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RAPID

SUPPORT FOR
TRANSPORT AND TELECOMMUNICATION REFORM IN SOUTHERN AFRICA:
PROTOCOL IMPLEMENTATION

TECHNICAL ASSESSMENT REPORT:

Railway Privatization Activities Within SADC

Larry Phipps
Transportation and Economic Research Associates, Inc. (TERA)

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1. Background

Six of the SADC countries' railways have been examined in terms of the degree to which the transport protocol has been, or will be, implemented as regards railway privatization. The original charge of the 2.1 task order was to assist in the privatization efforts in three countries, Namibia, Zambia and Zimbabwe. The status of privatization efforts in those countries led to examining other countries for potential assistance. Botswana, where no action has commenced, Mozambique, where progress was alleged to be the greatest, and Tanzania were reviewed in seeking to find a privatization process underway and producing firm results.

In the entire region, only Malawi has concessioned a state owned railway. In Zimbabwe, a Build Operate and Transfer concession was awarded to BBR by way of bilateral negotiation. Aside from these two cases, no railway has been concessioned and there is very little, if any, progress being made to improve the transportation infrastructure through concessioning within SADC. The lack of progress in this regard is cause for concern as the transportation infrastructure is deteriorating each day and its negative impact on trade within the region is growing. Freight rates remain far too high and service is becoming more erratic. Years of under investing in rail, sleepers and structures are producing the expected result, poor service and dwindling market share.

Only where donors have continued to supply funds is any activity that might lead to improved service taking place. Botswana has completed a mainline relay of all rail and a complete rehabilitation involving the changing out of all steel sleepers in the main line and replacing with pre-stressed concrete sleepers, with donor lending from China being used for the rehabilitation. Namibia is moving ahead with a planned line extension into the north of the country financed with donor funding, while the existing railway network within Namibia is deteriorating and is being funded by receipts from government, not from internally generated funds. Zambia's concession program has come to a halt, despite the approval by the World Bank of a loan to cover retrenchment costs, and the invitation for bids, which was expected in December 2000, has not been issued. Mozambique's concessions are all now held up for a variety of reasons, even though the World Bank loan for retrenchment has been approved. Only the USAID funding of repairs to the Limpopo Corridor prevents the statement that all of Mozambique's lines are deteriorating.

Tanzania's two railways are examining concessioning, but internal disputes over the design of the concessions have the process stopped. The ninth phase of Chinese assistance is nearing completion and thus there is some incentive to privatize, but concession decisions await review by the three governments, China, Zambia and Tanzania. Zimbabwe originally intended to use a vertically separated concession model. In the late stages of concession design, that model was rejected and the process was to have begun again. The deteriorating state of the Zimbabwe economy and lack of any prospects for improvement have now stymied any legitimate concessioning. That makes concessioning of NRZ highly unlikely. As NRZ is central to so many trans region traffic flows, its rapidly deteriorating service has a major impact on interregional trade. Spoornet and the government of South Africa continue to debate over if, or how, to design a concession. Swaziland has begun a consultant's study to determine potential concession of its railway.

2. Likely Privatization Scenarios

2.1 Botswana

The impact of having lost virtually all transit traffic to the BBR route is now being fully felt. Before BBR, transit traffic accounted for 41% of Botswana Rail tonnage, 58% of TKM (work effort), and 33% of total revenues. While the transit traffic was being handled at reduced rates, the loss of 33% of revenue is difficult to offset with cost reductions. This is especially true where restrictions to force reductions exist.

In the current parastatal environment there is little likelihood that costs can be reduced commensurate with the revenue reduction. With the recent rehabilitation of the mainline, the most likely outcome will be a severe reduction in ordinary track maintenance expense. In the short term, such reductions can be made, but in the long term, the track and infrastructure will deteriorate. The Botswana government has been in no hurry to privatize the railway, but significant operating losses may change the attitude towards privatization. If privatized in the near term the railway has value and might attract private sector investors. If privatization is delayed, the value of any concession will diminish.

