Polish Railways—Towards Privatization

Marcin Lipiński

General Economic Situation

Poland is a democratic, politically stable country of 39 million people. Its rapid transition to a market economy and favourable position at the centre of Europe is contributing to its business growth. It has the largest economy in Central Europe with a GDP in 1998 of $145 billion or $4000 per capita. Poland enjoys good investment grade ratings from top agencies. The country became a member of the OECD in November 1996 and joined NATO in March 1999. Full EU membership is expected by 2002.

The last 10 years have seen fundamental political and economic changes in Poland. In January 1990, radical reforms were launched to develop a market economy. Domestic demand was severely dampened at the beginning of the transition, but the situation turned around in 1992 when the economy returned to growth. During the last 5 years, the economy was probably the fastest growing in Europe with a GDP growth rate of 5% to 7% from 1994 to 1998. Economic growth is likely to continue in 1999, albeit at a slightly slower pace; the forecast GDP growth is 4.5% with inflation dropping to 8%. Unemployment peaked at 16% in 1993 and 1994 and has dropped to about 10% in 1997 and 1998.

The private sector is the locomotive of economic growth. Over half (4500) of more than 8400 state-owned enterprises were privatized and the private sector share of GDP increased from 30% in 1990 to 65% in 1998. The privatized companies include both industrial giants and small- and medium-sized businesses, many of which were bought out by employees. Privatization is also an important source of revenue for the state, bringing in $2 billion in 1998. Up to 70% of state-owned assets will be privatized by 2001. Foreign investors played an important role in the privatization, bringing both money, modern technologies, and management skills. Direct foreign investment has been a major factor in the growth of the last few years, amounting to $10 billion in 1998 and is estimated to reach $20 billion in 1999. This is good proof of investors' growing confidence in Poland's strong economic fundamentals.

There have also been important changes in infrastructure. An appropriate legal framework was created to implement national development programmes, especially construction of motorways and modernization of some railway lines to support speeds of 160 km/h.

An Association Agreement has been concluded with the EU and negotiations to join the EU are in progress. Membership of the OECD, NATO and the EU favour steady economic growth and transformation of the country.

Changes in Railway Sector

The first proposals to privatize Polish State Railways (PKP) were voiced in 1991 when the Inter-Ministerial Commission for Restructuring PKP was established to transform the railway sector.

There are two reasons for restructuring PKP—the requirements of EU Directive 91/440/EEC, and the financial pressure caused by dramatic declines in passenger and freight revenues.

EU Directive 91/440/EEC does not actually apply to Poland because the country is not yet an EU member state. However, the aspiration to become a full member as soon as possible is a strong stimulus for adopting the necessary measures in advance of membership. The main points of this directive are separate accounting of infrastructure and train operations, and open access for third-party operators to the railway infrastructure.

The financial pressure results in government subsidies to the railway amounting to 13.7% of total revenues. However, the current subsidy level is much lower than in previous years.

Legal Framework of Railway Operation

The legal framework for PKP's operations is regulated by the Law on State-owned Enterprise Polish State Railways PKP, adopted on 6 July 1995. PKP was classified as a public transport company providing services on a market basis, and obtaining subsidies from the state budget.

The scope of PKP's activities is described by the law as follows:

- Transport of passengers and goods in domestic and international traffic
- Construction, modernization and maintenance of railway lines
- Provision of access to the network to third-party operators
- Maintenance of network and rolling stock for reasons of national defence
- Provision of an internal telecommunications network and other activities providing that they do not restrict the main business of the company

PKP must maintain the railway lines to ensure reliable, regular, safe railway transport while protecting the environment. It also has responsibilities to pay pensions to railway employees and their families and to support health care for railway workers. The company is responsible for managing its assets and can transfer or lease some of its assets to other business enterprises. However, the Minister of Transport may veto transfer of assets of national importance as established by the Council of Ministers. PKP may transfer surplus facilities to the state, local authorities or other organizations. State subsidies to PKP are determined per train-km by the annual national budget to cover the difference between the railway's revenues and expenditures. There is also a subsidy covering the costs for constructing new lines of national importance and closing unnecessary lines.

The costs of maintaining lines not on the list of lines of national importance are borne by PKP.

The company charges fees for access to the railway lines. The fees are established by the Minister of Transport after consultation with PKP management and the Minister of Finance in relation to the lines of national importance.

