Railway Concessioning in Africa

An Investor's Perspective

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The theme that I would like to explore is "Africa." In particular, why at this point in time Africa can benefit from the lessons that have been learned in North America and South America without having to pay for them.

Background on RDC – Businesses

I would like to give you some background on our company. We are based in Pittsburgh and our business is investment in and management of railways. We have railway investments: (1) in the USA, the *Iowa Interstate Railroad* ("IAIS") (Interestingly the IAIS is a provider of information systems around the world including South Africa, where our dispatching system is used on unsignaled territory.); (2) *Buenos Aires al Pacifico* ("BAP") in Argentina, which is one of the pioneer rail privatizations; (3) *Ferrocarril Mesopotamico*, also in Argentina; and (4) most recently *Ferrovias Guatemala*, which was an abandoned railway that we reopened for commercial service in April 1999.

We are now also doing in business in Africa. We have recently signed a Memorandum of Understanding with CFM who will be our joint venture partner as part of a consortium to concession the *Nacala Port and Railway*. We also anticipate being awarded the Malawi rail concession, which together will present a single integrated commercial unit between Malawi and the Indian Ocean.

Background on RDC – Philosophy

Our philosophy has developed over the years, but I think the most important thing to note is that RDC will go anyplace in the world as long as the country is serious about restructuring. As long as there is a committed "seller", we will be interested. There also must be a transparent, disciplined concessioning process and local partners. And if those conditions are satisfied, then there is very fertile ground for whatever transaction may be contemplated. RDC is also a believer in management investment; we feel that management should take risks along with the investors in the enterprise. And finally, we believe that marketing is even more important than cost control. Those are the basic elements of our philosophy.

Successful restructuring has been driven by marketing…

Let's look at history and talk about what has really driven restructuring. I would argue that Europe is behind Africa, and the reason is that the Europeans are still trying to figure out how to restructure. They are still trying to identify what their core markets are, reconfigure their assets around those markets, and separate the other assets. An example is the ongoing debate as to when, how, and where Open Access will be implemented throughout the continent. It has been done pervasively in England, but it has barely begun in France. Compare that with Latin America, where restructuring is approaching its first decade of existence, and the results are there for everyone to see. The core markets are building, the volume is building, and there is capital flowing into Latin America, which 10 years ago would have been described as a basket case.

The phase that the U.S. is in I would describe as the prosperity phase, meaning that railways have penetrated to about the maximum extent that they are likely to penetrate. So we are looking at very small incremental improvements on very specific types of traffic such as intermodal and other traffic which is increasingly marginal and difficult to get. Quite frankly, that is why RDC is looking at Africa, because the potential to make a difference is much greater here than it is in our country.

…Conversely, misreading the market has led to expensive mistakes

I think it is important to note that, when you consider options for Africa, it is in the marketing area that the most expensive form of mistakes that have been made. If you look at why bankruptcies have occurred in the USA and Europe, it is usually due to revenue shortfalls and not cost overruns. Railway managers can control costs but they cannot dictate whether there will be a steel mill at the end of every branch line. It is also important to consider that the price has to be right. If you pay too much, then you will be a financial cripple from Day 1 and be unable to even make your capital investment programs. It is also worth noting that there has been a lot of wasted investment in North America and Europe. My background is that I came from Conrail. In the early years of Conrail, we rehabilitated our electric locomotive fleet and it was put into storage even before it could be put back into use, because the traffic shifted from the electric lines to the diesel lines. The locomotives were subsequently cut up for scrap.

The fundamentals of Africa's freight railways are sound…

If you look at the fundamentals of railways in Africa, I would argue that they are quite sound. Note that our philosophy is that revenue is the most important factor, more important than costs. Look at the difference between Africa and Europe. In Europe, under Open Access, the competition is other railways operating on the same infrastructure, i.e. with essentially the same variable cost structure. The ability to have anything better than a breakeven margin will be difficult to achieve. Contrast that with Latin America or Southern Africa where the competition is trucks. I would argue that this is a very favorable environment. You can have a true franchise in Latin America and Africa. And I would also argue that, because the market share is low in Latin America and medium in Southern Africa, there is still room to grow. It is not like the USA where if we have a 5 or 10 percent increase in our business, that is considered dramatic. There is no question that there are cost problems both in Latin America and in Africa, but those are problems that we as railway managers can solve.

…Making concessioning preferable to commercialization

I prepared this topic before I came to this conference and I think it is very interesting that there has not been much discussion here about commercialization and that most of the discussion has been about concessioning. I think that there is an increasing acceptance that while commercialization is better than ongoing losses, really what you have in the form of concessioning is: private financing, which keeps it out of the treasury; a lower threshold in terms of political sensitivity; and a focus on the customer, as opposed to staying under government ownership where the focus is more on the process.