Even now, it is unlikely that international railway operators will invest in a Botswana railway concession. Tonnage levels of less than two million tons are not sufficient for the risk involved for the international rail operators, even though by regional standards the railway has been one of the more efficiently operated. The most likely private investors are current users of the system with the largest being Botash, a soda ash company that depends upon rail transport to remain competitive in international markets. A consortium including Botash and local Botswana or regional investors might find a concession attractive. Other investors are unlikely to bid for a concession that has no transit potential. GOB funds can be used for the retrenchment costs and there is no dependence upon international lending institutions for funding. Rapidly increasing losses may give impetus to the privatization program and concession could take place in the next two years.

2.2 Namibia

Traffic levels on TNL declined significantly between 1980 and 1990, but have declined only moderately since 1990. In addition to the decrease in tonnage handled, the traffic mix has changed resulting in a decrease in average length of haul. 1999 TKM was 846,000 (000), only 24 % of the 1980 level. Tonnage handled is now approximately 1.5 million tons annually. Prospects for increased tonnage are not bright.

Financial performance shows losses for each recent year. This is despite the fact that depreciation expense is understated and that reserves for equipment and infrastructure replacement are inadequate. A series of restructuring make year-to-year comparison difficult, but suffice it to say that the railway is not profitable. While there have been reductions in work force over the last few years, approximately 2200 employees are currently employed while less than 600 are required to operate the railway.

The most recent restructuring envisions a financially independent parastatal, utilizing internally generated funds. Unfortunately the railway is not a generator of funds and thus replacement and renewal of equipment and infrastructure is inadequate. Recently, funds due from the state to reimburse for losses incurred by Air Namibia in past years, N$ 172 million, have been used to subsidize continuing operations. Those funds are provided in four equal annual installments of N$43 million and two installments have already been received. In 2003 the last installment will be received. These funds have been used to supplement working capital and when they are no longer received, other state subsidies will be required to meet day-to-day expenses.

An extension of the railway into the northern part of the country has been undertaken. The extension of 300 km has been proposed from Tsumeb to Ondango and Oshakati, and at a later date to Oshikango. The extension has been justified on an economic development basis and is not justified on a financial basis. It will add some incremental traffic to the TNL network but will probably not make a contribution to profit. Construction will probably be on a BOT basis with donor funds financing construction costs.

The government position towards privatization is that state assets will never be sold. This attitude carries over to the prospects for concession and at this time concession is not under consideration. When the financial situation is fully understood, the attitude towards concessioning may change, however by then it is unlikely that private sector investors will be anxious to invest in a concession. Prospects for interline traffic growth are limited, the infrastructure will be in a continuing state of deterioration, and the 1.5 million annual tons will not attract international railway operators/investors. The most likely scenario is that the concessionaire selected for the BOT Northern Line Extension will also be asked to assume the balance of TNL, perhaps as a negative concession.

2.3 Zambia

The privatization of Zambia Rail has been underway for several years. ZRL was tranched for privatization in 1998 and in March 2000 Cabinet approved concessioning as the mode of privatization. The World Bank loan to provide for retrenchment was received by the government of Zambia in December 2000. Solicitation of bids for the concession was to have been made in early 2001, but has yet to commence. Differing views towards the concession design within the government have caused the process to stop. It is now hoped that the process will begin again near the end of June 2001.

The concession design calls for a vertically integrated railway freight operation, a negative passenger concession (PSO) and a separate inter-mine shuttle concession. The winning freight concessionaire is required to bid for the passenger concession and the freight and shuttle concessions can be awarded to the same concessionaire. Open access is to be allowed other freight operators after five years.

Tonnage handled by ZR has dropped from 2.5 million tons in 1994 to 1.6 million in 1999. With the decline in tonnage, revenues have fallen from $33 million USD to $23 million USD. A large portion of the decrease has been in local traffic, 500,000 tons, and is mainly accounted for by decreased inter-mine movements. With the recent privatization of the copper industry, along with the rebound of world commodity prices, local traffic is expected to recover.