The railway sector is also governed by the Railway Transport Law. This law regulates construction and management of railway lines and specifies the system of access fees and the responsibilities of the General Railway Inspectorate (the body certifying construction and operation of railway lines and rolling stock). The law is consistent with the EU Directives, especially the requirements for separation of the infrastructure and train operations, and provision of open access for third-party operators.

Response to Falling Freight and Passenger Revenues

The financial situation of PKP has deteriorated in recent years due mainly to decreases in coal transport, which constituted the major part of freight revenues, resulting from lower industrial output, restructuring of coal mines, the crisis in Russia, and weak growth in Europe.

In response to falling revenues, PKP decided to:

- Re-orientate its business towards a market economy
- Act to increase revenues
- Remain as an independent enterprise but subsidized by the national budget
- Re-organize transport on a contract basis
- Privatize some units and create joint ventures

The basic reasons for the restructuring were to solve the financial problems, catch up with international technology standards, and play an integrated role in

Figure 1 PKP Employment

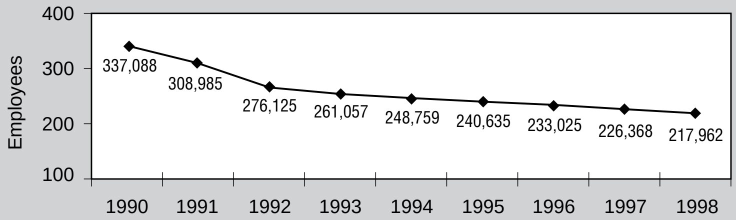


Figure 2 PKP Freight Traffic

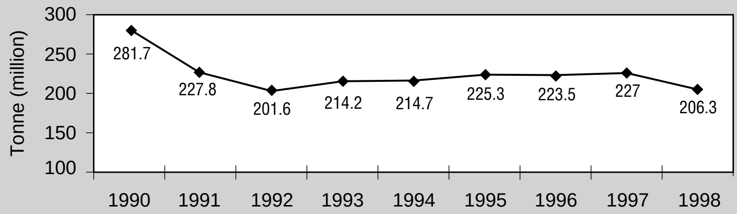


Figure 3 PKP Passenger Traffic

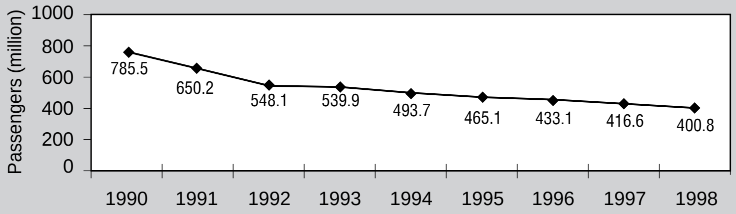
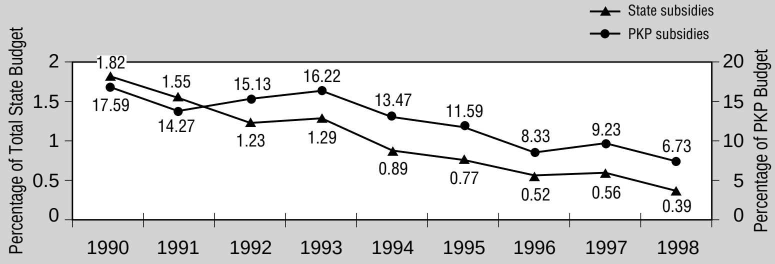


Figure 4 State and PKP Subsidies



the Pan-European Corridors plan (*JRTR* 14, pp. 18–26).

To achieve the above goals, PKP acted to adapt itself to a market economy and to rationalize its management. The issues were complex and involved putting business on a commercial footing, rationalizing employment, disposing of surplus assets, establishing new business units, and meeting the European standards.

First Restructuring (1991-96)

Restructuring began in 1991 in conjunction with the social and political changes. The main goal was to adapt PKP to a market economy by changing its management style, assets, employment structure, and finances. The first stage saw staff reductions and disposal of surplus assets. From 1990 to 1996, PKP eliminated 76 companies from its organizational structure, resulting in staff cuts of 65,000; a further 31,000 PKP staff were made redundant, leaving a total of 241,000.

The reduction of assets was obtained by liquidating:

- 88% of marshalling yards and 55% of shunting yards
- 30% of rolling stock maintenance workshops
- 13% of electric and 35% of diesel locomotives
- 17% of passenger carriages and 30% of freight wagons
- 3624-km unprofitable lines
- 22% of level crossing operators

Second Restructuring

The second stage of restructuring is already quite advanced.

