



Railway market liberalization in Ukraine

CES and FSR Transport joint research project
Preliminary findings

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Why does the Ukrainian railway system matter?

Key pan-European transit corridors



Key player in European railway market

#1

in Europe by cargo transportation turnover (Ukraine – 187 bn tkm, Germany – 116 bn tkm)

#5

in Europe by volume of passenger traffic (UK – 51 bn pkm, Italy – 51 bn pkm, Ukraine – 37 bn pkm)

#3

in Europe by railways line in use (Germany – 39 th km, France – 29 th km, Ukraine – 20 th km)

But... inferior to neighbours

Ukraine 2018

Infrastructure



Source: World Bank, Logistic Performance Index

Will the EU-Ukraine Association Agreement make Ukrainian infrastructure more efficient?

Key goals of the Association Agreement (Transport sections)

- Creation of a free trade area between Ukraine and the EU
- Integration of Ukrainian transport infrastructure in the Trans European Transport network
- Incorporating EU key rules in Ukrainian transport legislation and practice
- Increasing railway trade and travel flows with EU.

Indicative TEN-T Investment Action Plan (Eastern Partnership)



Source: <https://ec.europa.eu>

At the beginning of 2019 the Ukrainian policy think-tank Centre for Economic Strategy (CES) and Florence School of Regulation, Transport Area (FSR Transport) agreed to undertake joint research on the topic of railway market liberalization between the EU and Ukraine.

Key research questions:

Is the Ukrainian railway market ready for liberalization? If so, then which specific segments?

How can Ukraine apply EU countries' experience of opening their railways markets?

Which lessons should Ukraine learn from ongoing railway market liberalization in Europe?

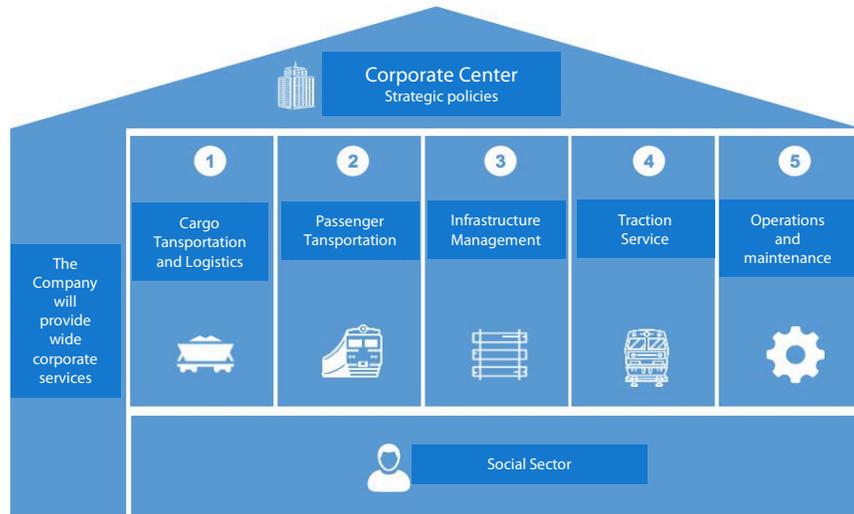
Which regulations should Ukraine envisage prior to the mutual opening of the EU and Ukrainian railway markets?

Under which circumstances can Ukraine realize the opportunity from mutual opening of EU and Ukrainian rail transport markets?

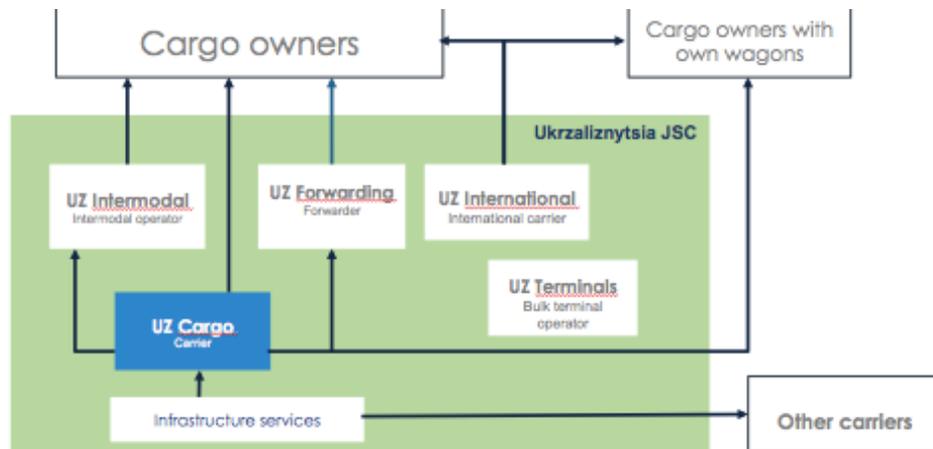
Ukrzaliznytsia – fit for liberalization?

