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THE STUDY ON PRIVATIZATION OF POLISH STATE RAILWAYS IN POLAND

FINAL REPORT

MAIN REPORT

February 1998

JAPAN RAILWAY TECHNICAL SERVICE
DAIWA INSTITUTE OF RESEARCH LTD.
TONICHI ENGINEERING CONSULTANTS, INC.

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1 US Dollar = 3.20 PLN = 115 Yen
(June 1997)

PREFACE

In response to a request from the Government of Poland, the Government of Japan decided to conduct a Study on the Privatization of the Polish State Railways and entrusted the study to the Japan International Cooperation Agency(JICA).

JICA sent to Poland a study team headed by Mr. Naofumi Takashige, Executive Vice-President of Japan Railway Technical Service (JARTS), 3 times between November 1996 and December 1997.

The team held discussions with the officials concerned of the Government of Poland, and conducted field surveys at the study area. After the team returned to Japan, further studies were made and the present report was prepared.

I hope that this report will contribute to the promotion of the project and to the enhancement of friendly relations between our two countries.

I wish to express my sincere appreciation to the officials concerned of the Government of Poland for their close cooperation extended to the team.

February 1998

Kimio Fujita
President
Japan International Cooperation Agency

Letter of Transmittal

February 1988

Mr. Kimio Fujita
President
Japan International Cooperation Agency

We have the pleasure of submitting herewith our report for the Study on Privatization of Polish State Railways. The report describes the results of the Study conducted by Japan Railway Technical Service, Daiwa Institute of Research Ltd., and Tonichi Engineering Consultants, Inc. in accordance with the contract with the Japan International Cooperation Agency (JICA).

In the Study, our Study Team carried out field surveys three times during the period between November 1996 and December 1997. The Team held sufficient consultations with the Polish Government and organizations concerned regarding the results of the field surveys and study activities in Japan, and drew up plans for contributing to the implementation of the privatization of the Polish State Railways. In close cooperation with the Polish side regarding these plans, the Team thereafter studied such subjects as the form of management, procedures for step-wise privatization, main measures for privatization, and setup for promoting privatization, in order to ensure smooth implementation of the railway privatization, and then prepared this report.

We would like to express our heartfelt gratitude to the Government of Poland and the organizations concerned in the country for the kind cooperation they extended to our Team regarding the implementation of the Study as well as for their warm hospitality provided during our stay in Poland.

Our thanks are also due to the Japan International Cooperation Agency, the Ministry of Foreign Affairs, the Ministry of Transport, the Japanese Embassy in Poland, and the JICA Austria office for their valuable advice and support rendered to us throughout the Study.

Yours faithfully,

N. Takashige

Naofumi Takashige
Leader of the Japanese Study Team
for a Study on the Privatization
of the Polish State Railways

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1. INTRODUCTION

1.1 BACKGROUND OF THE STUDY AND DEVELOPMENT IN THE PAST

While transforming its economy to a market-oriented one since 1989, Poland has been discussing the possibility of privatizing its state-owned railways (PKP) since 1991.
To support this movement, the Japanese Government conducted "The Study on the National Transport Plan in the Republic of Poland (1991 - 1992)", and proposed an early implementation of PKP reformation.
After the survey, Poland organized the Interministerial Commission for Restructuring Polish State Railways to start reforming PKP toward privatization.

In the way toward recovery of sound financial status and organizational innovation of PKP, however, there are a number of difficult problems including those between labor and management.

Under the circumstances, Poland, who took note of the successful privatization of Japanese National Railways, approached the government of Japan to obtain technical cooperation, in order to prepare an optimum plan for the privatization of PKP, and requested in 1995 September to conduct this survey.

In response to this request, a preliminary study team was sent to Poland in 1996 March. The team concluded an agreement on the scope of work with the government of Poland in 1996 April. Based on this agreement, Japan International Cooperation Agency (JICA) organized a study team and set up an advisory committee to implement this study.

The JICA team started a survey in 1996 October, collected relevant data and information during a site survey from 1996 November, reviewed reports in the past and submitted a progress report to the government of Poland in 1997 January.

Based on the site survey results and in response to the opinions on the progress report, the team prepared an interim report, in which the team explained the role of railways in Poland, results of demand forecast, problems for PKP privatization and alternative measures.
In 1997 June, the team explained the interim report to the government of Poland and obtained approval for its essential part. By reflecting the comments on the interim report offered by the government of Poland, the team prepared a draft final report.

In 1997 December, the team explained the draft final report and have discussions with the government of Poland. By taking into consideration comments on the draft final report by the government of Poland, the team made the Final Report of the Study on Privatization of Poland.

1.2 OBJECTIVE OF THE STUDY

The objective of the study is to implement a survey related to the master plan to support the privatization of PKP under the above-mentioned circumstances, based on the scope of work agreed upon between the government of Poland and JICA on April 11, 1996.

In this study, the study team reviewed the PKP privatization program, which is a means of shifting to a market economy promoted by the government of Poland, overviewed comprehensive transport networks encompassing conjunction with neighboring countries, implemented a survey to establish an optimum PKP privatization plan and transferred technologies to counterparts in Poland.

1.3 SCHEDULE OF THE STUDY

Table 1.3.1 shows the schedule of the study.

1.4 ORGANIZATION OF THE STUDY

This study was performed by a team organized by JICA with experts in railway operation, management analysis and other fields. Counterparts in Poland were members of Ministry of Transport and Maritime Economy (MTME).

To smoothly perform the study, a Steering Committee was organized with members of governmental organizations in Poland including the Ministry of Transport and Maritime Economy (MTME) and state-owned railways (PKP). For the convenience of site surveys and collection of information, a counterpart team was organized with members of PKP.

To lead the study team and facilitate smooth implementation of survey, JICA organized a Supervisory Committee.

Fig. 1.4.1 shows the organization of the study.

Table 1.3.1 Schedule of the Study on Privatization of PKP

Study item	Year	Fiscal 1996						Fiscal 1997									
	Month	10	11	12	1	2	3	4	5	6	7	8	9	10	11	12	1
Schedule of the study		1. Preparatory study	2. Phase 1	site	survey	3. Phase 1	study	in Japan		4. Phase 2	site	survey 5. Phase 2	study	in Japan		6. Phase 3 site survey	7. Phase 3 study in Japan
					△ PR/R		△ IT/R									△ DF/R	△ F/R

Legend: Period of site survey in Poland; Period of study in Japan; △ Submission and explanation of report

PR/R: Progress Report
IT/R: Interim Report
DF/R: Draft Final Report
F/R: Final Report

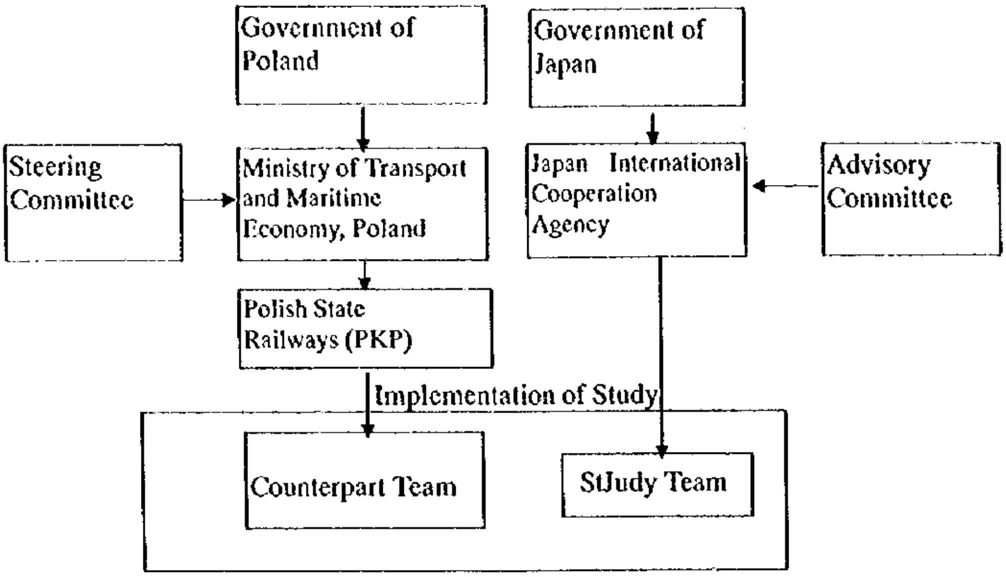


Fig. 1.4.1 Organization of the Study

1.5 MEMBERS OF THE ORGANIZATION OF THE STUDY

The following table summarizes members of the organization of the study

(1) Advisory Committee (five persons)

Name	Assignment	Present position
Tatsuhiko SUGA	Chairman, Organization and Management of PKP	Executive Director, East Japan Railway Culture Foundation
Osamu HASEGAWA	Railway Management	Manager, Administration Division, Railway Development Department, Corporation for Advanced Transport & Technology
Daisaku MURAKAMI	Railway Facilities and Operation	Deputy Director, Technology Development Office, Engineering Planning Division, Ministry of Transport
Tsutomu SHIBATA	Management Analysis	Director General, International Cooperation Department, The Japan Development Bank
Nobuhiro KOYAMA	Transport and Economic Development	Development Specialist, Institute for International Cooperation, Japan International Cooperation Agency (JICA)

(2) JICA (one person)

Name	Assignment	Present position
Koichi KITO (1996 October - 1997 March)	Study Planning	Staff, First Development Study Division, Social Development Study Development, Japan International Cooperation Agency (JICA)
Shoichi TSUGANE (1997 April - 1998 January)	Study Planning	Staff, First Development Study Division, Social Development Study Development, Japan International Cooperation Agency (JICA)

(3) Study Team (14 persons)

Name	Assignment
Naofumi TAKASHIGE	Team Leader, Organization Analysis
Ken MACHIDA	Acting Leader, Management Analysis
Pawel TOMCZYK	Public Investment Policy
Naoki TAKANASHI	Transport Demand Forecast
Seiichiro YAMAZAKI	Analysis of Fare Structures and Transport Economics
Michio FUJIHASHI	Business Enterprise Strategy
Daniel B. MESNICK	Personnel Management and Productivity
Charles WATSON	Financial Analysis
Nobutaka TATEMATSU	Passenger Transport Planning
Takashi JORAKU	Freight Transport Planning
Yoshihiro AKIYAMA	Railway Facilities Planning
Koji SAGAWA	Rolling Stock Planning
Masaaki MORITA	Environmental Analysis
Toshiyasu OHASHI	Coordinator

(4) Polish Steering Committee

Ministry of Transport and Maritime Economy	
Mr. Krysztof CELINSKI	Director of Railway Department
Mrs. Ewa SZCZEPANSKA	Director of Economics and Finance Department
Mrs. Danuta TYSZKIEWICZ	Director of Legal Department
Mr. Zdzislaw URBANIAK	Director of Transport Policy Department
Mrs. Ewa SPYCHAJ	Director of Ownership Transformation Department
Polish State Railways (PKP).	
Mr. Albin SPYCHALSKI	Deputy Director of PKP, Member of the Supervisory Board of PKP.
Mr. Marian LUKASLAK	Director of Strategy Office
Mr. Gerard ROGOWSKI	Deputy Director of Strategy Office

(5) Polish Counterparts

No.	Name of Task	Department	Name	Position
1	Organizational Analysis	KWE	A. Spychalski	The Member of the Board
		KSR	M. Lukasiak	Director
		KBS	E. Kubik	Director
2	Management Analysis	MTiGM		
		KFK	W. Woroniecki	Director
		KEK	G. Piekarzewicz	Council of the PKP
3	Public Investment Policy	MTiGM		
4	Transport Demand Forecast	MTiGM		
		KSR	M. Lukasiak	Director
		KI	K. Kozuchowski	The Head
		KSR	T. Szemplinski	The Head
		KSR	T. Trojanowska	The General
		KSR	G. Stachura	Higher Specialist
		KI	K. Kozuchowski	The Head
5	Fare Structure and Transport Economy	MTiGM		
		KD	M. Musial	The Head
		KSR	L. Rudzinski	The Head
			T. Szemplinski	The Head
			T. Trojanowski	General Specialist
		KHP	G. Uklejewski	Director
			T. Wermer	Higher Specialist
			K. Peryt	Higher Specialist
		KHT	J. Tymoszuk	Director
			S. Trzaskowski	The Head
			W. Czemiawski	The Head
6	Business Enterprise Strategy	KSB	St. Klubinski	General Specialist
		KSR	M. Lukasiak	Director
		KSR	G. Rogowski	Deputy Director

7	Personal Management and Productivity	KOS	T. Krajewski	The Head
		KSR	J. Blaszczyk	General Specialist
			B. Huczko	General Specialist
8	Financial Analysis	KF	A. Jarcczewska	The Head
			H. Blaszczyk	The Specialist
		KFK	W. Woroniecki	Director
		KSR	G. Rogowski	Deputy Director
		KEK	M. Kryszkiewicz	Council
		KN	R. Olejniczak	Director
		KI	K. Kozuchowski	The Head
9	Passenger Transportation	KHP	G. Uklejewski	Director
10	Freight Transport Planning	KHT	J. Tymoszuk	Director
			S. Wojtowicz	The Head
			S. Trzaskowski	The Head
11	Railway Facilities Planning	KD	M. Musial	The Head
		KSR	L. Rudzinski	The Head
		KI	K. Kozuchowski	The Head
		KE	A. Wach	The Head
		KA	M. Radziukiewicz	The Head
		KDK	M. Kopczynski	The Head
12	Rolling Stock Planning	KME	A. Skrodzki	The Head
			K. Kolodziejski	The Head
		KMU	W. Cywinski	The Head
			A. Kluczyk	The Head
13	Environmental Analysis	KSR	A. Wroblewski	General Specialist
14	Coordinator	MTiGM		

2. CURRENT SITUATION AND FUTURE DIRECTION OF THE PKP

2.1 CURRENT SITUATION OF RAILWAY TRANSPORTATION

2.1.1 Railway Network

The Polish railway network have an extensive network which covers whole nation; railways with a route length of 22,285km standard gauge (gauge: 1,435mm) including broad gauge (gauge: 1,520mm), and length of 1,3888km of narrow gauge (gauge: 600mm, 750mm, 785mm and 1,000mm)

At present 8,906km, 39.4% of standard gauge tracks is double tracked and 11,625km, 52.2% is electrified.

According to the present statutory definition and PKP technical regulation, PKP railway network is classified into following 3 types.

- Lines of National Importance:
  Lines of National importance, which have been recognized under the PKP law promulgated on July 6, 1995, amount to roughly 16,400km (according to the plan as February, 1996). The lines which PKP has classified into main lines (black line), are supposed to be included by this classification. (Fig. 2.1.1)
- Lines of Regional Importance:
  Lines of Regional Importance total 3,000km - 4,000km, which might remain under the management of PKP. This category is also supposed to refers to PKP line classification, white lines (elimination possible).
- Non-profitable Lines:
  Revenue of Non-profitable Lines operated at deficit for the most part amounts to merely 10 to 20% of costs, and 2,500km - 3,000km are subject to abolition or transfer of services. Lines in which services are suspended total approximately 1,500km at present. It is often very difficult to abolish this kind of line because of the need to negotiate with local governments. This category is also supposed to refers to PKP line classification, green lines (eliminated at once).

Table 2.1.1 Classification of lines

Classification	Length (km)	Remarks
Lines of National Importance	13,880(62%)	A ministerial ordinance of September 3 1996
Lines of Regional Importance	6,000(27%)	
Non-profitable Lines	2,400(11%)	income/cost=0.1～0.2

Source : PKP annual report 1996

2.1.2 Passenger Transportation

(1) Trends in customer preferences regarding types of tickets and train services

With the progress of transformation from the controlled economy to the market economy, the passenger traffic volume of PKP has been on the decrease year after year. In this connection, freight transport has been playing the central role in railway transport in Poland, and the passenger transport sector accounts for about 20% in the entire transport sectors in terms of revenues in 1995.

The yearly frequency of railway travels per person enormously decreased from 21 times in 1990 to 12 times in 1995. The number of passenger trains operated per day decreased by 1,413 trains (20%) from 7,118 trains in 1990 to 5,705 in 1995.