Employment levels have been reduced from approximately 5800 to 3100 in recent years, but 2100 still remain surplus to the needs of the service. With such decreases in business levels and such redundant labor, the railway loses money each year. Funds are obtained from the government. Increases in transit traffic have been hampered by the deteriorating economic and political situation in Zimbabwe, through which all transit traffic must pass. Southbound export traffic and northbound import traffic are similarly constrained by passage through Zimbabwe. The negative effects on regional traffic occasioned by Zimbabwe will not soon resolve.

Given the uncertainty caused by Zimbabwe and the open access issue, it is very doubtful that an international railway investor/operator would invest in Zambia Rail. The most likely scenario is that the major users of the system, the copper companies, will invest in the concession. Their enthusiasm for the concession will be dampened by current circumstances, but they are too dependent upon rail, especially for the inter-mine ore movements, to not attempt to participate in the concession. In the long term, such consortia typically focus their efforts on their vested industries and needs, while general freight customers do not enjoy all of the benefits of a cost efficient, privately operated railway, but at least it might preserve the railway for improvement when and if circumstances improve.

2.4 Zimbabwe

The process for the privatization of National Railway of Zimbabwe (NRZ), with the support of the World Bank, commenced about five years ago. Consultants to support the process carried out several studies, funded by the World Bank. Bids were invited in late 1998 for concessions based on a format that would separate the infrastructure of railways, the equipment, the freight and passenger segments, and would have geographically divided the railway. The response to the bid invitation was good and over 10 bids were received. However, in December 1999, while the bids were under evaluation, the Zimbabwe government decided not to pursue the NRZ concession process. As a result, and because of the political situation, the World Bank withdrew its support to the privatization of railways project in Zimbabwe

NRZ is suffering cash losses and now resorts to commercial borrowings and bank overdrafts. It has, over the years, reduced its staff strength from 17,000 to 11,000. However, even now, staff costs account for over 70 percent of its expenses. The major costs prior to NRZ privatization would be for compensating redundant staff. This cost could be of the order of US$ 75 million. The earlier concession plan called for World Bank funds to be used to finance the retrenchment. Without donor funding of retrenchment, it is doubtful that the railway can be concessioned. Any business plan for operation of the railway would fail when faced with an up front investment of $75 million for retrenchment. It will also be necessary to clean up the very substantial debts carried on NRZ books.

Two possibilities exist for privatizing NRZ. International railway operators/investors will not be involved in NRZ's concession. A bilateral deal involving extension of BBR rights might be arranged but would probably be dependent upon other sources being responsible for retrenchment. BBR's success is so closely dependent upon NRZ that it has good reason to seek the NRZ concession. A second possibility is that a Spoornet subsidiary might have interest in extending the Spoornet reach, but the issue of how to fund the retrenchment remains unresolved. One would assume that if the funds for retrenchment were available, Spoornet would first rationalize its own overstaffed operations before assuming retrenchment obligations of NRZ. An argument could be made that concessioning of NRZ to Spoornet merely replaces one inefficient parastatal with a larger inefficient parastatal, but at this stage the government of Zimbabwe would likely accept any offer.

The NRZ situation of deteriorating service and infrastructure, impacts many of the interregional trade flows which of necessity must pass through Zimbabwe. Its impact is already being felt and will affect ongoing attempts to concession the Limpopo concession in Mozambique, as well as future efforts to concession the Beira line. The value of the Zambia concession is diminished, and NRZ arrangements with BBR have diminished the value of any future concession in Botswana. International flows from the copper belt will be determined by NRZ's ability to move traffic in a timely manner. Prospects for improvement in interregional traffic flows are bleak.