Strategy target model

Ukrzaliznytsia's corporate target structure



Ukrzaliznytsia's core freight transportation business target structure



Source: Ukrzaliznytsia (2017)

Strategic plan includes:

- Explicit separation of the company's operations in five business directions (cargo services and logistics, passenger services, infrastructure, traction services, maintenance)
- Detailed development and investment plan for each business direction
- Detailed work of implementation regulations, building institutions and designing processes is still to be done
- The strategy's core is the company's UAH 132.2 bn investment plan for 2017-2021, with a focus on investment into upgrading its rolling stock, traction and railway infrastructure

Institutional setting for railway market in EU



Source: European Commission (2016)

Key performance metrics in 2018

Financials

- ✓ Sales increased 10% to \$3.1bn in 2018, reflecting a 15% freight tariff hike in late 2017 and sharp upward revision of railcar tariffs following their liberalization.
- ✓ Weak liquidity position – debt repayment major issue this year
- ✓ Debt dropped in 2018 for the third consecutive year, but Net Debt/EBITDA rose on lower EBITDA
- ✓ Net losses in passenger transportation business

Strategy

- ✓ Liberalization of freight wagon component
- ✓ Sizeable investment targets – \$2.8 bln over next 5 years.
- ✓ Strategy long-term renewable purchase program for diesel and electric locomotives
- ✓ Strategy cooperation with EBRD, EIB, World Bank

Corporate governance

- ✓ Corporate governance progress: new Supervisory Board and Management Board appointed.
- ✓ Corporate governance action plan approved and keep on track.

KEY TAKE AWAY

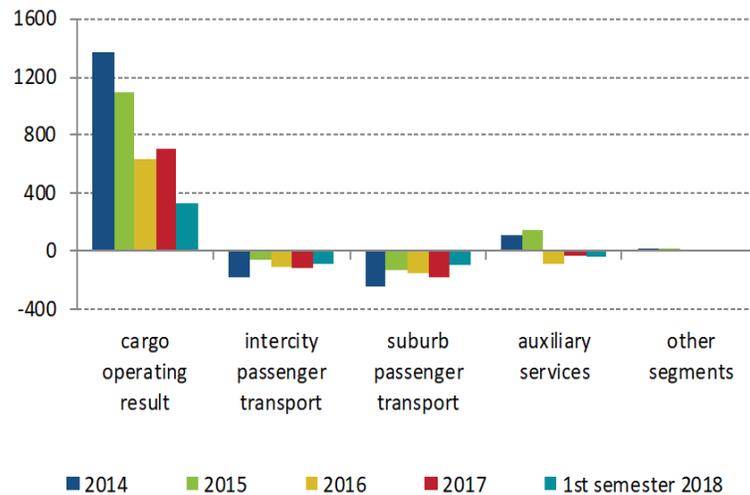
CES point of view:

- Strategy and reform of UZ underway, but UZ's permanent underinvestment and weak liquidity position influence negatively on efficiency.

Key challenge – new railway tariff policy

Why the railway tariff policy needs to be changed? (1)

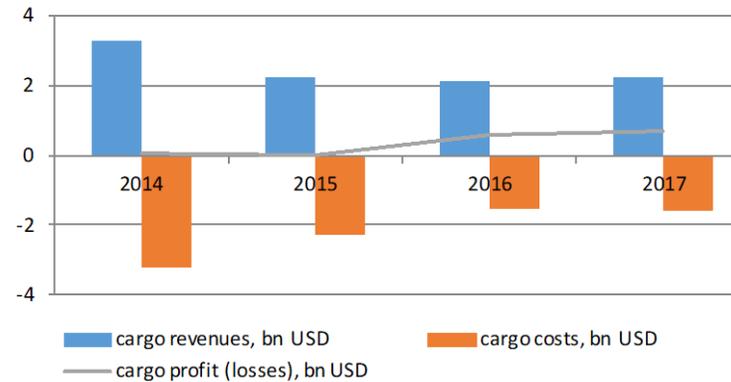
UZ operating results by operation segments, mln USD