The number of passengers in rapid and express train has gone down from 66 million and 18,000 million passenger-km to 50 million and 12,300 million passenger-km in the same period. Within general fall in railway passenger traffic the conventional speed trains suffered the most significant decrease-from 722 million passengers and 32,300 million passenger-km in 1990 to 415 million passengers and 14,300 million passenger-km in 1995. (Table 2.1.2, Figure 2.1.2 and Figure 2.1.3)

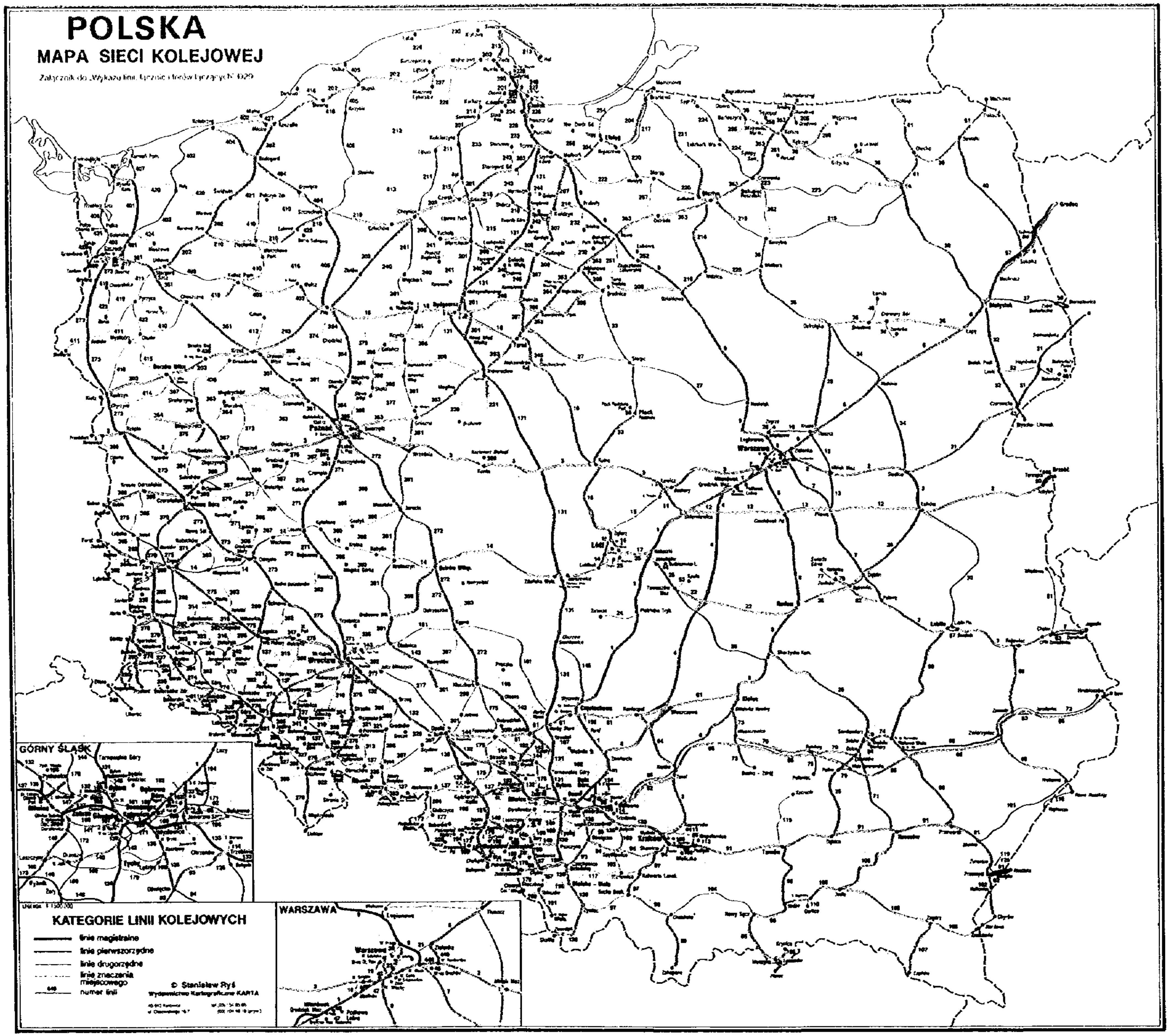


Fig 2.1.1 Lines of National Importance

Table 2.1.2 Changes of passengers transport volume by types and classes of train

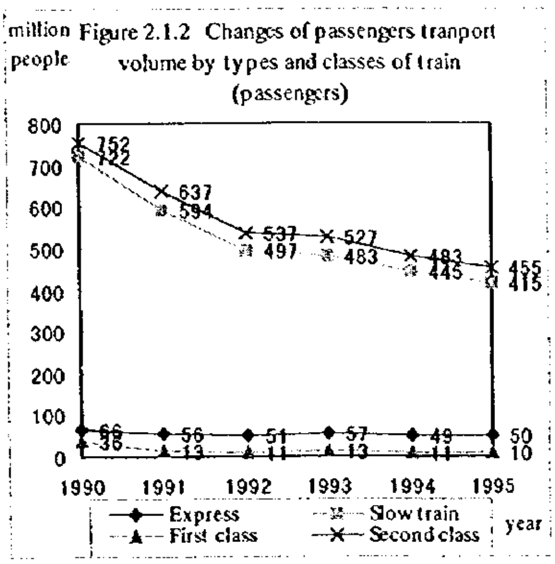
(Unit : million passengers)

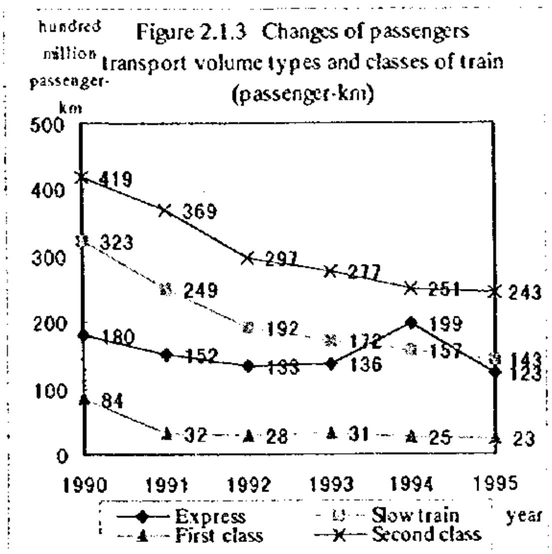
Year	1990	1991	1992	1993	1994	1995
Express	66	56	51	57	49	50
Slow train	722	594	497	483	445	415
First class	36	13	11	13	11	10
Second class	752	637	537	527	483	455

(Unit : hundred million passenger-km)

Year	1990	1991	1992	1993	1994	1995
Express	180	152	133	136	199	123
Slow train	323	249	192	172	157	143
First class	84	32	28	31	25	23
Second class	419	369	297	277	251	243

Source : Statistical yearbook PKP





Season tickets have become less popular. In 1990 the sales of such tickets amounted to 304 million passengers and 6,100million passenger-km while in 1995 there were 175 million passengers and 3,700 million passenger-km respectively. However in 1995 the number of suburban commuters season tickets has grown by 18.7% compared to 1994. On the other hand a number of full fare ticket holders on conventional speed trains has significantly decreased and this trend still continues. (Table 2.1.3, Figure 2.1.4 and Figure 2.1.5)

Table 2.1.3 Changes of passengers transport volume by types of ticket

(Unit: million passengers)

	1990	1991	1992	1993	1994	1995
Normal ticket	484	449	408	421	346	290
Season ticket	304	201	140	119	148	175
Total	788	650	548	540	494	465

(Unit: hundred million passenger-km)

	1990	1991	1992	1993	1994	1995
Normal ticket	442	364	299	286	247	229
Season ticket	61	37	26	22	29	37
Total	503	401	325	308	276	266

Source : Statistical yearbook PKP

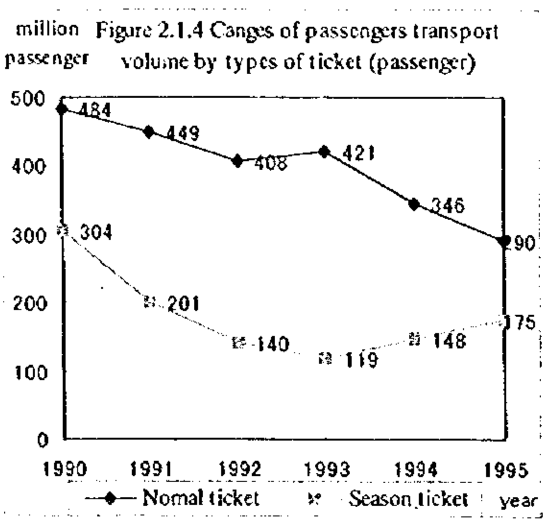


Figure 2.1.4 Canges of passengers transport volume by types of ticket (passenger)

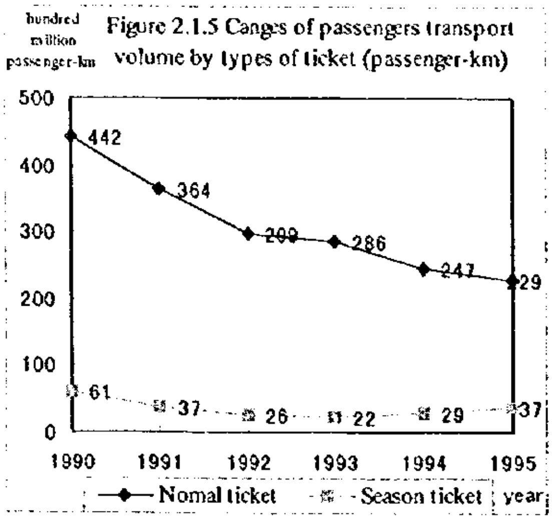


Figure 2.1.5 Canges of passengers transport volume by types of ticket (passenger-km)

(2) Situation in inter-city transport

1) International transport

The volume of international transport has decreased from 5,755 thousand passengers and 1,005 million passenger-km in 1994 to 5,049 thousand passengers and 857 million passenger-km in 1995. (Table 2.1.4)

Table 2.1.4 Comparison of transport volume in 1994 and 1995

Quality of :	thousand passenger		million pass-km		average pass-km	
	1994	1995	1994	1995	1994	1995
Internation. Transp.	5,755	5,049	1,005	857	175	170
Interregion. Transp.	65,068	64,266	15,830	15,617	243	243
Agglomer. Transp.	277,934	262,969	6,687	6,425	24	24
Provincial transp.	144,917	132,775	4,073	3,723	28	28

Source : Statistical yearbook PKP

The volume of international transport by countries includes the following:
Belarus - 1,324,000 passengers, Ukraine - 1,236,000, Germany - 950,000, Russia 916,000, Czech Republic - 156,000, Austria - 85,000.

PKP offers 6 IC and EC express services connecting Warsaw with following international destinations: Berlin (2 services daily), Vienna, Prague and Budapest. There is also Krakow-Berlin service. All cars in these trains are modern and comfortable. The trains are fast and services are highly appreciated by passengers. The occupancy rate in these trains is 60%.

2) Domestic inter-city transport

A number of Polish cities range from 500,000 to 1,000,000 inhabitants. Warsaw is situated in the center of country and distances to other big cities range from 100 to 300 kilometers. Besides the country is flat and there are many straight sections of railways so trains can go at high speed. Considering above observations the inter-city transport constitutes the most important component of future railways' development in Poland.

The number of EC, IC, EX and other express trains and rapid trains operating in inter-city transport on major routes exceeds 10 and passenger traffic one way varies from 700 to 2,900 passengers per day.

Table 2.1.5 Inter-city trains on major lines (1997)

Section	Distance (km)	Travel time (fastest train) (h-m)	Max Speed (km/h)	Scheduled speed (km/h)	No.of Trains, One way (trains/ day)	Transport Volume, one way (passenger/ day)
Warsaw-Krakow	287	2-35	160	111	12	2,980
Warsaw-Katowice	293	2-35	160	113	10	2,266
Warsaw-Gdansk	329	3-21	120	98	10	2,848
Warsaw-Poznan	306	3-04	130	100	8	2,154
Warsaw-Lublin	175	2-06	120	83	8	1,388
Warsaw-Wroclaw	385	4-35	120	84	5	1,248
Poznan-Szczecin	214	2-26	120	88	8	756
Poznan-Wroclaw	165	1-42	120	97	9	965
Katowice-Wroclaw	180	2-28	120	73	10	776

Source : Time-table PKP 1996, Data of actual passenger flow (7.1996)
Note : The one-way transport volume shows daily average in July 1997.

The total number of passengers in above trains in 1995 was 64,266 thousand (98.8% of previous year) and 15,617 million passenger-km (98.7% of previous year).

(3) Situation in commuter transport

There are a number of cities in Poland which are surrounded by densely populated metropolitan areas. In such areas railways constitute an important mean of mass public transportation in a city zone. Warsaw metropolitan area has the population of 1.8 million people. The passenger transport volume in its city zone amounts to 82,412 thousand passengers being the highest in the country. Next come Gdansk (62,517 thousand) and Katowice (31,577 thousand). These three city zones represent 67% of total commuter railway transportation in Poland. (Table 2.1.6)

Table 2.1.6 Transport volume in major city areas (1995)

(Unit ; thousand persons, %)

Major city area	Transport volume	share of commuter	city population
Warsaw	82,412	58.7	1,632
Gdansk	62,517	50.1	463
Katowice	31,577	45.4	351
Bialystok	16,079	53.3	279
Wroclaw	14,278	45.9	642
Poznan	13,528	50.7	581
Bydgoszcz	11,956	49.4	386
Krakow	11,313	47.0	745
Lodz	9,335	42.8	820
Szczecin	9,138	49.6	419

Source : Statistical yearbook PKP

The volume of commuter transport shows also the decreasing trend 262,969 thousand passengers (94.6% of the previous year) and 6,425 million passenger-km (91.1% respectively). Above figures represent respectively 57% and 25% of total passenger transport volume and prove the importance of commuter transport in overall passenger railway traffic of the country. (Table 2.1.4)

In Warsaw city zone there are about 1-3 one way trains which run during one hour to each of seven destinations (6-9 cars in rush hours and 6 in the rest of a day). The occupancy rate reaches 80% - 120% in rush hours and 30% - 40% in the rest of a day.

In Gdansk city zone population is concentrated along 27 kilometers of the line Gdansk-Sopot-Gdynia. There are 122 one-way slow trains running on this line daily. During rush hours they run every 6 minutes and normally every 12 minutes. Their timetable is arranged in the most comfortable way for the passengers.

(4) Local traffic lines

Conventional speed train passenger volume shows continuous tendency to decrease 132,775 thousand passengers (91.6% of the previous year) and 3,723 million passenger-km (91.4% of the previous year). As there is a tendency of migration to big cities and decrease of population number in rural areas, railways cannot expect any growth of local passenger traffic. (Table 2.1.4)

Along with the decrease of the passenger transport volume the number of has also decreased. On some local lines service has cut following respective agreements with local government authorities. Passenger on local lines encounter deterioration of services of to reduced number of trains and poor quality of cars. There is a continuous shift to automobile transportation.

Considering the fact that there is a number of people who need public transport, it is necessary to maintain railway services or replace them with other means of affordable transportation such as buses.

2.1.3 Freight Transportation

(1) Trends in freight traffic volume

In 1980 when the planned economy was carried out, freight traffic volume amounted to 482 million tons and 134.7 billion ton-km. By 1990, however, plummeted 282 million tons and 83.5 billion ton-km due to the change of the economic system, and decreased further in 1992 to 202 million tons and 57.8 billion ton-km. In the following years, freight volume followed an increasing trend while fluctuating in the process, reaching 225 million tons and 69.1 billion ton-km in 1995.

Comparing with other means of transportation, truck transportation continued to follow a similar trend to that of railways from 1990 onwards in terms of freight tonnage, but continued along an increasing trend from 1980 in terms of ton-km to greatly expand its share while showing fluctuations on the way.