Originally, the company had been divided into four divisions based on its operations: passenger, freight, infrastructure, and traction and maintenance. The main purpose of the next stage is to create a profitable business based on three divisions. However, the company still has to reconcile the negative impact of the restructuring programme on the staff and social issues.

The company is planning to purchase high-power locomotives and high-speed (250 km/h) passenger carriages. Work has also started on modernizing the Berlin–Poznan–Warsaw–Minsk–Moscow line using the company's own financial resources, state subsidies and loans from the European Bank for Reconstruction and Development (ERBD), the European Investment Bank (EIB), and Phare, the EU initiative to provide financial assistance to CEE countries. A new economic and financial system was introduced from January this year to create positive conditions for further changes, commercialization, and privatization.

PKP uses 105,000 hectares of land that it cannot presently sell because the legal ownership is unclear, but the government recently agreed that PKP should be given the legal right to the land. Selling or leasing this real estate, which is located in some of the most attractive parts of Polish cities, would raise funds to finance railway reconstruction.

Warsaw Central Station with Palace of Culture and Science in background *(Y. Akiyama)*

Infrastructure

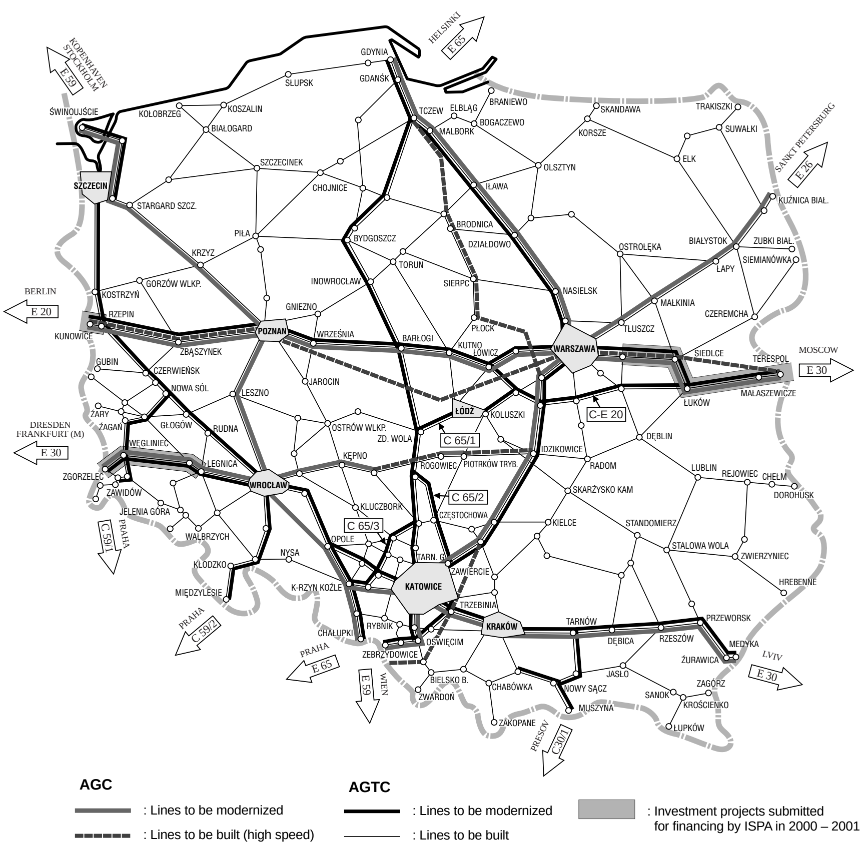
To upgrade the Polish railways to European standards in line with becoming a full EU member, the PKP management adopted *Strategy 2015* that sets out the main future investment objectives for modernizing rolling stock and railway infrastructure to make PKP competitive in the domestic and international transport markets.

The company played an active role in planning the four railway lines of the Pan-European Transport Network crossing Poland:

- Helsinki–Tallinn–Riga–Kaunas–Warsaw
- Berlin–Poznan–Warsaw–Minsk–Moscow–Novgorod
- Berlin/Dresden–Wroclaw–L'vov–Kiev
- Gdańsk–Warsaw–Zilina/Breclav (Vienna)

Lines of national importance to be modernized have been selected as the basic PKP railway network (17,500 km) based on forecast demand, and another 3,700

Figure 5 Railway Routes Through Poland Covered by AGC and AGTC



Source: PKP

km of lines will be rationalized either by offering them to third-party operators, or by closure, etc.