Source: JSC Ukrzaliznytsia

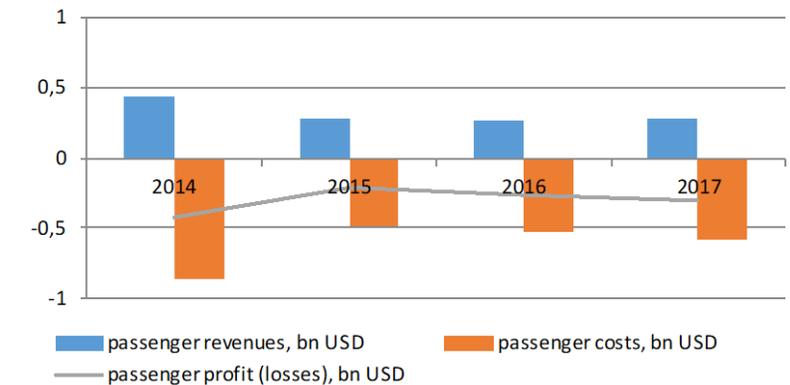
- Since 2015 UZ monitors its operations based on separated accounts, but mix services provided by different entities.
- Cargo operations remain its major profit generation center. Cargo tariffs fit the incurred cargo transport costs.
- But, loco operation costs are accounted separately under auxiliary services”.

UZ profits (losses) on cargo transport, bn USD



- Cargo tariffs exhibit high level of dependence of cargo categories. At the beginning of 2019 UZ had 14 cargo categories; all of them benefited from different rail tariff rates. In 2018 coal, construction materials, iron and manganese ores (60% of UZ cargo transportation) enjoyed the lowest rates.

UZ profits (losses) on passenger transport, bn USD



- Passenger transportation is a pure cost center: passenger transportation costs exceed profits almost twofold.
- Lifecycle cost of loco operations aside, average transportation tariff should be lifted at least twofold to cover the cost of service.
- UZ could also achieve efficiency gains by cutting operating costs of passenger transport.

But before making decisions regarding track access charge....

...it is needed to decide upon the approach to railway network policy

Expand railway network?

- TAC grounding on capital investment programs.

To limit (reduce) railway network

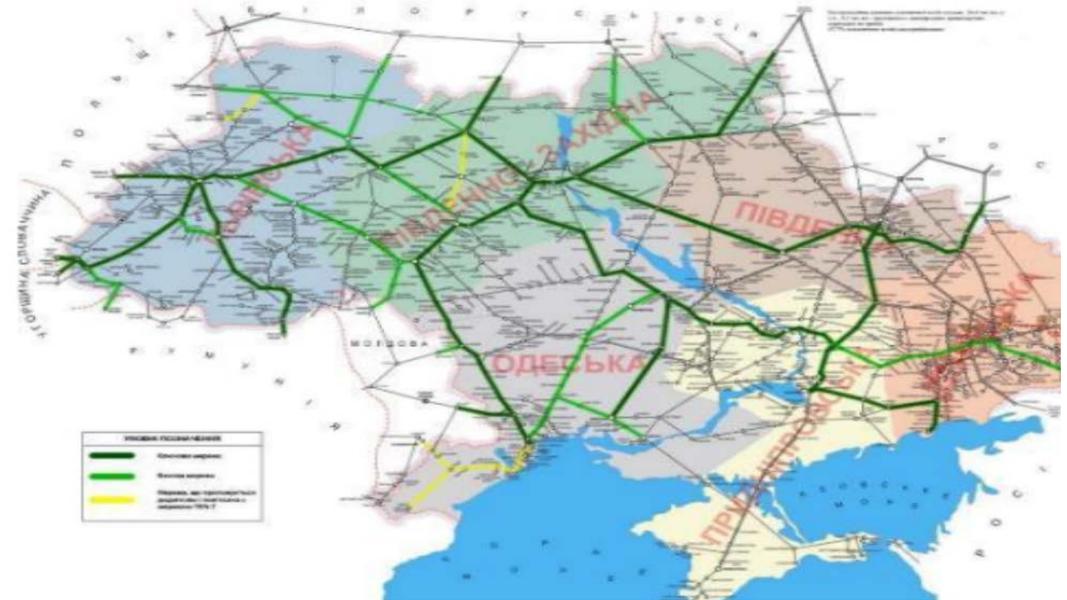
- Integrates congestion charges as a response to growing demand on the congested railway sections. Result – switching to cheaper routes.