Table 2.1.7 Traffic volume by means of transportation

Year		1980	1985	1990	1991	1992	1993	1994	1995
Freight tonnage (unit : million tons)		2711	1864	1617	1449	1360	1325	1319	1353
	Railway	482	419	282	227	201	214	215	225
	Road	2167	1393	1292	1188	1121	1071	1060	1086
	Pipeline	40	38	33	26	30	31	34	33
	Inland waterways	22	14	10	8	8	9	10	9
Freight tonnage (unit : hundred million ton-km)		1982	1755	1386	1157	1123	1179	1260	1347
	Railway	1347	1206	835	651	577	643	657	691
	Road	445	366	403	396	420	407	453	512
	Pipeline	170	169	138	103	119	122	142	135
	Inland waterways	20	14	10	7	7	7	8	9

Note : Poland national statistics annual report and PKP annual report

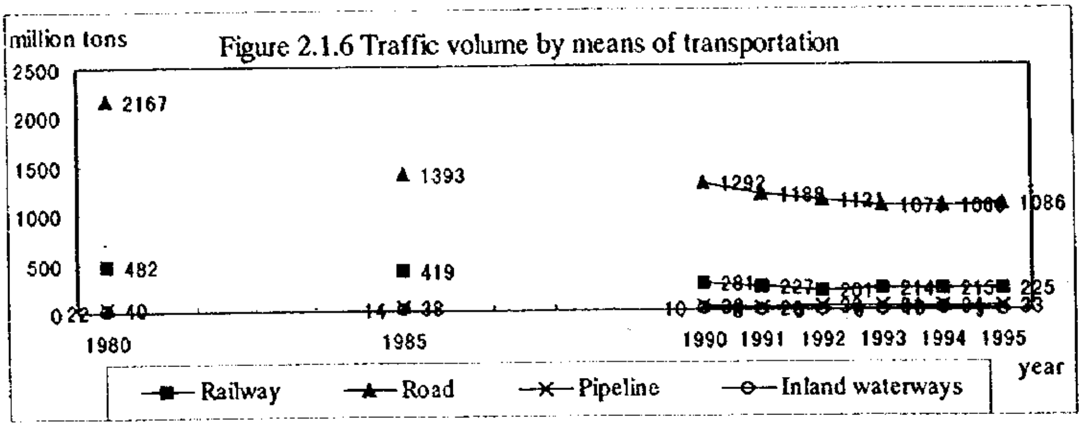


Figure 2.1.6 Traffic volume by means of transportation

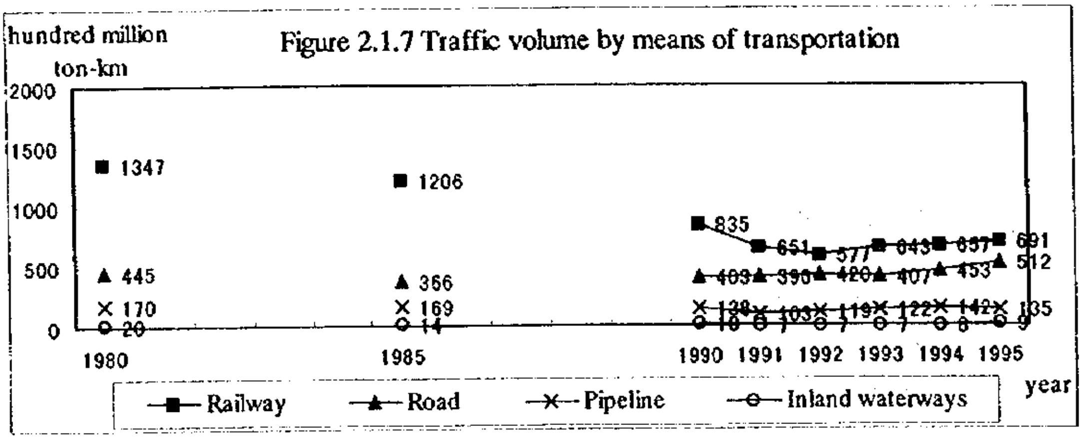


Figure 2.1.7 Traffic volume by means of transportation

(2) Trends in Freight Transportation Items

Coal accounts for roughly 50% of PKP's total freight transportation. In Poland which had performed the role of the energy supply base in the old economic system, coal occupies a large proportion of the gross national production, and coal transportation by the national railway stood at 62 million tons in 1980, which accounted for 34% of the freight traffic volume, and registered 160 million tons in 1985, which accounted for 39% of the total freight volume. During the shift of the economic system, the gross national production suffered a substantial decrease, and therefore the railway transport volume sharply dropped from 482 million tons in 1980 to 225 million tons in 1995, a marked 47% decline. Under this situation, coal, occupying a great weight in the domestic energy resources, took sharp successive drops in production, namely, 193 million tons in 1980, 192 million tons in 1985, 148 million tons in 1990, and 135 million tons in 1995. Nonetheless, coal being most suited to railway transportation, coal transportation on railway suffered a relatively small decrease, registering 60% of the total volume transported by rail in 1992, and secured stable transport volume from 1992 onwards, centering on domestic consumption and export (32 million tons in 1995).

The transport volume of the items other than coal is the way to gradual recovery after falls in transport volume up until 1992. A general look at performance from 1990 to 1995 reveals that large-volume primary products, such as coal, ore, and stone, occupy a substantial proportion of the total transport volume, whereas agricultural products and agriculture-related goods, including fertilizer do not amount to much, nor do secondary products a sizable proportion of the transport volume.

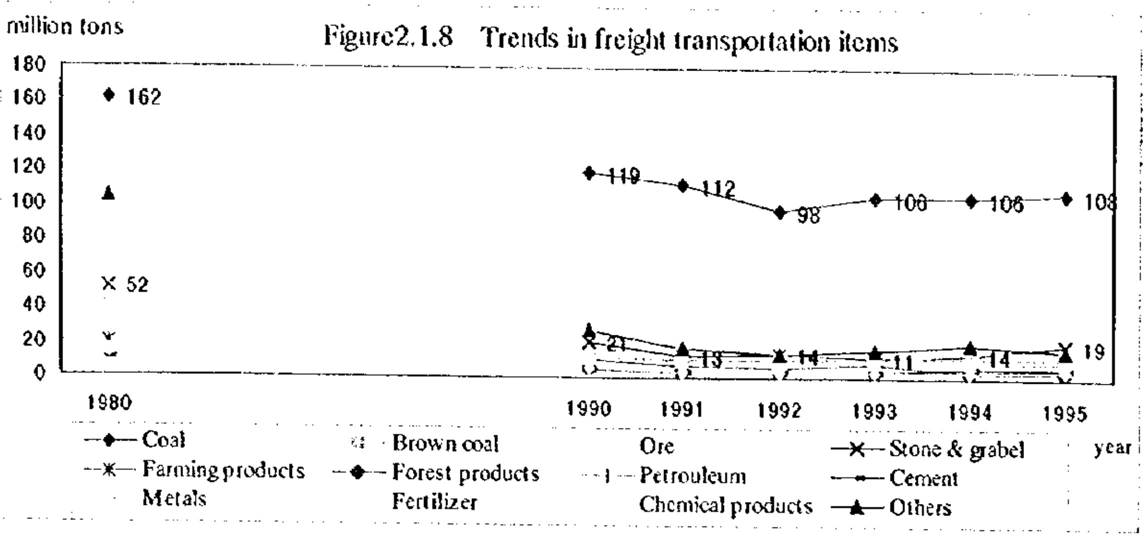
Table 2.1.8 Trends in freight transportation items

(Unit : million tons)

Year	1980	1990	1991	1992	1993	1994	1995
Coal	162 (34)	119 (43)	112 (50)	98 (49)	106 (49)	106 (50)	108 (48)
Brown coal	18	11	10	10	9	9	9
Ore	27	14	11	9	9	8	14
Stone & gravel	52	21	13	14	11	14	19
Farming products	20	10	7	6	8	4	6
Forest products	13	6	4	3	3	3	3
Petroleum	17	12	10	10	11	11	12
Cement	10	5	3	3	4	6	6
Metals	44	26	18	14	10	15	17
Fertilizer	14	6	4	4	4	4	5
Chemical products	15	11	9	8	9	9	10
Others	104	28	17	14	16	19	16
Total	**482**	**281**	**225**	**200**	**213**	**213**	**224**

Source : PKP annual report (The figures in parentheses are percentages to totals.)

Figure2.1.8 Trends in freight transportation items



(3) International Transportation

Poland, being a country in Europe, is to play an important role in international transportation, especially in the sector of freight transportation. In 1995, international freight transportation by PKP amounted to 82.8 million tons and 34.3 billion ton-km, which account for 37% in tonnage and 50% in ton-km in PKP's total freight transportation. From this, it is presumed that PKP's international freight transportation is on the track to recovery while the polish economy is moving from the chaotic period to stability.

International transportation consists of export, import and transit. Among these three, exports represent the largest share in international transportation, accounting for 66% in tonnage and 67% in ton-km.

Table 2.1.9 PKP's international freight traffic volume

Year	1990	1991	1992	1993	1994	1995
Traffic (million tons)	278	225	200	212	213	224
Domestic	198(72)	166(74)	143(73)	149(71)	72(66)	141(63)
International	79(28)	59(26)	55(27)	64(29)	72(34)	83(37)
Export	49	41	39	41	51	55
Import	23	13	13	17	16	22
Transit	8	4	4	5	6	6
Traffic (100 million ton-km)	835	651	577	643	657	691
Domestic	485(68)	418(64)	359(62)	372(68)	345(53)	347(50)
International	349(42)	233(36)	217(42)	271(42)	311(48)	343(50)
Export	215	154	183	183	227	233
Import	89	55	65	65	56	78
Transit	45	24	23	23	28	32

Source: PKP annual report (The figures in parentheses are percentages to totals.)

Among the items associated with international transportation, coal accounts for a large share in exports while ore represents by far the greater share in imports. The recent trend is an increase in products transportation by containers, etc.

Table 2.1.10 Railway transportation of imported goods

(Unit : thousand tons)

Item	1980	1985	1990	1995	Remark
Coal	1073	1071	574	1131	
Brown coal	4	97	7	45	
Ore	20161	12111	8506	6215	Due to change of economic system
Stone, etc.	60	65	45	63	
Petroleum	2284	2015	1496	1538	
Metals	3709	2871	2144	1352	Due to change of economic system
Cement	97	10	30	2	
Fertilizer	3423	4035	915	935	Increase in domestic production
Chemicals	1249	1026	1064	1759	
Cereals	7035	1866	1360	1655	Due to change of economic system
Other farming products	2224	1451	642	811	
Lumber	533	459	172	303	
Others	3761	3304	1791	1420	
Total	**45613**	**35638**	**22709**	**22015**	

Table 2.1.11 Railway transportation of export goods

(Unit : thousand tons)

Item	1980	1985	1990	1995	Remark
Coal	30727	34088	26102	31790	
Brown coal	1702	1666	3346	3928	
Ore	18	185	84	191	
Stone, etc.	155	68	76	3154	Construction boom in Germany
Petroleum	831	481	1032	762	
Metals	3000	2756	5497	3808	
Cement	1233	1152	712	3113	Construction boom in Germany
Fertilizer	297	210	1456	1570	
Chemicals	3694	3193	3116	3676	
Farming products	524	1580	2278	1724	
Lumber	1553	2126	742	315	
Others	2725	2403	2481	2116	
Total	**46459**	**52645**	**49146**	**55256**	

Figure.2.1.9 Railway transportation of inported goods

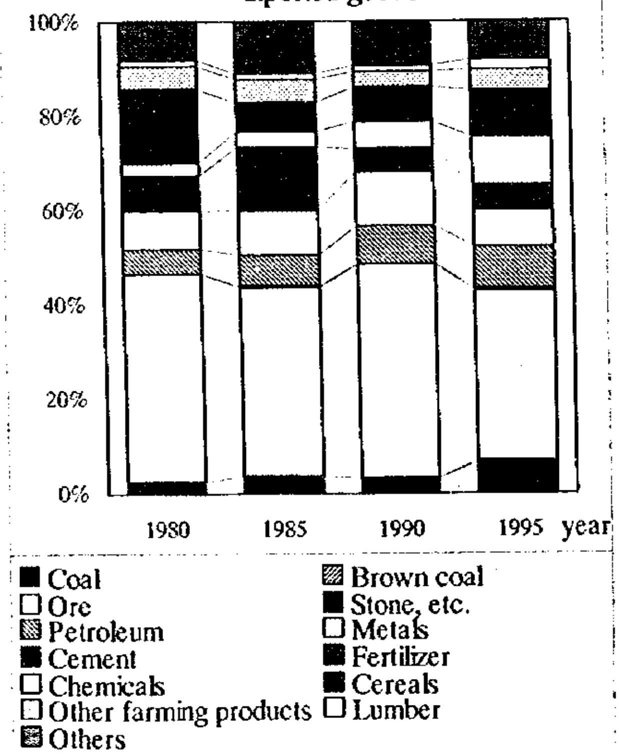
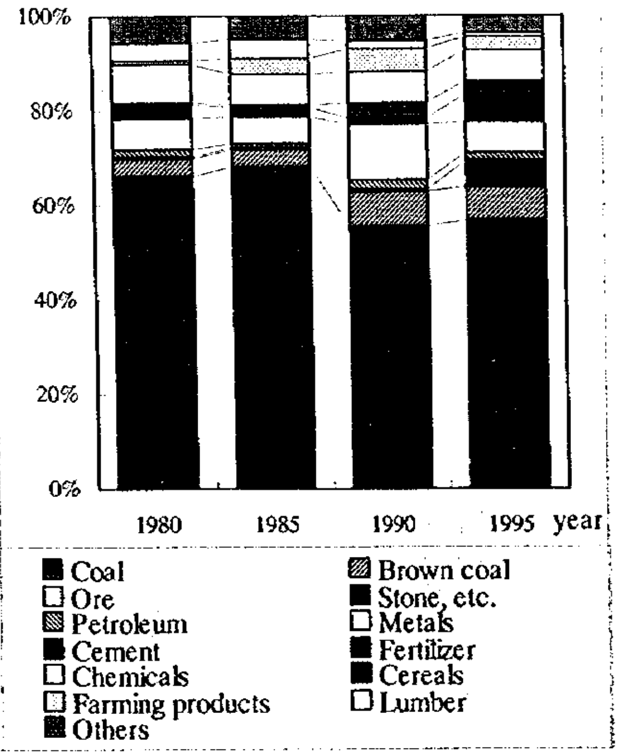


Figure 2.1.10 Railway transportaition of export goods



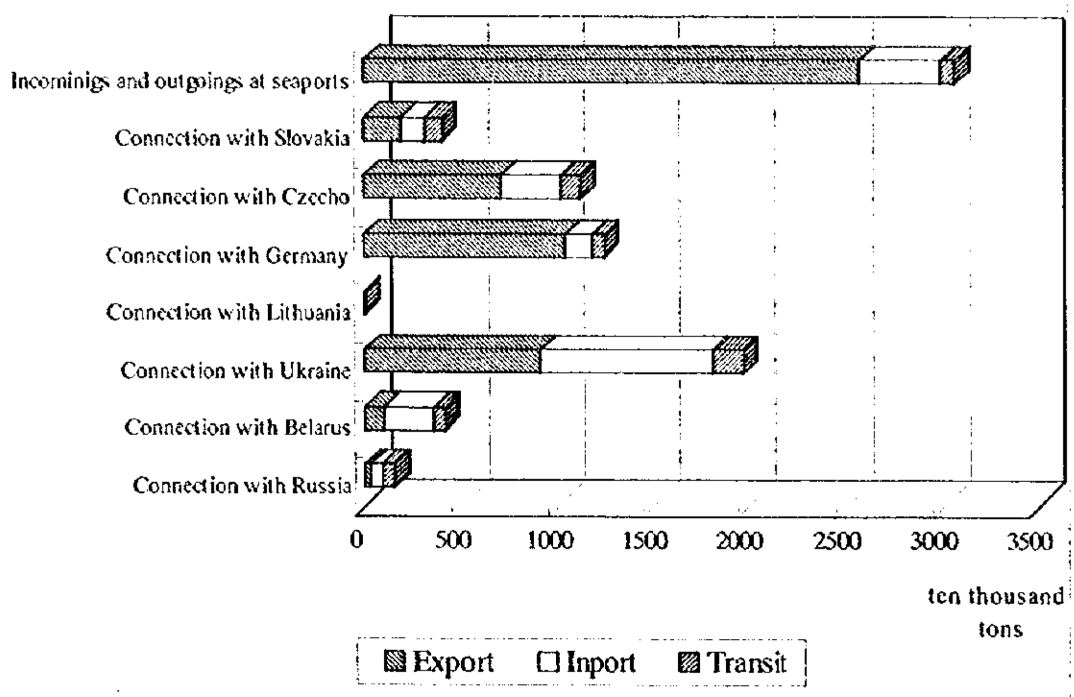
As junction station for international freight transportation, there are 36 stations (31 inland stations; 5 seaport stations). The traffic volume of international cargoes in those stations in 1995 is shown below.

Table 2.1.12 International freight volume by rail

(Unit : ten thousand tons)

	Export	Import	Transit	Total
Connection with Russia	**32**	**55**	**62**	**94**
Braniewo	4	55	5	65
Glomno	1	-	-	1
Skandawa	26	-	1	27
Connection with Belarus	**102**	**252**	**56**	**411**
Kuznica	3	11	1	15
Sieminowca	3	48	1	53
Czeremcha	1	-	-	1
Telespol	95	193	54	342
Connection with Ukraine	**903**	**903**	**161**	**1967**
Dorohus	442	10	-	452
Hrubieszow	123	479	1	602
Werchrata	54	-	-	54
Medyka	284	414	160	859
Connection with Lithuania	**1**	**2**	**3**	**6**
Trakiszki	1	2	3	6
Connection with Germany	**1034**	**140**	**66**	**1239**
Szlzecin	105	55	3	162
Kostrzyn	170	4	1	175
Kunowice	269	48	57	373
Gubin	169	1	-	170
Zasieki	201	15	3	219
Bielawa	120	17	2	139
Connection with Czecho	**695**	**312**	**105**	**1115**
Zawidow	15	2	28	46
Lubawka	7	12	2	21
Mieroszow	35	8	1	44
Miedzylesie	25	39	5	69
Glucholazy	2	3	-	5
Chalupki	254	65	33	352
Zebrzydowice	218	174	17	408
Marklowwice	139	9	19	168
Connection with Slovakia	**190**	**118**	**91**	**399**
Muszyna	141	105	91	336
Zwardon	49	13	1	63
Incominigs and outgoings at seaports	**2569**	**418**	**71**	**3059**
Swinoujscie	400	184	47	631
Szczecin	717	133	23	873
Gdansk	1078	30	-	1108
Gdynia	366	71	1	439
Kolobrzeg	8	-	-	3
Total	**5525**	**2201**	**564**	**8291**

Figure 2.1.11 International freight volume by rail



As the track gauge differs in Russia, Lithuania, Belarus and Ukraine, goods for these states are transshipped at the junction stations near the national border.

