# Renegotiation of Freight Railway Concessions

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Today I will present an overview of Railroad Development Corporation ("RDC") and some of the businesses we are involved in; the railway business in the USA, and in particular the Short Line business, which is the business we are in; railway concessioning as it exists elsewhere in the world; and draw some conclusions. I would also like to present a Case Study of the current situation in Guatemala.

## Background on RDC – General

RDC is a railway investment and management company based in Pittsburgh, Pennsylvania, USA. Our focus is on "Emerging Corridors in Emerging Markets." One year ago I would have told you that RDC is a railway investment company; but some of the businesses that we are now involved with include ports. In particular, in Mozambique we are the process of taking over a railway and port; also much of our growth in Peru and Guatemala will come from increased integration with port facilities. We are also looking at opportunities such as fiber optics and pipelines. Therefore I see it becoming more of a corridor business than just a rail transportation business.

In each of the countries in which we do business, we are in joint ventures with local people. RDC feels it is important to be an expert in the railway business, but it is more important to be integrated into the local culture and the local economy. So in each of these railways is a completely different structure, with a completely different strategy, with completely different investors. I am also very proud that RDC is the only U.S. company investing in Africa, and for us, that is the next Latin America.

## Background on RDC – Transactions

Our business in the USA is the **Iowa Interstate Railroad** (IAIS), which runs from Chicago to Omaha. It is formed from pieces of an abandoned railroad called the Rock Island, which actually went into liquidation during the worst years of railroad bankruptcies in the USA in 1980. It was restored as a through route in 1984 and RDC became involved in 1991.

In Argentina, RDC is one of the shareholders of **Buenos Aires al Pacifico** and **Ferrocarril Mesopotamico**. These railways are two of the concessions that were referenced in the earlier presentation about Argentina, and together form the backbone of the Mercosur corridor linking Argentina with Brazil, Paraguay, Uruguay and Chile.

An extreme example of a business that RDC is involved with is in Guatemala – **Ferrovias Guatemala**. The railway was abandoned in 1996 – one of very few countries to abandon its entire railway system. This railway is now running again. You are invited to review this case study at the end of this presentation.

In Peru, RDC is one of the shareholders in **Ferrocarril Central Andino**, the world's highest railway. This is a transaction that we are very proud of and it is a wonderful piece of engineering. But more important than engineering is the fact that it carries a significant amount of traffic. It's an important engine of economic growth for the Andean region and we look to double our business in the next five years.

**Central East African Railways** – In Africa, as I said before, RDC is the first U.S. investor in African railways and, in fact, we are the first Private Sector railway company to invest in the continent, which we are very proud of as well. Like all of the other businesses that I just described, in this particular case, our shareholders include Mozambicans.

Again, culture is more important than technology. If we are not being integrated into the local culture and the local economy, we as a company will not succeed. That is why in every case RDC is doing joint ventures; this is NOT "The RDC Show."

Along the theme of "Emerging Corridors in Emerging Markets" as I've discussed, we are in the process of integrating the **Nacala Railway and Port** in Mozambique with the Malawi Railway. Again, "Emerging Corridors in Emerging Markets."

## USA Short Line Trends

Why is RDC investing in Latin American railways if the Short Line business is so good in the USA? With the Short Line business in the USA, we are not competing with trucks – we are competing with other buyers. Typically there are many potential buyers and what results is an auction process where the railway ends up being owned by the group that offers the highest price. This is quite often not sustainable; and as a result, it is a business that RDC has not been successful in because we have not been willing to pay prices that are too high. Further, we believe that this is not going to change anytime soon.

### *Strengths*

The Short Line railroads are important and they do have definite strengths that they bring to the rail network, in particular, a retail focus in which a locally managed railway will get much closer to the customer than a railway managed by a Class 1.