KEY TAKE AWAY

CES plan to consider several policy options for TAC definition during the next stage of analysis (July 2019). As of now, we defined that UZ can break even with the following TAC: 2.1 EUR per cargo train-km; 0.6 EUR per passenger train-km.

We plan to take the above stated TAC as a base case for our analysis.

Where is the railway market?



- According to UZ, the length of core railway network should comprise 10,492 km.
- The planned core network covers 53% of the operated public railways. In 2017 these lines served 82% of cargo transportation by rail. According to the World Bank, it could potentially self-support financing without cross-subsidy and the rest would need to be cross-subsidized or budget funded as a network of operating PSOs.

Main infrastructure challenges for rail track management

Railway classification

- In 2017 only 25% of network was profitable
- Overall 8% of railway stations served 70% of cargo
- Need to differentiate its maintenance and operation policies

Infrastructure renewal and upgrade

- As of 2017 one third of UZ had overdue capital maintenance programs
- 60% of traction stations and catenaries are worn out
- 40% of railways are equipped with centralized dispatching and auto safety

Electrification of lines

- In 2017 UZ had 9,3 th. km (or 47% of operated network) of electrified lines
- Dolynska-Mykolaiv-Kolosivka (253 km) project will last till 2023.
- Two more projects are in pipeline and might be realized within next 10-15yrs

Railway interoperability

- Is one of the major bottlenecks to develop international routes of UZ
- Narrow gauge hub at Mukachevo in the pipeline
- Might be needed to consider wider network development

Is the Ukrainian railway market ready for liberalization?

What does railway market opening mean in Ukraine?

Current railway market design

Ukrzaliznytsia JSC

The only provider of rail cargo and passenger transport services on a public railway network



Private owners/operators of rolling stock

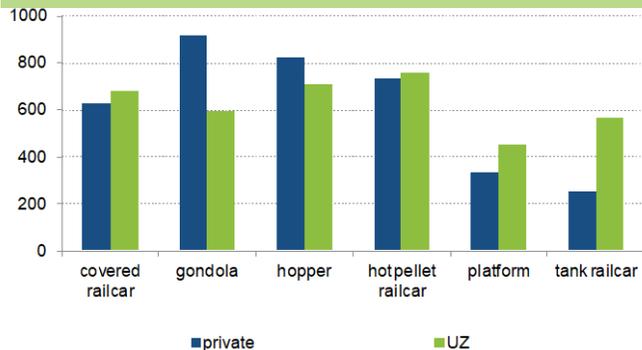
They own 40% of railway cars

Private owners of locomotives

For the moment, private locos can be operated on non-mainline network only

Source: JSC Ukrzaliznytsia

Railway rolling stock of private owners and UZ

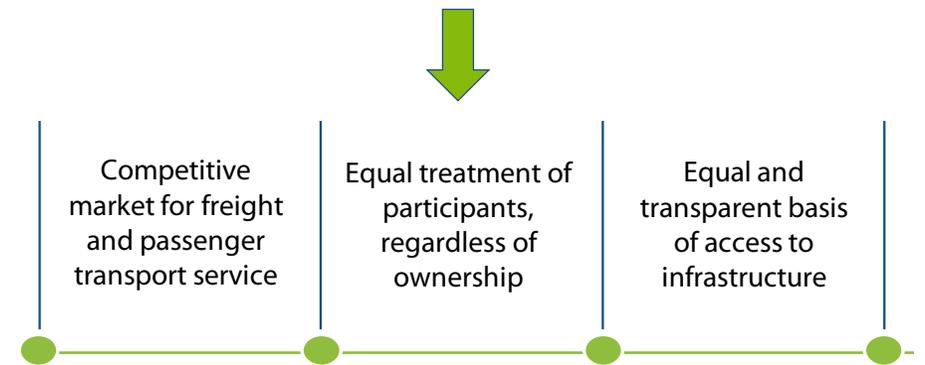
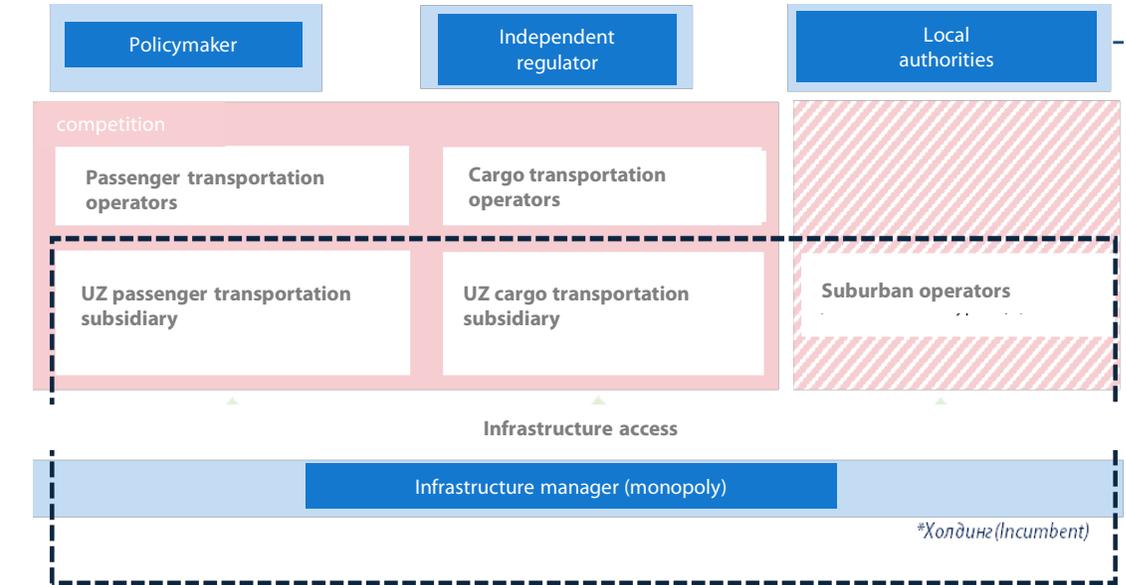


