Rewards Down the Line

Potential rewards in Latin American rail privatizations justify the work and the risk.

By Henry Posner III

Freight railways in the U.S. are profitable businesses, largely owing to deregulation in 1980. Unlike trucking, airlines or water transportation, railways are a franchise business in most cases—only one railroad serves the customer. Rail enjoys cost advantages over other modes of transportation, particularly trucking, with regard to low-value, high-volume, long-haul commodities such as grain, coal, chemicals and steel. Rail has also penetrated the higher-value truck market, where sufficient volume exists to support dedicated intermodal service.

Hoping to duplicate the success of the U.S. rail industry, countries throughout Latin America have begun privatizing their state-owned railways. Argentina was the first. In 1991 it divided its 30,000-kilometer freight network into six operating entities and offered each for 30-year concessions. Bolivia has already copied the Argentinean model, and Mexico, Brazil and Colombia are in the process of doing so.

These are not traditional build-operate-transfer (BOT) projects but what I like to call ROT deals (rehabilitate-operate-transfer). In most Latin American countries, the rail infrastructure is in desperate need of upgrading; the rolling stock is antiquated or mismatched to freight markets; and the railways lack modern communications systems. Furthermore, many governments have an unrealistically high idea of what these concessions are worth.

Compared to telecommunications, electricity or other privatizations, railways in Latin America have generated little interest among international investors. For the most part, U.S. rail investors perceive Latin American transactions to be management-intensive, capital-intensive and relatively risky when compared to domestic opportunities. Therefore, the number of bidders on the dozen or so railways that have been privatized in the region over the past few years has been modest at best.

Sound Fundamentals

So why should anyone invest in railways in Latin America? Because in many cases the economic fundamentals, especially with regard to freight markets, are quite sound. Revenue is usually more important than costs in the determination of value. And the lessons learned in the U.S. are that railways have failed for revenue reasons, not because of operating costs.

Obviously, costs are important, but railway managers know how to control them. For example, in many cases we can reduce staffing levels and other operating expenses in line with a shortfall in traffic. Similarly, we can renegotiate labor agreements as long as sufficient trust exists between labor and management. What we can't control is the revenue side of the equation—whether the steel mill at the end of a branch line will stay open.

However, the revenue side of the equation in Latin America is quite positive. Trucking is the main competition, whereas in the U.S., competition comes from both trucking and other railways. And the prospects in Latin America are certainly better

Privatization Runs Along Different Tracks

	U.S.	ARGENTINA	SWEDEN	NEW ZEALAND	U.K.	CHILE
Franchise Scope	Region	Region	Branches	Country	Country	Region
Number of Franchises	1	6	Unlimited	1	5 initially	1 initially
Franchise Type	Exclusive	Exclusive	Open Access	Exclusive	Open Access	Open Access
Transaction Year	1987	1991 – present	1988 – present	1993	1995 and beyond	1995
Infrastructure Transaction	Purchase	Lease	Utilization Fee	Purchase	Utilization Fee	Utilization Fee—core lines; Lease-branch lines
Initial Rolling Stock Transaction	Purchase	Lease	Purchase	Purchase	Purchase	Purchase
Ongoing Subsidy	None	None	As needed	None	As needed	None
Example	Conrail	BAP	Osterlentag	NZRL	EW & S	Fepasa
PRIMARY GOVERNMENT OBJECTIVES:						
Reduce/Eliminate Losses	X	X	X		X	X
Improve Service/ Lower Transportation Costs		X			X	X
Raise Cash	X	X		X		X

Source: Railroad Development Corp.

than in Europe, where competition now comes from trucks but in the future will also come from evolving open-access policies, whereby any rail operator can use the same tracks for the same variable cost.

The European open-access model, I believe, is a disincentive to investment. Its effect is to destroy much of the franchise value of railways by opening them up to cannibalization by other operators running on the same tracks with the same costs. This is analogous to the U.S. domestic airline industry—hardly an attractive model for risk capital. Fortunately, only one Latin American country—Chile—has adopted this model.