2.5 Tanzania

Both TRC and TAZARA have explored concessioning options. A Presidential Parastatal Sector Reform Commission (PRSC) was set up in 1992 by an act of Parliament to carry out the privatization programme. In mid 1997, PSRC initiated work on privatization of Tanzania Railway Corporation (TRC) and Tanzania Zambia Railway Authority (TAZARA).

PSRC engaged a consultant in July 1997 to advise on measures that could be taken in respect of TRC for introduction of private capital and management and help relieve government of financial burdens while providing better services to customers. The consultant concluded that "in spite of substantial donor support" TRC has not been able to compete with road effectively. It recommends that privatization through long term concessioning of TRC should be pursued vigorously.

Another study, funded by the World Bank, to evaluate the options for the privatization of TRC was carried out in year 2000. This study also recommended concessioning as the most suitable option and provided the format of the proposed concession(s). It appears that TRC and the Ministry of Transport are not in full agreement with the consultant's recommendations with respect to the design of the rail concessions. The Ministry of Transport is currently preparing a Cabinet Note that will recommend the precise parameters for concessioning. After the cabinet approval of the Ministry's proposal, the consultant will be asked to prepare the concession bid documents and commence the process for selecting concessionaire(s). This process is expected to take at least 12 months. The internal target for appointing one or more concessionaires is June 2002. An important issue that will need to be resolved is the method of funding staff reductions.

The government of Tanzania asked PSRC to evaluate the restructuring options for TAZARA and PSRC and ZPA (Zambia Privatisation Agency) discussed the issue in

1997. However, for various reasons, especially the need for the involvement of several agencies and Ministries in the two countries, significant progress could not be made. Later, it was agreed between the two Ministries of Transport that a restructuring options study be carried out for TAZARA and this study should also examine the possibility of joint venture between the owners and Chinese companies to run TAZARA on a commercial basis. In addition, the study should examine the possibility of having a holding company as a concessionnaire that would operate TAZARA through two subsidiaries, one operating the Tanzanian leg and the other operating the Zambian leg of TAZARA.

It is understood that the governments of Tanzania and Zambia (the equal owners of TAZARA) now agree that TAZARA be privatized. They favour a Joint Venture with a private party in which such a party would hold a majority proportion of the equity. It was further noted that the Chinese government also agrees with approach. Shanghai Railway Company was appointed as a consultant to study and recommend the options and the process for joint venture route for privatization in 1999. The consultant is understood to have submitted its report to the Chinese government early in 2001. Further steps will be taken after the Governments of Tanzania and Zambia receive and review the consultant's recommendations. It is expected that the process of privatization will take about 18 months after the three governments agree on a particular format. The most likely outcome will be one that involves Chinese participation. Other international railway operators/investors are unlikely to participate.

Pending legislation in Tanzania will make concessioning of either of the railways much more difficult and will dissuade potential investors. The Surface and Maritime Transport Regulatory Authority Act (SUMATRA), is enabling legislation setting out the powers of the Regulatory Authority as they apply to Public Transport, Ports, Railways and Maritime Sectors. The specific powers of the Regulatory Authority will be set out in the respective Sector Specific Legislation. The broad powers will include "…shall carry out regular review of rates and charges…", subpoena powers, "Grant renew or cancel a license other than a class license", criminal penalties of up to five years imprisonment for anyone "…who contravenes or fails to comply with a provision of this act…" and an annual levy of up to 1.5% of gross annual revenues. The sector specific legislation is not included and could be very onerous, given the very broad and vague nature of SUMATRA. International investors find that such broad regulatory powers lead to uncertainty and that uncertainty will be discounted in the value of the concession.