### *Weaknesses*

Nonetheless, we see these railways as having less of an advantage in the future. First of the all, the big railroads – the Class 1's – have reduced their costs. So a low-cost Short Line is not that much better off than a slightly higher cost Class 1 railroad. Secondly, in the USA we are evolving into an era of labor shortages. While in the past one of the ways to finance these deals was by cutting wages, this is no longer possible because we are experiencing a shortage of skilled labor in the U.S. So we have to pay people more to keep them on the job. I also believe that as the big railways continue to consolidate and there are fewer and fewer Class 1's to connect with, the importance of any one Short Line is much smaller. A Short Line is fixed and if its Class 1 connection doubles in size, that means the Short Line is half as important as it used to be as a feeder of traffic.

Short Lines in the past were very useful for political support of the mergers and strategies of the Class 1 railroads. The era of consolidation is more or less behind us in the U.S. so that political support is no longer necessary. Again, competition will continue to be very fierce among the many buyers looking to buy the very few lines for sale.

### *Options*

So what are the options that we have for doing transactions in this environment? We can be more aggressive in marketing, except that our competitors are also more aggressive in marketing. We can renegotiate the deal, meaning we can offer a higher price and then withdraw that price before we close the deal, forcing the seller to accept less money. We could buy the line and then go back to the railway that we had just bought it from and renegotiate the commercial arrangements. We could stop maintaining our track and have the local government pick up the cost because it's infrastructure. We could extend our payables, which is a very nice way of saying, "don't pay our bills." Or we could look overseas for better opportunities, which is what RDC has chosen to do.

## **Overseas Trends**

### *Positive*

Investing overseas is a positive in that the competition is trucks and not other railways. In Latin America and Africa, there are no parallel railways competing with each other like in the USA. There are cost problems, but that is an opportunity for improvement. For these reasons we believe that railways overseas can be just as profitable as railways in the USA.

### *Negative*

On the other hand, revenue is much harder to predict, especially when a railway has been abandoned, under-maintained, or badly operated. So the risk of a revenue shortfall, which is the single biggest determinant of value, is much greater. In the cost area, it is especially difficult to obtain financing because in a country where the railways have already been in the government's hands, there has never been private sector financing of railways. As I mentioned earlier, there needs to be a lot of work on the cultural and logistical areas to make sure that the ideas that come from outside the country are actually put to work and embraced by the workforce.

### *Options*

In this environment there are many of the same options as in the USA – be more aggressive, renegotiate the deals, etc. But where does that leave us? This is a question of both economics and ethics. Let me now draw some conclusions.

## **Conclusions**

### *USA Transactions*

The market in the USA will continue to be extremely competitive and not be a particularly good place for investment because there will be plenty of buyers pushing the prices up. In fact, the focus will be more on how one manipulates the game than the actual price paid.

### *Overseas Transactions*

Overseas, since it will be less competitive in a more difficult market, we will be under less pressure to make deals that are fundamentally unhealthy. RDC is doing more investment in the developing world. However, success will continue to focus on as much as understanding the country as understanding the railroad business, and a high tolerance of risk.

At this point I would like to present our activities in Guatemala as a Case Study in which many of the above factors are applicable.

# CASE STUDY: GUATEMALA

**1996…ABANDONMENT** — In 1996, the railway was abandoned, and in fact, the only service in Guatemala was this private sector light rail service, which actually helped preserve the infrastructure as there was a problem with rails being stolen from the mainline.

**1997…ACCELERATED DETERIORATION** — In the three years that the railway stood abandoned, there was no maintenance done. As a result, when it rained, many of the bridges were washed away.

**1998…REHABILITATION BEGINS**— In 1998, we began work to rehabilitate the railway. Let me say, that this not a TGV. This is a low technology labor-intensive solution based on the railway's ability to survive. I am very proud to say that we provided hundreds of manual labor jobs putting this railway back into operation. And what you do not see are concrete ties nor electrification.

**1998…REHABILITATION** (cont.) — We rebuilt this bridge using 50 manual laborers and the highest technology was a cement mixer. The cost of the entire project – 200 miles of a national railway system, track, rolling stock, etc. – under US$10 million. Why? Well, a railway with no revenue cannot justify an investment much higher than that.

**1998…HURRICANE MITCH** — We were in the middle of rehabilitation when Hurricane Mitch struck in 1998. This is one of our mainline bridges after Hurricane Mitch.