On international transportation, bilateral agreements have been concluded with the trading partner countries, while the transportation plan was formulated to facilitate the traffic such that 60 international preferential freight trains (TEA,TEC,TED,TET) have been designated and given top priority and differentiated from some 480 international general trains (TGL,TGR,TGZ,TGT) in transportation operations.

International preferential freight trains:

TEA...EUC standard transport trains (20)

TEC...Transport trains connected with containers, etc. (20)

TED...Transport trains under international agreements (16)

TET...Transit transport trains priority (4)

International freight general trains:

TGL...Local transport trains (263)

TGR...Collected transport trains (116)

TGZ...Exclusive-use freight transport trains (80)

TGT...Transit transport trains (21)

2.2 MANAGEMENT AND FINANCIAL SITUATION

The various methods for determining the price to be paid for a company or its shares depend heavily on the Balance Sheet (e.g. Net Asset Value or "NAV" method) or the Profit & Loss Statement (e.g. Earnings Per Share or "EPS" method).

The accounts of the PKP are not the consolidated (acquisition method) results of the PKP and its subsidiaries. As a result it is impossible to comment on the financial situation of the group. The results of the holding company PKP enjoy the benefits of government grants (not loans) and so look relatively strong.

There is a lack of transparency regarding the financial results of subsidiary companies and joint ventures. Details of related party transactions (e.g. between the main PKP and subsidiaries) are not available.

The Balance Sheet Assets, the Balance Sheet Liabilities and Profit & Loss is shown in tables 2.2.1 and 2.2.2 and 2.2.3 respectively in Appendices. Note: comments are also based on the auditors report prepared by Finans-Servis for the World Bank where the numbers vary slightly from the segmental tables shown.

2.2.1 Analysis of the 1996 financial statements

(1) The Balance Sheet (see tables 2.2.1 and 2.2.2 in Appendices)

The Balance Sheet as of 31 December 1996 shows assets and liabilities of 21,956,543,600 PLN, an increase of 763,462,200 PLN.

1) Intangible Assets

The intangible assets of 31,311K PLN comprises mainly of purchased software, licenses and interest on credit (pre-1991). These assets are depreciated over a period of 5 to 10 years.

2) Tangible fixed assets

Net Tangible Fixed Assets

	PLN 000's	1996	PLN 000's	1995
Land	5,519	0.03%	4,968	0.03%
buildings & constructions	13,746,263	69.8%	13,825,033	72.2%
technical equipment and machines	919,465	4.7%	835,659	4.4%
means of transport	3,962,825	20.1%	3,792,532	19.8%
other	1,067,390	5.4%	681,707	3.6%
Total	19,701,462		19,139,899	

3) Land and Buildings

Land and Buildings of 13,746,263,000 PLN accounts for 63% of the total assets (69.8% of the fixed assets) of the PKP.

Only the property for which the PKP is in possession of the title deeds included in the fixed assets for 1996. Property that is rented (from the government or others), property for which ownership records have been lost or have disputed ownership is not included in the Balance Sheet.

An estimation of the proportion of land not included in the fixed assets can be made from the 1994 financial statements which shows 82,891,360.16PLN as rented and 2,312,561.58PLN as owned. In the 1995 statements, only the owned portion is shown i.e. over 97% of the land utilized by the PKP is not owned and thus not included in the current financial statements.

The value of land shown in the Balance Sheet is 5,519,317 PLN (about US$1.9 million @ $1 = 2.8755). We would expect that the value of all the land "used" by the PKP to be much higher.

4) Depreciation of fixed assets

Gross and Net Fixed Assets & Depreciation

	1996 (000's)	1995 (000's)
- gross value of depreciable assets at 31/12	41,997,222	41,048,856
- depreciation	23,281,616	22,527,010
- net value of depreciable assets	18,715,605	18,521,847

From the table, it can be calculated that the percentage of depreciated assets has gone up from 54.88% in 1995 to 55.44% in 1996. If one considers the inflation effect e.g. transport equipment being depreciated at inadequately revalued costs, the net under-investment would be greater.

Changes in Gross Assets

	Gross Assets (PLN 000)		
	1995 end	1996 end	Change
Fixed assets	41,048,856	41,997,222	948,366
Land	4,968	5,519	551
buildings and constructions	25,541,794	25,997,346	455,552
technical devices	3,492,803	3,646,363	153,560
transportation means	11,800,661	12,107,860	307,199
remaining fixed assets	208,630	240,134	31,504
investment in progress	600,243	958,331	358,088
pre-payment for investments	17,809	26,197	8,388
Total I+II+III	41,666,908	42,981,750	1,314,841
legal and intangible values	47,139	56,250	9,110
research work costs	0	0	0
other intangible	47,139	56,250	9,110
pre-payments for intangible	0	0	0
	0	0	0
TOTAL	41,714,048	43,037,999	1,323,951

Changes in Depreciation

	Depreciation (PLN 000)		
	for 1995	for 1996	Change
Fixed assets	846,621	1,126,936	280,316
Land	0	0	0
buildings and constructions	477,519	592,782	115,262
technical devices	106,250	142,738	36,488
transportation means	246,790	373,448	126,658
remaining fixed assets	16,062	17,969	1,907
investment in progress	0	0	0
pre-payment for investments	0	0	0
Total I+II+III	846,621	1,126,936	280,316
legal and intangible values	4,773	6,040	1,267
research work costs	0	0	0
other intangible	4,773	6,040	1,267
pre-payments for intangible	0	0	0
	0	0	0
TOTAL	851,393	1,132,976	281,583

From the tables above (showing changes in gross fixed assets and depreciation for different classes of assets), it can be seen that the gross value of buildings and constructions increased by 455.6m PLN and that the depreciation increased by 115.3m PLN. The expected change in depreciation can be calculated based on the approximate depreciation rates for the various classes of assets. Finally the difference between the actual depreciation charge increase and the expected depreciation charge increase gives an indication of a possible over-charging of depreciation.

Actual and Expected Increases in the Depreciation Charge

	Gross Change	Depreciation Change	Expected	Difference
buildings and constructions	455,552	115,262	11,400	103,862
technical devices	153,560	36,488	15,350	21,138
transportation means	307,199	126,658	20,480	106,178
Total				231,178

The above tables show that the increase in depreciation might be overstated by 231.2 m PLN. If the depreciation for 1996 is reduced by this amount, the loss of the PKP might have been only 24.5m PLN.

5) Investments in progress
The value of fixed assets in construction as at the end of the year increased by 59% to 984,527,900 PLN (1995 – 600,243,429).

6) Investment in fixed assets
Investments of 1,798,888,500 PLN during 1996 were financed by:

Financing of Investments in 1996

International Bank for Reconstruction and Development (IBRD)	94,942,600
European Investment Bank (EIB)	122,426,500
Polish Government subsidy	385,430,200
PHARE and the PKP	1,122,168,000
Other foreign credits	73,921,200

7) Financial fixed assets
This is comprised of 29,997,700 PLN (up from 23,699,190 PLN) in investments in shares and Long-term loans granted of 77,794,400PLN (up from 74,172,775.02

PLN).

The loans granted are the receivables from technical back-up companies' external to the PKP. These loans have been financed by money from the IBRD and the EIB.

8) Stocks

The inventory amounted to 574,467,829 PLN (1995 - 530,631,989 PLN), an 8.3% increase over the previous year. This is less than the rate of inflation (19.9%).

The stock turnover period can be calculated as:

stock X 365

value of goods and materials sold + consumption of material and energy

This shows 107 days (1995 - 120 days). In actuality, the figure would be higher because the denominator includes energy costs.

9) Debtors

Debtors amount to 1,102,177,300 PLN (1995 - 938,383,015 PLN), a 17.5% increase. The debtors turnover period i.e. (debtors/total operating incomes) X 365 was 48 days (1995 - 47 days).

10) Cash

The cash balance was 366,298,400 PLN and consisted mainly of cash in the bank (76%) and in hand (24%).

11) Long-term liabilities

The long-term liabilities of 762,28,400 PLN (1995 – 507,137,751) is:

Long Term Creditors of the PKP

	1996	1995
IBRD	367,245,044	303,654,489
EIB	321,503,585	203,483,262
Bank Kreditanstalt	73,479,780	

The long-term liabilities account for just 3.5% (1995 - 2.4%) of total assets [1].

[1] Annex I/2 of the EU White Paper "A Strategy for Revitalising the Community's Railways" shows that the EU average was 54% in 1994 (highest 89% and lowest 14%). Thus the PKP at 3.5% has a smaller proportion of debt than any EU country.

12) Current liabilities

The current liabilities of 1,646,850,977 PLN (1995 -- 1,262,016,322) are made up of short -term bank loans (14,730,240 PLN), accounts payable (1,335,949,844 PLN), Social Benefits Funds (131,806,364 PLN) and advance payments received (164,364,529 PLN).

(2) The Profit & Loss Account (see table 2.2.3 in Appendices)

The Profit & Loss Account for the year to 31 December 1996 shows a loss of 260,997,600 PLN compared to a loss of 106,221,531 PLN for 1995.

If the costs include depreciation, then there is a deficit. If however we exclude depreciation but include state subsidies, then there is an operating profit i.e. positive cashflow from operations of 871,978,563 PLN (1995 – 745,163,473 PLN).

1) Revenues

The total revenue of 8.4 bn PLN was from freight (5.0 bn PLN), passengers (1.2 bn PLN) other sources (1.2 bn PLN) and government subsidies (1.0 bn PLN). Revenues increased by less than the rate of inflation. Freight handled was 222.6 m tons (down 0.8%) and was carried 68306 m ton-km (down 1.1%). Passengers carried totaled 433.5 m persons (down 6.8%) over a distance of 26,558 m passenger-km (down 0.2%).

In the case of passengers, the Ministry decides tariffs. This is because the Ministry buys the services from the PKP and also because of PKP's monopolistic position.

In the case of freight, prices have been deregulated since 1994 except for coal and iron ore for which the MTME and the Ministry of Finance set prices.

Freight tariffs rose on average by 18.3% whilst passenger tariffs rose by an average of 14.5%. These increases can be compared to the consumer price inflation of 19.9% for 1996.

Government subsidies were for passengers 571.5 m PLN (1995 - 338.3 m PLN), maintenance nil (1995- 365.5 m PLN) and the Rail Medical Service 392.2 (1995 - 307.8 m PLN). Note: in addition, the PKP received grants for capital spending of 385.4m PLN (1995 - 95.8 m PLN) which was credited directly to the legal capital.

a) Analysis of Transportation Income (Vertical) see Table 2.2.5 in Appendices
This table shows the actual incomes for 1995 and 1996. Also percentages shown are for each category as a percentage of the total revenue for the year.

This table shows that the transport income has dropped from 94.1% to 91.6% of income. The proportion of the targeted subsidy has increased from 5.9% to 8.4% of total income.

Freight transportation incomes as a percentage of total transportation incomes is lower in all categories of freight i.e. falling to 73.5% from 75.2% of total income.

The proportion of receipts from Passenger tickets has fallen by 1.5% (from 15.9% to 14.4%).

b) Analysis of Transportation Income (Horizontal) see Table 2.2.4 in Appendices
This table shows the actual incomes for 1995 and 1996, the difference between 1995 and 1996 and the difference as a percentage of the actual for 1995 has been calculated. The table shows that incomes in all significant sectors have under-performed the consumer inflation rate (19.9%).

2) Expenses
Expenses were 8.6 bn PLN of which 96.5% was for operating costs. In addition there were financing costs of 114.6 m PLN and extraordinary losses of 5.2 m PLN. A different analysis of expenses shows that wage related costs were 48% (1995 - 46%), energy and materials 22% (1995 - 23%), external services 12% (1995 - 13%), depreciation 14% (1995 - 12%) and other expenses 4% (1995 - 6%) of the total expenses.

c) Depreciation expense
The depreciation expense for 1996 of 1,132,008,041 PLN (1995 - 851,385,004 PLN) is 280,623,037 PLN or 33% increase.

The increase in depreciation can be compared with the net loss for the year of 260m PLN.

d) Staff numbers
The total equivalent full-time staff was 233,183 (1995 - 240,792) a 3.2 %

decrease from the previous year.

e) Net Loss

The net loss for the year was 260,750,400 PLN and differs from the figure in the English version of "Annual Report PKP 1996" which shows a loss of 255,715,400 PLN.

f) Operating ratios

PKP's operating ratios [2]:

	1996	1995
with subsidies	102.9	101.3
without subsidies	116.2	117.5

(3) The Cashflow Statement (see table 2.2.6 in Appendices)

The Cashflow Statement for the year to 31 December 1996 shows a net decrease in cash of 92,990,155 (1995 - increase of 202,797,027 PLN) to 366,013,537 PLN (1995 - 459,003,692 PLN).

Inflows consisted of a net positive income from operations of 833,598,656 PN (1995 - 758,518,269 PLN) and from net financial activity of 221,863,785 (1995 - 230,152,892 PLN) whilst outflows were for net investment activity.

(4) Auditors Report

The auditors of PKP are a firm called "Finans-Servis". They audited the financial statements for the year 1996 in accordance with the relevant Polish regulations and have given "an unqualified opinion".

(5) Reporting procedure

There are about 500 accounting offices (e.g. each locomotive has its own accounting office) that report to the 8 divisional offices (i.e. DOKPs). Separately there are 22 units that report the DGPKP. Finally the results of the 8 DOKPs and the DGPKP is consolidated.

[2] The PKP has contracted to control these ratios as part of their debt agreement with the IBRD.

The Financial Statements of the PKP are obtained by consolidating 9 divisions i.e.:

- General Directorate PKP
- Central DOKP in Warsaw
- East DOKP in Lublin
- South DOKP in Kracow
- Silesian DOKP in Katowice
- North DOKP in Gdansk
- Lower-Silesian DOKP in Wroclaw
- West DOKP in Poznan
- Pomeranian DOKP in Szczecin

The General Directorate PKP accounts for the following 22 organizations:

- A Railway Information Center (CIK) in Warsaw
- A Railway Technical -Scientific Center (CNTK) in Warsaw
- A Central Office of International PKP Settlements (CBRZ) in Bydgoszcz
- A Central Office of Buying and Selling (Ferpol) in Warsaw
- A Central Equipment Store (Cetakol - CSEA) in Sosnowiec
- A Central PKP Construction Office (CBK) in Poznan
- Central Travelers Service Office (POLRES) in Warsaw
- An Office of an Income Control in Lodz
- An Office of an Income Control in Kracow
- An Office of an Income Control in Olsztyn
- An Office dealing with Free-Ticket Transport in Gniezno
- An Office dealing with the disability pays for railway workers in Olsztyn
- The Center for Diagnosis and Welding of the Railway Trucks in Warsaw
- Public Cable Ways in Zakopane
- The Work of Truck Machines in Gdansk
- The Work of Truck Machines in Krakow
- The Work of Truck Machines in Wroclaw
- The Work for the Regeneration of the Sleepers in Ostrowia Mazowiecka
- The Railway Printing-office in Warsaw
- The Railway Printing-office in Krakow
- The Railway Printing-office in Poznan
- The Directorate of the Railway Health Care Service in Warsaw

(6) Accounting separation of subsidiary companies

The accounts of wholly owned subsidiaries, partially owned subsidiaries and joint ventures are not consolidated into the accounts of the PKP i.e. the financial statements of the parent company alone are shown. The partial equity method is used to account for all investments i.e. only the PKP's shareholding is included (in financial fixed asset). PKP's P&L too does not include the turnover etc. of subsidiary companies but only the dividends received.

In this respect, the PKP does not produce true consolidated financial statements. True consolidated financial statements should use the acquisition method of accounting.

There are approximately 40 unconsolidated subsidiaries. Not all of these are 100% subsidiaries. The Annual Report of the PKP does not list major subsidiaries as is done by 'western companies'.

(7) Method of depreciation

Depreciation is carried out by the straight-line method to reflect the useful lives of individual assets. The rates used have been set by the Ministry of Finance in the Taxation Law.

(8) Consistency of Polish GAAP with IAS

Polish GAAP (Generally Accepted Accounting Principles) have been revised (Accounting Law , 9/1994) to bring them closer to International Standards. The Annual Report PKP 1995 (in English) certainly does not meet the disclosure requirements as required by Western countries.