Source: Ukrainian Logistics Alliance

For the base case scenario we assume that UZ will operate as one holding. It will be in charge of:

- 100% of public railway infrastructure
- operating up to 60% of cargo transportation by 2040
- operating up to 80% of passenger transport market by 2040.

New railway market design (according to the draft Railway Law)



... but it's still only regulatory framework law*
...still waiting for specific actions and regulations...

Key elements need to be progressed

- Improvement of UZ's financial position for sustainable capital investment in infrastructure – sustainable funding.
- Separation of management and accounting of infrastructure management and transport operations
- Tariffs deregulation and PSO assessment
- Licensing system for railway players. Regulatory agencies need to be formed.

Infrastructure access mechanism

- Capacity allocation framework
- Infrastructure charges framework
- Safety certifications
- Network statement
- Infrastructure contract

Key risks

- Private operators will capture the profitable segments.
- Corruption and discriminatory risks in the allocation of capacity between carriers
- Negative environmental impacts of the increased diesel traction volume due to the need of the heavy investments in the rolling stock.

KEY TAKE AWAY

CES point of view:

- Opening market without established rules will impact the declining share of railway transport
- Drafts of specific regulations and implementation roadmap need to be published

Further research steps

Sound out the market

- Face-to-face meetings with potential stakeholders (cargo owners, freight forwarders, foreign operators, commercial bank and IFIs)
- Discussing the preliminary findings of the research (track access charge, cargo tariffs, financing needs, terms and conditions of network statement).
- Main goal – to assess stakeholders' positions, to collect ideas about alternative railway market set-ups directly from operators.

Clarify PSO potential

- Price labeling, service level and technical needs.
- Main goal – strong understanding about the capacity of local authorities to subsidize suburban transport.

Refine market share assumptions

- Find out the preferences of stakeholders to enter different market segments (cargo and/or passenger transport, international and/or domestic market)
- Polish initial assumptions depending on stakeholders' vision of their potential clients/markets in Ukraine.

The scope of possible questions (not be limited by) :

Institutional arrangements

Interest of private business to enter railway market? Their ability to assess capital to finance development needs?

Interest of government to own UZ? Any news/feedback on UZ ownership policy?

The stance of GoU regarding vertical separation of UZ? Keep UZ as one holding, but split its operations?

New information on the National transport regulator? When could it be established? Which roles shall it be assigned?

What is the stance of GoU regarding the existing railway network?

Passenger transportation

Which way to reform local transport, e.g. establish JV with local authorities and IFIs?

Capacity of local budgets to subsidize passenger transportation? If so, in which amount, which categories? If not – suburban buses?

Interest of the potential private investors to go for high-speed lines development (PPP models)?

Interest of EU/EIB to address the issue of transport interoperability at the border?

Milestones



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Thank you!

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