2.6 Mozambique

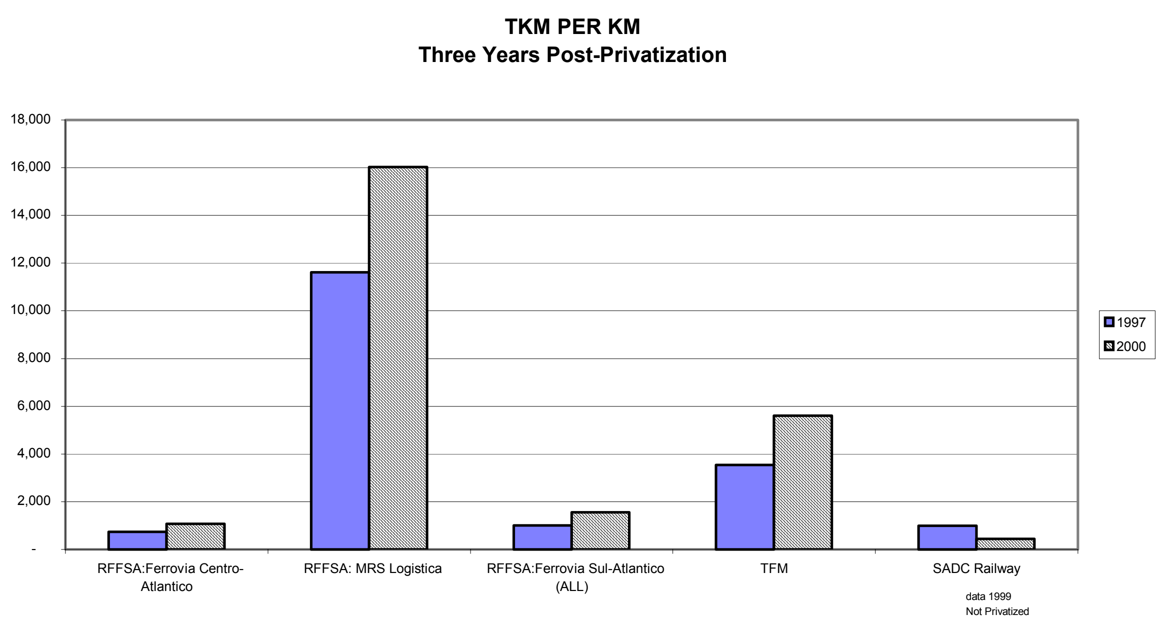
The railway /Port privatization process in Mozambique has been ongoing since 1999. A concession has been negotiated for the Nacala railway line but it is not now expected to be finalized before October. The concessions were awarded for the Goba and Limpopo lines, as well as the marshalling yard and locomotive facility, but transfer of responsibility to the concessionaire has not been made. The Ressano Garcia line concession was awarded Spoornet, but differences remain between the parties and transfer to the concessionaire has not been made.

The concession process has been managed internally by the railway company, CFM, and not by an independent privatization agency. The design of the concessions and the residual responsibilities of CFM bring into question the wisdom of having those with vested interests and strong ties to the railway directing the concessioning effort. World Bank funds for retrenchment have been available, but thus far little improvement in staffing levels, service dependability, or rail tariff levels has been made. Until such improvements are made, traffic handled will continue to decline.