A programme to modernize lines of international importance has been in progress since 1994, but the scope depends on available funds. For example, in 1998, it was estimated that a total of 2.2 billion zloty (US$1 = 3.9 zloty) was needed to modernize lines of national importance but the state subsidies fell short of previous years.

The shortfalls were covered by external sources from international financial organizations, EU Phare assistance funds, EU Cross Border Cooperation funds, and the EU Instrument for Structural Policies for Pre-Accession (ISPA). The EU contributions to railway infrastructure projects are defined by a memorandum signed at the ministerial level by the candidate country and the European Commission. The aid is spent on modernizing railway border crossings and railway lines of international importance located in the transport corridors crossing Polish territory and included in the *European Agreement on Main international Railway Lines* (AGC) and *European Agreement on Important International Combined Transport Lines and Related Installations* (AGTC).

A good example of the need for modernization is the Legnica–Wroclaw–Opole line, which was heavily damaged in 1997 by serious floods. Most of the infrastructure was flooded and some bridges were completely destroyed. In 1997 and 1998, PKP undertook emergency repairs totalling 167 million zloty (42 million euro; US$1 = 0.96 euro) to restore traffic in the south–west section, but the repairs were insufficient. The EIB provided 13.6 million euro of this total with 6.4 million euro of the remainder coming from PKP's own resources, and 22 million euro from the national budget.

The very poor condition of the repaired infrastructure requires replacement of old facilities and equipment just to maintain existing operational capacity. The general renovations include reinforcement of the bed, reconstruction of tracks, renovation and upgrading of over 40 engineering structures, upgrading of the catenary system and supports, changing of signals and telecommunications network, etc.

In November 1998, PKP submitted a proposal to the Committee of European Integration to co-finance modernization of the line. The European Commission agreed that the proposal met the priorities for development of railway transport infrastructure and the total investment cost was assessed at 355.5 million euro.

In 1993, PKP started modernizing the western section of the 430-km Kunowice–Poznan–Warsaw line forming part of corridor No. II in the Pan-European Transport Network. The investment cost was assessed at 487 million euro. Like the Legnica–Wroclaw–Opole modernization, the line standard is being upgraded to allow speeds of 160 km/h for passenger traffic, 120 km/h for freight traffic, and axle loads of 22.5 tonnes. By late 1998, in addition to track modernization and electrification, 19 stations had been modernized, 10 stations changed to passenger stops, 14 passenger stops modernized, and two stations closed. All the railway crossings on the line were modernized, allowing speeds of 160 km/h on three quarters of the line. The renovation is to be completed by 2000.

The modernization of PKP created an infrastructure sector divided into 8 regional directorates that are responsible for 45 infrastructure workshops. The whole

New PKP InterCity train running on newly upgraded tracks (Y. Akiyama)

infrastructure sector is a separate organization under the Directorate of Railway Infrastructure in Warsaw and the PKP management with totally separate accounts within the PKP budget. The infrastructure sector has units responsible for bridge construction, infrastructure maintenance, railway telecommunication, power supplies and electric traction maintenance.

Future plans for restructuring the infrastructure sector envisage changing to a two-level management system by closing the 8 regional directorates and significantly downsizing the workshops.

Towards Full EU Membership

Due to the government reforms of the railway administration, pension, healthcare, and education systems, there is still no solution for financing unprofitable passenger services. There are now no state subsidies to cover losses from unprofitable passenger traffic, but on the other hand, PKP is no longer obliged to contract regional passenger services with local authorities.

To offset public criticism about closing unprofitable services, PKP has adopted plans to improve other services. These include launching more comfortable *InterCity Plus* trains with better on-board service. There are plans to gradually introduce modern tilting trains running at 200 km/h and to standardize rolling stock and station buildings. An automatic fare collection system and computerized ticket sales are also urgent necessities.

To diminish the adverse environmental impact of road transport, the intermodal system will be extended to heavy freight. Many independent operators are waiting for the total separation and privatization of the railway infrastructure sector. After the reforms, third-party operators will contract access rights with the new infrastructure owner. So far, 12 companies have been licensed to operate freight services but PKP is the only one also having a passenger service licence.

This third-party licensing system brings Polish railway operations one step closer to compliance with EU Directive 91/440/EEC, which also prohibits cross-subsidy of unprofitable passenger services with freight revenues.

Many European passenger services are unprofitable and some combined freight transport operations make losses too. EU regulations oblige the member states to provide citizens with the cheapest and most economic mode of transport. Consequently, many state and local authorities contract fully compensated Public Service Obligations (PSOs) with suburban railway services.

