff restrictions, inadequate budgets at all levels, and an uncertain tariff policy;
- ▶ growing competition from road, pipeline and water transport;
- ▶ reduced carrying and processing infrastructure capacity due to an increase in the running of empty private cars along the network's main lines.

In these conditions, it is essential to have strategic plans in place as there are always two sides to adverse macroeconomic conditions — threats and opportunities.

Through these strategic plans the Company has identified a considerable number of opportunities — for example, lower prices of resources, a growing supply of labor and opportunities to upgrade sections of the infrastructure to reduce bottlenecks (which is hard to do during periods of peak traffic).

The Company has considerable potential to minimize both economic risks (for example, the adverse consequences of a decline in transport) and other risks.

JSC "RZD" has adopted and consistently implements the policy of only increasing real wages if higher growth in labor productivity has been achieved, which necessitates greater responsibility, labor discipline and productivity.

To improve its performance, the Company must introduce innovative technologies to create new transport (and associated) products, new railway machinery and technologies, improve rail transport management, and identify and use new opportunities to improve railway efficiency. The effects of adverse macroeconomic conditions must be used to achieve a new level of quality and efficiency.

Railway companies need to go beyond their traditional market segments to create and promote innovative transport products and services, enter new markets and develop promising lines of business.

This diversification strategy must focus on the needs of customers who are increasingly interested in purchasing competitively priced, integrated door-to-door transport and logistics packages in Russian and foreign markets.

Changes in organizational, legal, tax and other business trends may impose threats on JSC "RZD" in 2013:

- ▶ Russia's joining of the World Trade Organization in 2012 requires a certain future redistribution of internal and international rail transport cargo flows, which may necessitate an increase in the capacity of individual network sections and intensification of track repair operations;
- ▶ amendments to the Russian tax legislation enacted on 1 January 2013 that provide for a repeal of property tax privileges in relation to railway tracks have incurred considerable additional expenditure for JSC "RZD";
- ▶ given the Company's limited sources to self-finance investments and additional borrowings, an increase in loan debt and debt/EBITDA ratio is expected, which will negatively affect the Company's financial stability and may adversely affect the credit rating of JSC "RZD";
- ▶ transition to a new railway transportation market model that requires local carriers to enter the market in 2013 may worsen operations in the railway system, which is already complicated by freight car market deregulation, and may cause additional traffic control challenges and decrease the income of JSC "RZD".

In order to minimize any adverse consequences of a decline in transport in 2012 and to ensure balanced financial activity, the Company's economic, strategic and production units worked hard to prepare and develop the Company's medium-term cost optimization program .

The program's activities were implemented across the Company by JSC "RZD" branches which are responsible for their performance. In terms of their targets, cost optimization activities are divided into:

- ▶ investment (restoration and upgrading of fixed assets currently in use, commissioning of new production facilities and equipment that improve process efficiency);
- ▶ technical (optimization of processing equipment operation modes, reduced waste of fuel and energy resources, timely maintenance and repair work);
- ▶ process (reconstruction (upgrading) of processing equipment, improvement of processes, introduction of advanced troubleshooting techniques; revision and introduction of a higher use of improved materials and technical resources, alternative fuel and energy resources);
- ▶ organizational (decreased costs of purchased goods, works, services through the awarding of orders and contracts on a competitive basis, management structure optimization, improvement of management processes, reduction of costs and storage losses, decreased transportation costs, including through improved logistics).

MEDIUM-TERM COST OPTIMIZATION PROGRAM FOR 2013–2015

Commissioning of new fixed assets, restoration and upgrading	<ul style="list-style-type: none"> ▶ acquisition and upgrading of railway machinery (commissioning of new locomotive series); reconstruction and commissioning of new rail infrastructure facilities (improvement of the track structure, traction substations, signals and interlocking systems); replacement of production equipment with advanced high-capacity alternatives
Optimized use of labor resources and enhanced labor productivity	<ul style="list-style-type: none"> ▶ balancing the scope of work performed by employees through increased labor standards, multi-skilling and extension of service areas ▶ consolidation of stations under common supervision, change in the station operation mode in low-traffic sections (daily operation, home-based duty)
Optimized consumption of materials and spare parts and other material resources	<ul style="list-style-type: none"> ▶ implementation of lean manufacturing technologies ▶ reduction in the use of new assemblies, parts, spare parts through a greater level of refurbishment; introduction of a new repair model
Lower power consumption	<ul style="list-style-type: none"> ▶ assurance of effective use of regeneration braking and locomotive automated driving systems ▶ operation and heating optimization ▶ observance of the lighting mode
Lower fuel consumption	<ul style="list-style-type: none"> ▶ assurance of effective use of regeneration braking and locomotive automated driving systems ▶ operation and heating optimization ▶ observance of the lighting mode
Other process activities	<ul style="list-style-type: none"> ▶ diesel unit upgrading to replace two-stroke diesel with four-stroke units; ▶ use of self-contained diesel unit heating systems ▶ optimization of operation modes of special-purpose self-moving rolling stock