Africa will support market-specific private sector solutions…

It is also worthy of note that it is not just in the freight sector that there are models that can be translated to Africa. Regardless of whether it is passenger or freight, you can now look at many places in the world for examples. In Australia, intercity passenger service is being privatized, and New Zealand Rail runs a profitable passenger service. Argentina was the first country to concession its suburban service. So at this point, you can find examples that you can use, with appropriate modifications, in your own country.

…However, many transactions will probably require public investment to attract private investment

The above being said, I think it is unrealistic to expect that every railway in Africa can be made into a stand-alone profitable business without participation from the public sector. It is a fact that, for example, in West Africa there are a lot of relatively short stand-alone railways and it is often a question of size. Looking at a country like Jamaica, they do not really have any track or equipment because the railway was abandoned 10 years ago. Even if the railway were put back into service, what would be the constraints on the market? Well, they really do not have a substantial length of haul because it is an island; the traffic potential is limited, because with the exception of bauxite there is not that much heavy haul traffic available; and the fact that they closed the railway 10 years ago and the customers are obviously doing something else, will make it extremely difficult for Jamaica to come back. With that being said, Guatemala is also on this list, and in Guatemala we made an investment and it has been running now for several months. So there are exceptions but one has to really focus on the market and the cost for achieving that market.

Results of concessioning have been mixed…

Let's look at the results to date of concessioning. I would argue that it has really been a mixed bag. Let's discuss the positives first. In Latin America, operating performance, investment programs, traffic increases, and lower tariffs to the customer are all being achieved. In the area of capital gains, we recently re-capitalized the two railways in Argentina and we have found that they are worth more than they used to be. So, there is progress being made.

On the other hand, there have been negatives. Those negatives include the fact that on many concessions the traffic has been less than forecast. I think that the governments themselves have been very disappointed that there have been only one or two bidders, even for the biggest concessions in Mexico. Governments look at what has happened with businesses like electricity and telephones, where there have been dozens of bidders; and they are surprised and disappointed that for railways there have only been two or three. That is the nature of the business.

What is also disappointing to me is that railways have been liquidated before other options such as privatization or concessioning have been considered. For example, Nicaragua's railway was scrapped in 1994 even as other railways in Central America are coming back. There is also the tendency for political interference, which we have experienced in places ranging from Pakistan to the State of New York in our own country.

…And future transactions are also likely to have mixed results

I would like to predict that results are going to continue to be mixed in the future. Railways will continue to prove that they are efficient, and the capital markets will continue to support railway investment. Even in a little country like Guatemala we were able to raise financing in the local markets. Also the macro economies are, as a result of restructuring, improving and the size of the market available to the railways is going to increase. On the other hand, I think that the negatives will continue in that, for example, governments will continue to be disappointed at the level of interest from the private sector relative to other businesses like electricity, telephones, etc. And I think that there will continue to be plans that do not make sense. One classic example is the "Dry Canal" where every country between Mexico and Colombia is planning to have their own railway, whose business plan is to drain traffic from the Panama Canal. The flaw in that logic is that even if that economic prospect might exist, people forget that the Panama Railroad parallels the Panama Canal. The Panama Railroad is 50 miles long and it is flat. Let me assure you that we have no expectations that our 250-mile railway in Guatemala, with its 3.7 percent grades, is going to compete with a 50-mile flat railroad across Panama.

Conclusions

To conclude, Africa's railways are true franchises unless some consultant sells Open Access. The competition is trucks, not other railways. The economies in Africa are on the rebound–Mozambique is a classic example. And the fact that there are high cost structures in Africa suggests that there is plenty of room for improvement. However, I think that as an investor one needs to consider that there is a substantial amount of revenue risk, meaning one does not know what the traffic is going to be with any great precision simply because these railways have not been particularly active in their own markets. I think in terms of financing, this is going to be very difficult because there has never been a private sector railway in many countries. Marketing is more important than cost reduction. It is easy to fire people; this has been pervasive in the USA. What is difficult is growing the business so that you can hire people. Commercialization is a compromise; concessioning is, in our opinion, the way forward. Again, the benefit is that Africa can look to Latin America to get free consulting, to avoid the mistakes, to look at what went wrong in Latin America, and not repeat it.