The unprofitability of passenger transport in Poland explains why no other transport operator except PKP applied for a passenger transport license. However, there was wide interest in licenses for freight services. Since there is no need to own freight wagons or have a railway network to receive a license, entry by third parties into this market will certainly reduce PKP's 90% share of the freight market. But from the customers' viewpoint, this competition will improve services and cut tariffs.

In addition, Poland's new administrative division into 16 districts will impact local transport routes because local governments will become responsible for deciding what transport will be most suitable and which company will provide the service. This handover of some authority to local governments means that local governments will subsidize local passenger services—a good chance for local lines.

Nevertheless, problems are expected between PKP and the local authorities because the local authority is more interested in the service contracts within its region while the railway's infrastructure is based on its own operation centres that do not match the local government regions. This explains why costs calculated by railway can differ from costs calculated by local authorities.

At present, PKP management has two financial plans and budgets prepared by the General Directorate of Polish State Railways for this year.

In Plan 1, PKP will spin off its unprofitable passenger services into a joint stock company called Passenger Traffic and PKP will continue operation of the profitable *InterCity, EuroCity,* and *EuroNight* services.

In Plan 2, PKP will continue under its existing structure and close the financial year with a loss of 613 million zloty. Choosing the right variant is the subject of controversy.

At present, the restructuring plans presented by the Parliament propose a holding structure for PKP. The passenger and infrastructure sectors would remain under PKP management until privatization. However, the Ministry of Transport proposes separation of infrastructure from operations. Three months after privatization, a state organization owning the infrastructure would be created under the Minister of Transport. The infrastructure would generate revenues by imposing access charges on railway operators. Passenger and freight services would be transferred to independent private operators from PKP. The British system of Railtrack owning the rail infrastructure and operations provided by railway franchises is a good example.

The Polish Economic Committee of the Council of Ministers and the government will tackle the restructuring legislation later this year and it should become law by the third quarter of FY 1999, so that PKP can start commercial operations in early 2000.

However, the labour unions oppose separation of passenger services because they believe the local authorities and government will not find funds to subsidize unprofitable local lines.

Whatever the case, the new law on PKP restructuring and privatization will create a breakthrough in relations between the government and the railway, and the major burdens will be transferred to the government.

Recent News

On 7 July, the Economic Committee of the Council of Ministers (KERM) accepted the main guidelines for PKP restructuring and privatization submitted by the new Minister of Transport, Mr Tadeusz Syryjczyk, including legal ownership of assets, partial debt settlement, laying off 60,000 employees, dividing up the company, and almost complete privatization. However, several points were changed:

1. Instead of using World Bank credit, the money for severance payments will come from long-term government bonds of 1 billion zloty (around US$ 264 million).
2. Outstanding liabilities, amounting to 1 billion zloty will be converted into shares in the privatized PKP.
3. The function of the Railway Regulator who is responsible for establishing access charges, settling disputes between railway businesses, etc., will be taken over by the Chief Railway Inspector.

In order to smoothly implement the program outlined above, the new management of PKP was appointed from 1 August with Mr Krzysztof Celinski (*JRTR* 8, pp. 10-14) as President. The change occurred following a proposal by the Prime Minister and Minister of Finance, Mr Leszek Balcerowicz, due to concerns about the deteriorating situation of PKP.

Conclusions

Polish railway reform is not a concept borne of a planned economy, and the Polish government and PKP have taken extensive and valuable advice from various countries, including Japan and the USA.

Based on experiences worldwide, PKP is trying to demonstrate that the Polish government must accept responsibility for the infrastructure part of railway transport, while leaving day-to-day operations to PKP and other operators.

Railways are clearly the transport mode of the future, but their successful development requires meeting a number of important preconditions:

First, the state as the basic legislator and infrastructure owner must provide a framework that optimizes the scope of railway business.

Second, the state must give operators true autonomy in the key sphere of operations.

Third, the state and local authorities must take responsibility for PSOs in the transport sector.

Finally, the state must accept its responsibility for the railway infrastructure as part of the Pan-European Transport Network.

If these preconditions are met, PKP can do its best to provide service levels expected by customers. Many railway reforms in Europe and elsewhere show the feasibility of these aims. ■

Marcin Lipiński

Mr Lipiński is Chief Specialist for Project International Financing in the Bureau of Investment and Development of the Directorate of Railway Infrastructure of PKP. After graduating in 1995 with a Masters degree from the Warsaw School of Economics, he worked in the Railway Department in the Ministry of Transport and Maritime Economy until 1998.