Additionally, Stock Exchanges have additional reporting and disclosure requirements. The Annual Report PKP certainly does not fulfil these requirements as well.

(9) Profitability by lines

This information cannot be derived from the current accounting information received from the PKP / MTME.

The PKP receives subsidy targeted at unprofitable passenger services. The amount of the subsidy is the difference between the cost and the income from such services (see also section on subsidies i.e. chapter 5.8). This would indicate that both the MTME and the PKP have an idea of the costs and incomes by service / line.

(10) Project / Investment appraisal

The Investment Department is responsible for making feasibility studies for all proposed investments. Alternative investment plans are made, a cost-benefit analysis is done, the financial effects are estimated and the shortfall is known.

A discount rate of 12% is used to appraise potential investments. This rate matches the economic rate of return required of infrastructure investments by the World Bank / European Investment Bank.

(11) Monthly Management reports

The financial statements for each month are used as the Management Information System. There is no separate system of Management Accounting. Control is exercised by using "Detailed Costs Accounting".

An annual budget is prepared and actual incomes and costs are compared to the budget.

(12) Experiences of previous privatization

The companies providing technical services to the PKP were privatized in a process that started in 1991. A total of 70 industrial enterprises were separated including :
- 20 companies to maintain rolling stock
- 5 companies producing concrete sleepers
- 5 companies producing wooden sleepers

The method of privatization was liquidation by the NIF. Although the companies are still in a difficult position (as capacity is higher than requirements), only 2 of these (very weak and with few staff) have closed down. Four have yet to be privatised.

(13) Conclusion

The true value of all of the assets being used by the PKP is not shown in the financial statements (e.g. leased property). There is also no mechanism to value PKP's investment in subsidiary companies.

The PKP should form Business Units for all its functions and produce audited accounts for each of them. The financial performance for each should then be improved. This will ensure that in any possible privatization, proceeds will be maximized.

The current disclosure requirements mean that the PKP has to disclose very little information to its shareholders - the citizens of Poland. Under such circumstances, there can be abuses of trust with little chance of discovery. Improved disclosure will ensure that valuable assets cannot be disposed of without adequate compensation.

The lack of debt (the PKP has less long-term debt than any country in the EU), means that the PKP can be privatised that much more easily.

2.2.2 PKP's 20-year forecast

Data for till 2005 from the PKP's 20-year forecast dated 24 June 1996 (in 1995 prices) in is shown in tables 2.2.7 to 2.2.15. The base data is from the previous year's forecast and is found in table 1.2.16. The Strategy Department is currently (September 1997) updating this forecast.

1) Optimistic scenario — This is shown in tables 2.2.7 to 2.2.10 in Appendices. The main points are

- Freight and Passenger revenues increase by 11% and 44% respectively
- Other income increases by 637m PLN
- Losses peak at 776m PLN in 1998 and improve to a profit of 38m PLN in 2005
- Investment of 16,737m PLN (total for 1997 to 2005)
- Total borrowing in 2005 of 2.5bn PLN (1996 – 2.5 bn PLN)

2) Pessimistic scenario — This is shown in tables 2.2.11 to 2.2.10 in Appendices. The main points are

- Freight and Passenger revenues decrease by 9% and 7% respectively
- Other income increases by 313m PLN
- Losses peak at 1,067m PLN in 1998 and improve to a loss of 935m PLN in 2005
- Investment of 11,875m PLN (1997 to 2005)
- Total borrowing in 2005 of 2.2bn PLN (1996 – 2.5 bn PLN)

3) Comparison with Scenario 1C(i) The PKP's optimistic scenario is compared with Scenario 1C(i) (see annex to chapter 4) in the table below :

Comparison for the year 2005

PKP - Optimistic (1995 PLN)	Scenario 1C(i) (1996 PLN)
Freight revenues increase by 11.8%	Freight revenues increase by 6.3%
Passenger revenues increase by 44.8%	Passenger revenues increase by 26.4%
Other income increases 637m PLN	Other income increases 650m PLN
Profit of 38m PLN	Profit of 1,125m PLN
Investment of 16,737m PLN	Investment of 26,862m PLN
Decrease in borrowing of 129m PLN	Increase in borrowing of 1,886m PLN
Salary costs are 24.8% of total costs	Salary costs are 29.9% of total costs
Passenger subsidy of 577.0m PLN	Passenger subsidy of 571.5m PLN

2.2.3 Requirements for PKP restructuring / privatization

(1) Disclosure requirements

In order to attract investors to any separated part of the PKP or to the Holding Company, increased financial information is essential.

1) Annual Report

a) The table below is indicative of PKP's current level of public disclosure.

Document	Company status	Total length	Financial-Management
		(pages)	Information (pages)
Annual Report PKP 1996	State Owned Enterprise	58	4
Deutsche Bahn Annual Report and Accounts 1995	One-man state owned company	95	82
Railtrack Annual Report & Accounts 1995/96	Publicly Quoted Company	68	56

b) The situation is worse than revealed in the published PKP accounts. This is because the maintenance and depreciation provisions are both inadequate. –

Economic costs of Transport and user charges by BCEOM, French Engineering Consultants for PHARE

The financial statements are prepared and presented according to Polish Accounting rules. There is no adjustment for the effects of inflation. Investors would have to first convert these accounts into a form that they can understand e.g. the use of IAS 29 so as to include the effects of inflation.

The PKP could thus assist analysts by providing "current cost" financial statements.

(2) Briefings for analysts

In addition to the Annual Report that is publicly available, the PKP will need to have private presentations several times a year to representatives of financial institutions (Analysts, Stockbrokers etc.). During these sessions, the management will have to fully disclose detailed information and answer all questions.

The current culture of secrecy / confidential information that exists in the PKP / MTME cannot continue if the PKP wants to be a privatized company. (Note – The argument that tariffs for example must be kept secret presupposes a weak and imperfect market. In actuality markets are well informed e.g. freight customers would have investigated alternatives and chosen the best mode).

(3) Financial Management Skills

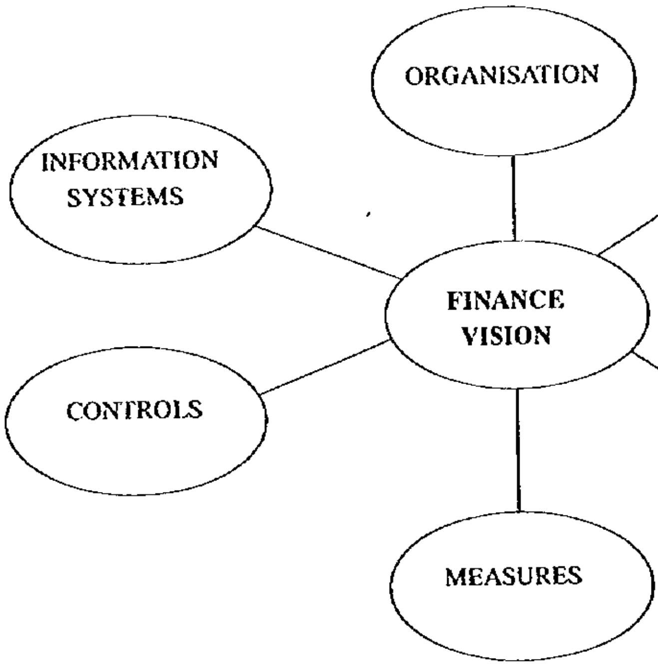
The structure and objectives of PKP as an organization is changing as it moves from a state monopoly, to a more commercially orientated organization. Accordingly, the structure of the finance function must change also, as must the service it provides to support the business.

As well as internal changes, external factors will affect the management and information that PKP is required to produce in the future. For example, compliance with the EC directive 91/440 will require greater complexity and visibility of costing information. Increased commercialization and future privatization of the business will require management information and measures to be produced as well as financial information. The cash/treasury management aspects of the business will be put on a more commercial footing, requiring more timely and regular information on an individual unit as well as a consolidated basis.

1) Influencing Factors

In order to provide these enhanced services, the means by which this service is delivered must be investigated and evaluated. This must all be within the context of an overall "vision" for the finance department, which in turn must support the overall organizational goals and objectives.

This is represented in diagrammatic form below :



The new FMIS systems will provide modern, flexible information systems providing not only financial reporting, but also management reporting and ad-hoc/decision making support capability. However, it is important to note that information systems represent only a part of the overall requirement for the finance function. They are a tool to do a job, and will not be effective without proper consideration and integration with the other areas, i.e.

- an appropriate organization structure for the function, supporting the business functions;
- clearly defined processes, providing consistency across the business;

- people with the appropriate level of skills to provide the required service levels to the business;
- quantifiable measures against which the performance of the finance function can be evaluated; and
- controls which provide a framework for management of the financial aspects of each function, but with a consistent approach across the whole business.

2) Context of Information Systems Improvements

The FMIS systems will provide the foundation for the information systems required to support the financial function of PKP for the foreseeable future. However, as can be seen from the above diagram, and described above, they are only one component and will not be as effective as they could, nor give PKP the full return on their investment, unless parallel consideration and changes, where appropriate, are implemented in the other areas. In addition, the FK-BIS system will not provide the functionality or flexibility for supporting the business in the longer term.

3) Changes required in the Approach/Skills of the Finance Function

The current finance function can be characterized as being concerned mainly with :

a) external reporting/accounting
b) technical compliance with Polish accounting law;
c) concentration by staff on book-keeper/administrator/custodian roles.

This approach requires that the main skills of the senior staff within the finance function concentrate on technical knowledge of the "rules" and Polish accounting law.

The aim should be, over a period of time, and in a controlled, phased manner, to move to having finance function concerned more with providing :

a) business leadership in terms of the advice given to management and meeting agreed service levels to the business;
b) "value-added" advice and improvement of the business;
c) professional financial managers to manage the business and provide a professional service.

These aims require the skills of the staff to move, over a period of time, to those of business judgement & financial expertise, rather than technical knowledge of the "rules" and Polish accounting law.

It is therefore recommended that PKP undertake a full review of all areas of the finance function outlined in the diagram above. This will ensure that :

- the investment in the FMIS systems can be more fully realized;
- there is a clear direction and strategy for the finance function;
- the needs of the business can be serviced more adequately; and
- senior management have a framework against which the performance of the finance function can be more accurately measured.

(4) Auditors role in cost allocations

All privatised companies need to be audited. This does not mean that shareholders do not trust the management but auditing is an accepted method for checks and controls. The PKP's accounts are audited in accordance with the auditing requirements of the Polish State.

The current costing system of the PKP is such that very few costs are direct costs. For example in the case of passenger services it would appear that only about 10% of the costs are direct costs i.e. the rest being costs that are apportioned.

PKP's restructuring plan would go some way toward reducing the level of indirect or apportioned costs. The various privatization plans, if adopted, would go even further toward reducing the level of cost allocation. The fact remains however that there will always be a degree of cost allocation.

We recommend that the PKP & MTME should use the services of auditors to check the cost allocations. Just as in the case of normal auditing where there is no presumption by the owners of dishonesty on the part of a company's officials, the use of auditors to verify cost allocations can be a useful method for control.

(5) Use of auditors for subsidy determination

The PKP and the MTME have reached agreement as to which activities will be subsidized. It is expected that the State will always require certain uneconomic activity e.g. passenger services where the government will cover the deficit. The problem is to accurately determine the amounts to be reimbursed.

The US Government often awards contracts on a "Cost Plus" basis. The agreement between the PKP and the State can be likened to a "Cost Plus" system. The US government and Contractor as part of the contract would agree that auditors are used to verify the amounts to be reimbursed. The PKP and the State could similarly agree that auditors would verify the amounts to be reimbursed for uneconomic services that the PKP is obliged to provide.

Once again it is not presumed that the Contractor (the PKP) would overcharge the customer (the State) but the use of auditors would provide adequate checks and controls.

2.3 RESTRUCTURING PLAN PKP ITSELF

2.3.1 Main Objectives

The restructuring process of PKP has been forced by two main groups of factors:

- domestic, being a result of deep structural and institutional changes in the transformation processes towards a market economy in Poland. In the case of PKP it has led to dramatic revenue declines in the transportation (decrease of 47% from 1988 to 1995) and created financial pressures to reform the enterprise, additionally affected by a „hard constraint" policy in the government subsidy (decrease of 50% from 1990 to 1995)

- international, resulted from the present association and future membership in the European Union. PKP, as a part of the European railway system, will be obliged to implement EU directives and regulations, e.g. Directive 91/440 determining the separation of infrastructure from railway operation and introduction of open access for other operators

The transformation processes should create a new image of the company. The main objectives can be identified as follows:

- market oriented modern company as a part of the European railway system
- financial equilibrium in the first stage and generation of profits in the further stages
- strong competitive position both for other transport branches and other railway operators

In order to achieve these objectives, the following strategic goals are postulated:

- adaptation to the market economy, realized by:
  - commercialization of operations
  - decentralization of management through division into sectors and verticals
  - implementation of marketing strategies
  - readiness to compete with other transport branches and operators
  - market orientation for investment strategy and management

- harmonization of PKP standards to the European Union, conducted by:
  - granting an autonomy to the PKP
  - contract type relations between government - PKP and local governments - PKP
  - accounting separation of infrastructure from railway operation
  - modernization of line and station infrastructure (AGC and AGTC agreements)
  - implementation of compatible computer systems
  - improvement in security and environment protection

- internal rationalization of PKP operations, realized by:
  - improvement in cost accounting system
  - implementation of new economic-financial and organization systems
  - improvement in equipment and materials
  - rationalization of employment and permanent training of personnel
  - liquidation or disposal of surplus assets
  - separation of non-core activities
  - improvement in management by introduction of sector management.

2.3.2 Actual Progress made to date

(1) The first stage of restructuring (1990 - 1996)

The restructuring program of PKP was initiated in 1990, together with the economic and institutional changes in Poland. The restructuring in the first stage, which lasted until the end of June 1996 , allowed to reduce considerably staff numbers and fixed assets. The number of staff declined by 120 thousand and additionally by almost 70 thousand employees through the separation of 70 enterprises outside the PKP structure in the period from 1990 to 1995. The PKP employment amounted for 231 thousand at the end of 1996. The reduction of fixed assets has been achieved by the liquidation of 88% of marshaling and 50% of maneuvering yards, 22% of crossing gate operating points, 3624 km of unprofitable lines, 30% of rolling stock and technical base enterprises, 13% of electric and 35% of combustion traction rolling stock and 17% of passenger and 30% of freight rolling stock. In addition there was the new PKP Law passed on 6 July 1995, which determined a market orientation for the PKP and prepared the framework for further restructuring.

(2) The second stage of restructuring

The essential part of restructuring in its second stage, introduced as a pilot program in the Eastern DOKP (Lublin) on 1 January 1997, is a creation of market oriented enterprise, managed in the system of sectors and verticals.

The basic part of enterprise will be composed of four sectors (see Annex 1, presenting the new organizational structure of the PKP):
- passenger transport,
- freight transport,
- traction and workshop backup,
- infrastructure.

The verticals i.e. real estate, housing, welfare, pensions, railway health care, data processing, telecommunication, power engineering, training, procurement, railway security service and units subordinated to Management Board of PKP are all service functions and will be later transformed into joint stock companies with PKP as the shareholder (holding company).

Following the vertical and sector implementation, PKP intends to liquidate 300 of the remaining 500 workshops (WORG). Similarly, the need for workshop supervisors and mid-level managers will be diminished accordingly but not proportionately.

The sectors and verticals will be autonomous units, including the infrastructure according to the EU Directive 91/440, operating with their own accounts and budgets but subordinated to the Management Board of the PKP. The directorates of sectors and verticals execute management, coordination and control functions in respect to organizational units. The Management Board of PKP has functions of strategic decision making and management in the scope of the entire PKP. (Annex 2 lists the issues, responsible department and deadlines for the second stage of PKP restructuring).

In addition, two new legal acts have been elaborated:

- Railway Transport Law, approved by the Parliament in July 1997
- Draft of PKP Restructuring Law, submitted to the Parliament in April 1997

The Railway Transport Law, following the EU directives, introduces:

- open access to infrastructure for operators outside PKP
- infrastructure charges and their determination
- concession rules for operators
- rules of technical control for railway operations and safety

The draft of the PKP Restructuring Law proposes:

- establishment of the Agency of Railway Property (ARP) outside PKP and its subordination to the Ministry of Transport
- rules of ARP operations for property, transferred from PKP as surplus assets, housing, land and real estate, both with solved and unsolved legal ownership or documentation, liquidated unprofitable lines with infrastructure and other assets
- scope of allowances for employees during the PKP restructuring.

It is assumed that the PKP will transfer to the ARP in the first stage:

a) narrow gauge railways
b) liquidated normal gauge railways
c) housing

The surplus assets, which should be transferred to the ARP, are estimated at 16.3% of the total PKP assets. The transfer shall decrease the total PKP revenues by 1.9% and reduce the total costs by 7.1%. The employment shall be reduced by 15.9 thousand.