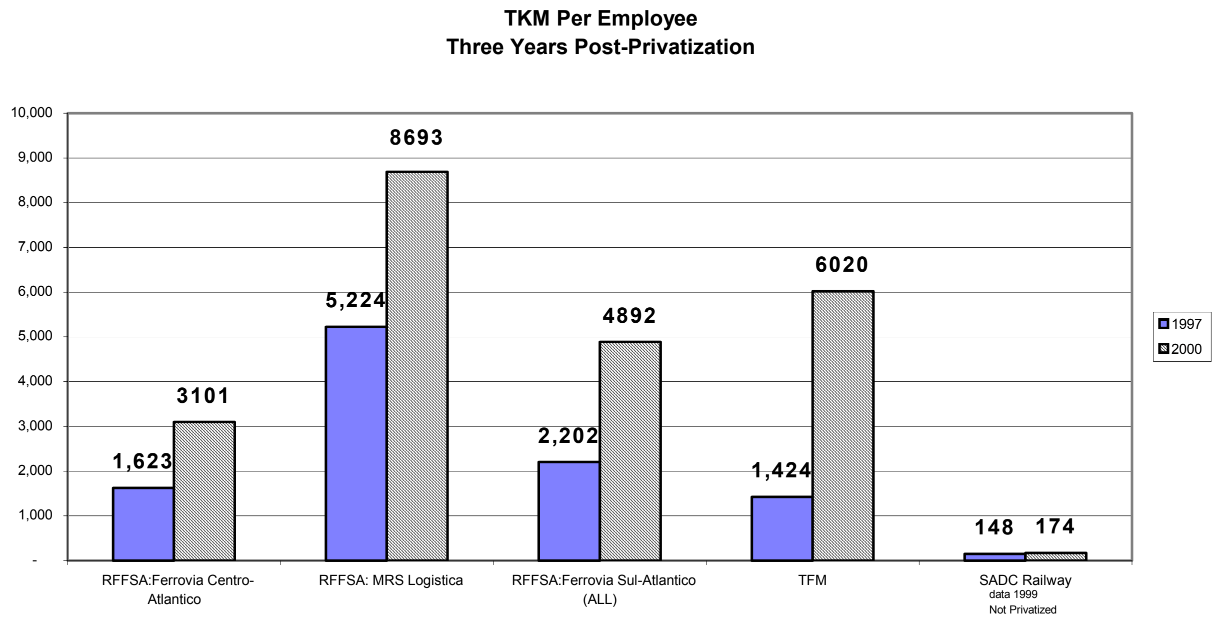
There is a question of the concessions already awarded being consummated and operations transferred to the concessionaire. It is quite possible that the concessions will have to be re-bid or renegotiated and the completion of the process may take several more years.

3. Impact of Lack of Progress in Privatization

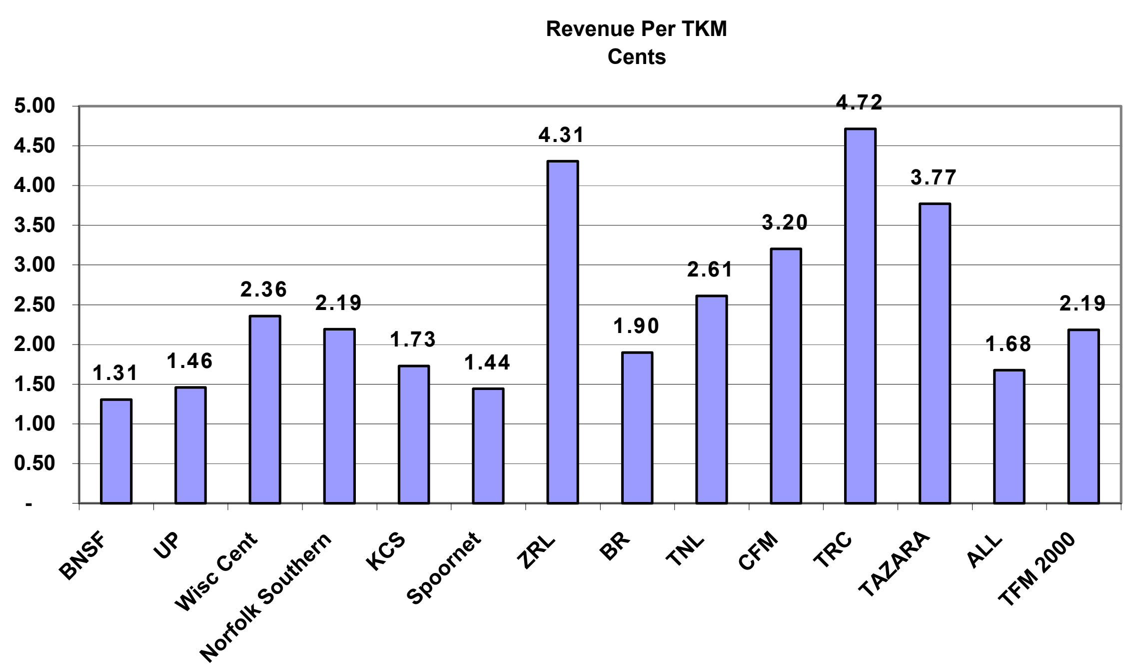
With no clear progress in privatization of the regions railways, the transportation system within SADC does not facilitate increased trade. Service is undependable, tariffs are too high and increasing tonnage is moving to road. Other parts of the world have seen the opposite with transport tariffs being reduced, service improving and volumes increasing, following privatization. The following examples demonstrate the potential outcome of privatization.