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A Diverse Market

Latin America is also ripe for railway investment because rails' market share is quite low. It was almost zero when in 1993 our group took over both the ownership and operation of Buenos Aires al Pacifico (BAP) in Argentina—the 4,800-kilometer concession running from Buenos Aires to the Chilean border at Mendoza—and the Ferrocarril Mesopotamico, the 2,800-kilometer concession running from Buenos Aires to Brazil, Paraguay and Uruguay. By contrast, the market share for railways in the U.S. is mature.

It is important to note, however, that the smaller railways in Latin America will still require public investment to attract private capital. For some countries, there is a real question as to whether their railways will survive without substantial public investment. If one looks at the combination of capital needs and market constraints (such as potential demand and length of haul), the picture is not always encouraging.

In North America, a 300-mile length of haul is considered the minimum needed to compete with trucks. In a country such as Jamaica or Panama, the length of haul tends to be 50 miles or less, because that's the width of the country.

On the other hand, Paraguay's railway, although in very poor condition, offers interesting possibilities. As an extension of the Argentinean network, the through length of haul is truck-competitive and the demand exists, though probably not enough for the private sector to justify the rehabilitation required.

So where are the opportunities? The Brazilian railway system has heavy-haul, relatively modern assets. Its railways will survive and prosper. And in fact the market response has been good to date, with three networks auctioned to strong bidders as of October 1996.

Mexico's two major concessions, both running from the U.S. border to Mexico City, are much like Brazil: heavy traffic, good infrastructure, substantial value. So the market response should be positive, with several competitive bidders for each. These concessions are expected to be awarded by early 1997. Mexico's lighter-density network will follow and is likely to prove less attractive.

In Peru the equipment and track are in good condition. Unfortunately, the problem is the amount of freight traffic that is likely to be available to the railway. Chile's Fepasa has not met short-term expectations—more because of operational factors than market demand. But in the long run, it is also expected to be a solid business on its 3,700-kilometer system, which runs south from Santiago.

Perhaps the saddest story in Latin America is Guatemala. The Guatemala railway is legendary for its civil engineering and its route through this spectacularly beautiful country. Unfortunately, the service has recently been suspended—just as it has also been in Costa Rica and Jamaica—decisions that are likely to prove shortsighted.

Each of these countries has pretensions toward privatization. But the fact that the respective central governments chose to close the systems to stem operating losses has forced the few remaining rail customers to find alternative methods of transportation—and even to invest in trucking operations. That means it will be very difficult and expensive to revive these railways.

The results of rail privatizations in Latin America to date, then, have been mixed. In Argentina three of the lines that were privatized in 1992 and 1993—BAP, Ferrosur Roca and Nuevo Central Argentino—are making profits. The traffic increase has been dramatic, more than doubling on each concession in the first three years. There have been substantial traffic shortfalls on the other Argentinean concessions, particularly on the Ferroexpreso Pampeano.

From the perspective of the selling or concessioning governments, the privatization programs have also been disappointing in terms of investor interest. In Argentina there were only one or two bidders for each of the concessions. Likewise, in Bolivia, where seven groups were prequalified, only one actually bid for the two concessions that were offered. In Chile there was only one bidder for Fepasa. And in each of the three Brazilian privatizations so far, the number of bidders has been one or two.

Looking Forward

As for future transactions, the results are also likely to be mixed. The efficiency of the railways will continue to improve wherever privatization occurs. This will be proven again in the next several years in both Brazil and Mexico. However, the expectations of the sellers will probably continue to be too high. For example, in October the Mexican government withdrew its first rail privatization after the only bid fell substantially short of the minimum price set by the government. And Nicaragua, which scrapped its existing system in 1994 without even considering privatizing it, now hopes to follow Costa Rica and Mexico in pursuit of the elusive "dry canal" between the Atlantic and Pacific oceans, pointedly ignoring the pending revival of the Panama Railroad.

Our philosophy: Every deal is a good one at the right price. The challenge therefore is to be selective in the identification of transactions. Latin America is a more difficult environment than the U.S., but the potential rewards justify the work and the risk. ■

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