2.3.3 Evaluation of the Pilot Program in the Eastern DOKP

On 1st January 1997 the implementation of the pilot restructuring program began in the Eastern DOKP with the following organizational restructuring:

Table 2.3.1 Organizational restructuring of the Eastern DOKP

Liquidation of enterprises	Creation of enterprises
Separation and liquidation of regional departments (10) - passenger sections - freight sections	Passenger sector (2) Freight sector (5)
- traffic control sections Liquidation of road departments (4)	Infrastructure sector (5)
Liquidation of traction enterprises - locomotive garages (7) - wagon garages (5) - rolling stock enterprises (2) - garages (1)	Traction and workshop backup sector (4)
Liquidation of building departments (2)	Real estate vertical (1) Railway security vertical (1)

Note: number of enterprises is given in brackets

Source: "PKP Restructuring. WDOKP Pilot Experiment", Lublin 1997

The new enterprises were selected according to specific criteria in particular sectors:

- 2 enterprises of passenger transport, selected according to the number of passengers, financial revenues from passenger transport, number of passenger trains, number of dispatching points, number of express luggage packages and size of employment.
- 5 enterprises of freight transport, selected in regard to location of marshaling and maneuvering yards, size of employment, inclination system to maneuvering yards, size of freight work, number of freight points with turnover over 5 wagons per 24 hours, number of locomotive-hours of maneuvering work, revenues from freight transport and number of points for repair of wagons,
- 5 enterprises of infrastructure, selected according to their location and functions,
- 4 enterprises of traction and workshop backup, selected in regard to their size of repair capacities and location. The passenger and freight rolling stock has been assigned to passenger and freight sectors respectively.

The most important part of the pilot experiment is the economic-financial restructuring. This process covers the introduction of management accounting, new financial system, new principles of bonus motivation and systems of mutual settlements. The new financial system allows for:

- settlement of costs in their place of origin for all units in sectors and verticals,
- cost allocation to freight and passenger transportation,
- calculation of maintenance costs for lines and objects,

- determination of unit costs.

The cost allocation for the Eastern DOKP is as follows:

- primary allocation: freight 46%, passenger 27%, infrastructure 7%, rolling stock 12%, real estate 1%, other 7%
- secondary allocation: freight 58%, passenger 35%, other 7%.

Obviously, this allocation expresses some specific features of the Eastern DOKP with its dominating role of freight transportation. The volume of its freight transportation is the second largest among all eight DOKPs, wile the volume of passenger transportation is the lowest one.

The assets have been specified and allocated to infrastructure, traction with workshop backup and to newly established real estate vertical. The surplus assets, estimated at 30%, have been already reduced by 10% and transferred to the real estate vertical. It is planned to transfer them later to the Agency of Railway Property.

The Lublin experiment is also being conducted in an intensive cooperation with employees and trade unions ("mentality restructuring"). There have been assumed only the employment transfers within DOKP and no layouts outside the company. All changes and directions of restructuring are discussed with trade unions and employees.

It is difficult to evaluate the experiment in a comprehensive way due to its short time of operation and lack of many important indicators and data. Being aware of these constraints, we have conducted an attempt of very rough evaluation using two simple criteria:

- financial-economic effects
- social impact

The presented evaluation is based on available documents and the meeting with the Director of the Eastern DOKP Mr. Augustowski, on 10th July 1997 in Lublin.

Table 2.3.2 Evaluation of the Eastern DOKP experiment

Financial - Economic Effects	
Advantages	**Disadvantages**
• Increase of revenues (not disclosed) • Decrease of total costs (not disclosed) • Increase of efficiency (not disclosed) • Increase of nominal wages by 28% and its direct link to efficiency • Decrease of unit costs • New realistic cost allocation • Clear determination of costs for each enterprise (including assets) • Determination of infrastructure charges • Identification of surplus assets • Projected balanced final result (no loss / no profit) for 1997 • Possible decrease of government subsidies • New organizational and business culture • structures • Improvement of management • Improvement of services • Improvement of motivation system • Testing and improvement possibility before implementation to the entire PKP	• Lack of internal settlements for sectors (introduction planned on 1 January 1998) • Time consuming process for identification of surplus assets • Lack of legal status for ownership (90% of real estate) • Lack of plans for separation of company units outside or with PKP shareholding and their privatization • Surplus employment allocated only within PKP ("social peace")
Social Impact	
Advantages	**Disadvantages**
• Maintenance of "social peace" (no strikes) • "Mentality" restructuring of employees a) active participation in the restructuring process b) identification with the company aims c) creation of positive attitude towards restructuring and future privatization	• Possible too high allowances for the maintenance of "social peace"

Generally, the experiment seems to be a success story. The restructuring is being realized gradually and without any significant disturbances. It is interesting to notice that the careful surplus employment policy can be evaluated simultaneously as an advantage from the social point of view and disadvantage if a pure economic criterion only is applied.

The performance of Lublin experiment is also affected by general socioeconomic factors, e.g. high unemployment rate, insufficient number of apartments, low mobility of labor force or legal difficulties with the unsolved ownership status of real estate and lack of the Restitution Law.

2.3.4 Timetable for the Future

PKP has elaborated its own program of transformation and privatization. The program distinguishes four stages of transformation into a commercially oriented company until 2015, independent on the state administration and running business on the criterion of profit maximization. The realization of public service shall be based on negotiated contracts with the government or local governments.

- The first stage („centralized structure"), until the end of 1998, aims at creating of sector and vertical structure with full internal settlements. An eventual privatization shall be limited only to some selected activities, e.g., social activities, and will not cover the core operations. The integration processes with the EU programs will be conducted as well. There is also assumed to terminate and implement the Eastern DOKP experiment to the entire company. The PKP intends to issue bonds to finance the infrastructure, rolling stock and backup. The legal ownership of land, real estate and apartments shall be also gradually clarified and allocated. This transformation stage shall result in a minimization of the financial loss.

Table 2.3.3 The aims and activities in the first stage until the end of 1998

Finance	Implementation of agreement between PKP and the Government Gradual implementation of new economic-financial system Accounting separation of all sectors Introduction of management accounting Marketing activities Issue of bonds
Assets	Establishment of criteria for asset allocation Identification of PKP assets and their allocation to sectors and verticals Specification and value estimation of infrastructure, rolling stock, real estate and land Transfer of assets to sectors and verticals Establishment of criteria for assets utilization in activities of sectors and verticals Determination of use for surplus assets Modernization and developments activities in core operations (infrastructure, rolling stock and backup) Systematic regulation of legal ownership
Employment	Elaboration and introduction of Over-Enterprise Collective Treaty for labor motivation Social Agreement as pact of employee guaranties Determination of size and structure of employment Determination of redundant employment and its use with the aid of government funds, European Social Fund, EU ADAPT Initiative and earlier retirement system Education of employees Permanent internal information on restructuring Cooperation with trade unions, parliament, government, EU institutions
Organization	Elaboration of restructuring concept Definition of core operations in sectors and verticals Evaluation and conclusions from the Eastern DOKP experiment Appointment of mandataries for creation of sectors and verticals Implementation of pilot experiment to the entire PKP Creation of enterprises from executive units Appointment of directorates for sectors and verticals Full implementation of sector and vertical structure Liquidation of DOKP structure Eventual privatization of social activities Initiation of preparation for the Agency of Railway Property activities
New Laws	PKP Restructuring Law
Estimated costs	13.6 million PLN

Source: PKP

- The second phase („integrated structure“), from 1999 to 2002, shall create an organizational independence for all four sectors. The infrastructure sector will be organizationally separated (inside PKP) according to the Railway Transport Law and EU Directive 440/91. The activities of verticals will be expanded through services outside PKP. It is planned to establish the Agency of the Railway Property (ARP) outside the company and transfer the surplus assets there. The full integration with the EU regulations is assumed as well. The company should reach the financial equilibrium.

Table 2.3.4 The aims and activities in the second stage 1999 - 2002

Finance	Full implementation of economic-financial system Implementation of SKPZ system (costs and revenues in places of origin, controlling) Implementation of agreements between PKP and local governments Total liquidation of internal subsidies for passenger transportation Activities towards increase of revenues More effective use of liabilities Development of management accounting and decentralization of management
Assets	Rationalization of asset management Improvement in effectiveness of asset utilization Modernization of infrastructure, rolling stock and backup Further regulation of legal ownership
Employment	Rationalization processes of employment Implementation of Social Agreement for redundant employment Implementation of pro-effectiveness corporate culture (motivation system of wages) Continuation of education and training Continuation and improvement in internal communication Cooperation with trade unions, parliament, government, EU institutions
Organization	Organizational independence of sectors, including infrastructure sector Separation of services to avoid monopolies Creation of commercially oriented management in sector structure Preparation for establishment of Joint Stock Company of the State Treasury - PKP S.A. Transformation of verticals towards better economic-financial performance
New Laws	PKP Privatization Law
Estimated Costs	7.5 million PLN

Source: PKP

- <u>The third stage</u> ("integrated structure" - Joint Stock Company of the State Treasury PKP SA), will cover the transformation of PKP into a Joint Stock Company of the State Treasury PKP S.A. in the period from 2003 to 2005. The sectors will be fully independent with settlements on the principle of "internal customer". The transfer of surplus assets to the Agency of Railway Property will be terminated. The PKP SA shall be fully integrated with the Western European railways (membership of the European Union is expected in 2003). The company should also generate profits.

Table 2.3.5 The main aims and activities in the third stage 2003 - 2005

Finance	Full implementation of Commercial Code rules Development of different related business activities More effective use of liabilities Offensive financial policy towards use of non-conventional sources for development Full use of management accounting Improvement in controlling
Assets	Improvement in effectiveness of assets Transfer of surplus assets to the Agency of Railway Property Modernization and development of infrastructure, rolling stock and backup Creation of new companies with the PKP SA shareholding
Employment	Continuation of employment rationalization (modern management) - 178 thousand in 2005 Continuation of use and training for redundant employment Continuation of pro-effectiveness corporate culture (motivation for increase in revenues and efficiency) Continuation of comprehensive education and training Professional internal and external communication Cooperation with trade unions, parliament, government, EU institutions
Organization	Transformation into a Joint Stock Company of the State Treasury Improvement in management Preparation for establishing the PKP joint stock company operating in the holding structure Termination of surplus assets transfer to the Agency of Railway Property
New Laws	No new laws
Estimated Costs	20 million PLN

Source: PKP

- <u>In the fourth stage</u> ("holding structure") after 2005, the privatization through IPO (Initial Public Offering) will be performed. The new capital flow will accelerate the further development of the company. It shall influence on new competitive offer through modernization of infrastructure, rolling stock, backup and information system. The Polskie Koleje S.A. shall reach a significant financial surplus.

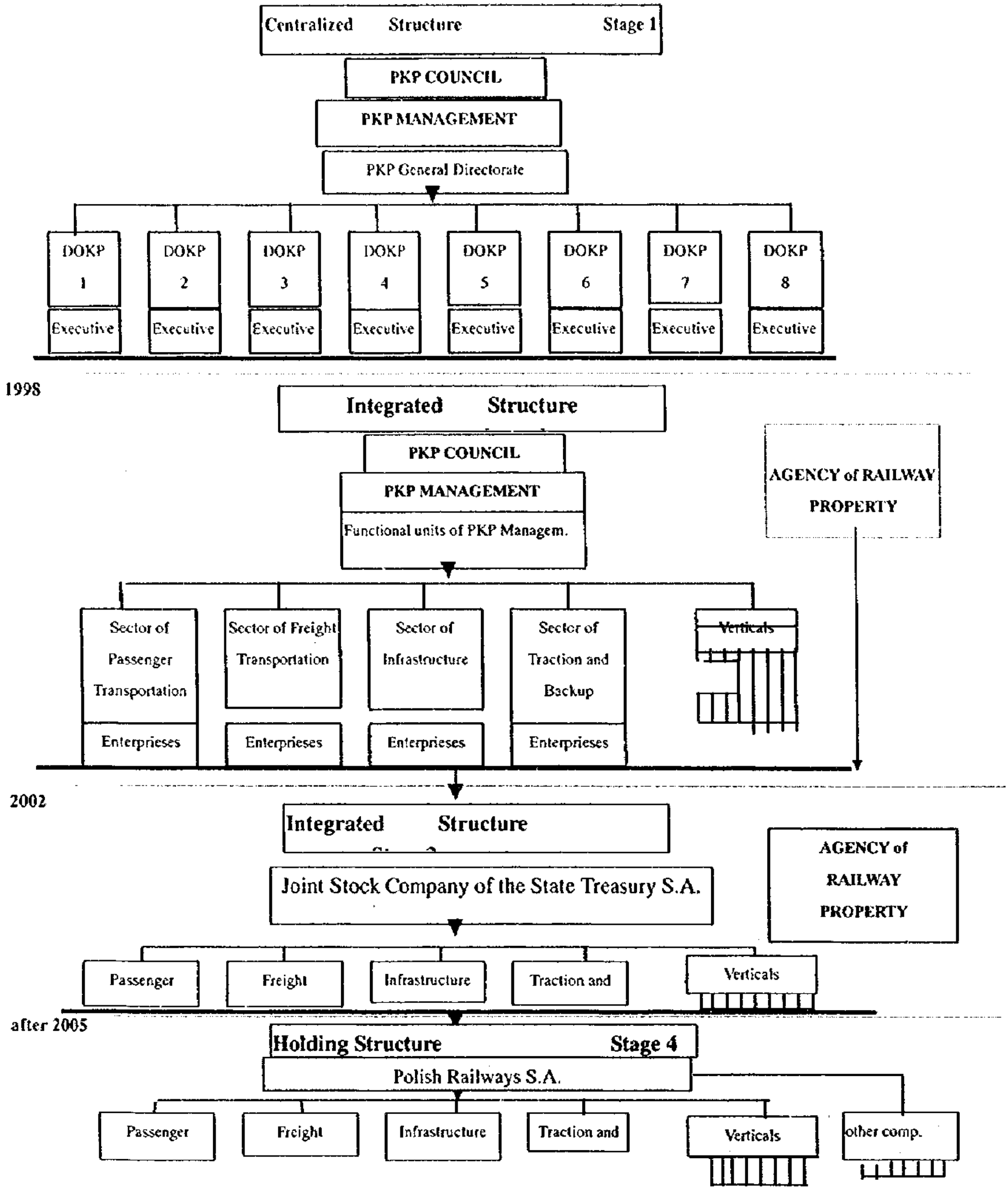
Table 2.3.6 The aims and activities in the forth stage 2005 - 2015

Finance	Initial Public Offering Transfer of free of charge shares to employees Creation of possibility to exchange convertible bonds for company shares Improvement in management accounting Improvement in controlling Offensive financial policy towards use of non-conventional sources for development More effective use of liabilities
Assets	Improvement in effectiveness of assets Further modernization and development of infrastructure, rolling stock and backup Creation of new companies with the Polskie Koleje SA shareholding
Employment	Continuation of employment rationalization (introduction of modern management) Achievement of strategic employment size - 155 thousand in 2015 Continuation of pro-effectiveness corporate culture Continuation of comprehensive education and training Professional public relations Cooperation with trade unions, parliament, government, EU institutions
Organization	Creation of holding structure - dominating company - dependent companies
New Laws	No new laws
Estimated Costs	30 million PLN

Source: PKP

The particular phases of PKP transformation are presented by the Fig.1:

Fig.1 Stages of PKP Restructuring



General remarks

The PKP transformation program is an interesting and coherent document reflecting a picture for modern railway company, integrated with the European system. Its scope covers the most important aspects of restructuring, simultaneously taking into account the Polish circumstances.

Let us concentrate our comments and remarks on some selected problems:

Impact of social factors

- The PKP restructuring program indicates a strong influence of social factors on the employment restructuring. The plan does not assume any massive layouts and aims at performing of smooth path for gradual employment adjustment. This solution is a result of present employment policy, strongly affected by trade unions. There is no social compliance for a massive PKP employment reduction, observed in the years 1990 - 1992. The "social peace" approach dominates over the economic and financial restructuring criteria. It is expressed by a careful determination of size and structure of employment, taking into account specific Polish features, e.g., very low mobility of labor force, lack of housing, still high unemployment rate etc. The rationalization of employment is conducted in cooperation with the trade unions through social agreements and supported by the government and EU funds. This policy will finally result in an employment reduction by 53 thousand (23%) in 2005 and by 76 thousand (33%) in 2015 as compared with 1996.