Case Study: Latin America

(1)


(2)


Now, I know what you are thinking: here is a guy from the USA and he is talking about Africa. African conditions are not American conditions and I accept that. Here is a picture of a typical American train and, in this case, it is our Iowa Interstate Railroad (photo 1). There are relatively modern facilities and a fully functional intermodal system, so what does this have to do with Africa? Well, let me give you some examples of what happened in Latin America, which I would argue was worse than what's happened in Africa.

(3)


This is our locomotive fleet in Argentina before privatization (photo 2); and this is the same locomotive after privatization (photo 3). The locomotives have not been rebuilt; they have just been repaired and repainted. Locomotives run better in fresh paint—it is a self-esteem thing.

(4)


The communication system was of the turn-of-the-century in Argentina before privatization; and this what we are doing now. We have essentially the Iowa Interstate system with one guy sitting at a computer with a radio, nobody in the stations, and that is how we move the traffic (photo 4).

You also do not necessarily need to spend a lot of money in order to make a railway viable. In the case of Argentina, we had a lot of cattle wagons but no cattle traffic. We also had a workshop with plenty of capacity, so we cut the tops off of the cattle wagons and we use them for moving containers. This is not an optimal solution from an engineering perspective, but we are moving the business.

You also do not necessarily need to invest in expensive intermodal facilities. We are trying not to have derailments anymore so we are able to use our Takraf crane to load containers. And for basic traffic like boxcar traffic where things move in bags, one type of intermodal business is to carry the bags one-by-one by manual labor.

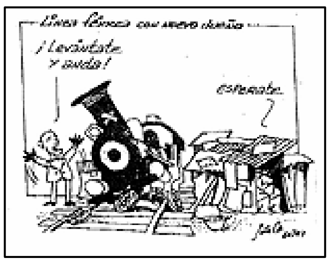
A more extreme example, which is possibly more relevant for some of the railways in Africa, is what happened in Guatemala. What we are doing in the initial phase is reopening the line from Guatemala City to the Atlantic Ocean. The system runs from Mexico to El Salvador and from the Atlantic to the

Pacific. But we're just completing the reopening of the section from Guatemala City to the Atlantic in September of this year; currently we're running between the cement plant and Guatemala City.

(5)

(6)

(7)



(8)

(9)

(10)

This was the mainline after the railway was abandoned; it had been taken over by squatters (photo 5).

A train had been derailed in place because the bolts holding the bogies together had been stolen. And the rails were being stolen from the main line. The only rail service running in Guatemala for three years was a private sector "push car" light rail operation (photo 6), which fortunately for us had the effect of protecting the mainline because, as long as the rails were there, the private sector would benefit from their use.

When we signed the concession, this was the reaction of the press. The guy in the bow tie is telling the derailed steam locomotive, "Get up and go!" and the squatter in the shack is saying, "Wait!" (photo 7).

One of the other problems we had was Hurricane Mitch, which destroyed three of our major bridges. Here you see a bridge that is about a quarter of a kilometer down from where it used to be because it was carried away by the flood (photo 8). So how did we solve all of this? Fortunately manual labor in Guatemala is relatively cheap, so the first thing we did was dig up the track and then manually replace only 25 percent of the sleepers (photo 9).

So this is what our completely upgraded mainline looks like – no ballast, 25 percent of the ties have been replaced, which is adequate for a 40 kilometer per hour freight operation (photo 10). Bob Pietrandrea, the President of our company, is the person who came up with this plan. Without this plan, this would never have happened, because it was the only way to justify an investment in this railway.

(11)

(12)

(13)

In the case of washouts, there has been some very creative civil engineering—drive rails into the side of the hill, put boxcar doors against them, and put dirt in as fill (photo 11). Again, these are not optimal from an engineering perspective but they allow us to operate commercially. To the extent that we are successful, we can always go back and put in concrete ties and electrification later. We are also rebuilding bridges, and again, the most sophisticated piece of equipment we are using is a cement mixer (photo12).

For the locomotives, just like in Argentina, it is a case of using the spare parts, which as it turns out, were in the warehouse. And again, the best way to raise the self-esteem of a locomotive is to paint it. This is what many people thought was an impossible dream. The private sector restoration of a national rail system has never been done (photo 13).

Let’s talk about Mozambique. Mozambique has modern locomotives and substantial workshop capacity, so why shouldn’t this work? It will work! The way we do business is not as the “Railroad Development Corporation Show”. We do business with partners and, we view joint ventures as the way forward. In Mozambique, our joint venture partners in the consortium include CFM, which is among the most pragmatic and business-oriented organizations that I have come across in my career. This will be a successful business and we are very pleased to be doing business in Africa.

Thank you.

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