**1999…MORE STORMS** — Nonetheless, in 1999, despite more storms that severed our mainline again.

**1999…CREATIVE ENGINEERING** — After some creative engineering that included dragging the bridge pictured previously back into position using a bulldozer and a front-end loader (Truly a low technology approach!).

**1999…COMMERCIAL OPERATION RESTORED** — The railway was opened for commercial traffic.

**2000…MOVING TRAFFIC** — Now in the year 2000 we are moving containers and steel.


**2000…MOVING TRAFFIC** (cont.) — and we're moving Cuban sugar (!) commercially in Guatemala.

This project is a project that I take great personal satisfaction from being associated with because it is a combination of both economics and values.


I would like to say that there is a message here…for these types of deals, it has to be more than a business – it has to be a cause. A cause that must be committed to with sufficient resources to see it through. In the case of Guatemala we did NOT renegotiate the concession. We rebuilt this railroad as we promised the government. It was late because Hurricane Mitch was not in the business plan. But we did it, not only because it is a good business, but also because we are committed to the business.

A LUTA CONTINUA!

I would like to end on an optimistic note and actually with a quote that comes from Samora Machel, the first President of independent Mozambique, "A luta continua!" or "The struggle continues!" RDC is optimistic for railways in the developing world as long as we are not alone in the struggle. What that means is – as long as there are countries that are willing to have us, as long as we find can joint venture partners, and as long as we have the cooperation of the railway people – the struggle is worth continuing. Again, "A luta continua!"

## Question-and Answer Session

**Q: When the Argentines sold out to the Brazilians, what happened to your participation?**

A: We have remained shareholders with the Brazilians. We believe that it was a good business despite the problems and we believe that is a better business integrated with Brazil. The main potential of the railway is integration for international traffic. In the earlier presentation you saw a railway whose track was under water – that was our mainline. We recently completed a detour around the lake, which was just like Hurricane Mitch – it was not in the business plan. But we believe that the reason this is a good business is because international traffic flows that have never moved by rail can be diverted. A great example of this is the Roadrailers that are now running between Sao Paulo and Buenos Aires.

**Q: It has been stated that many of the lines privatized in Argentina are now in fact, closed. Can you comment on this?**

A: I cannot respond with a statistical breakdown of the lines that are being operated, but I can tell you that, for legitimate reasons, it is true that parts of the network where there is no traffic have not operated since the early days of privatization. One excellent example is the line to Malargue, which was one of our biggest movements – petroleum. However, after the railway was privatized, YPF built a pipeline across the Andes and that business now goes to the Pacific. So there are no carloads of petroleum to move and for that reason the line is closed.

In terms of the percent of the network, again there is a significant percentage that is not operating but on those pieces of the network, we have no traffic. We are attempting to develop additional traffic. A good example of that is the line to Rojas that was basically closed. We have opened it as an inland port for imports from

Brazil. If the focus is on, “Are you maintaining 100 percent of the network?” my opinion is that would have been a bad allocation of resources, because where there is no business, there is no point in operating trains. The railway is mothballed and, if traffic evolves, it will be reopened.

Nobody has accused us of cutting service when there was no business. I believe that is a model that is followed everywhere in the world – where there is no traffic, the railway ceases to operate. The benefit in Argentina, however, of not owning the assets is that the assets are going to stay there. They are not going to be hauled away for scrap. If there is a potential for traffic in the future, then the line will operate.

**Q: How did you analyze the concession in Guatemala?**

A: We approached Guatemala the same we have looked anyplace else. We identified traffic which was likely to be divertible to rail – nothing exotic, basically containers, steel, cement, coal and the traditional businesses that railways handle anywhere in the world. We developed a revenue projection based on what we thought would be a reasonable amount of traffic diverted from truck. We also recognized that we would have to offer a lower price in order to attract the business. Then we attempted to put a cost structure together which was sustainable in that environment. That’s really it.

In terms of financing, in Guatemala we have Guatemalan investors who were put together using a local investment bank; in Mozambique we also identified a local investor group. It’s a relatively unsophisticated approach, but I think that the key is simply to go to a country and find out how it works, and then try to come up with something that meets their needs.

Thank you very much.

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