The chart above demonstrates the increased business levels experienced by privatized railways in Brazil and Mexico. The initial bar indicates the performance level in the first year <u>following</u> concession (note that the SADC average does not include Spoornet but includes BR, ZRL, CFM, TNL, TRC and TAZARA).



The chart above demonstrates productivity increases following concession. Prior to concession, productivity was much worse than depicted, not much better than SADC. The following chart shows the revenue levels and demonstrates the excessive rate levels on SADC railways. These rate levels, if adjusted for Purchase Price Parity, are even more excessive than here shown.



Only Spoornet, which has significant volumes of bulk commodities, coal and iron ore, shows rate levels comparable with other world railways. Again, if adjusted for PPPI, the differences would be even greater.

4. Lessons From World Railway Privatizations

Most of the railways in Latin America have now been privatized. In Argentina, Brazil and Mexico alone, total annual losses of over US$2.2 billion were eliminated while simultaneously generating payments to the Governments of about $4 billion over the next 30 years. The process began in Argentina in 1990 when the national railway employed over 90,000 employees, and its deficit amounted to almost one percent of GDP. Today, freight ton kilometers have more than doubled since 1993, the year before privatization, and the number of passengers has quadrupled, while employment has been reduced from 90,000 to 17,000.

The Brazilian experience is much the same. America Latina Logistica has gone from 11,000 employees to 2100, while tonnage handled has increased from 12 million tons to over 16 million. MRS system has gone from 41 million tons before concession to over 55 million tons in 1999. FCA has seen a decrease in employment from 14,000 to 2,300 in the past eight years, and following a long decline, business is now increasing. In almost every case tonnage handled by rail has increased and that has a positive impact on trade.

Argentina and Brazil followed the same pattern in concessioning. The national railway was split into smaller regional railways, which were then concessioned as vertically integrated businesses, that is the infrastructure, though still owned by the state, is maintained and operated by the same concessionaire. Concessionaires can grant trackage rights, but generally there is no open access. Mexico's successful privatization is also based upon vertically integrated concessions. Those locations in the world that are currently having difficulties with concessions are those with functionally separated concessions.

Privatization of state owned railways, when properly done, results in improved service, improved infrastructure and increased market share for railways. Private investment in rail equipment and facilities is significant and the deterioration of infrastructure is reversed.

5. Recommended Steps

RAPID's approach to the railway privatization issues in the region have been to become familiar with the railway systems, evaluate their efficiencies and determine the stage of the concessioning process in each of the countries. This has shown that the railways are inefficient and will not improve as long as they remain parastatal. It has also shown that many of the countries, even though signatory to the Protocol on Transport, are not moving forward with plans to concession the railways. Further, in those countries where concessioning has begun, the process has been flawed, has incurred years of delay, and is unlikely to bring about the desired result in the next few years. All the while, cargo shifts to road and railway infrastructure deteriorates. With the deteriorated infrastructure and diminished market share it becomes unlikely that private investors will find a concession attractive.

Governments of the region must be shown that the railways, as now constituted, cannot exist in the long term and that in the short term the railways are constraining trade. Within the government this message must be communicated to the highest levels within the ministries of transport, trade and finance. We have prepared numerous evaluations that well demonstrate the need to concession quickly. Rapid will arrange meetings within select countries and will develop and present materials on a road show in each of the countries. The attached project brief sets out the process that will be followed and the expected results of the road show.