Limited separation of PKP units

- The restructuring program limits the separation of PKP units to some non-core social activities in the first stages. A creation of new companies is projected in the third stage after 2002. It seems to be too hard constraint. There are legal possibilities for a separation of other units with or without shareholding of PKP (Art. 22 and Art. 44 of the PKP Law) and their further privatization. These processes could be performed only on the "initiative basis" of management and employees with positive statement from the trade unions and PKP management. For example, these processes could encompass some traction and workshop backup enterprises or other enterprises with potentially existing demand for their services also from outside PKP. Such bottom up procedures would enable to rationalize employment and assets in a smooth way. Also an establishment of joint venture companies with PKP as shareholder in some freight market segments, not necessarily the most attractive ones, could enable an improvement in financial results. A new joint company could execute transportation payments in more efficient manner ("first payment and then service" following the passenger transportation pattern). It would also improve the cash liquidity and eliminate a creation of "bad loans".

Marketing approach

- Financial and organizational restructuring introduces new corporate culture structures into PKP. The main aim is to reduce costs and increase revenues through a comprehensive improvement of all activities at the presence of other operators and competitors. PKP should develop many new products, supported by aggressive marketing activities, so called "new offer approach" (not only market driven one) to attract new customers, e.g. annual railway card (very successful product in Germany), special weekend family tariffs, etc. A special role should be played by strong marketing for qualified passenger transportation as a potential source for increase of revenues. This approach should be additionally expanded through active participation in railway related businesses generating profits already in the years 1998 - 2002.

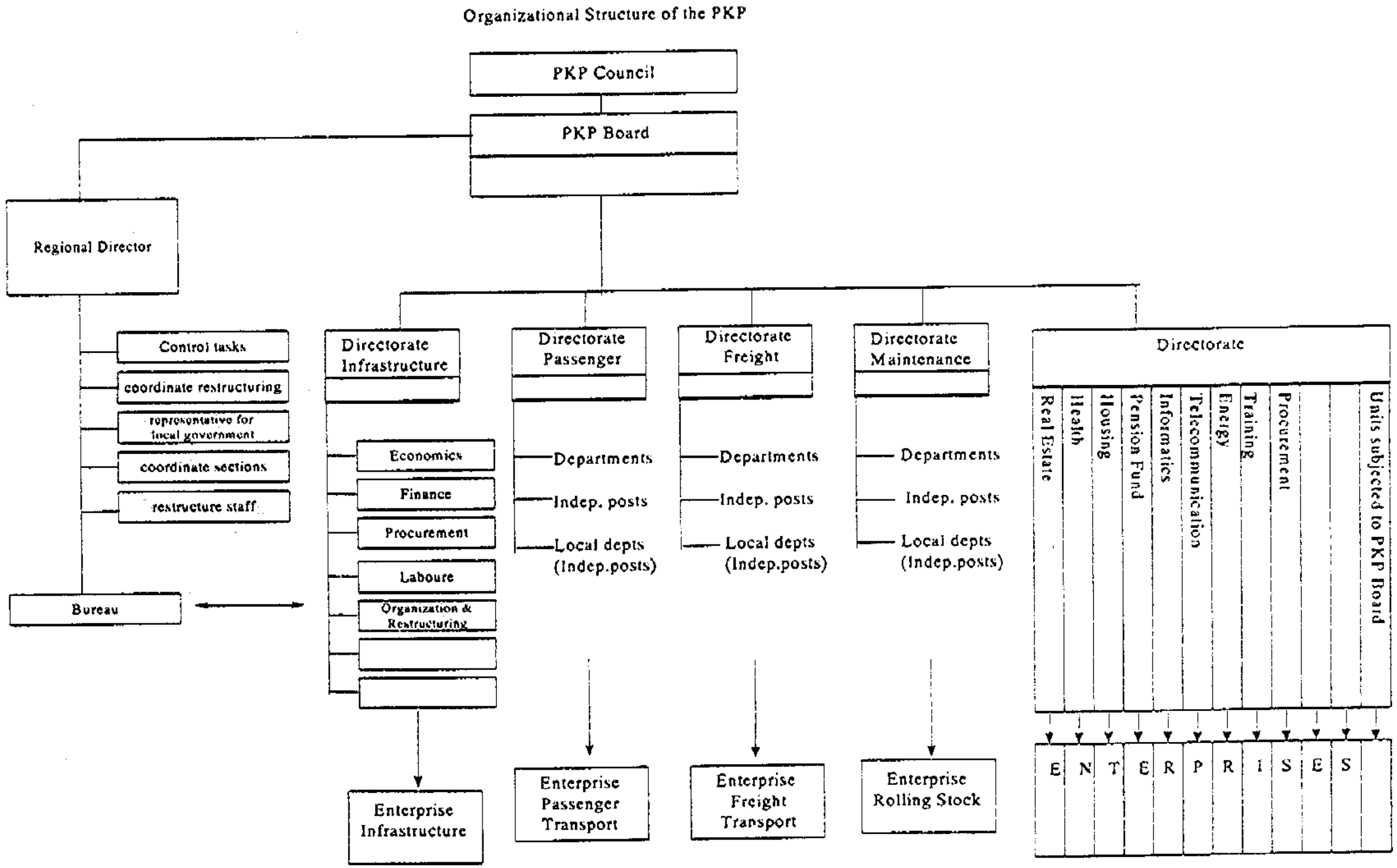
Sources of investments

- One of the most important problems for the PKP future is its investment strategy. PKP own financial possibilities do not cover the growing investment needs, especially after deep investment shortfalls in the last few years. The planned issue of bonds in 1998 (no amount disclosed yet) seems to be a proper step. The policy towards new financial sources shall be expanded earlier, i.e. in the second stage of transformation. A promoting role of the government should be also continued. The consolidation processes of banking system in Poland and growing participation of foreign banks shall create a good offer of banking products. The market will offer a choice from traditional loans in different currencies and different commercial banks or international financial institutions to issues of bonds and leasing.

Split of passenger and freight units

- The restructuring program does not propose a spilt of passenger and freight transportation into smaller units of highly specialized profile. These solutions exist in other countries and seem to be a natural way towards an increase of efficiency and effectiveness. The passenger transportation could be divided with accordance to types of services into inter-city, agglomeration and local (regional) companies. The freight transportation could be reshaped into 3-4 units accordingly to homogeneity of commodity groups. Such a split would create impetus to improve management, employment rationalization and financial results.

Annex 1: The new organizational structure of the PKP



Annex 2: Issues, Responsibilities and Deadlines in the 2nd stage of restructuring

1. The Management Board accepts the 1. July 1996 as the day of starting the introduction of the second stage of PKP's restructuring.
   Responsible: The Management Board
   Date: 30 June 1996

2. Preparing the frameworks of regulations for organizational structures participating in the program..
   Responsible: Eastern DOKP
   Supervisor: KOR
   Date: 31 August 1996

3. Preparing the organizational regulations for units taking part in program.
   Responsible: Eastern DOKP
   Date: 30 September 1996

4. Defining the functional part of PKP's board of directors and presenting it to PKP's council. Responsible: The Management Board
   Date: 30 September 1996

5. Defining the part and the place of middle stages in managing PKP.
   Responsible: The Management Board
   Date: 30 September 1996

6. Appointing the Managing Director of Eastern DOKP for authorized agent of PKP's Managing Director. His responsibility is to coordinate and supervise starting the initial program of PKP's restructuring in eastern district of PKP (Eastern DOKP).
   Responsible: K
   Date: End of October 1996
7. The Board accepts proposals of particular sectors and sections. It follows item 3 of PKP's Management Board resolution No. 8.
   Responsible:
   KWH for Passenger and Freight Sector
   KW for Infrastructure Sector, Real Estate Vertical, Telecommunication Services Vertical, Data Vertical)
   KWT for Traction and Workshop Backup Sector
   KWP for Social Vertical, Accommodation Vertical, Training Vertical, Insurance

Department, PKP's health care
KWE for Maintenance, Financial Vertical, PKP's printing offices
Date: 31 October 1996

8. Preparing the rules of settlement accounts between sectors and Vertical, adapting the accounting system of costs and controlling(appointing the introduction team)
   Responsible: KWE
   Date: 31 October 1996

9. Including to agreement with trade union some essential working positions in order to start the initial program.
   Responsible: KOS
   Date: 30 November 1996

10. Preparing the financial and economical system, that takes under consideration the managing the pilot units by the management of sectors and sections.
    Responsible: KWE / PKP's Management Board)
    Date: 31 December 1996

11. Liquidation of old organizational units and creating of new structures and basic enterprises in the Eastern DOKP .
    Responsible: Eastern DOKP
    Date: 31 December 1996

12. Introduction of restructuring of PKP's property. /determination of useful property for sectors and verticals/
    Responsible:
    KWH for the Passengers and Freight Sector
    KW for Infrastructure Sector, Real Estate Vertical, Telecommunication Services Vertical, Data Processing Vertical
    KWT for Traction and Workshop Sector
    KWP for Social Vertical, Housing Vertical, Training Vertical, Insurance Department, PKP's health care
    KWE for Maintenance, PKP's printing offices, Financial Vertical
    Date: 31 December 1996

13. Appointing the Real Estate Directorate
    Responsible: KW / The Management Board)

Plan: 31 December 1996 Realization: 1 July 1997 Headquarters: Warszawa

14. Appointing the Housing Directorate
Responsible: KWP / The Management Board)
Plan: 1 January 1997 Realization: 1 July 1997 Headquarters: Katowice

15. Setting up the companies of social activities
Responsible: KWP (the board)
Date 1 January 1997 Realization: 1 July 1997 Headquarters: Gdansk

16. Transition to the full internal settlements of KSZ (railway health care)
Responsible: KWP / The Management Board
Date: 1 January 1997 Realization: 1 January 1997 Headquarters: Warszawa

17. Appointing the Traction and Workshop Sector in organizational meaning
Responsible: KWT / The Management Board
Plan: 1 January 1997 Realization: 1 July 1997 Headquarters: Krakow

18. Periodical evaluation (made by the Management Board) of introducing the second stage of restructuring on the Eastern DOKP's area (eventually making some improvements)
Responsible: Eastern DOKP / The Management Board, every one quarter in half-yearly period of 1997

19. Appointing of Passenger, Freight and Infrastructure Sectors
Responsible: KWH, KW / The Management Board
Plan: 1 July 1997 Realization: 1 January 1998

20. The closing evaluation. Taking the resolution concerning extension of the restructuring program on other districts, taking under consideration some experience of the former program.
Responsible: The Management Board
Date: 3rd quarter of 1997

2.4 RESTRUCTURING PLAN SUPPORTED BY THE WORLD BANK

The aim of this chapter is a brief description of the of restructuring plan for PKP prepared by the Mercer Management Consulting and financially supported by the World Bank. The presentation is concentrated on different approaches to the PKP reorganization, their discussion and selection of „the best" option according to the assumed criteria. The proposed variant, including the PKP restructuring strategy with a separate Restructuring Agency, is shown in the context of its structural changes and necessary additional steps towards its implementation. The principles and role of the Restructuring Agency, restructuring in the scope of employment and surplus of assets and its financial effects are also presented.

2.4.1 Basic Concepts

The study of the Mercer Management Consulting postulates two main objectives of the restructuring and reorganization of the PKP:

- creation of a market oriented commercial railway that applies the best world models in reference to quality standard of service and costs, facilitating an effective competition with road and air transport;
- minimization of the railway transport costs for the Government.

The realization of the postulated objectives has been analyzed in respect to the following key aspects:

1) breaking of the current structure and culture
2) minimization of service disruption
3) creation of low cost and high service railway
4) reduction of costs to the Government
5) quick production of results
6) effective disposal of surplus assets
7) acceptance by employees and trade unions
8) probability of success.

On the basis of these criteria five approaches to the restructuring of PKP have been discussed in the study. The organizational options, presented below, distinguish different types of possible changes and adaptations for PKP:

- Continuation of current strategy (state before the beginning of PKP own restructuring program). This "status quo" strategy, relatively easy to implement, would maintain a loss making company strongly subsidized by the Government.
- Acceleration of improvement actions within current structure. This variant would allow to improve efficiency targets towards a new organization based on business units. However the company would still be dependent on the Government subsidies.
- Creation of Restructuring Agency within PKP and restructuring. This option would

separate the PKP assets and activities into commercial and non-commercial orientation and significantly reduce the Government subsidies. The location of the Restructuring Agency within PKP would lead to some difficulties in evaluation of real financial results, e.g. revenues from sale of surplus assets can substitute former subsidies, or would petrify previous organizational structure.

- Splitting into New PKP and a separate Restructuring Agency and restructuring. This strategy, selected as "the best" one for PKP, will be discussed in the next section.
- Privatization the enterprise either in whole or in parts. This option would ensure a relatively short period for commercial orientation and fast reduction in the Government subsidies. However, this strategy is not recommended by the report mainly due to potential social disruption, little private sector experience in Poland on such a large scale and possible partial privatization of railway (e.g. profitable freight lines).

The criteria's fulfillment in respect to the particular strategy options is presented in the table below. The evaluation is composed of a five point scale (the report introduced different symbols but of the same substantial meaning). The ranking values from 0 to 4, where 4 means „the best" degree for fulfillment of criteria, are defined by the following ordering: 4 - fully meets criteria, 3 - substantially meets criteria, 2 - partially meets criteria, 1 - remotely meets criteria, 0 - does not meet criteria.

The results of ranking indicate that the options, which include the creation of Restructuring Agency and the privatization variant, would allow to reach successfully the restructuring objectives (table below).

Table 2.4.1 Ranking of strategies in respect to fulfillment of criteria

	Break current structure and culture	Minimize service disruption	Create low costs, high service railway	Reduce costs to Government	Produce results quickly	Dispose of surplus assets effectively	Be acceptable to employees and unions	Probability of success
Current Strategy	0	3	1	0	0	1	3	1
Improvements within present structure	0	3	2	2	1	1	3	1
Restructuring Agency within PKP	2	2	2	2	3	3	3	2
Separate Restructuring Agency	4	2	3	4	3	3	3	3
Total or partial privatization	4	1	4	3	4	2	1	2

Source: Mercer Management Consulting

2.4.2 Role and Functions of the Restructuring Agency

The PKP restructuring with a separate Restructuring Agency has been proposed as the most desirable variant. This solution allows for more efficient management of surplus employees and assets than that with Restructuring Agency within PKP. Simultaneously the management of PKP could better concentrate its efforts on operation and improvement of service level by transferring the responsibility (not ownership) for surplus assets and employees to the independent Restructuring Agency. The privatization variant, although economically „the best" option according to the ranking, has been rejected due to its organizational and social disruption.

The proposed variant of PKP restructuring is presented in the table below.

Table 2.4.2 Proposed restructuring option and its evaluation

Selected Option	
Split into New PKP and a Restructuring Agency and Restructure - Creation of a separate Restructuring Agency - Identification of surplus assets and non-core lines and transfer their management to the Restructuring Agency - Creation of commercially oriented „New PKP" with cost-competitive level of assets and staff	
Advantages	Disadvantages
- Breaking of previous organizational and cultural structures - Clear separation of activities - Irreversible change - Management can focus on providing high quality, low cost rail service - Reduction in cost to the Government	- Possible disruption in short term with impact on service quality - Takes time and effort to get prepared for the change (e.g. separation of assets, employees) - Risk of Restructuring Agency continuing for a long time

The minimization of the disadvantages requires an open and permanent discussion with trade unions before the restructuring. The proposed program should ensure an efficient retraining and communication program. The preparation for separation of employees and assets should be initiated as soon as possible due to its long lasting process. The establishment of the Restructuring Agency should include a strictly determined time of its existence and introduce incentives for managers to accelerate the restructuring.

In addition, the Mercer Management Consulting suggests an introduction and adaptation of the following rules to manage the New PKP:

- Establishment of "arm's length" links between the Government and the New PKP that would facilitate independence of the company. This principle means a clear management contract that would be based on mutual obligations of both sides. Subsidy should be assigned by services instead of global level subsidizing.
- Organization of the New PKP based on business units instead of a regional basis. Such a organization should concentrate the New PKP activities on individual market parts and should meet different needs, constraints and high service level. Segmentation of business units simplifies collection of revenues and costs, utilization of assets and other required information.
- Adoption by the New PKP of the "best practice" levels of costs and resources (manpower, investment) and achievement of the top level quality standard in service. This activities should lead to implementation of the detailed benchmarks for crucial areas and their adjustment processes to Polish situation.
- Creation of a commercially oriented work culture and management processes. This principle would express a strong profit and service orientation with an establishment of decision making centers at possible lowest levels.
- Creation of customer's attitude. The implementation of this rule should allow to identify customer's preferences by regular market research and permanent improvement of service towards customer's needs.
- Establishment of long term rules for Public Service Obligation subsidies. This principle requires a definition of service level, clear and simple contracts with their efficient system of selection. In addition it should be created incentives to improve efficiency.
- Liquidation of cross-subsidies from profitable to non-profitable activities. This process would allow to clarify the situation and problems of business activities and improve the competition processes.
- Introduction of a clear and precise system of charges for infrastructure. The infrastructure charges should reflect the real costs with the recovery ratio defined by the Government. The rules for access to the network should be implemented with non-discrimination procedures for operators.
- Changes towards regional and local financing of commuter services. This principle would allow for a better determination of services and their performance and changes in Public Service Obligation subsidies through regional authorities. In this case local taxes could be used to finance local transport.
- Introduction of incentives for management. A clear system of aims and targets for management at all levels would allow to improve services. The system should also include a review of performance and rewards and actions against a poor results.
- Transformation of the New PKP into a joint stock company providing for possible

involvement of private capital. This principle would accelerate a commercial orientation and independence of the company. Private capital would guarantee attendance to profit making company and would obligate to provide public financial and operational information.

The Mercer Management Consulting proposes the organizational structure of the New PKP as presented below:

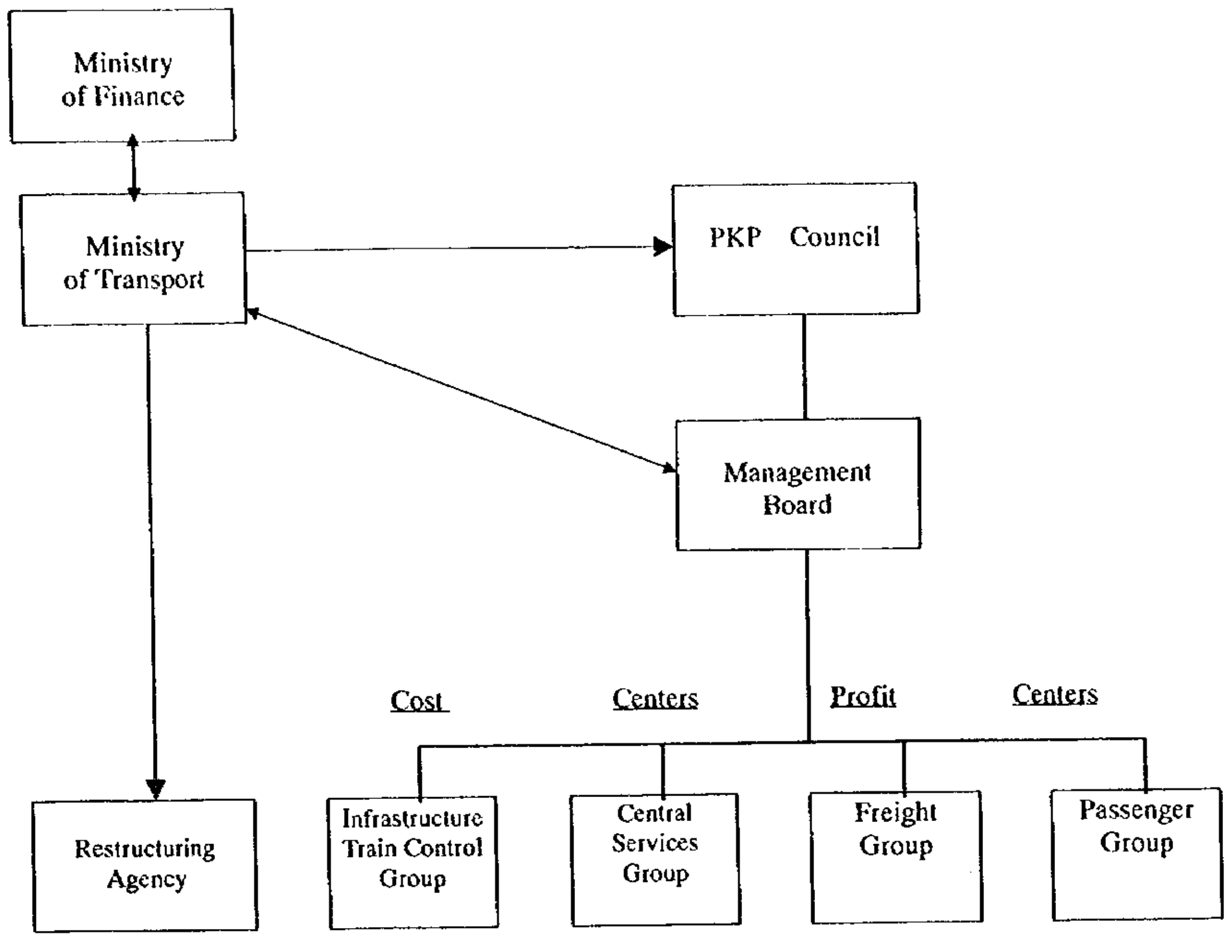


Fig.2.4.1 Organizational structure of the New PKP

The proposed variant of the PKP restructuring includes an establishment of the separate Restructuring Agency on the basis of the following principles:

- Transfer of all surplus labor, real estate, rolling stock and non-operating services (except health) and light density lines
- Setting a limited period of operation of the Restructuring Agency
- Determination of funds for Agency in the fixed required time
- Identification of the status of Restructuring Agency as a Government Agency (probably under the responsibility of the Ministry of Transport)

- Establishment of a Board of Directors and designing a management structure similar to those of commercial companies
- Appointment of Chief Executive and members of top management with commercial experience
- Setting of time limits for implementation of tasks and introduction of a system of incentives to management to stimulate tasks within agreed time limits
- Identification of an obligation to proceed with retraining, early retirement or severance payment

The organizational structure of the Restructuring Agency is presented below.

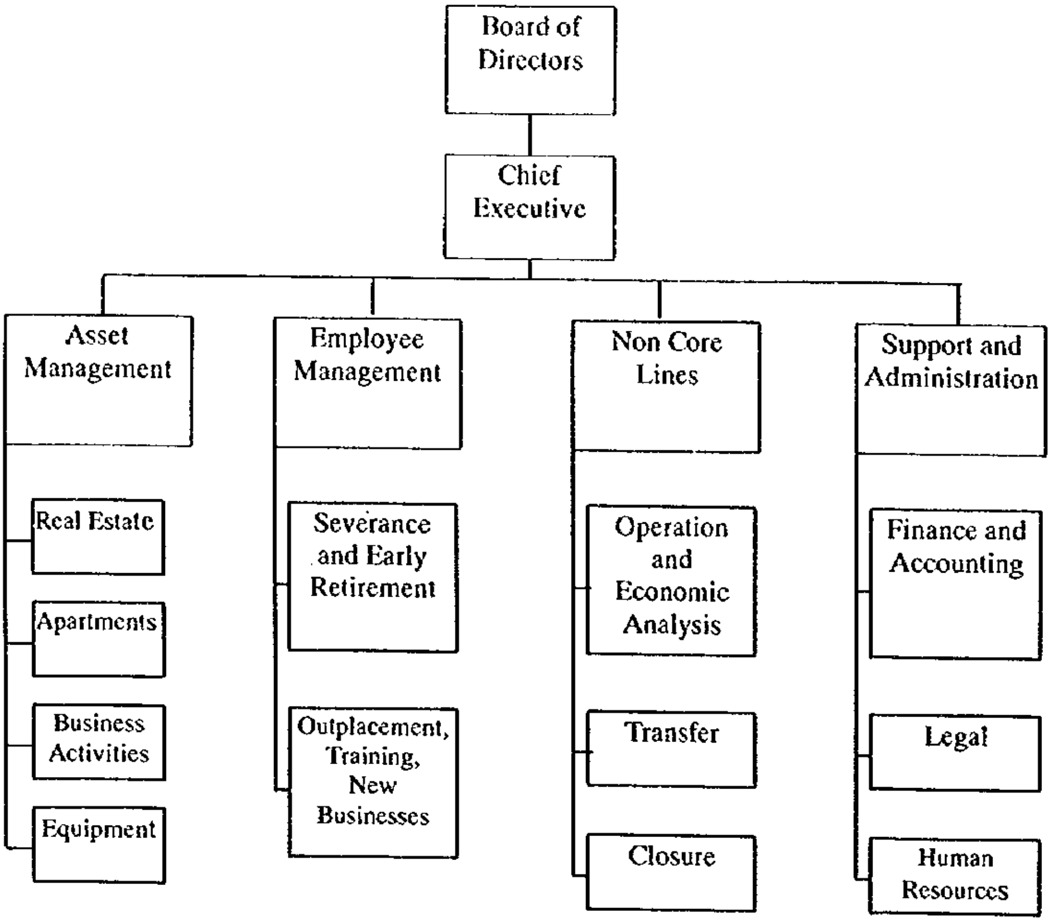


Fig.2.4.2 Organizational structure of the restructuring agency

The Restructuring Agency will be separated into four divisions covering assets, employees, non core lines and administration.

The Asset Management Division will be divided into four departments:

1) Real Estate, responsible for identification, legal authorizations and sale of surplus land and buildings through bidding procedures;
2) Apartments, responsible for valuation, legal authorization and sale of apartments,

houses and related real estate;

3) Business Activities, responsible for transformation of non-rail activities into limited liability companies, transfer of assets, analysis of costs, sale and its organization through bidding procedures, legal support and organization of preferential loans to start new business;
4) Equipment, responsible for scrapping or sale of surplus rolling stock, technical equipment, closed non core line, raw materials and inventories.

The Employee Management Division will be composed of two departments:

1) Severance and Early Retirement, responsible for management of the passive form of employment reduction through negotiations with the trade unions, preparation of programs and analysis of eligibility of candidates;
2) Outplacement, training Programs and New Businesses, responsible for organization and monitoring of active forms of support for redundant employees through selection of subcontractors specializing in retraining, training and outplacement, cooperation with Ministry of Labor and regional units of the Labor Fund, support to employees to new business activity;

The Non Core Lines will be divided into three departments:

1) Operations and Economic Analysis, responsible for analysis of costs, revenues and asset level by line, financial evaluation of each line, subsidy requirements and negotiations of operation contracts with PKP and public services with the Ministry of Transport;
2) Line Transfers, responsible for identification and selection of operators, tender procedures and negotiations of performance, service level revenues, costs and subsidy requirements;
3) Line Closures, responsible for analysis of alternative solutions for transport, negotiations with Ministry of Transport, local authorities and subcontractors closing or restoring a line;

The Support and Administration Division will be composed of three departments:

1) Finance and Accounting, responsible for financial and accounting analysis of the Restructuring Agency;
2) Legal, responsible for coordination of all legal activities within the Agency;
3) Human Resources, responsible for coordination and administration of employees.

The total staff of the Restructuring Agency shall oscillate between 50 - 62 persons between 1997 and 2001 and after this year a decrease in staff is assumed to 12 persons until 2005.

The projected revenues will exceed costs after two years of Agency's existence and should result in an increase in profit until 2005.

- Comments:

The proposed employment for the Restructuring Agency seems to be underestimated in order to match its scope of tasks and division into twelve departments. The assumption of 60 persons, including regional branches, is not realistic. In addition it would be difficult to separate the competencies of the Agency, e.g. for the non-core lines department from the competencies of railway operator.

2.4.3 Treatment of Employees and Assets

The comparative analysis of Western European railways by traffic unit (traffic unit = passenger kilometer + ton kilometer) per employee involved in railway activities indicates that the PKP employment level should be between 98 thousand (the most efficient European railways) and 152 thousand (the second group of railways). It was assumed that PKP would need 20% more employees to compensate the technological gap. After this adjustment the targeted PKP employment should be 180 thousand in 1998 and about 110-120 thousand in 2005. Other comparisons, based on different measures indicated the employment level between 54 and 98 thousand (depending on the ratio used).
The proposed employment reduction plan is illustrated by the table below.

Table 2.4.3 Employment Restructuring Plan 1997 - 2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Employment (thousand)	207	180	153	130	115	115	115	115	115
Reduction (%)	10	13	15	15	12	0	0	0	0
Cumulative reduction	13	24	45	45	52	52	52	52	52
Reduction (thousand)	23	27	23	23	16	-	-	-	-
There of attrition (thousand)	6	5	5	4	3	-	-	-	-
Remaining (thousand)	17	22	22	19	12	-	-	-	-

Source: Mercer Management Consulting

The Restructuring Agency will manage the following categories of employees:
- employees of the non rail activities,
- employees of the non core lines or in connection with non core lines
- employees not necessary for the functioning of the rail activities on core lines (surplus).

The performed financial analysis of employment restructuring has been conducted under assumption that 12 month average salary would be paid to employees as a compensation. The total costs of restructuring also include unemployment benefits and incentive payments. These cumulative costs are five times lower than the cumulative wage savings in the period between 1997 and 2005.

The revenue generation potential of the restructuring from PKP's surplus assets is based on the following foundations:

- Most valuable assets are land, apartments, office buildings and surplus rolling stock
- The total revenue of the surplus assets is between PLN 1.7-5.1 bn (only for 9 agglomerations and central areas for buildings and only Warsaw for land)
- The potential revenue would be sufficient to cover the costs of restructuring and would contribute to investment

The current situation is a combination of two factors: huge number of assets as a result of PKP's role in the centrally planned economy and necessity to improve the efficiency in a market oriented company. These two factors have created a large group of assets no longer needed for the railway. The PKP assets can be grouped into three categories:

- Non-rail assets, covering land, health service, building construction, health resorts, schools and other assets not directly related to the operation of rail. These assets should be separated from PKP. This process does not cover the health service due to the PKP Law and units providing services directly and exclusively for the railways (research and development, maintenance of machinery, track and rolling stock etc.).
- Non-core assets, created as a result of decrease in passenger and traffic transportation. These assets are estimated on a level of 7-8 thousand kilometers and should be separated from PKP.
- Surplus, amount of assets and equipment of two origins - decline in transportation in the last years and the restructuring efficiency improvements generating further surpluses. These surplus assets will be managed by the Restructuring Agency.

The study proposes some methods of disposal for different categories of assets. Part of the non-rail assets, like social units - cafeterias and buffets, holiday resorts, hotels social buildings can be privatized or transferred to local authorities. Real estate should be sold or rented, after clarification of legal title of many assets. The Restructuring Agency should also participate in the real estate development. Non core assets and related assets require a detailed analysis, including revenues, subsidies, operating costs and financial support of local authorities. Surplus assets, like rolling stock or railway equipment should be sold by tenders or scrapped as raw materials.

The Restructuring Agency should concentrate its efforts on the following activities:

- Identification and sale of large parcels in major agglomerations
- Development and execution of a plan for sale of houses and apartments to current occupants
- Sale of surplus stock
- Identification and sale of surplus office buildings inside major agglomerations

The Mercer Management Consulting has attempted to evaluate a potential financial impact for PKP, the Restructuring Agency and the State Budget. The estimated revenue from sale of non rail, non core and surplus assets is presented below.

Table 2.4.4 Revenue from Sale of Assets

Assets / activities	Revenue Potential (PLN million)	Comments
Surplus land	700 - 2 800	Assuming 10-40% range of surplus and minimum scenario. value calculated for land in Warsaw agglomeration only
Apartments	700 - 1 700	Assuming 20-50% of market value
Surplus buildings	140 - 270	Assuming 25-50% range of surplus (only central buildings in 9 major agglomerations)
Surplus rolling stock	140 - 270	Estimated value according to efficiencies of Western railway
	50 - 60	Assuming net book value (underestimated)
Social assets	10 - 20	Assuming 3-5 years of capitalized revenue
PKL	< 10	No data received
POLRES		

Source: Mercer Management Consulting

- Comments:

The table indicates that the main source for revenue is sale of surplus land. It can not be accepted in the situation of 10% legally proved land ownership and long lasting legislative procedures. In addition, the total PKP legally proved land amounts only for 5.5 million PLN, an equivalent of 0.03% total its assets in 1996.

2.4.4 Financial Evaluation of the Selected Restructuring Variant

The proposed restructuring option has been analyzed in the context of total financial aspect, including all potential costs and benefits and involvement of all organizations to the restructuring process. The calculations have been conducted under the following definitions and foundations:

- The benefits of the restructuring is the sum of wage savings and revenue from sale of assets
- The costs of the restructuring is the sum of severance payments, cost of retraining, outplacement, performance bonuses for the New PKP employees and costs related to the sale of assets
- Each of three organizations has its own scope of responsibilities:
  - The Restructuring Agency supports the costs of redundancy payments, the costs related to the sale of assets and its own expenses and receives revenues from sale of surplus real estate
  - The Labor Fund finances the unemployment benefits for those previous PKP employees who do not find a new job
  - PKP realizes the wage savings and covers the costs for performance of related businesses
- The total costs and benefits of the restructuring plan for the period from 1997 to 2005 are given in the table below. The total net benefits of the PKP restructuring exceed PLN 10 bn.

Table 2.4.5 Total financial results of the PKP restructuring

(constant 1996 PLN million)

Restructuring Agency		Labor Fund		New PKP		Total
Redundancy payment	1 071	Unemployment benefit payments	321	Performance bonuses	2 015	
Costs related to labor reduction	21					
Administrative costs	75					
Costs related to asset sale	48					
Total costs	1 215		321		2 015	3 552
Revenue from sale of assets	2 400			Wage savings	11 547	13 947
Cost / benefit	1 185		321		9 531	10 395

Source: Mercer Management Consulting